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FUTURE TRENDS AND ISSUES IN WORLD TRADE AND ECONOMIC DEVELOPMENT[†]

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THE INITIAL CONDITIONS

Solutions of dynamic systems in mathematical economics and econometrics provide useful insight for future trends at local, national, and global levels of analysis. I am going to discuss issues at the global level since this is, indeed, a World Econometric Congress. One of the first steps in obtaining such solutions is to establish the initial conditions. There are, of course, many such conditions that presently describe the world economy, but I am going to focus on some that appear to me to be of unustual importance.

I believe that there is such a thing as a World Business Cycle, and we are well along in the recovery phase from recessionary conditions that started approximately in 1989 or 1990. Unfortunately, our host country is at a hesitant and delayed state of recovery. There are real economic, political, and social problems facing Japan now, but I find the pessimistic feelings overdone and expect to see a more vigorous recovery during 1995 or 1996. The *World Economic and Social Survey* of the UN, for 1995, shows Japanese economic growth to have been erratic in 1993 and 1994, averaging near zero in both years but expected to return to positive growth of 1.5% for the calendar year 1995.

Except for Japan, most of the major industrial countries are well along in business-cycle recovery. This is most clearly seen in North America and Western Europe. The Transition economies, i.e. former members of the Soviet Empire are at varying stages of shifting from Plan to Market. Until 1994, they held down world averages for growth but boosted those for unemployment and inflation. Now, they constitute less of a depressing burden for the world average, but Russia and a few other states of the former Soviet Union are still in economic trouble. The former Yugoslavia, apart from Slovenia, is one of the world's economic and social disaster areas.

An interesting aspect of the world economy now is that industrial countries

[†] Keio University (Mita Campus) was host to the 7th World Congress of the Econometric Society held from August 23 to 29, 1995. To commemorate the event, on the eve of the Congress, August 22, the Keio Economic Society and the Department of Economics of Keio University jointly organized a series of lecture meetings with the common theme, "The Future of the World Economy." This is a summary record of one of the lectures given on that occasion.

in the full swing of growth from recession levels of production are still not maintaining, in many strategic cases, the strong trend rates of growth that led to their economic greatness. In being highly concerned about inflation, they appear to be content to grow at very moderate rates, between 2 and 3 percent annually. In this situation, many developing countries are growing much faster than the major industrial nations. In 1988, the UN report shows developed economies to have expanded at 4.5%, but all the other figures for the past 10 years are below 4% and mainly fall between zero and 3%. The expected value for 1995 is 2.75%. By contrast, developing countries, as a whole, are expected to expand by 5% in 1995 and have been growing more vigorously than the industrial countries since 1990.

The modest growth paths for output in the advanced industrial countries has been associated with the use of restrictive monetary policy to hold down inflation. In this respect, these countries have achieved their inflation targets—low single-digit values, with some very close to zero. They have, however, paid a significant price, namely through having to carry a significant social burden of high unemployment. This is especially true in Western Europe.

While the growth rates for Sub-Saharan Africa are among the lowest values in the group of developing countries, it can be seen in the UN tabulations that they have fared particularly badly on a *per capita* basis. Population growth during the last two decades has been almost 3 percent—not the highest for all developing areas, but high enough to exceed total output growth and therefore indicate negative figures for per capita GDP movement. This is so not only for historical periods but appears to be the case for the near future, as well. At best, production in Sub-Saharan Africa is expected barely to match population growth.

Some developing country growth rates are quite spectacular—between 5 and 10 percent—notably in East Asia. To some extent, the strong economic performances among Asian countries are being challenged in Latin America, but the results there are not as consistently strong as in Asia. For example, Mexico and Venezuela, both oil-rich developing countries, are recessionary, but many other Latin economies are strong enough to raise their continental average. It should be noted, however, that inflation performance in Latin America is not as unusually good as is output growth performance, and unemployment is much more of a problem in Latin America than in Asia.

In the Middle East, performance is more uneven, but oil wealth does bring some good economic performnance there. This carried over to parts of Africa, especially in North Africa, but sub Saharan Africa generally remains in poor economic condition. We can look for good things, economically speaking, in South Africa under the new government, but the take-off is restrained by an inherited recession, caused to some extent by the hangover of economic sanctions.

The degree of economic equality suffers at the moment. The transition economies are heading strongly for more inequality, and recovery in many industrial countries is featured by downsizing of work forces, quite high unemployment in Western

Europe, unusual wage restriant, and conservative trends in political administration among industrial countries. An important difference between East Asian and Latin Amercian economic development is that specific equalitarian policies were important in the former cases, during take-off periods, but missing in the latter.

World trade is poised for expansion. Many countries have taken a more liberal stance towards openness. This has been important in East Asia and especially in China. Both export and import activity have stimulated the growth process in Asia, and other large countries are becoming tempted to try some of the same practices. India is a case in point. Mexico was apparently on the same development path, but is in deep financial trouble now as a result of unfortunate experience with respect to international capital flows. But, for all countries, there is a change in institutional conditions by virtue of the founding of the new World Trade Organization, following the ratification of the Uruguay Round.

Two other major events are taking place beneath the surface while economy-watchers wait. They are looking for more definite signs of Japanese recovery and for the inevitable transfer of political power in China.

This is where we stand, by virtue of initial conditions. What can be said about prospects for future trends? Some of the issues to be considered are:

1. Exchange rate stability and alignment—in particular is the US$ misaligned at present, and are developing countries, such as Mexico, victims of instability?
2. What are the factors behind Mexico's sudden problems of last December? Can they be put in order in the near future?
3. World military spending had been on a promising downward path. Is it being stopped or reversed? How can we get on a Peace track again?
4. Can the econometric talent assembled here in Tokyo unravel the mystery of the mechanisms at work in today's global financial markets? Are we in need of new data bases and new methods to get at an understanding of the massive, instantaneous financial flows taking place around the clock in these markets?
5. Are the large-scale demographic trends such as aging in some populations, high birth rates in other populations, changing family practices, new illnesses, and major migrations dovetailing with economic fluctuations and trends?
6. Are the rapid technical changes taking place in telecommunications, biology, computing, new materials being absorbed by the economy in a way that promises to contribute to stable, peaceful growth?

1. During the first half of the 1980s, the US dollar was misaligned; it was too high to be supported by economic fundamentals, and economists generally felt that it would have to depreciate significantly, but they could not specify the date of the breaking point. It did fall, as anticipated, from the beginning of 1985. Now we have a reverse phenomenon, with the dollar misaligned on the low side; correspondingly the yen and possibly the deutschemark are stronger than can be

justified on fundamentals. It certainly seems to me that Japan's present economic troubles are more serious and pervasive than are those of the US; yet strength in the value of the yen persists. As in the 1980s, the misalignment is widely perceived, but the timing for adjustment is quite uncertain.

It is widely believed that Plaza, Louvre agreements and other state interventions were effective in bringing about exchange rate adjustment starting in 1985, but the dollar adjustment started in February, long before the (September) Plaza meeting. I believed then that the process was not engineered by governments, and I also believe that intervention is not very successful, on a lasting basis today. As I shall elaborate under point 4, it will be up to econometricians to find the deep-seated mechanism that can generate adjustments in these times, when the daily transactions are so rapid and huge that they defy central bank intervention.

2. Mexico's problems were probably confounded by inept management of exchange rate policy in terms of appropriate devaluation (not simply depreciation) of the peso in 1994. I would, however, prefer to emphasize such fundamental problems as intolerable trends in income distribution, political instability (related also to income distribution), failure to monitor or report central bank reserves in terms of openly published data, and excessive reliance on portfolio investment inflow without directing the funds towards healthy capital formation.

A joint effort of the United States, supported by some other governments and the direct involvement of the International Monetary Fund (IMF) did provide enough financial support to keep Mexico away from widespread bankruptcy and total economic collapse. This effort was hastily put together at the last minute and enabled Mexico to enter an adjustment phase—devaluation, inflation, high interest rates, import restraint, export promotion, and severe recession—but it does underscore the need for a structural change in international financial policy, namely the need for having a "lender of last resort," in order to deal with sudden balance-of-payment/exchange rate crises. It is plausible to think of the IMF for that role.

3. World military spending peaked, in real terms, at about 1986 or 1987, depending on geographical location. A decline was stimulated by the ending of the Cold War, the break-up of the Soviet Union, and the public's interest in aspects of civilian growth in Warsaw Pact countries. This process of substitution of civilian for military spending gained strength after 1989–90. Military spending declined on a path of about 3% annually, with due allowance for the Gulf War operations. The rise of political conservatism, especially in the US, the lack of good organization in some transition economies, and the "hot" wars prevailing round the world have endangered the peace path. Surplus military stocks should have been destroyed on a wider basis; warring factions should not have had such easy access to arms; corruption in arms trade should have been forcefully confronted and the world should be led back, by a variety of means, to the path of arms reduction. There was some degree of reduction in official deficits, especially in the US, and this contributed to declines in long term interest rates, either *gross*

declines from period to period or declines from what otherwise would have occurred without the fiscal prudence (virtual declines shown in econometric simulations) and this has, in fact, provided a Peace Dividend. Dividends may be jeopardized in the near future if there is a return to arms buid-up or to cessation of the trend declines.

4. Technological change has led to financial innovation and enormous enlargement of the transaction base. These changes, together with increasing liberalization of global financial markets, will make it even harder to find stability in such markets. Large scale swindles, mistakes, bankruptcies, and other disturbances take financial markets out of central bank control or prudent supervision. The Mexican public is being subjected to a sharp recession, in some respects a repeat of the early 1980s and a lost decade of growth. We must try to gain a better understanding of what is going on in these markets.

There are many plausible lines of research to be followed; the most promising seems to me to construct techniques to deal more accurately with high frequency data. Econometricians have designed good models for intermediate and longer term forecasting, with understanding of the economy's inherent structure. For the short run, generally under one year in duration, measured in months, weeks, days, or real time, we need to develop new models which can be readily combined with those at quarterly or annual frequency. I can already see fruits of such blending at monthly frequency, and now research should be directed at obtaining good results for higher frequency, spanning both the real economy and financial markets.

5. Among all related social sciences, the most tractable for integration with econometrics is demography. From a methodological point of view age-specific fertility and overall population growth can be related in feedback mode in econometric models in annual periods, stretching over decades. Large scale census-type surveys have also contributed much. The aging process has been studied in Japan, at some length, for its effects on personal saving behavior. Family size and composition is well-known to be related to economic demand, labor force movements, and unemployment. The slowing down of Japanese population growth after the Second World War probably had beneficial effects on the high growth performance that got underway in the 1950s. If, however, a country has few children for a few decades, the population ages quickly. That has become a potential problem for Japan, and China should be studying Japanese economic-demographic development over the last 40–50 years in order to gain some insight about what may be confronting them in another 30–40 years.

Europe and the United States have experienced significant immigration for some time. While this can be a safety valve for certain types of shortages in the work force, it creates problems of social unrest until the immigrants and their issue become more fully assimilated in the new societies of Western industrial nations. To this date, immigration has been allowed on a very limited scale in Japan. It could be one demographic measure for benefit of Japan, but there is great hesitation in accepting immigrants on a large scale.

Alternatives for Japan are increasing resort to higher ages for retirement, relaxation of the concept of "lifetime" employment, and significantly increased rates of productivity growth. In the United States and Western Europe, labor shedding (work force downsizing) has been occurring on a large scale and has contributed to rising productivity trends. In many places, elevated rates of unemployment have resulted from labor shedding activities of firms.

6. In countries where manufacturing has been the dominant economic activity there have been some major changes in sectoral distributions of output and employment. While manufacturing has retained its share of output quite well in the US, there has been a definite fall in its employment share. This is another way of looking at productivity growth, but there are some qualitative changes that accompany these shifts. In place of goods manufacturing we find a relative rise in the provision of services—medical, financial, technical, and personal. Some of these services help manufacturing, but in some cases they represent new activities, in their own right, such as computing, automation, financial instrumentation, new kinds of medical treatment, communication, entertainment, etc. This changes the demand for labor towards people who can comprehend the new technologies. The educational system will have to play an important role in training and in supplying fresh kinds of talent.

It also means that major advanced countries will resort more to "outsourcing" for manufactured goods that are not too demanding in technical sophistication—textiles, electronic assembly, manufacturing of sporting goods, basic optical items, and even cars, steel, plastics, and prefabricated structures. For the foreseeable future, many of these goods will be produced in less advanced economies for use in both developing and developed countries, while the most advanced countries will produce more of the high technology lines of goods and services.

In this brief essay, I have tried to lay out some of the problems facting the world economy beyond the next few years. By way of summing up, I want to emphasize that some of the major problems of most immediate concern, such as the transition from plan-to-market, have been gradually yielding to solution. With these and other immediate problems behind us, prospects for good economic performance until the end of this century are in place. For the longer run, the problems of demographics, unemployment, economic inequality, absolute poverty, arms limitation, will still be prevalent, but even subject to all the very great uncertainties of long range forecasting, the economic prospects look promising.

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