My Views on the Present Maladies of the World Economy and Recommendations to the Economic Summit of the Developed Countries*

Tsang Shu-ki
Lecturer
Hong Kong Baptist College

I. Introduction

The world-wide stock market crash of October 1987 shocked people out of their complacency. They were forced to take a hard look at the present state of the international economic order and the extremely serious problems revealed in the advanced industrial economies. Developing and "newly industrialized" countries, whose export-oriented growth prospect depends so much on sustained prosperity in the first and the second worlds, were also confronted with the unpleasant question of whether the economic miracle of the past two or three decades, of which some of them have been among the major actors, can go on for ever.

Before appropriate recommendations can be presented, the right diagnosis must be made first. Half a year from the crash, there is now a renewed danger of complacency. After all, the U.S. economy is apparently still booming, in contrast to all doomsday sooth-saying, and the Nikkei Stock Average Index has already surpassed its pre-crash high. A repeat of 1929-30 seems only to be the wild dream of unrepentant pessimists. To many analysts, the present situation is just like that in 1962-63: a bear market completed in one go.

I, for one, am not optimistic at all. The present rebound from the crash is nothing much to cheer about. It only delays the inevitable adjustments which are necessary to bring the world economy back to health. The longer the delay, the more severe will be the ultimate downturn, dominated by the "natural" forces of the markets. The necessary adjustments, as I will point out below, are no doubt unpalatable in many ways, but I think time is running out. While both the advanced industrial countries and the developing economies should each shoulder part of the responsibilities, the advanced industrial economies, by virtue of their sheer sizes and their role as the locomotive of the world economy, must take the lead, unless what we want is to restore "balance" at a lower, instead of higher level. In any case, I hope that the coming G-7 Meeting can result in a real breakthrough.

II. The Fundamental Factors behind the Crash of October 1987 and the Present World-wide Economic Maladies

The crash of October 1987 was attributed to various factors such as the huge budget and trade deficits of the U.S., monetary tightening by the Federal Reserve, the open policy disputes between the U.S. and West Germany, the worsening international debt crisis, or even the tense situation in the Persian Gulf. These explanations are hardly convincing. In the past few years, the international stock markets have overcome factors of similar types and climbed to extraordinary heights. That the intensification of some of these factors could have touched off an one-day fall of 20-35% all over the world really stretches one's mind.

I would argue that these factors are just superficial symptoms, the tip of the iceberg. The crash was an expression of the seriousness of the maladies in the world economy and the fundamental factors conditioning the crash and the maladies are actually due to a phenomenon which I would like to look at in terms of what is known as the long, waves in the capitalist system.

The long-wave hypothesis was first put forth most systematically by the Soviet economist N.D. Kondratieff in the 1920s. He found out from statistical evidence that since the late eighteenth century there had been three long cycles in the capitalist world, lasting from 47 to 60 years. Unfortunately, the particular long cycle he was witnessing, which descended disastrously into the Great Depression of the 1930s, did not historically turn out to be the last one. Kondratieff's hypothesis was almost forgotten in the golden era of the 1950s and the 1960s. Since the western world entered into obvious troubles in the 1970s, however, his ideas have been resurrected. The crash of 1987 only makes him and his writing again the subject of world-wide attention.

The modern economist is brought up in the tradition of the neoclassical orthodoxy which asserts that the market mechanism, inherently efficient and stable in itself, Could only be prevented from doing its job well by exogenous factors such as stupid governments or greedy trade unions. That history could repeat itself every 50 years or so is something that he would write off almost immediately.

I do not believe that history will repeat itself, in exactly the same manner. To argue that would be utterly foolish. However, the opposite position - that the historical situation is so different today that a disaster resembling that of the 1930s is hence impossible - is equally untenable. Unless we know the deep-seated causes of the long waves and do something to prevent them from recurring, the underlying forces can again assert themselves. Their exact manner of expression will of course be modified by changing historical circumstances. But surely the thought that we are going to have an inflationary depression this time, instead of a deflationary depression a la 1930s, is of little comfort to us.

There are various schools of theories which try to explain why long waves exist and recur in the capitalist system. Four of them, I think, are the most important and there is sufficient prima facie evidence that a recurrence of a down.7wave in the capitalist system may have already begun. These theories point to factors which are very long-term in nature. Hence they are extremely difficult to be detected by economic agents and governments who only take short time horizon into consideration in maximizing their benefits. These factors include the law of capital accumulation, the law governing the distribution gap, the population long-cycle and the technological cycle.

The post-war tendency towards greater government intervention, which has been reversed partially in recent years due to the onslaught of neo-conservatism, was based on Keynesianism which was essentially short-term in conception and application, relying heavily on stabilization through fiscal and monetary policies over a time horizon of a few years. Keynesianism could hardly have effectively dealt with long-term problems such as over-accumulation of obsolete technologies, declining productivity because of aging population, or insufficient purchasing power due to the widened gap in wealth and income distribution. The Classical-Keynesian controversies are uninteresting from the long-wave perspective. Hence it would not be surprising at all that history could repeat itself, in a somewhat different manner. It is high time for governments around the world to shake off their complacency and directly tackle the problems of the down-wave.

Let me now present in summary form the four most important theories on long waves and their supporting evidence.

(1) The Over-accumulation Theory

During the up-wave period, it is very easy for entrepreneurs to become very optimistic or even excited about the unfolding economic prosperity and its continuation in the future, despite short-run hiccups. They will pool in more investments. This will generate, through a mechanism which economists led by Professor Jay Forrester of MIT called "self-ordering", an aggravated effect on capital accumulation. "Self-ordering" simply means that within the capital sector, when a firm wants to produce some capital goods, it has to purchase other capital goods. It takes a machine to produce another machine. So when one capital sub-sector is prospering, other capital sub-sectors will also become prosperous as they will receive ample orders from the leading sub-sector. This characteristic is absent in the consumer-goods sector. Both consumer goods and capital goods are made with capital goods, but consumer goods are not made with other consumer goods. Hence, within a certain time period, it is possible for the capital sector to be self-boosting in the sense that there may be a superficial phenomenon of inflated paper profit, not because of an increase in purchasing power on end-products or a rise in demand for consumer goods, but just because of the process of self-ordering in the capital sector.

Ultimately, such paper profit can only be realized through the sales of consumer goods. In the meantime, however, huge paper profit will be sufficient incentive for more investment to be poured in. Eventually, the capital sector will grow to such an extent that there will be excessive investments. The productive capacity represented by the capital sector will become too large.

(2) The Under-consumption Theory

The same mechanism that generates over-investment will also lead to a widening gap in the distribution of wealth and income. Afterall, inflated profit, paper in nature notwithstanding, means lower wages, at least in the relative sense. Distribution will shift in favour of capital. In the short-run, so far as the process of self-ordering is self-sustaining, realization of profit will not be a pressing problem. Ultimately, however, profit can only be realized through the sales of consumer goods. The deterioration in wealth and income distribution, however, works against the realization process. Since the poor have much higher marginal propensity to consume than the rich, widened inequality implies that there will be insufficient effective purchasing power for the huge amount of final goods streaming out of the gigantic productive system. A "realization crisis" will set in. Over-investment and under-consumption are therefore two sides of the same coin. Investment is excessive because there is not enough purchasing power to absorb the end products.

P. N. Batra, in his controversial book, The Great Depression of 1990 (Simon Schuster, 1987) provides some evidence on the long cycle of wealth distribution in the U.S. Just before 1929, 1 % of the U.S. population owned 36% of total wealth. The Great Depression pushed the ratio significantly downward as the rich, with a lot of wealth in hand, suffered more drastically from the depression than the poor who did not have much assets to lose. By late 1940s, the ratio dropped to 21%. The up-wave of the 1950s and the 1960s, however, led to a re-widening of the gap. By 1983, 1% of the U.S. population again held about 34% of total wealth.

Similar situation is occurring in other advanced capitalist countries. Take the example of West Germany. According to a report of a West German scholar Stefan Welzk, which was quoted by Business Week on October 26, 1987 (p.9), between 1970 and 1985, the combined profit of the banking sector in West Germany rose by 572%, that of non-bank enterprises by 174%, but total wage bill remained almost the same. Despite the problem of an aging population and stagnant labour supply growth, this represented a severe worsening in distributional inequality, which will eventually inflict the whole system with the problem of insufficient purchasing power.

(3) The Population-cycle Theory

The up-wave brings economic prosperity to the world. People become increasingly materialistic and pleasure-seeking. Fertility rates therefore drop significantly as people care more about themselves than their offsprings, pushing up the dependency ratio of the elderly while reducing labour supply growth. The population ages rapidly. This will dampen economic growth both on the supply and the demand sides.

The down-wave pinches the bubble of economic miracle and is frequently associated with social disturbances. Manpower is lost in large scale, in the battle field or somewhere else. When the situation stabilizes, a "baby boom" will take place. A much younger population comes into the world, bringing with it ample labour supply and a lot of demand.

The population in most advanced industrial economies has been aging rapidly. The West German population has remained almost unchanged in absolute size since 1970. Old-aged population (of 65 or above) in Japan grew at an annual average rate of 3.6%, much faster than that of the total population itself. The ratio of old-aged to total population in Japan is now around 9% and will according to projections shoot up to about 15% by the end of this century. The problem is however not confined to the leading economies. Both Singapore and Hong Kong, for examples, are now troubled by it and have been hard pressed to find new sources of labour supply. New labour supply in Hong Kong is forecast to grow at an annual rate of only 1.4% in the next twenty years. To maintain the average of 8% real growth in GDP, productivity must then rise by more than 6% each year, way above the average of about 3.5% in the past fifteen years.

(4) The Technological-Cycle Theory

The up-wave generates excessive investment leading to an overabundance of capital goods of the same mode of technology. These capital goods have been accumulated through retained earnings or debts. The failure to successfully validate those debts and realize the expected profits will dampen capitalists' enthusiasm in investing in research and development and exploring new technologies. Under such a circumstance, there is not much chance for radically different mode of technology to enter the historical arena. "Stalemate in technology" occurs. Productivity sinks further, bringing down the economy with it.

The down-wave however destroys a great deal of these "obsolete" capital goods through bankruptcy, writing-offs and natural wastage. Space is created for radically new modes of technologies to emerge. Productivity and aggregate demand will be enhanced, bringing another up-wave, provided that the newcomers enter in clusters, touching off "self-ordering" effects.

There is ample evidence about technological stalemate in the West despite some recent reports about new technologies like biotechnology and super-conductors. The number of patents issued in the U.S., for example, has been following a secular downward trend since the 1970s. The developments of many of the so called "new technologies" are still far from the application stage. Their real applications will certainly be severely constrained by stagnant aggregate demand in the capitalist system. What is needed is the emergence of a "'cluster" of new technologies which have sufficient backward, forward and horizontal linkages which could push the economy onto a new growth path. That is difficult under the present situation unless there is a significant change in government policies and increase in international co-operation.

Technological stalemate is also a structural problem. This point is important in understanding the present global economic imbalance, particularly trade frictions. While investment is excessive in an overall sense, its distribution is very uneven and biased against frontier technologies in the advanced countries. There is over-accumulation in the traditional fields such as farming, textile and garments, and automobile but insufficient investment in sunrise industries like nuclear power, biotechnology, and information technology. Of course, the vested interests in the overaccumulated fields will not volunteer to leave the center-court of history. This internal imbalance within the leading economies not only retards productivity, but also creates an "overcrowding" situation in the lower echelon of the advanced economies, to which the developing countries and NICs want to make an entry.

According to the textbook theory of shifting (dynamic) comparative advantage, the advanced economies should continuously move upward on the technological ladder, creating rooms for the developing economies to catch up. That will be welfare-enhancing to every party concerned. The '(glut" in the lower echelon of the former will inevitably generate trade conflicts and lead to protectionism which is destructive for all.

The whole western world is now deeply troubled by all the abovementioned factors which, at this particular historical juncture, are generating severely depressing forces that may push the world into a deep depression. To deal with them effectively would require courageous and imaginative initiatives on the part of the advanced industrial economies and international authorities, and co-operation from developing economies.

Nevertheless there have been so many *superficial explanations around that scratch only the surface and so easily give rise to blind optimism that they must be dealt with first.

III. Do not Confuse the Symptoms with the Causes

There have been a variety of superficial explanations for the stock market crash of 1987 and the present crisis confronting the world economy. Let me deal with them one by one.

(1) Financial speculation

Firstly it has been attributed to excessive speculation and loop-holes in the' operational and regulatory frameworks, particularly in the U.S. market. Nevertheless, speculation in the financial markets is actually a manifestation of the underlying problem of over-investment in the real economy. Given the problem of over-investment, capitalists do not want to pump further money into the productive system for fear of insufficient sales to recover their money. Instead, they would rather move into the financial sector because it is more volatile --- easier to put in, and, so they imagine, take out funds, compared with the real economy.

In this context, I would like to quote Stefan Welzk again. According to his analysis, between 1975 and 1979, net capital formation in West Germany increased by 49 billion marks but productive investment rose by 57 billion marks. That means the German capitalists borrowed to invest in the real sectors. Nevertheless, between 1982 and 1986, the situation was reversed dramatically. Net capital formation increased by 105 billion marks but productive investment rose only by 25 billion marks. In other words, more than 75% of investments went into non-productive sectors, probably mostly into the financial markets.

Financial speculation is therefore a function of over-investment in the productive system. It is a symptom of the maladies in the real economy. Dealing with them may remove some instability, but will not cure the disease.

(2) The Twin Deficits of the U.S.

Other than speculation, it has been thought that the crisis confronting the world today is mainly due to the fiscal and trade deficits of the United States. Most people are now blaming the U.S. for causing these two problems and regard them as the core of all other problems. The "Twin deficits" are no doubt the most dangerous imbalances upsetting the stability of the world economy today but even they, I would argue', are just symptoms. They are in effect consequences of President Reagan having understood too well the plight of the U.S. economy.

Since the seventies, problems of over-investment have been very serious in the advanced capitalist countries, particularly in the U.S. The immediate result was the fall in the profit rate and the rise in the gearing ratio of the private sector. When Reagan came to power, he cut taxes; but expenditures were not reduced commensurately. The consequence was of course the huge fiscal deficit. But this was because Reagan wanted to rejuvenate the U.S. economy and save it from severe adjustments. In the long run, of course, the real effect of the Reagan era might just be to delay the final reckoning.

In any case, the effort has not been very successful, because the problems of over-investment were not really solved. The tax cut did have the effect of stimulating consumption. This facilitated to some extent the realisation process of producers who found it easier to sell their products as the disposable incomes of consumers increased. In fact, consumption was also helped by the increase in consumer debts. The American consumers have been borrowing to consume as if there were no tomorrows. One indication is, for example, that the ratio of consumer instalment debt to disposable income which climbed from the average of 15% in the 70s to the present level of 19%.

However, when the U.S. consumers increased their purchase they bought mainly foreign goods instead of American goods. There are a lot of reasons behind this: poor quality, high prices, bad servicing, or, simply the nonexistence in U.S. of those goods that they want. So Reagan's expansionary fiscal policy has led to an increase in purchasing power which was unfortunately channeled significantly to foreign goods. This inevitably results in huge trade deficits for the United States.

There is of course an additional factor, that is, the differences in policies among the advanced capitalist countries. While the Reagan administration pursued an expansionary policy in the early 80s, the Japanese and the West German government, for example, were much more cautious. They did not go along with Reagan. The reasons are two-folded. First, ideologically, they are less "pro-business", compared with Reagan. Second, the degree of freedom in fiscal expansion was also smaller for Japan and Britain compared with that of the U.S., as can be seen from table I below. Given these reasons, the advanced economies pursued policies of rather different stance in the 80s. The U.S. implemented expansionary policy white West Germany, Japan and Britain have been much more cautious.

This is one of the major factors underlying the present imbalance in the international economy, with regard not just to trade but also to capital flow. Interest rates in the U.S. remain very high both in nominal terms and in real terms. A lot of capital has been attracted to the U.S. from West Germany, Japan and other countries. Under such circumstances, other countries have been forced to keep their interest rates at high levels to stop the outflow of capital. So, in a way, their autonomy in macroeconomic policies is undermined by the U.S. All these conflicts and problems have arisen because of the different strategies that advanced capitalist countries have adopted in dealing with the pressing problems of the down-wave,' particularly the phenomena of over-investment and insufficient consumption.

(3) The Debt Crisis

The crash of October 1987 has also been attributed to a perceived worsening in the world debt crisis, caused by the apparent attempts of the U.S. Federal Reserve to tighten money supply and push up interest fates before the crash. Moreover, there was the general impression that the present cyclical upturn in the world economy, very long in duration by historical standards, might end rather soon and the debt crisis, which had been hardly solved in this round of "prosperity", would only further deteriorate in any downward adjustments. Financial institutions of the advanced economies are still heavily involved in the debts of the developing countries despite some bold attempts at provisions for bad debts. They may face more devastating blows if the crisis gets worse.

Table 1. Gross and net public debt (percentage of nominal GNP/GDP)

	1973	1974	1975	1976	1977	1978
Gross debt of general government						
United States	40.6	39.6	42.6	42.5	40.8	39.0
Japan	17.0	18.0	22.4	28.0	33.4	41.9
Germany	18.6	19.6	25.0	27.0	28.5	29.9
France	25.1	24.7	25.8	24.7	25.2	26.3
United Kingdom	69.7	69.6	65.3	64.1	62.5	59. 6
Italy	60.6	57.7	66.8	65.4	65.2	71.2
Canada	46.7	44.5	44.8	42.5	44.8	48.7
Total of above countries	36.8	36.3	39.2	39.9	40.2	41.2
Net debt of general government						
United States	22.9	22.0	24.4	24. 1	23.0	21.0
Japan	-6.1	-5.4	-2.1	1.9	5.5	11.3
Germany	-6.7	-4.7	1.0	4.6	7. 0	9.4
France	8.3	8.8	11.1	10.9	10.2	10.2
United Kingdom	57.5	54.9	57.4	56.8	55.8	53.3
Italy	52.1	49.2	59.9	60.9	60.7	63.9
Canada	2.7	1.1	4.4	5.3	7.7	10.6
Total of above countries	17.2	16.8	20.1	21.0	21.2	21.6

1979	1980	1981	1982	1983	1984	1985	1986[a]	1987[b]	1988 [b]
37.2	37.7	37.1	41.1	44.0	45.1	48.5	50.5	51.6	52.2
46.9	52.0	57.0	61.1	66.9	68.4	69.4	69.4	69.1	68.8
30.7	32.5	36.3	39.5	40.9	41.7	42.3	42.4	43.2	44.4
26.2	25.0	25.9	28.3	29.8	32.6	34.6	36.4	38.3	39.9
55.6	54.9	54.9	53.6	54.0	55.3	53.7	53.8	53.0	52.4
70.6	67.4	70.5	76.8	84.4	91.1	99.6	102.4	107.1	112.7
43.6	44.7	45.1	50.5	54.5	58.2	63.7	67.4	70.2	72.5
40.7	41.7	42.9	46.5	49.7	51.4	54.0	55.4	56.6	57.4
19.4	19.5	18.8	21.4	24.0	25.1	26.8	28.8	29.9	30.6
14.9	17.3	20.7	23.2	26.2	26.9	26.5	26.2	26.6	25.9
11.5	14.3	17.4	19.8	21.4	21.7	22.1	22.2	23.0	24.1
9.8	9.1	9.9	11.3	13.4	15.2	16.7	18.5	20.4	22.0
48.6	48.0	47.2	46.4	47.1	48.5	46.9	46.9	46.1	45.5
63.7	61.8	66.8	73.4	80.6	87.8	96.3	99.2	103.9	109.5
10.7	11.5	10.7	16.9	20.4	24.7	30.3	34.0	36.7	39.0
21.2	21.8	22.5	25.1	27.8	29.3	30.8	32.2	33.3	34.1

Note: [a] Partly estimated
[b] Forecasts
Source: OECD)

In fact the debt crisis in again a symptom rather than an underlying cause. Given over-investment and insufficient consumption at home, entrepreneurs in the advanced countries have to find other outlets for their end products. The developing economies, which up to the 1970s were mainly a source of cheap resources and labour supply, seemed a natural target to dump those surplus goods, provided of course they were given the ability to buy them. The oil shocks of the 1970s, and the emergence of private banks as the most important agents of "recycling" funds to the oil-importing developing countries, facilitated the large-scale pumping of purchasing power southwards. For a time, the over-supply in the international financial markets, as well as the motto "sovereign countries can't go bankrupt", generated euphoria. Even commercial banks of the lower echelon of the second world jumped onto the bandwagon.

However, such artificial manoeuvre did not pay off. Instead, it has generated disastrous results. Most of those debtor nations have not made good use of the money they borrowed and a debt crisis - a persistent danger of failing to repay or even service the mounting debts becomes almost inevitable. But are the developing countries the only culprits?

There is a common misconception that debt crisis is confined to the developing world. It is not. Both the public and the private sectors in the developed countries are also dangerously enmeshed in mounting debts. In the United States, for example, all debt owed by non-financial sectors, both public and private, was 140% of total income before the 1980s. The ratio shot up was approaching 180% by the end of 1986. The balance sheet of U.S. enterprises has also deteriorated markedly. In the early sixties, total liabilities were less than 60% of total equity for non-financial firms, on the basis of historical costs. Now the ratio is nearing 90%.

Tim Congdon, chief U.K. economist of Shearson Lehman Hutton, argues in The Debt Threat (Basil Blackwell, 1988) that the present debt crisis across the world, whether in developing countries, the American farm belt or among European firms, has a common cause: exceptionally high real interest rates. It is the very high interest rates, which are even higher than the growth rates of the economy, that cause serious debt problems because incomes are insufficient for servicing debts. I would think, however, that Congdon is confusing the effect with the cause. Interest rates are so high in real terms because the financiers know how much risk they are taking when lending out money to an economy which is beset with all sorts of problems, although not necessarily along the lines that I have described above. It is the "risk premium" that drives the interest rates into such high levels. High real interest rates are ultimately an expression of anxiety about the ailing real economy.

Unless we cure the fundamental problems in the real economy, real interest rates will not fall below the real GNP/GDP growth rate, no matter how much more money central banks decide to inject. The extra funds will stubbornly refuse to go into the real sectors. Instead they will continue making a fuss in the financial system. We may end up with an inflationary depression, accompanied by deepening debt crisis.

IV. Measures Taken so Far and Their Inadequacy

Since 1985, of course, the major economic powers awoke to the fact that something really wrong was happening. They tried to coordinate their policies, and this started the new era of the international cooperation among central bankers and treasury officials. The superficial results have been quite remarkable. First, there had been a joint effort to reduce the value of the U.S. dollar which has dropped since the beginning of 1985 by over 40% against major currencies, without much adverse impact on the world economy. Second, there has been a joint effort to reduce interest rates, not exactly simultaneously, but in an orderly fashion. Third, the "Baker Plan" was proposed in an attempt to ameliorate the seriousness of the world debt crisis. Fourth, Japan and some of the NICs having large trade surpluses with the U.S. such as Taiwan and South Korea have been pressurized into raising the exchange rates of their currencies and opening up their domestic markets. However, such increased cooperation has not generated very impressive effects on the real economy.

Despite the drastic fall of the U.S. dollar and efforts on the part of Japan and some NICs, the improvements in the U.S. trade deficit and the imbalance in capital flow have been disappointingly limited and slow. There are a lot of research reports around that point out the inevitability of a further significant fall in the U.S. dollar before a sustained trade balance can be restored. The debt crisis has been prevented from worsening significantly but not effectively solved. As for the imbalance in capital flow, people now are focusing attention on the U.S. fiscal deficit which many regard as the core problem in the present international economy.

But as I have argued above, that is not the real cause. The real causes lie with over-investment, insufficient consumption, stagnant labour supply growth and technological stalemate in the leading economies, particularly in the U.S. and West Germany, which interact with and reinforce each other. Since the prospect of the real economy is gloomy, a lot of funds have moved into the financial sector which has then grown out of proportion. The total volume of transactions in the world's foreign exchange markets now is about 10 times that of total world trade. This is certainly something one did not see before the 1929 crash. Another indication is that in the past fifteen years, world trade has grown by an average annual growth rate of 3.75% while the size of financial markets doubled every 5-year. So there is an increasingly large financial system which is built on a slim foundation - a very small real economy. The financial system is not much more than a hierarchy of paper assets and liabilities, which can multiply themselves rather rapidly, through all sorts of accounting arrangements. Ultimately, however, profits have to be generated from the real economy to validate those accounting entries. But the real economy is now increasingly incapable of delivering the goods. I would argue that the crash of 1987 was actually due to the recognition on the part of many speculators that the sort of self-reinforcing multiplication of paper profit cannot go on forever. Everybody opts for the exit almost at the same time. The result could only have been what it was: panic selling and instant collapse.

After the crash in October 1987, central banks all over the world, remembering too well the lessons of October 1929, joined in a coordinated effort to turn on the monetary tap. The apparent result is that the widely predicted severe contractionary effect on consumption and investment, arising from the drastic reduction of net worth caused by the plunge in stock prices, or the "domino effect" of one bankruptcy leading to another, have been avoided, at least for the time being.

However, monetary loosening is not an effective method to deal with the fundamental strains in the world economy today. The twin problems of over-investment and insufficient consumption, as well as sagging labour supply growth and technological stalemate, cannot really be solved by monetary loosening, which works largely through credit expansion. As I have argued above, consumers and enterprises are already deeply enmeshed in debts. They are of course happy to receive new funds at slightly lower costs, but it is very unlikely that they will then be able to get out of the debt trap. Whether the new money will mean more investment in the real sectors, and at the right spots to improve productivity and raise demand, is also doubtful. The money may simply chase after existing assets, particularly after their post-crash depreciation, causing asset-inflation, or go back into the financial markets, generating further instability.

The apparent increases in U.S. exports and capital investment are more the result of the accumulated depreciation of the U.S. dollar during the past three years than that of the monetary loosening, which afterall, has not resulted in a notable decline in real interest rates. Further drop in the exchange value of the U.S. dollar, however, may lead to a total erosion of confidence and large scale retreat of capital that can derail the world economy.

The increase in money supply, plus the further opening of the domestic market to foreign goods, did fuel the extraordinary consumer-boom in Japan. Moreover, due to the very limited choices of investments after the crash, funds have been flocking to the Tokyo stock market, sending the Nikkei Index to an all-time high. But many of the domestic industries in Japan are under severe strains because of the extraordinarily high exchange rate of the Yen and the consumer-boom is not expected to last forever. The high-tech industries, which have allegedly overcome the problems of the high Yen and structural transformation, will be hard pressed to find markets for their advanced products in a world of stagnant demand.

The rise of the Nikkei Stock Average Index to the stratosphere, resulting in an average P/E ratio more than three times that of New York, has to my mind been driven more by portfolio decisions in a world here the financial system is overblown relative to a shrinking real economy than faith in the fundamental achievements of the Japanese economy. I would not therefore be surprised that any further shocks to the world financial markets start from Tokyo.

Moreover, from the perspective of developing countries like the Asian-Pacific NICs, a booming Japan, even if it lasts, may not be a viable replacement for an ailing United States. Afterall, Japan's total imports are now still less than one-third that of the United States. Market restrictions are also more stringent. At least for quite some time, Japan still cannot serve as the locomotive for the real sectors of the world economy, the financial spectacle notwithstanding.

V. Complacency may Bring Disasters to the Developed and Developing Economies

The problems confronting the world economy are very serious. It is very misleading to compare the crash of October 1987 with, say, the drastic fall in 1962 and draw the complacent conclusion that this time the economy will again bounce back, like what it did in 1963. The world economy now is so much weaker than in 1963 in terms of the balance between aggregate supply and demand and the underlying productive vigour. Equally misleading is the view that the New York Dow Jones Index is still much below its peak in the 1960s, after adjusted for inflation must realize that the world economy has passed its golden era and another up-wave is still far away. All those pressing problems --- over-investment, insufficient consumption, stagnant labour supply growth and technological stalemate --- have yet to be effectively solved.

There is of course a "natural" way to deal with these problems: a near-total collapse in the financial markets accompanied by a severe depression in the real economy. A-great depression actually performs very positive economic functions despite the very high costs. Within a very short period of time a great deal of those over-accumulated capital goods of obsolete modes of technologies will be destroyed through bankruptcy, forced sales at drastically reduced prices, writing-offs or natural wastage. At the same time, there will also be a significant improvement in the distribution of wealth and income, albeit at a much lower level of prosperity. While every one is losing money, the rich will lose much more than the poor. Eventually, the problems of over-investment and under-consumption will be solved and a balance between aggregate supply and demand will be restored. The end of the depression may bring forth another "baby boom", thus heralding a new era of ample labour supply and rapidly rising demand.

No one will welcome such a "natural" course of event, not just because the economic, social and political costs will be very high, but also because the outcome will be extremely uncertain. Whether another up-wave will be forthcoming at the end of all the drastic adjustments and suffering is everybody's guess. We should therefore do everything we can to ward off such a scenario.

This of course does not mean that we can sit back and hope for the best. The problems confronting the world economy are very serious and significant changes in policies and counter-measures are required. To the developing and "newly industrialized" economies in the Asian-Pacific region, successful adjustments in the advanced nations are vital to their continued growth. Because of their high degree of dependency on the markets of the U.S. and other leading industrial nations, a depression in the first and second worlds would mean disasters to their export-oriented industries and therefore the whole economy.

Even now, the problems are already severe enough for them. The problem of stagnancy in the advanced economies implies not only shrinking demand but also, as I argued above, structural stalemate. The developing countries are blocked in their upward movements to take up the lower echelons of technologies that the advanced economies should leave behind if their own continuous up-grading process is not itself delayed by over-investment, insufficient consumption and other problems, which suffocate the smooth emergence of new technologies. Trade frictions will become inevitable. Given the relative weak bargaining position of the developing economies, they will be the ones who really suffer.

VI. My Recommendations to the Economic Summit

The only rational way to deal with the maladies lit the world economy is therefore to address directly their fundamental causes. The following recommendations of mine flow naturally out of the above analysis.

What we should aim at is the restoration of balance in the world economy on a course of sustained growth, rather than down a self-destructive spiral. In principle, the solution is simple enough, given the diagnosis. Since the down-wave is generated mainly by over-investment on declining industries coupled with under-investment on emerging technologies, insufficient purchasing power due to widening distributional inequality, as well as shrinking new labour supply from an aging population, what are needed are obviously an appropriate restructuring of investment and distribution and suitable policies on population and technological development.

Over-investment in those declining industries in the advanced economies should be channeled to the sunrise industries through appropriate industrial policies including, if necessary, some administrative measures, and, preferably in the context of capitalist economies, fiscal incentives of subsidy and taxation. These policies should also be used at the same time to effect a more equal distribution of wealth and income, and to stimulate aggregate demand for the products of the sunrise industries. The major task is to push the advanced economies onto a new growth path where a different composition in aggregate supply and demand and their balance are achieved.

The traditional policies of overall loosening or tightening through fiscal and monetary measures, on which the governments of advanced economies are still relying today, are hopelessly ineffective as instruments for performing these tasks of structural reforms. They are both based on the simple belief that given the right type of general environment the market system itself will ensure the optimal allocation of resources. The economy may be overheated or under-stimulated for various reasons. The government's duty is to provide a guidepost which the entrepreneurs, too busy seeking their own profits, may not give sufficient attention to. Given the anchor, everything will be fine as the market will take good care. However, the fundamental problems confronting the world that I have described above are no ordinary allocation exercises. They are structural contradictions which will only come to be detected long after they have accumulated to very serious proportions, and it is usually too late for any painless solution. The market system which excels in "small decisions" obviously cannot deal with these problems effectively. One example that we have quoted above is that under the present situation monetary loosening will not achieve structural reallocation of investment but may lead to further speculative instability. The only effective way to reduce the latter is to absorb as much as possible the "hot money" back into a re-invigorated real economy. The market system could hardly accomplish these tremendous tasks.

Hence, if the western governments really want to cure the present economic maladies, they must first perform some serious soul searching and re-orientate themselves for tasks that are significantly different from what they have routinely been accustomed to.

Other than a restructuring of capital and distribution, supplementary measures on population and technology must also be taken. Rapid aging of the domestic population creates labour shortage. Incentives for higher fertility rates may be tried, like what Singapore is doing. Another rational way to tackle the problem is to implement a more flexible immigration policy. For the whole world, population growth is excessive, not insufficient. Immigration involves of course social and political problems. But there are so many examples of economic success for countries that suitably admitted immigrants, the U.S., Australia and Canada being outstanding examples. Among the leading economies, Japan in particular should do some rethinking on this. Complementary measures on training and community development will certainly raise the chance of harmonious integration.

Besides ensuring adequate labour supply, it is also necessary to develop an appropriate technology policy. One of the most important tasks is to deal with the orderly withdrawal of traditional technologies. It will not be an easy task because a lot of vested interests are involved. These vested interests will certainly demand protectionist measures to prolong their survival and in the process play up national sentiments as an excuse.

It is of course much better to avoid over-accumulation in those traditional technologies in the first place. That would require a very intelligent policy on the long-run development of technology and extraordinary international co-ordination on the global division of labour. In any case, it is irrelevant to the present situation as over-accumulation has already occurred. To ward off protectionism by just reiterating free-market ideologies is however not enough. What is needed is a positive attitude towards channeling funds into rising technologies from those declining ones through suitable administrative, fiscal and financial measures. This implies an inevitable task of identifying the rising technologies In other words, some form of technological targetting is inevitable. On the other hand, re-training programmes to facilitate the transfer of manpower in the same direction is also necessary.

Suitable technological policies in the advanced economies will ameliorate protectionism and create rooms for NICs and developing economies to grow. They will also help solve the debt crisis, although obviously other imaginative initiatives have to be taken.

In any case, structural reforms in the advanced economies alone are not enough. The developing countries must also do something to facilitate the smooth transition of the world economy onto a new growth path. The NICs in particular cannot take their average growth rates in the past two or three decades as "norms" which can be projected indefinitely into the future without considering long-term cyclical fluctuations. The past few decades are probably very extraordinary by historical standards. They should therefore not be taken for granted. Some form of "sacrifice" on the part of most NICs is inevitable, be it through exchange rate revaluation, abolition of trade restrictions, opening up of financial markets to foreign capital etc.

Containing the trade surplus on the part of NICs will help to dampen protectionist sentiments in the advanced countries and reveal the truth of over-accumulation of declining technologies to their own people. That will make it easier for their governments to implement those necessary structural reforms outlined above.

However, the present international economic system is plagued by the problem of leadership and credibility, resembling that of the famous it prisoner's dilemma" in game theory. The developed economies pressurize the NICs and developing economies to make concessions. But the latter fear that such concessions are demanded by the former just for very short-term considerations, mainly to pacify domestic interests. They will not bring any long-term benefits, i.e. they are pure sacrifice. Obviously these countries are reluctant to do so. Without such concessions, however, it would be very difficult for the governments in the advanced countries to carry out structural reforms, because, in the short run at least, these reforms may mean giving an even freer hand to the NICs to reap larger trade surpluses. Hence, each side does not want to make the first move. The result is a stalemate.

What is needed is a co-ordinated effort to engineer systematic reforms, under which no one takes benefit at others expense. After the last Great Depression, we started to have the IMF, the World Bank, and the United Nations, which have been fostering global co-operation, to varying degrees of success. I hope this time we do not need another great depression to motivate major reforms and new forms of international congruence.

However, NICs and developing economies are not partners of equal strength to the advanced countries. To effectively solve the crisis facing the global economic system, the developed economies must therefore take the initiative and act as worthy and credible leaders. It is high time that they behave like that this coming June in Toronto.

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