SPECIAL REPORT

The Direction of the World Economy Up to the Year 2000

By Miyohei Shinohara

Centenary of Marx, Keynes and Schumpeter

The year 1983 is an unusual year, for it marks the centenary of the death or birth of three giants of economics. Karl Marx passed away in 1883, the very same year John Maynard Keynes and Joseph Alois Schumpeter were born.

In the 100 years since the death of Marx, the world has witnessed various experiments in socialistic management. In the period before World War II, Marxism was nothing more than a form of romanticism. There is little romanticism left to it now. Has Marx's ideal of restoring humanity and building an egalitarian society been realized under socialistic management? It seems that the old inequalities remain and human rights have, if anything, been restricted. Nor does it seem erroneous to say that the vitality and effectiveness of socialism cannot be sustained without introducing into it the market principles which form the core of capitalism. This is the impression we have a century after Marx. If this is a correct evaluation, then the year 2000 may well prove the time of final judgment on the *raison d'être* of socialism.

Today, 100 years after the birth of Keynes, it is frequently said that Keynesianism is dead. Keynes' thinking had a profound impact on the world's economists and policy-makers. The "Keynesian Revolution" brought recognition of the positive role of fiscal finance and the central bank. It is generally accepted that the long period of prosperity following World War II was due to the application of Keynesian policies.

However, the Keynesian macro-economic policy of aggregate demand management suddenly ceased to work anywhere in the world after the oil crisis. The effectiveness of fiscal monetary policy declined and eventually came to a dead-end. The so-called plus-sum situation in which consumption induces investment and investment induces consumption faded away. Instead, the world economy today has moved into a zero-sum situation in which consumption must drop for investment to increase and investment must fall for consumption to rise. This raises the question of what, after all, was the Keynesian era all about? Will we never see its like again? These are questions we would like to pose as the year 2000 draws near.

On the other hand, was Keynesian policy alone responsible for the strong global economic growth for more than 30 years after World War II? The switch from the gold standard to managed currency certainly freed the world economy from old restrictions. Aggressive new fiscal policy brought unprecedented force to bear on the realization of full employment and the promotion of economic growth. However, if there had not also been technological progress on an unprecedented scale during this period, the world economy might have been more quickly plunged into the vortex of inflation.

In that sense, might we not say that it was the "new combination" and "innovation" advocated by Schumpeter, whose 100th anniversary also falls in this year, that contributed more than anything else to prolonging the Keynesian era? It cannot be denied that the key for freeing the world from today's protracted economic stagnation will be the innovation of which Shumpeter was so enamored.

Clearly no attempt to divine the direction of the world economy from now to the year 2000 can afford to ignore these three great economists—Marx, Keynes, and Schumpeter.

Kondratieff's Long Wave

In weighing the present state of the world economy, I believe that it is appropriate to give due consideration to Kondratieff's "long wave" (hereafter referred to as the K-wave), which reputedly runs in a cycle of 40-60 years. This does not mean that I myself subscribe to the views of Kondratieff, any more than I do to those of Schumpeter or Rostow. Rather, I offer my own reinterpretation of the K-wave, as follows: Propelled by the three stimulative forces of technological innovation, war, and money supply, the K-wave is the longest economic cycle to break through short-term and medium-term barriers (international balance of payments, full employment, and the like) and continue along a dynamic expansionary path until eventually rebounding off the barrier of resource/energy constraints.

Before World War II, the resource barrier triggered long-term deflation. The long-term stagflation of recent years has merely taken the place of this deflation.

I myself, however, prefer to turn to what is called in business cycle theory the "limit cycle theory" when addressing the argument that the world economy will continue to rush upwards until it hits this barrier. But in fact, as this is a long wave and war may play a part in the process, there may not be that much need to concern ourselves with cyclicality or regularity. On the other hand, it is important to note that when they reach the limits of the available resources, all countries almost simultaneously experience an economic downturn and stagnation. This being so, one would expect that the K-wave would result in a "synchronization" of the upper turning point in the world economy.

I would also like to draw the attention of the reader to the following point: When the world economy is continuing along the path of long-term prosperity and is expanding without awareness of resource limitations, it could be said to be in a "Keynesian era" or "Keynesian phase." Increased investment induces increased consumption which in turn induces additional investment. Fiscal expenditures also play a part in creating the virtuous "consumption-investment" circle which characterizes this feedback-driven growth. Moreover, as long as net investment remains positive, there should be annual increments in production capacity. Consequently, the expansion of effective demand will not trigger inflation. In this "Keynesian phase" you do indeed get the so-called plus-sum situation. It constitutes, in fact, a principal part of the long-term upward phase.

However, as the wave gradually nears the resource barrier, the prices of basic resources, energy and primary products gradually begin to rise much faster than prices for finished products. Corporate managers gradually come to hold "inflationary expectations." And, generally speaking, long-term interest rates tend to remain at high levels.

Once inflationary expectations become entrenched, the effectiveness of Keynesian fiscal and monetary policies for aggregate demand management deteriorates markedly. It is this that has hamstrung macroeconomic policy worldwide during the past ten years.

The approach of the limits to resource availability marks a state wherein the plus-sum situation is near its end and the zero-sum situation close at hand. If a huge fiscal deficit should develop at such a time, crowding-out would occur, limiting funds for private equipment investment and forcing up interest rates. In this event, if consumption and fiscal expenditure should increase, the "acceleration principle" of the Keynesian phase will yield to the "deceleration principle," in which increased consumption induces decreased investment. This was the starting point of Frederick August von Hayek's analysis of business fluctuations, and it could be said that when the long-term K-wave nears its peak, the Keynesian phase gives way to the "Hayek phase."

The seriousness of the stagnation stemming from the zero-sum state parallels the severity of the inflation which precedes it. South Korea was a typical case of "inflationary growth" accompanying unbalanced development in the investment goods sector. Compared with Taiwan, which achieved non-inflationary growth, South Korea had a very high inflation rate. As an inevitable consequence, the personal savings rate in South Korea plunged far below that in Taiwan, while the outstanding balance of South Korea's external debts ballooned to three times that of its neighbor to the south. Thus, in South Korea's case, the effort needed to check inflation, the domestic sacrifice necessary to normalize the economy, and the depth of the recession were all that much greater.

This kind of inflationary growth can accompany the unbalanced development of the investment goods sector. But it also frequently occurs along with the excessive expansion of fiscal expenditures or an excessive fiscal deficit. In the United States the unbalanced expansion of the government sector after the Vietnam war combined with the post-oil crisis inflationary spiral created today's difficulties. Whereas in the Keynesian phase the expansion of the government and investment goods sectors was accompanied by a further plus-sum expansion of the economy, the same unbalanced expansion occurring as the world economy approached a zero-sum state and entered a difficult era of stagflation.

Ten Years After the Oil Crisis

The year 1983 is the 10th year since the first oil shock rocked the world. During the decade from 1973 to October 1982, consumer prices rose 2.05 times in the United States, 3.2 times in Britain and 1.5 times in West Germany. During the same 10-year period, the unemployment rate went from 4.9% to 10.4% in the United States, from 2.6% to 12.8% in Britain, and from 1.2% to 8.4% in West Germany. These figures show clearly the continuing co-existence of inflation and unemployment.

In the Keynesian phase, unemployment usually accompanies deflation. But this time, unemployment has persisted even under inflation. "Keynesian unemployment" can be surmounted by expanding effective demand. However, the same policy does not make a dent in unemployment that occurs with inflation.

Hayek examined the great surge of inflation that hit Germany and Austria after World War I and noted that a plunge in the inflation rate from 5,000 to 2,000% in one year led to massive unemployment. He observed that, even before the deflationary cycle began, unemployment was being generated by the stabilization crisis even as inflation was losing steam. In short, unemployment occurred despite the fact that there was an overall surplus of demand. This point was one of the foundations on which Hayek built his unique theory of business activity.

Judging from the fact that unemployment has risen during the past 10 years despite the inflation that followed the first oil crisis, we might surmise that "Hayek-type unemployment" has prevailed. In actuality, however, this "Hayek-type unemployment" co-exists with Keynesian unemployment caused by tight-money policies. The proportion of each in total unemployment differs by country and industry.

The co-existence of these two different types of unemployment makes it difficult for policy-makers to take positive policy measures to stimulate business. Policy-makers thus split into two camps—those who advocate positive business stimulus measures and those who frown upon them. Needless to say, if the share of Keynesian unemployment should become overwhelming at a time of subsiding inflation, it would be appropriate to exercise Keynesian policy options. However, positive business stimulative policies would be difficult to implement while both Hayek-type unemployment and inflation remain high.

A review of the 10 years following the oil crisis brings into focus a very interesting phenomenon. Though the price of crude oil skyrocketed after the first oil shock, the resultant worldwide inflation meant that the price of crude relative to other goods actually declined, hitting bottom in 1978. This means that the oil crisis effectively came to an end in 1978. Moreover, OPEC will gradually realize that excessive crude oil price markups upset market principles and have a boomerang effect, and will assume a more cautious attitude toward crude oil price hikes in the future. As a consequence, future OPEC price hikes will likely come in small increments, drawing out the oil cycle and dampening its amplitude.

Accordingly, we may conclude that the impact of crude oil price hikes on the world economy will be smaller in the 1990s than in the 1980s.

Although we cannot be certain about the tempo of technological innovation in the 1980s and 1990s, it appears a foregone conclusion that the introduction of new technologies will be held back greatly in the 1980s due to the sluggishness of plant and equipment investment. Technological innovation will quicken in a limited number of fields, including electronics and industrial robots, but will not be promoted uniformly in all industries as was the case in the high economic growth era.

However, there is a good possibility that the seeds of technological innovation sown during the stagnation and labor pains of the 1980s will begin to bud in the 1990s. Naturally they will not all flower at once; there will be differences depending on the fields, be they synthetic energy, new materials, telecommunications, or biotechnology. But at least one thing is certain: Technological progress will be faster in the 1990s than in the 1980s.

It appears certain that the world economy will be better off in the 1990s than in the 1980s due to these two background factors—the weaker oil cycle and accelerated technological innovation. This does not, however, necessarily mean that the world economy will not turn upwards until the 1990s. On the contrary, the world economy will likely start to recover from the late 1980s due to the above-mentioned factors. On the average, however, it will fare better in the 1990s than during the present decade.

Needless to say, some short-term fluctuations may yet occur, depending on how aggregate demand is managed through fiscal and monetary policies. However, as long as Hayek-type unemployment persists throughout the world, the efficacy of macro-economic policies will inevitably be limited. Even before World War II, the long K-wave remained on the downswing for many years. A two or three-year downward curve now will not represent a significant dip in the long wave.

We must not forget that long-term deflation has changed into protracted stagflation, which may require a much longer adjustment period. Though 10 years have passed since the first oil crisis began, the world economy has not yet been able to shake free of stagflation. Macro-economic policy will consequently have little effect on the ailing world economy at least through the 1980s. The world economy will have to wait for the re-emergence of technological innovation before it finds an opportunity for renewed growth from the late 1980s through to the end of the century. And it will be difficult for the K-wave to turn upward until the world economy is revitalized by technological innovation, even if it takes time for this revitalization to occur.

Schumpeter saw the static period in the long wave as an "input-increasing" or gestation period of technical innovation and the expansionary period as an "output-increasing" period when the flowers of technological innovation would finally blossom. In this sense, the first half and the second half of the time left us before the year 2000 may be considered to correspond to Schumpeter's "input-increasing" and "output-increasing" periods.

Pressure for Institutional Change

In general, the aggressive execution of Keynesian macro-economic policy appears to have encountered few obstacles in the Keynesian phase of the long wave. However, when putting Keynes' theory on the role of fiscal administration into practice, there was a strong tendency to slight inflation control, even though strong fiscal policies were implemented with an eye toward preventing further business recession, realizing full employment and accelerating economic growth.

To be sure, democracy has its undesirable aspects, one of which is that the desire of politicians to rake in votes from their constituencies means that the policies that actually get implemented tend to concentrate on combatting inflation because of their great popularity with the public. Even if Keynesian theory with its advocacy of disinflation and disdeflation is vindicated as an academic theory, in practice it harbors the danger of causing an inflationary bias over the long run through politicization of economic policy. This point has been emphasized by Colin C. Buchanan. It is now evident that Keynesian theory actually led to "big government," resulting in inflation which the government authorities then found extremely difficult to check.

The point I want to make here is my afore-mentioned contention that the failure of Keynesian policy finally became apparent when the world economy plunged into a zero-sum state near the apex of the long wave. Keynesian policy would not have failed had the world economy stayed permanently moored in the Keynesian phase preceding the zero-sum state.

The concept of "cheap government" was conceived as a reaction to big government. Reaganomics in the United States, Thatcherism in Britain and the administrative reform movement in Japan all aim for cheap government. This worldwide movement cannot be ignored.

Meanwhile, what is to become of the countries operating under the socialist system? It has gradually become clear in the 100 years since Marx that it is difficult to maintain a vigorous and efficient form of socialism with only a vertically structured, top-down planned economy. It is even more difficult to realize a humane form of socialism under a decentralized socialistic economic system which ignores market principles. Consequently, the biggest economic problem that socialism will face in the years up to the end of the century will be how to harmonize centralized planning with the dynamism of decentralized market principles.

In fact, under the socialist system product prices tend to remain pegged despite the fact that technological progress varies greatly from industry to industry. Normally, both costs and prices fall in industries where the rate of technological progress is high. Under socialism, however, the price structure is rigidly fixed and there is no flexibility. Thus advanced industries suffer from overproduction and excessive inventories, while more backward industries experience underproduction and inventory shortages. As a result, resource allocation in a system marked by price structure rigidity proceeds irrationally.

To overcome this, the socialist system will have to steer toward decentralization, individual responsibility, and self-support accounting within the framework of its planned economies. Furthermore, price structures will have to be managed in a flexible manner not inconsistent with the so-called "law of value."

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The lease on the New Territories in Hong Kong will expire in 1997. The world is immensely interested in how China's insistence on the recovery of sovereignty will be resolved. About one-quarter of China's total exports and about one-third of her foreign exchange earnings are said to flow through Hong Kong. There is concern that if China should treat Hong Kong after 1997 in the same way it does other regions of the country, the island's entrepreneurs will flee and it will lose its economic dynamism. It would therefore seem advantageous for China's modernization and industrialization to retain the capitalistic economy of Hong Kong as is.

To do so, of course, would pose the problem for socialist China of how to utilize external market principles and harmonize them with its domestic economy. Probably the wise course for China is to regain sovereignty over Hong Kong but to treat it as a special autonomous region, allowing it to exhibit the dynamism of capitalism, and in the process impart flexibility and vitality to China's own socialist economy.

It is evident that socialism, too, will experience great trials in the period leading up to the year 2000. In order to surmount these trials, the socialist countries will have to transcend excessive dogmatism and adopt a realistic approach to their problems. ●

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