

International Political Economy "After" the Business Cycle

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Business cycles – concurrent expansions and contractions of activity across many sectors of an economy – have been associated with significant changes in modern international politics and economics. International political economy makes significant assumptions about the cyclical nature of economic activity. Many of the central problems that IPE theorizes about are set in the context of a world with vibrant business cycles. But there are empirical and theoretical reasons to believe that the business cycle in advanced industrial economies is at the end of the 20th century being damped out, and that economic activity will fluctuate less violently in the future than it did in the past. The dampening of business cycles will have important consequences and implications for practical and theoretical issues in IPE – including (but not limited to) low inflation political economy, North-South relations, government policy, and the role of international institutions.

Western political economy since the industrial revolution on aggregate has been a vibrant world of rapid growth and development, at least for countries in the industrial "core". But it has also been a world of continuing and sometimes massive fluctuations in economic activity. Business cycles – concurrent expansions and contractions of activity across many or most sectors of the economy – became a taken-for-granted fact-of-life in this world.

The modern social science of international political economy (IPE) shared in basic assumptions about cyclical economic activity. The problems of conflict and cooperation between states that IPE theorizes about are generally set in a world of vibrant business cycles. Hegemonic stability theory grew out of Charles Kindleberger's arguments about the requisites for provision of a market for distress goods, a lender of last resort, and other "collective" goods *during the great depression*. Regime theory developed in the context of gradually declining American power, upon which were superimposed energy

price shocks which brought *recession* and "stagflation" to the core. Studies of the international politics of exchange rates generally assume that states at any given moment want to do different things with their currencies and that their preferences at least partially conflict.

This paper asks the question, how would international political economy – the reality, and the social science – look different if business cycles were severely dampened out, if fluctuations in economic activity were subdued. The question is more than a thought experiment. *There are empirical and theoretical reasons to believe that the business cycle in advanced industrial economies is being damped out and that economic activity will fluctuate less violently in the future than it did in the past.* Obviously, there is no way to prove the truth of this statement. What I can and try to do, is to establish the strong plausibility of the argument on theoretical grounds and with some empirical support. If it is possible (likely?) that business cycles will be subdued, it makes sense to consider consequences and implications of that scenario for international political economy. Some of those consequences and implications are novel and at odds with widely held beliefs and expectations.

The first section of the paper "defines" what a business cycle is. The second section explores some of the roles that business cycles play, often implicitly, in modern theories of IPE. The third section takes a step back to review several major arguments about why business cycles happen. I then discuss the "future" of the business cycle in three steps. Step 1 looks at some peculiarities in the current cycle – mainly, statistical indicators that don't make sense in the context of traditional arguments. Step 2 is a fictional tale focusing on what could be different in modern economies that would counteract driving forces behind business cycles. Step 3 extracts six specific things about the modern world economy that I believe contribute to the muting of the cycle, and presents arguments and evidence that each is indeed having that effect. In the final section of the paper, I discuss several important consequences for IPE. The conclusion considers some objections to the argument in the form of possible "de-railers" to the picture I have presented.

What is the Business Cycle?

There is no single definition of the business cycle. Economists

often use as a baseline some version of a 1946 statement by Mitchell and Burns:

Business cycles are a type of fluctuation found in the aggregate activity of nations that organize their work mainly in business enterprises: a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals which merge into the expansion phase of the next cycle.

This definition reflects the descriptive (rather than tightly analytic) nature of the concept business cycle. So do the terms used to label the four "stages" that make up a typical cycle: prosperity, transition, depression or recession, and recovery. The archetypal business cycle narrative connects these four stages temporally.¹ During the prosperity phase, the economy is operating at or close to full capacity. Increased lending by banks and spending by some combination of consumers, firms and government drives up aggregate demand. New jobs push the workforce toward full employment. But eventually growth slows and the economy slips into the transition phase. The increase in demand for loans will cause interest rates to rise above the expected return on some proposed investments. Wage demands exceed gains in productivity. Production inputs become more expensive. As the costs of doing business increase across the board, the profit margins of firms begin to fall. Some firms lay off workers and the rate of investment declines as businesses concentrate on selling off inventory rather than developing new ideas and products.

The economy moves toward the trough of the cycle, a recession or depression depending on its severity. Demand slackens as consumer borrowing and spending slow down. Firms postpone capital spending and try to streamline production by laying off more workers. The general mood becomes increasingly pessimistic as employment, income, and demand continue to decline. But eventually the decline in demand levels off. Wages and prices adjust as workers and firms respectively recognize their shifting positions on supply and demand curves. Interest rates move downwards, usually

¹ That is, without a strong account of causality.

because of government action as well as diminished loan demand. Investment starts to pick up as inventories run down and predicted marginal returns on new projects exceed the costs of borrowing. Businesses start to buy more inputs and more labor. New jobs spur consumer optimism that in turn induces increased spending. The boost in demand will bring the economy back to the prosperity phase. The cycle will start over.

Business Cycles in International Political Economy

Business cycles have been associated with significant changes in modern international politics and economics. The depression at the end of the 19th century marked the end of an historic era of advancing free-trade (which began in 1815 with the repeal of the Corn Laws).² Although Britain held out for freer trade, Germany and America moved decisively toward protection. An accelerated shift in world economic power away from Britain and toward the US and Germany laid the groundwork for conflicts that would culminate in world war.

The great depression of the 1930s saw the modern heights of nationalist defensive protectionism and the near-collapse of international trade. The gold-exchange standard disintegrated in competitive devaluations and fragmentation into competing monetary blocs. International finance was manipulated by national authorities to serve state mercantilist goals. This depression tore apart international cooperation, facilitating the rise of illiberal and vehement nationalist ideologies that contributed, in turn, to another world war.

The oil shock and ensuing stagflation of the 1970s brought massive change to international trade and finance. The increasing cost of energy forced energy importers to compete more intensely for export markets, and (for many) to borrow massively from states and banks. Debt crises and a "lost decade" for many LDC economies were a partial result. In the North, inflation was accompanied by contractionary monetary policies and slow growth, boosting

² Industrial production expanded greatly during this falling-price boom period, although with severe fluctuations. Average annual growth for industrial production 1873-96: US, 4.9%; Germany, 4.2%, Britain, 2.1%. W. Arthur Lewis, Growth and Fluctuations 1870 - 1913. Boston : G. Allen & Unwin, 1978.

protectionist forces.³ The Bretton Woods system came finally to an end, *de facto* in 1973 and then *de jure* at the Jamaica Conference in 1976. Partly in response, the G-7 was created in 1975 and the European Monetary System in 1979.

These are only a few examples of how business cycles and major shifts in IPE have been connected in time. They are not intended as causal arguments. But there are theoretical bases for causal connections, some of which I consider below. The basic point is that many central problems of cooperation and conflict between states that IPE theories address, are closely tied to business cycles in those states.

Consider some basic examples.⁴ Open trading systems are often modeled as a collective good, because the unilateral incentives of individual states are to free-ride and/or exploit the liberal policies of others. Hegemonic stability theory is the classic realist solution.⁵ In Kindleberger's formulation, the hegemon plays a crucial role in establishing the norms and rules of a liberal system as well as "paying" or coercing others to join it, but most importantly in maintaining the system in the face of crises. As he put it "for the world economy to be stable, it needs a stabilizer, some country that would undertake to provide a market for distress goods, a steady if not countercyclical flow of capital, and a rediscount mechanism for providing liquidity when the monetary system is frozen in panic".⁶ While there are other complications to hegemonic stability in the long term, the immediate challenges that the hegemon must face come in large part from business cycles – massive fluctuations in economic activity that "create" distress goods, cause rapid repatriation of capital, and set off financial panics.⁷

The maintenance of an international monetary "system" is another

³ W. M. Corden, "The Revival of Protectionism" Occasional Papers No. 14. New York: Group of Thirty.

⁴ I am, naturally, not trying to cover in this discussion all theories of IPE, just some major arguments in order to show the impact of business cycles.

⁵ It is, of course, not the only solution that can be generated theoretically.

⁶ Charles P. Kindleberger, *The World In Depression, 1929-1939*. Berkeley: University of California Press, 1973. p. 247.

⁷ Hegemonic stability theory identified a number of long term problems including but not limited to differential growth rates; the increasing costs to and relative decline of hegemons, the difficulty of replacing one hegemon with another peaceably.

central problem of IPE, since the ability to create money is held almost entirely by states as a sovereign prerogative. If exchange rate stability is roughly a collective good, it is still the case that any particular monetary regime imposes differential costs and benefits which means states have incentives to try to skew the system and their own position in it to serve parochial interests. Many of those interests are tied to business cycles in the domestic political economy. For example, excessive government spending on deficit that a state undertakes during downturns creates incentives to inflate away some of the debt that accumulates. Devaluation of the national currency is a classic individual state strategy for boosting international competitiveness and saving jobs at home – most tempting during periods of high unemployment. Even the basic notion of an "optimal currency area" depends heavily on the geographic and sectoral shape of economic shocks – disruptions that (as I explain later) play an important role in business cycles.

Central problems in North-South relations and development are also tied to business cycles. In the modern liberalizing world economy, development in the South depends heavily on sustained global growth that can be accessed through trade and open markets, stable financial flows for investment, diffusion of appropriate technologies, and protection of the environment. Business cycles complicate each of these. Direct official transfers in the form of state and multilateral aid come under pressure when economic activity slows. Downturns in the North breed protectionism that can cut off export markets for producers in the South. If interest rates rise and/or exchange rates shift so as to make debt service more burdensome at the same time, debt crises, defaults, and/or massive devaluations with their attendant political risks for Southern regimes (and problems of cooperation both between creditors and debtors, and among the members of each group) follow. Finance also trends to track cycles, with abundant FDI and portfolio investment that is available during upswings often suffering retrenchment and repatriation during downturns.

International issues of unemployment are also shaped by business cycles. As "adjustment unemployment" in a booming and fundamentally transforming world economy digs deeper into the domestic political agenda of the major northern states, the question facing political leaders becomes more concrete than just location of

production in a world economy. It is about locating a certain number of jobs, and jobs of a certain kind and quality, within national borders. New problems of cooperation arise as the northern states struggle to deal with the employment consequences of exploding low-cost production in the developing world. Certainly there is potential for beggar-thy-neighbor dynamics in allocating adjustment unemployment; what the French call "social dumping"; and other non-cooperative policies (in exchange rates, most obviously) aimed at keeping jobs onshore. Business cycles will place enormous strain on any international regime arrangements put together to avoid such policies.

These are a few examples of how business cycles play an important but often implicit role in central problems of IPE. Probably we have been comfortable in leaving this implicit, because it never before made much sense to ask what would look different in the absence of something that we thought would be a constant. The next sections of the paper argue that business cycles may not, however, be as important in the future as they were in the past.

Explaining the Business Cycle

There is no consensual body of theory that clearly explains why business cycles happen. Business cycle theories have developed mostly through empirical investigation and inductive reasoning, not deduction. This yields strengths and weaknesses. The major strength is that business cycle theories address concrete problems and observations from the real world. The major weakness is the possibility that any particular theoretical explanation might be overly specific to the observations that prompted it. And in what might be either a strength or a weakness, there exist in the literature a large number of different stories about why business cycles happen. I try here to develop a loose typology of those stories, emphasizing for each what are the major driving forces that set off and sustain business cycles.

In a 1950 review, Achinstein distinguished three main types of proposed explanations for cycles: physical, psychological, and

cultural.⁸ Theories of physical processes traditionally emphasized fluctuating agricultural production, which was in turn driven by changes in the weather.⁹ Psychological theories emphasize recurrent waves of optimism and pessimism in the minds of consumers and business decision makers. Cultural arguments have as their major driving force the institutional patterns within which production is organized, income distributed, capital accumulated, and goods exchanged. Achinstein argued that most business cycle theory was actually cultural. Of course, psychological processes in economics as elsewhere are deeply embedded in social institutions; so it is hard to imagine studying optimism and pessimism in consumption and investment behavior without putting cultural institutions at the center of that study. Physical processes in some sense could stand on their own. But unless we are looking at something like a world-wide famine caused by global climate change of magnitude, the consequences for economic activity of a physical change are unclear until we know the institutional structure on which physical processes impact. Schumpeter was perhaps the most prominent spokesman for the view that the study of business cycles was, in fact, the study of capitalist institutions.¹⁰

Modern business cycle theory makes analytic sense of this by dividing its stories about business cycles into *exogenous shocks* and *endogenous dynamics*. There is an exogenous shock that hits the economy. Then there are endogenous dynamics that drive a cycle. Another way to describe this, is a series of stories about inherently cyclical responses to exogenous shocks.¹¹ Current mainstream arguments differ from each other on two grounds. First, from where does the exogenous shock arise? Second, what are the endogenous cyclical dynamics that turn the shock into a business cycle? There is more disagreement about the first point than about the second. I

⁸ Asher Achinstein, Introduction to Business Cycles (New York: Thomas Y. Crowell, 1950).

⁹ Ibid, p. 5.

¹⁰ Joseph A. Schumpeter, Business Cycles; a Theoretical, Historical, and Statistical Analysis of the Capitalist Process. New York: McGraw-Hill, 1939.

¹¹ Distinguishing endogenous from exogenous things here is an analytic device that makes it easier to construct an argument. Even if "exogenous" shocks were shown to be the consequence of some endogenous process, that would not change the argument fundamentally nor damage its analytical utility.

present a typology of major arguments here along with brief explanation and selected criticism. My purpose is not to establish or dismiss these arguments as *theories*. The debate between them may not be resolved anytime soon. I take these arguments as serious *claims about critical driving forces* that lie – probably in reality, in some combination – behind business cycles.

Exogenous Shocks: Demand Side Arguments

Two kinds of arguments see shocks coming principally from the demand side. The first, *monetarist* explanations, stress as the critical driving force "errors" in monetary policy that lead to instability in expectations via inappropriate rates of change in the money supply. This can set off a number of endogenous cyclical dynamics. Price information can be confused. Businesses can mistake a move in the price level (which is actually here about restoring equilibrium between supply and demand for *nominal* money) for a *real* change in demand for goods and services – with impacts on investment decisions. Banks can over- or under- lend. There are problems with these arguments, not least of which is the difficulty researchers have in finding empirical evidence to support them. On deductive grounds, economists who accept the notion of rational expectations equilibrium point out that only unanticipated changes in money supply could have these effects. The evidence, however, is not compelling that there is any substantial difference in the cyclical consequences between anticipated and unanticipated changes in money supply.¹²

Keynesian explanations provide a second plausible demand side argument about exogenous shocks. (Keynesian economics is also central to much of the endogenous dynamics of cycles, which I discuss later).¹³ Here, the shock comes from instability of private spending and even more so, from investment. In this scheme, investment changes the level of income and in turn governs savings. With $S=I$,

¹² A classic statement is Ralph G. Hawtrey, *Currency and Credit* (NY: Longmans, 1931). Milton Friedman is a well-known modern proponent of this view. For evidence on the impact of rational expectations see Victor Zarnowitz, "What is a Business Cycle?", NBER Working Paper 3863 (Cambridge, MA: NBER, October 1991), p. 47.

¹³ Keynes himself did not pay much specific attention to cycles, but did emphasize the general idea that exogenous shocks get propagated through endogenous processes into large cyclical movements.

the main problem is to understand the forces that influence decisions (mostly private ones) to consume or to invest. Decisions to consume depend on the marginal propensity to consume, which is really a psychological assumption about non-linearities in the relationship between income levels, rate of change, and spending. The more important driver is the marginal efficiency of capital, which determines the level of investment by business. The marginal efficiency of capital reflects the expected return on money spent on additional capital formation. Decisions to invest depend, basically, on the marginal efficiency of capital versus interest rates. That comparison has to be made in the context of volatile and uncertain expectations – about demand, technology, productivity, future prices, and so on. Those expectations are erratic. Over-optimism and over-pessimism drive fluctuations in capital investment, with multiplier effects in either direction.

Supply Side Arguments

The simplest supply side arguments are basically extensions of Achinstein's physical processes story. Things happen that change the price of important inputs. If these things happen rapidly and unexpectedly, the result can be the exogenous shock that sets off a cycle. Sunspot activity leads to climate change, and the price of food skyrockets. Or (more realistically) a group of oil exporting nations establish a (temporarily successful) cartel that multiplies the price of oil. It's not that politics or institutions are absent from this kind of shock, of course. But the emphasis is on a price change set off by primarily physical processes, affecting a central economic input significantly enough to set off endogenous cyclical dynamics.

The more interesting supply side arguments fall roughly into a category known as "*real business cycle theory*". The common theme here is productivity shock, usually brought on by a large and sudden change in technology that alters substantially the costs of production or makes possible the production of entirely new things. Productivity shocks throw a wrench into even a dynamic equilibrium, by changing the basic contours of supply (and usually – although less directly – demand as well). New technologies make necessary decisions about new capital goods, which take time to produce and then to incorporate into production processes that in turn feed demand. The long gestation period involving capital goods means that output

movements (or lack thereof) are persistent and can't respond smoothly to changes in demand. Resulting price fluctuations on the supply side set off the endogenous dynamics that create business cycles.

I have indulged in considerable oversimplification here, as well as omitting discussion of a few other possible sources of shock – notably, electoral rhythms that certainly influence the way governments conduct fiscal and monetary policy. What I hope I have accomplished, is to highlight the essential driving forces that major arguments point to as critical exogenous shocks.

Endogenous dynamics drive the cycle in response to shocks. Stories about how these dynamics evolve differ in chronology (what comes first, what comes later, what variables lag the cycle and what variables precede it) as well as in emphasis (what is most important). Part of the reason for that lies in different theoretical predispositions. Part lies in empirical differences among real world cycles, each of which tends to yield its own set of stylized facts to which an explanatory story has to bear some resemblance.

I summarize here major common elements among these stories. They share the notion that uncertainty in business planning leads to mistakes that propagate through the economy. Planning uncertainty, in turn, results from the competitive structure of the economy and the time lag between perceived demand and production. Since people know this is happening, psychology comes into play as business planners look not only to the external world with its noisy signals about prices and demand but also to each other for signals of optimism, pessimism, and clues on how to interpret what data they have. Business fixed investment fluctuates. Inventories expand and contract in ways that don't reflect closely changes in demand. The costs of carrying inventories depend in part on interest rates, which may also be changing. Since expectations of the marginal efficiency of capital are themselves uncertain even before the comparison to expectations about interest rates, there is plenty of room for error. Prices will shift to adjust but wages, which are sticky, less so, causing cyclical unemployment. As multiplier and accelerator effects work their way through the economy, further demand shifts complicate again calculations about inventories and the marginal efficiency of capital. Profits fluctuate, and so do future expectations of profits. Investment calculations change. And so on and so forth.

This last paragraph would best be read not as a series of linear sentences but as a circle. Where you start on the circle depends on your theoretical predisposition, as well as what you believe are the most important sources of exogenous shock. Stylized stories about particular cycles usually work from a starting point, through a series of these changes, to show that many arrows point in the same direction and reinforce each other. Positive feedback (at least at the beginning of a cycle) leads here to recession, or here to recovery. A few arrows point in the opposite direction; these are the countercyclical forces that will pull the economy out of the trough or stall it at its height. Recession begets revival; and revival, recession.

In sum, business cycle "theory" – like the reality it tries to explain – is a complicated thing. Rather than taking theory as a set of falsifiable propositions that specify causes and their relative weights, I have treated these arguments as claims about driving forces that lie behind cyclical movements in economic activity. For my purposes, these claims do not compete one with the other. They are complementary and it would be perfectly fine if all were operating as partial causes.

The next section makes two points on this score. First, the exogenous shocks that business cycle theories identify are diminishing in the modern economy (though not going away entirely). Second, the cyclical dynamics that respond to shocks are increasingly damped. The argument is that modern economies operate in ways that reduce the propensity to shock and cycle.

The Future of the Business Cycle

Popular media described the 89-95 recession/recovery cycle in many OECD economies as "different", "peculiar", or "strange". Because there are no precise definitions or standard measurement criteria for business cycles, the question "was that cycle *different*" really begs the question "are they *all* different".¹⁴ They probably are. Still, aggregate statistics on production, employment, real income, sales, prices, hours worked per week, inventory sales ratios, etc. do reveal cyclical patterns as well as some interesting changes in

¹⁴ See for example Michael Ulan, "Is the Current Business Cycle Different? Does How We Measure Matter?" Business Economics 29. April, 1994. pp. 41-47.

cycling in the American economy. Victor Zarnowitz lists several important trends:¹⁵

- The expansion phases of cycles have gotten longer on average as well as more variable in length, although that variation is almost entirely on the upside. Peacetime expansions before 1945 lasted between 10 and 50 months; after 1945 between 12 and 92 months.
- Contractions have gotten shorter and more uniform in length.
- Contractions have gotten milder. Even the most severe post war recessions, the 73-75 period and the 81-82 Reagan recession were much milder than the two interwar downturns and of course the great depression.

Zarnowitz's work attracts discussion. Christina Romer questions the basic finding. She argues that traditional estimates on pre-World War I data have a built in bias toward volatility (since they rely heavily on commodities) and that when this is taken into account the trends Zarnowitz finds are not statistically significant.¹⁶ John Taylor (along with most other macroeconomists) accepts that fluctuations probably have become less severe, but he finds at the same time that wages and prices are more rigid in the post world war II period (at least until 1983).¹⁷ It seems that all things equal, wage and price rigidity should *exacerbate* fluctuations by making it harder for demand and supply to adjust to shocks. Taylor's view is that counter-cyclical government policy compensates for rigidities (and might even partially explain them, since the expectation that governments will act to damp cycles reduces incentives of private actors to challenge rigidities connected to long union based work contracts, large business enterprises, etc). DeLong and Summers

¹⁵ Zarnowitz, "What is a Business Cycle?"

¹⁶ Christina Romer, "The Pre-War Business Cycle Reconsidered: New Estimates of GNP, 1869-1908," Journal of Political Economy 97. 1989. pp. 1-36. An opposing view is N. Balke and R. Gordon, "The Estimation of Pre-War GNP: Methodology and Evidence," Ibid pp. 39-92.

¹⁷ John B. Taylor, "Improvements in Macroeconomic Stability: The Role of Wages and Prices", in Robert J. Gordon, ed., The American Business Cycle: Continuity and Change, Chicago: University of Chicago Press, 1986.

propose that rigidities could actually have been a *stabilizing* factor during this period.¹⁸ The intuition here is that rigidities under some conditions can counter deflationary pressures and keep real interest rates steady. For example, long term labor contracts might slow the response of employment to fluctuations in demand and stabilize workers' disposable income.

Would it then be right to suspect that a *less* rigid economy (like the picture I paint in the next section) will be *more* volatile to fluctuations, even with countercyclical stabilizers in place? Probably not, since the relationship between rigidities and fluctuations is almost certainly not monotonic. In an economy with high transaction costs and rampant inefficiencies, rigidities might very well have a stabilizing effect. But in an economy where factors (including labor) can move and re-deploy at lower cost, and where a well-developed private credit system smoothes out consumption and investment, removing rigidities would probably have the overall effect of smoothing adjustment to demand or supply side shocks – thus reducing macroeconomic fluctuations. Each of these arguments almost certainly picks up part of what explains apparent dampening.

The most recent American business cycle is largely consistent with these trends. The 90-91 recession was unusually shallow and brief, and was followed by a long gradual expansion phase. Real output declined a total of only 1.6% and only for only two quarters – the fourth quarter of 1990 and the first quarter of 1991.¹⁹ The fall in output was so mild that *The Economist* in 1992 declared that the experience barely qualified for the label recession.²⁰ Changes in employment were similarly mild. Unemployment – which topped 11% in 81-82 – reached a little over 7% in 90-91. On the upside, a shallow recession gave way to a shallow recovery – particularly in employment, earning the nickname of “jobless recovery”. In 50 months after the trough of the recession the US economy generated about 8.1 jobs (full and part time). After the ‘75 and ‘82

¹⁸ J. Bradford DeLong and Lawrence H. Summers, “The Changing Cyclical Variability of Economic Activity in the United States”, in Gordon, ed., *The American Business Cycle*.

¹⁹ According to NBER, the recession started in July 1990 and bottomed out in March 1991. For comparison, output shrunk between 3 and 4% in the previous two recessions, and about 30% in the great depression.

²⁰ “Recession or Doom?” *Economist*, October 24, 1992. p. 13.

recessions the numbers were 13.5 million and 12.1 million jobs respectively.

<i>Recession (Approx)</i>	<i>Change in Output</i>	<i>Unemployment</i>
73-75	-4.1%	9%
81-82	-2.8%	11%
90-91	-1.6%	7%

(Source: "Free fall?" *The Economist*, January 4, 1992. p. 9)

The recovery phase of this cycle (arguably still going on as I write this) has been peculiar in other respects. Most interesting is the lack of inflationary pressures. Two standard driving forces of inflation – low unemployment, and high capacity utilization – do not seem to be operating "normally". Although economists disagree about the precise number, the consensus has been that when unemployment falls below some particular threshold the labor market becomes sufficiently tight that workers can demand and receive higher pay – the classic story of wage push inflation. The Fed reportedly uses 6.2% as a conservative estimate of that threshold.²¹ Unemployment drifted downwards from 6.4% in December of 1993 to 5.4% in December of 1994 and remained as low as 5.6% in January 1996, falling even further through the spring to around 5.2%. But there is no evidence of substantial wage push inflationary pressure. Average hourly earnings in America rose 3% in 1993 which was 0% in real terms; and 2.9% in 1994 which was about .4% in real terms.²²

Capacity utilization is also supposed to drive inflation when it reaches 81 to 82 %.²³ After recovering from below 78% in 1991, capacity utilization hit 81% in the middle of 1992 and has not fallen below that level since. In August 1994 capacity utilization for US

²¹ Louis Uchitelle, "Growth of Jobs May Be Casualty in Inflation Fight," New York Times 16 Nov 1994 p. 6.

²² University of Michigan gopher, Department of Commerce Statistics.

²³ As with unemployment, there is disagreement about the precise numbers. 81 to 82 % are conservative estimates, reportedly used by Fed economists. Financial Times 13 July 1995 p. 11.

factories, mines, and utilities hit a local maximum at 84.7%; in the automobile industry the number was more than 87%. Three months later, overall utilization peaked at over 85%. The slowdown of spring 1995 brought the level down only to about 83.7%, still significantly above the supposed threshold for inflationary pressures.²⁴ And although producer prices did in 1994 reflect some upward pressure (presumably from capacity utilization at least in part), consumer price inflation has steadied at around 3% and expectations of future inflation as reflected in the long bond market have been similarly steady.

These peculiarities have prompted occasional speculation in the popular and business press that the business cycle has somehow died out.²⁵ A more modest argument is that the current cycle reveals some significant changes in how modern economies operate, and that these changes will tend to dampen out business cycles and render them in the future less prevalent, less severe, and less significant than in the past.

I am going to defend the plausibility of that argument in two steps. First, I present a modern economic fairy tale. This is a fictional story about a business cycle that didn't happen. The story captures and integrates the four schools of thought concerning the driving forces of business cycles that I outlined. The story also highlights in a narrative fashion what is different in modern economies, that would counteract the driving forces.

Like all fairy tales, this one contains important lessons that can be extracted and looked at separately. In the second step I extract six things about the world economy that I believe contribute to muting of the business cycle, and I present arguments and evidence that each is indeed having that effect. The six are: "globalization" of processes of adding value, changes in finance, changes in the nature of employment, government policy, emerging markets, and information technology.

²⁴ *New York Times* 17 Sept 1994 p. 1 (Louis Uchitelle, "With Factories Near Their Limits, Inflation Fears are Rising Again") and 16 Nov. 1994 p. 6 (Robert D. Hershey Jr., "US Industry Had A Surge in October").

²⁵ For example, see The Sommers Letter, June 29 1993, The Conference Board, New York, p. 2.

The Business Cycle That Didn't Happen

It had been a robust recovery and now it was reaching its supposed end. The problem was, businesses had not expected it to be quite so robust. Those were sensible expectations. The preceding slowdown had been painfully drawn out, and the recovery, at least when it began, was halting and weak. Fearing overcapacity, businesswomen had held back on investment and had been slow to hire permanent employees. So when the expansion picked up steam and kept rolling right along, they soon found themselves struggling to meet orders.

Undercapacity turned out to be the real challenge. In effect, business had vastly underestimated the marginal efficiency of capital in this recovery. Demand, far from being sluggish, had exploded in the form of robust export markets in the developing world. Billions of new consumers in Asia and elsewhere took an increasing percentage of developed country exports and kept factories in America running hard to keep up.

Many economists said that these mistakes would cut off the expansion. With inventories cut to the bone, capacity utilization, now reaching near to 87%, could hardly go up further without sparking increased prices. 5.5% unemployment meant that any new demand for workers would bring wage pressure. Inflation was surely on the horizon.

A sharp rise in commodity prices over several months seemed to confirm these predictions, and struck fear into the collective heart of the Federal Reserve. In a dramatic move, the Fed boosted the discount and the Federal funds rate 100 basis points each. The reaction on Wall Street was glum. Surely this was an over-reaction, too much too fast for this economy. Traders expected a predictable sequence of events: firms paying more to carry inventory and service debt; investment declining; consumers postponing purchases so they could pay off existing debt; falling demand; weak corporate profits; worker lay-offs; and so on.

Many of these predictions turned out to be mistaken. The Fed's move did increase the costs of borrowing for business, but not to the extent that Wall Street anticipated. Corporate finance was much more sophisticated and diversified now, and many firms were utilizing complex financial instruments that weren't so closely tied to the prime rate. Deregulation and information technology meant that not only

large multinationals, but a surprising number of small and medium sized businesses as well, had access to a global pool of capital. Markets in Singapore or Taiwan, increasingly transparent and competitive with London and New York, were ready and able to finance projects in America.

Consumer spending did decline somewhat, particularly among Americans unlucky enough to hold variable rate mortgages and credit card debt. But for many businesses, those Americans had become a significantly smaller part of their overall demand structure. It wasn't only large multinationals that serviced the global economy. Low transport costs and the declining costs of information made it possible for medium sized and increasingly even small firms to find niches in foreign markets.

Surely American firms cut back on inventory. But as many of the input items on their shelves were imports anyway, the cuts did not deeply affect production in America. The trade balance a few months later showed exports up and imports down, with domestic production in most sectors holding nearly steady.

The pressure was on to cut costs. But with production still robust, firms found it hard to lay off workers. Those who were laid off were disproportionately temporary workers, many of whom found new temporary positions in sectors that were doing well. Unemployment on aggregate was up, but not nearly so much as had been feared. In fact, government deficits barely suffered because there was no marked increase in welfare or unemployment insurance payouts. Long term interest rates settled back to near where they had been before the Fed's move.

Of course, there were some serious shocks in the price of inputs. This was made worse for American mass commercial bakeries, in particular, by a spate of severe thunderstorms which destroyed large proportions of the cane harvest in the Caribbean and boosted the price of raw sugar by 30%. Market analysts predicted a disastrous 50 cent per package rise in cost of cookies.

But the bakeries were protected. Low tariffs and decreasing transportation costs along with the growth of spot markets made it feasible to seek and find quickly other sources of sugar. Futures contracts for raw cane backed up by exchange rate derivatives to protect against currency fluctuations were a further hedge. Engineers pushed production technologies to the limit and found that with

newly efficient ovens and rapid cooling systems coming on line, they could boost efficiency and make up for nearly a third of the sugar price increase. Inventories were cut to a bare bone, but this could now be done without risking reputations for supplier reliability, since information technologies made it possible to assess supply and demand in diverse market segments in near real-time. Some temporary workers were sent back to Manpower, but overall employment in the industry barely budged. Profits declined marginally, but in response to articles in the business press that applauded the way the industry had handled a prospective crisis, stock prices actually increased. Ambitious investment plans by some industry leaders to open new cookie factories in Beijing moved forward.

The economic pundits soon went back to worrying about inflation from wage-push and capacity-utilization. But the meaning of "full capacity" had changed in an increasingly globalized production system linked up by low transport and low information costs. American firms that had trouble filling orders from their factories in Kansas were able to locate substitutable capacity in factories in Malaysia and India. In some cases, they bought output from those factories. In others, they leased capacity. In fact these were the best options, because if the American firm had tried to raise its prices instead, then the Malaysian and Indian factories would have eventually found and serviced the buyer on their own. In a globalized production system, there was always slack capacity somewhere and the problem was simply to find it and make it work.

"Full employment" also meant something different. In March 1994 Martin Feldstein (head of NBER) had said of 6.5% unemployment that "we are essentially at full employment today."²⁶ But wage-push remained weak far below that number. Unions that had suffered the politics of the Reagan administration in the 1980s suffered even more the economics of the 1990s. Low wage unskilled workers in the West faced new technologies and new competitors in Indonesia and China. While productivity was still much higher in the OECD than in most developing countries, it was not so much higher that factories faced with wage demands in labor intensive industries

²⁶ "Inflation Specter," New York Times March 28 1994 p. C1.

would not choose to move. The bottom line was a fall in demand for unskilled workers in the developing world – leading to declining real wages in America and Britain, or rising unemployment in countries where unions and welfare state provisions had put a floor under wages. In both cases, higher wages go to skilled workers with higher productivity – which is not wage push inflation. And in all labor segments, the increasing use of temporary workers puts firms in a position where they were essentially managing a portfolio of labor more so than a permanent work force. Portfolios are flexible; they can be priced and repriced, hedged and insured, adjusted through selling and buying on spot markets, and so on. Wage push inflation at 6.5% unemployment seemed a thing of the past.

The rise of Asia had important supply side effects in the developed world. With (relatively) open trade, lower wages and costs in the developing world and the strong energy of economic growth there brought new competition to the developed world – first in low technology and later in middle technology industries. Prices were pushed downwards, stimulating the search for efficiency in production and use of resources. Cost cutting hurts, but there are compensatory advantages, such as improved terms of trade for rich country consumers who enjoy lower prices on imported goods; and financial diversification for investors who seek (and find) through increasingly globalized capital markets higher returns in emerging economies.

The push "upmarket" for developed countries spawned new fears of an "info-tech" recession brought on by the technology shock of computerization. Would unforeseen productivity fluctuations eliminate entire classes of jobs, create a permanent underclass of information know-nots, and "hollow out" the real economy of the West leaving massive unemployment in its wake? Of course, information technology did displace workers – but not on the scale that pessimists had feared. In the manufacturing sector, at least, many of these workers would have lost jobs anyway through competition from NEC imports.²⁷ But the manufacturing sector had become a much smaller segment of the workforce, more important symbolically than in the real economy. Meanwhile,

²⁷ NEC is an acronym for "Newly Exporting Countries" -- China, Indonesia, Thailand, Malaysia, perhaps Vietnam.

computers created new classes of employment – higher wage, skilled service employment open to more educated and flexible workers of the "next generation".

Demography and labor market flexibility made the adjustment process less onerous than it was expected to be. Slow population growth in the West meant it simply wasn't necessary to provide quite as many jobs. Rigid labor markets (even in Japan and Germany) gradually loosened up. In many industries, info-tech transformed labor into nearly a just-in-time input. But this suited fine the increasing number of temporary workers who learned to sell their capabilities on something like a spot market rather than through long term contracts. Once the US passed a comprehensive health care bill, the negative stigma attached to temporary employment was replaced by a certain kind of cachet. This was the permanentization of temporary work, and Americans got used to it (and began to value the freedom and flexibility it entailed) faster than anyone had believed they could. The permeation of info-tech through the economy also forced Americans to take much more seriously education and education reform. From elementary school through workforce training and into "adult" education, the system was being transformed gradually toward the ideal of a seamless web where the norm was that "learning" would be a lifetime profession for everyone. Even marginal improvements in this direction proved a great boost to the workforce and the companies that they moved between.

Many of those companies found the world they were selling into changing just as quickly as the world inside their walls. Successful firms were innovating at an unprecedented rate. Service firms found that they could sell a wide range of services on world markets. Not everyone in the world needed state of the art sophistication; good old insurance and lending services along with simple computer technology had enormous markets in the developing world and Asia. (Coincidentally, this buffered the jobs of at least some "obsolete" service workers as well) Profits from these ventures helped to amortize the enormous installed capital base of late 1980s technology in the West, and financed the development of new services whose markets, at least initially, were in the West as well.

By the late 1990s worries about an info-tech "overheating" had largely replaced concern about recession. But this too would turn out to be a chimera. The info-tech phase of the industrial revolution

would no sooner run out of inputs than out of customers. Increasingly sophisticated and deep markets traded things that *could* run out (or at least run into shortages) – so price swings in commodities, land, and other real "assets" were damped and the impact of those price swings mediated by complex hedging and trading of longer term risks and expectations. When the statistical measures collected by governments caught up with what was happening in the real economy, they would show that a moderate rate of growth for the world economy but more interestingly an increasingly steady growth rate. The business cycle was damped.

Six Things That Are Different

The modern international political economy is changing in ways that could reduce the overall propensity to cycle as well as the depth of cycles in the developed world. I extract here six major differences – a selective not comprehensive list.

Changes in the Nature of Employment

Two major changes in the nature of employment contribute to the dampening phenomenon: the shift from manufacturing jobs to service jobs; and the growth of temporary and "portfolio" employment relative to "career" employment.

There has been an enormous increase in employment in the service sectors of modern economies. In 1950, services employed about half of US workers. In 1992 services accounted for almost 80% of American jobs.²⁸ The US numbers are the most dramatic among the OECD countries, but by no means out of line with trends in other advanced countries. This matters because – while some service industries remain subject to cyclical swings in employment – service employment generally is less cyclical than employment in manufacturing.²⁹

There are two principal reasons for this. First, services are less vulnerable to large swings in inventories. The sector is composed of

²⁸ See Jaewoo Lee, "Do Services Temper Business Cycles?", UC Irvine Dept of Economics Working Paper 95-96-3, February 1996.

²⁹ Andrew Wyckoff, "The Growing Strength of Services," OECD Observer No. 200, June 1996.

relatively intangible goods (stocks and bonds, knowledge); or the rental of equipment (BlockBuster Video); or the delivery of a function in real time (haircuts or medical care). It is hard to build up or run down stocks of these. Second, the demand for many services (particularly real time delivery) remains relatively constant through downturns in economic activity. Government services rarely decline in a recession; they are almost always countercyclical. Restaurants suffer during recessions, but not nearly so much as makers of automobiles. In the most recent US economic downturn, manufacturing output dropped about 3.4% while the output of services did not decline at all. Even in the manufacturing "powerhouses" the difference was clear: Japanese manufacturing output dropped 13.5% in the last downturn, while services dropped only 2%; for Germany the numbers were 11% and .2% respectively.³⁰

The increase in service employment is also one factor behind the general decline in union strength. Strong unions are typically associated with manufacturing and industry: steel, rubber, autos, textiles, and the like. Union membership peaked in the United States in 1953 at 34.1% of the labor force; in 1992 that figure had fallen to 16%.³¹ Finland and Sweden aside, trade union membership fell in all OECD countries during the 1980s by an average of 6.4%.³² Weaker unions should signal diminished pressures for wage push inflation. One measure of that, the prevalence of strikes among workers, shows the trend. Almost all the advanced industrial countries lost fewer working days per 1000 employees to strikes in 1989-93 than they did in the previous four years.³³ US strikes fell in 1995 to a historic 50 year low.³⁴ Declining union power has contributed to the development of increasingly "flexible" labor markets, extending to downwardly flexible wages in some OECD countries and most notably in the US.

³⁰ Statistics from Economist May 20 1995, p. 106.

³¹ Nick Salvatore, "The Decline of Labor." Dissent, Winter, 1992. (non-agricultural workers)

³² Economist 23 July 1994 p. 102.

³³ Economist 21 January 1995, p. 106.

³⁴ "Strikes Decrease to a Fifty Year Low," New York Times 29 Jan. 1996 p. A1.

Labor market flexibility has also gained from a secular shift away from the old paradigm of career or lifetime employment, towards the fastest growing category of worker in the US - the temporary worker. "Tems" are typically employed through an agency, acting essentially as a labor broker, that fills an assignment with a worker for a given period of time which is often the length of a specific project. In principle, the growth of temporary employment mirrors the development of spot markets and just-in-time management of other factors of production. And temporary employment is growing quickly. While the Fortune 500 companies have reduced their regular full time labor force by more than 30% in the last 15 years, the number of tems in the US has grown nearly 19% in the last three years – and is projected to increase another 60% over the next decade.³⁵ Growth has been most rapid in technical and professional fields (including not-so low wage ones like accounting, computer services, and medicine) where "permanent" status as a temporary worker is increasingly becoming a respectable career path. The effect in the short to medium term should be a more efficient labor market overall. In the longer term, labor analysts foresee the development of something like a "portfolio career" in which workers mix assignments and "jobs" that put their skills and talents to use in a variety of ways. Risk is being shared out among labor as well as capital. The result should be more flexibility in cost, production, and output – both size and kind.

Information Technology

Rapid innovations in information technologies may work in several different ways to dampen the business cycle. One important application of IT is in the management of inventories. Consider as an example Caterpillar Corporation's "Antares" parts system which manages more than half a million part numbers for the estimated 1.3 million pieces of Caterpillar heavy equipment that exist worldwide. Antares performs about 25,000 parts searches per day by browsing through the inventories of 150 Caterpillar dealers and 23 distribution

³⁵ Statistics from US Labor Department, quoted in New York Times 20 May 1996, p. C1, 10. See also San Francisco Business Times, February 17, 1995.

centers.³⁶ The major advantage to Caterpillar is speedy availability of parts and, even more importantly, much slimmer inventories.

There is evidence that on aggregate inventories are being managed more efficiently. In America and Britain, the ratio of stocks to sales in manufacturing fell by about 17% during the 1980s. US ratios have been reduced an additional 8% in the first half of the 1990s.³⁷ In the most recent cycle inventories barely budged: the ratio of sales to inventories rose by only 5% in the mid-1990 downturn (compared to 15% during the 81-82 recession) and increased by even less than that in the spring 95 downturn.³⁸ The same is true on the upswing: companies are resisting the temptation to build inventory in anticipation of unmet demand. In 1994 inventory expansion added just about 0.7% to GDP growth. And despite shortfalls in production during the 94 expansion at some large consumer durables makers like GM and General Electric appliances, the anecdotal evidence strongly suggests that inventory lean-ness is here to stay.³⁹

It also contributes more directly to efficiency in production and marketing. Though the effects are often hard to measure precisely, the use of CAD/CAM, enterprise resource planning software, production scheduling systems, EDI (Electronic data interchange) networks, etc. has probably contributed significantly to productivity and has almost certainly helped industry shorten time-to-market through improved management of the supply chain. In some industries the term "supply chain" itself is becoming obsolete as information systems link suppliers to factories to customers, and run in both directions. In 1995 US manufacturers probably spent close to \$4 billion on such integrated systems, a 30% increase over the prior year.⁴⁰ When customers work together with suppliers to design products, manage inventory, modify requirements, and bring innovation to market, the disconnect between demand and supply is

³⁶ Doug Bartholomew. "Blue Collar Computing." *Information Week*, June 19, 1995, p. 34.

³⁷ *Economist*, 5 August 1989, p. 63; "The Economic Recovery May Not Be Robust But It's Certainly Real." *Chicago Tribune* August 14, 1992, p. 17.

³⁸ *Business Week* 4 April 1994, p. 57; American Express Bank, *Economics for Investment*, July 1995, p.12.

³⁹ *Ibid.*

⁴⁰ Bartholomew. "Blue Collar Computing."

reduced. As information about markets and buyers improves, the need to hedge against uncertain developments in demand diminishes apace. The end result is an improvement in supply-demand coordination in near-real time, and a dampening of business cycle pressures.

Globalization of Value-Added Processes

The on-going globalization of value-added processes should also contribute to dampening of the business cycle. Clearly, we do not now live in a global or borderless economy. But it is also clear that production activities, services, and finance are spreading out spatially around the world. The increasing ease with which production and other value-added processes move across national borders will have a number of favorable effects on business cycles, primarily by reducing the sensitivity of economic activity to monetary, capacity, or demand conditions in any single country.

Albeit in fits and starts, the post War world has seen a massive overall reduction in trade barriers. Every industrialized country in the world (with the sole exception of Japan) today exports a higher percentage of its GDP than in 1960. The growth of merchandise trade is legion. A few statistics just to remind: world merchandise exports have grown every year since 1976 with the sole exception of 1982. Since 1985, US exports have more than doubled, Britain's exports have increased by 50%, Japan's imports by nearly 100%.⁴¹ The growth in sales by foreign affiliates of multinational firms is harder to measure, but probably now exceeds world trade.⁴² For an increasing number of companies and not just the big multinationals, "demand" is becoming more a global than a national concept. The same is happening with supply, particularly as firms in many industries "delaminate" and link up with supplier networks which are themselves increasingly international. Having multiple suppliers in different countries and different regions of the world insulates firms from labor movements, capacity blockages, and government policy in any one place. For example, when capacity

⁴¹ *Economist* 10 June 1995 p. 97.

⁴² "Global Economic Prospects and the Developing Countries, 1995" World Bank, Bank News Release No. 95/S74, 18 April, 1995.

utilization peaks in one country, the problem is to find slack capacity somewhere else in the world and use it – whether through supplier arrangements, subcontracting, leasing, or something else. Gillette is often cited as a case-study in this kind of arrangement, as it shifts production from factory to factory around the world to cope with fluctuations in demand as well as changes in input prices.⁴³ It is not so easy to juggle and fine-tune a “manufacturing portfolio” as it is a financial portfolio, but the two are becoming somewhat more like each other than they are different.

The shift towards services reinforces this trend. Just as services (which are inherently less cyclical than is manufacturing) are becoming a greater proportion of value-added processes, trade in services is increasing – recently, at a rate far exceeding trade in manufactures. Although it was starting from a much lower base, world trade in services grew 7.7% annually on average between 1980 and 1993, while merchandise trade grew 4.9% on average.⁴⁴ So-called “invisible exports” (which include services, non-commercial transfers, and income from overseas assets) reached \$2.4 trillion in 1993 for the world; merchandise trade that year was \$3.6 trillion. For the US, which leads the world in invisible exports (and accumulates the world's largest invisible trade surplus), invisible exports may now account for as much as 10% of GDP.⁴⁵ Maturation and deepening of financial markets, further (even patchy) progress in the WTO on services, sweeping privatization in telecommunications, and so on will likely accelerate these trends in the near future, which will future diminish the driving forces for cycling in the advanced industrial countries.

Finance

Developments in finance, in particular increasingly sophisticated products traded in deepening markets, should contribute to dampening of the business cycle. Modern finance is increasingly efficient at linking capital to production, spreading risk, and providing

⁴³ *Economist* 24 June 1995.

⁴⁴ “Global Economic Prospects and the Developing Countries, 1995,” World Bank, Bank News Release No. 95/S74, 18 April 1995.

⁴⁵ *Economist* 16 July 1994 p. 97.

investors and producers new ways to manage uncertainty and smooth out fluctuations.

Finance during the 1980s went both high-tech and global. The growth of financial markets in the last decade has been impressive in absolute terms, and relative to the size of real economies. As an example, many Latin American countries began the 80s with stock market capitalizations around 5-10% of their GNP. Now the numbers range between 50 and 100%. Between 1988 and 1994 the total market capitalization of 21 countries in the IFC Composite Emerging Market Index jumped from \$352 bn. to \$1.1 tn. At least five developing countries had in 1994 stockmarkets with capitalizations worth more than national income.⁴⁶ Developed countries' market capitalization increased somewhat less, but of course they had larger markets to start (aggregate numbers are also depressed specifically by the recent weakness of the Japanese market).⁴⁷

The growth of securitization, "non-banks", and alternative markets as well as mutual funds and similar products has been phenomenal – particularly, but not only in the US. Concerns about derivatives reflect this enormous growth. In developed countries, trading in over-the-counter derivatives (including but not limited to currency and interest-rate swaps) jumped from about \$750 bn to \$5.2 tn. in 1992. Over \$6 tn. of interest rate swaps were outstanding at the end of 1993.⁴⁸ Activity in standard exchange traded instruments such as currency futures, stock market index options, interest-rate futures and options, and so on, reached nearly \$8 tn. in 1993.⁴⁹ Despite heavy losses incurred by a few (well-publicized) firms on derivative contracts, these numbers were set to grow further as

⁴⁶ In the developed world that is true only of Britain and Switzerland; US market capitalization is around 70% of GDP. The five are Malaysia, Hong Kong, South Africa, Singapore, and Chile. *Economist* 17 Sept. 1994 p. 118.

⁴⁷ Minus Japan, developed countries market capitalization jumped from \$5.5 tn to \$9 tn. between 1988 and 1994. David Hale, "Is the World Economy Heading for Its First Post Cold War Boom," Kemper Financial, May 1994.

⁴⁸ *Financial Times* 16 November 1994 p. 9. Interest rate swaps in principle can reduce the costs of borrowing overall, as well as hedge against currency risk (example: a borrower swaps fixed interest yen for floating interest dollars).

⁴⁹ *Economist* 25 June 1994, p. 109.

corporate treasurers and fund managers learned better how to use these valuable tools of risk management and diversification. And they are growing not only in the US but abroad as well, in economies across Europe, Asia, and Latin America.⁵⁰

Money is increasingly raised and borrowed internationally as well as through domestic markets, further increasing diversification in funding sources. Total borrowing on international capital markets rose to nearly \$800 bn in 1993 and about \$850 bn in 1994 from under \$500 bn just 5 years before.⁵¹ In 1993 US investors bought \$8.4 bn of foreign equities and \$19 bn of foreign bonds. During the peak year of Japan's boom (1989) that country bought \$94 bn of foreign bonds and \$18 bn of foreign equities; in 1992 Japan sold a net \$3 bn in equities but purchased another \$35.6 bn in bonds.⁵² Foreign exchange trading supports international lending and international trade, of course, but is also an enormous market in its own right. No one knows exactly how large this market is but the numbers on daily turnover exceeded \$1 tn. *per day* sometime in 1993.

These numbers signal more than anything else diversification of funding sources for business, investment income for capital, and currency risk management for a globalizing economy. A firm that wants to borrow money has an enormously broad range of choices: what currency, what term, what kind of interest contract, what forms of hedging against what kinds of risk, and so on. Investors can buy re-packaged pieces of risk and spread their holdings across different countries, different industries, and different time periods. While the complexity seems daunting and may lead to greater volatility for some individuals or firms, on aggregate the global economy as a whole should benefit from this kind of market deepening and diversification. Not the least benefit should be a flattening out of aggregate fluctuations, as short term ups and downs in any single market or small group of markets can be compensated for elsewhere. The argument that complex markets might act in synergy and come crashing down together simply is not supported by a compelling

⁵⁰ Listed derivatives trading in 1993 grew 28% within the US and 54.8% outside the US. *Financial Times* 16 Nov. 1994 p. 8.

⁵¹ *Economist* 13 Nov. 1993, p. 124; 3 December 1994, p. 127.

⁵² "IMF, World Economy, and Finance," *Financial Times* 24 September 1993, p. 5, 6, 13.

theoretical logic or by recent empirical evidence.

Emerging Markets

The explosive growth of “emerging markets” in the post Cold War world should also contribute to dampening of the business cycle. Growth in the *developing* world has now become a major influence on economies in the *developed* world as pent-up economic energy in the developing world is released. Brazil doubled its real per capita income in 18 years from 1961; Korea doubled its income in 11 years from 1966; China did the same thing in 10 years from 1977. With new IMF estimates using PPP not exchange rates, developing countries’ share of world GDP is close to 34% (instead of 17%); China becomes the third largest economy in the world, India #6, Russia #9, and Brazil #10.⁵³ IMF estimates for growth rates in the developing world are now typically more than double expected growth rates in the developed world. Explosive growth in even a few of these economies will change the way the world economy works.

The most direct linkage is the demand effect of a billion-odd new consumers. The numbers here are becoming legend; I simply quote a few conservative estimates to give a feel for what is at stake. The World Bank believes that in 2002 a “Chinese Economic Area” made up of China, Hong Kong, and Taiwan could have a GDP of \$9.8 trillion, a little bigger than America’s is projected to be then.⁵⁴ An embryonic middle class is fueling consumption booms across industries. Motorola estimates that China will by 1997 make up half the world market for pagers. Refrigerators, washing machines, and cars are all a part of this boom – by some estimates, Asia (excluding Japan) will account for two-thirds of world increase in car sales this decade.⁵⁵ On top of this (or beneath it) is demand for new infrastructure and public investment. Estimates vary widely, but it is almost certain that Asia will spend several trillion dollars on capital investment and infrastructure in the next decade. Electrical generating capacity, roads, telephones, airports, and so on will all be built in staggering numbers.

⁵³ Hale, “Is the World Economy Heading for its First Post Cold War Boom?”

⁵⁴ World Bank statistics, quoted in *Economist* 30 October 1993, p. 13.

⁵⁵ Thanks to Ken Courtis, Deutsche Bank, for pointing this out.

A substantial part of this demand will be met from the West. Between 1990 and 1993 US exports to developing countries grew 36% (exports to developed countries grew only 6%). In 1993, 42% of America's total exports (accounting for 3.1% of GDP) went to developing countries; for Japan the numbers were 48% of exports accounting for 4.1% of GDP.⁵⁶ The significance of this trade became clear during the early 1990s downturn in the developed world. Between 1990 and 1993, total imports by developing countries rose by 37% which more than accounts for the total net increase in world imports during that time.⁵⁷ Continuing growth in the developing world (which stayed above 5% during this period) was an important source of locomotive energy pulling the developed countries out of the downturn.

Emerging economies will drive supply side effects as well. New competition at the low to medium end of industrial production creates concern about low-wage job losses in the developed world, without doubt. But the medium-term effects are likely to be beneficial. Competition at the low end should incite factor redeployment, new investment in human and physical capital, and a move "upmarket" by developed countries all of which spurs productivity. At the same time, terms of trade improve as the cost of rich countries' manufactured imports decline.⁵⁸ Obviously, a hard turn toward protection against developing country imports would hamper this. But the political forces that support general protectionism are not decisively strong in most Western states – in the US they lost the battle over NAFTA, over MFN for China, over the WTO. And pressures for broad protection will weaken over time as exporters and others who gain from open trade and developing country growth push their agenda forward.

Investors are an important "other". Emerging economies offer substantially higher returns than developed countries. Between 1989

⁵⁶ Economist 1 Oct 1994 p. 12. These numbers are likely to increase as developing country growth rates continue to outpace developed country rates.

⁵⁷ Developing country exports rose by 22% during this period. Economist 1 Oct. 1994 p. 12.

⁵⁸ Example: 30% of clothing purchased by Americans is now made in the developing world, and average prices have fallen by more than 20% over the last decade.

and 1992, American FDI in Asia rose 120% which was double the rate of increase for the rest of the world. Total FDI inflows to developing countries have risen sharply since 1990 just as FDI inflows to developed countries have fallen – so that while in 1990 developing countries attracted less than one-fifth of world FDI, in 1993 that number had jumped to nearly 45%.⁵⁹ Add to this an explosive growth particularly after 1993 in portfolio investment (that is certain to increase as financial markets in these countries develop and mature), and the result is a strong constituency of developed country investor interests that benefit from growth in what used to be the third world.

Government Policy

Developments in government policy among the G-7 countries in particular should contribute to dampening of the business cycle. With the de facto abolition of capital controls, governments deal with their revenues and outlays in an environment that is less insulated from market pressures. This constrains both fiscal and monetary policy in complex ways, but with a simple yet important consequence. The incentive to inflate away debt must decline as governments face the long term future costs of higher real interest rates that will result. Within the OECD at least, governments with larger budget deficits and higher average rates of inflation are paying higher real interest rates and the evidence suggests that this market sanction is becoming more severe in recent years.⁶⁰ It is no surprise that OECD countries have been reducing their average structural budget deficits in response.⁶¹

Monetary policy shows a similar anti-inflationary bias. Among central banks over the last several years there has evolved a clear, nearly consensual philosophy about the importance of price stability. The "official doctrine" is something like this: do what you can to support activity in the real economy, but do not ignite inflation. The

⁵⁹ *Economist* Sept. 10 1994 p. 128. Source: UNCTAD

⁶⁰ See Adrian Orr, Malcolm Edey, and Michael Kennedy, 1995. "The Determinants of Real Long Term Interest Rates," OECD Working Paper No. 155.

⁶¹ Excluding Japan, average structural budget deficits have declined by 1.8% GDP over the past three years. *Economist* 23 Dec '95 - Jan 5 '96, p. 92.

notion that there is a policy-manipulable Phillips curve in the medium and long term is strongly out of favor among central bankers.

Even for the short term, central banks are taking the position that unemployment is not their concern. When Fed Vice Chairman Alan Blinder suggested rather mildly at the 1994 Jackson Hole meeting that it ought to be otherwise, *The New York Times* described his speech as like "sticking needles in the eyes of central bankers" and Robert J. Samuelson proclaimed that "Blinder lacks the moral or intellectual qualities needed to lead the Fed."⁶² This at a meeting whose theme was the problem of "excess" unemployment in developed economies! Central bankers now agree that the unemployment problem requires boosting skills and productivity as well as increasing flexibility in labor markets so as to make fuller employment less inflationary.⁶³

This signals a broader trend in which governments are increasingly adjusting to economic change by trying to enhance the operation of markets rather than intrude upon or insulate themselves from markets. Transparency is a consistent theme here (for example, the 1995 G-7 specific proposals for the IMF to support "improved and effective surveillance of national economic policies and financial market developments, and fuller disclosure of this information to market participants.")⁶⁴ Also consistent are the information "benchmarks" that matter. The Maastricht criteria for EMU tell an important story about what governments agreed to aim for: budget deficit less than 3% of GDP, debt less than 60% of GDP, inflation within 1.5% of the average of the three EU countries with the lowest rate of inflation, and no currency realignments for two years.

Consequences: IPE with Subdued Business Cycles

An international political economy with subdued business cycles in the core will operate differently than did the post war political

⁶² Keith Bradsher, "Tough-Decision Time for the Federal Reserve," *New York Times* 26 Sept. 1994, p. D1; Robert J. Samuelson, "Economic Amnesia," *Newsweek* 12 Sept 1994, p. 52. Blinder's modest Keynesian point was simply that macro policy could be used under some conditions to reduce unemployment. quoted in Robert Kuttner, "Economic Viewpoint," *Business Week* 26 Sept. 1994 p. 22.

⁶³ See for further reinforcement the G-7 Halifax Summit Final Communiqué, 15-17 June 1995, particularly pages 2, 3, and 8.

⁶⁴ Ibid, p. 3.

economy. I have chosen here four broad areas to consider, within which I see important differences that our understanding of political economy allows us to talk about now. The four are: low inflation political economy, government policy, north-south relations, and the role of international institutions. Although they overlap and interact, I discuss them separately for clarity. The arguments here are not exhaustive of the possibilities, and they are not point predictions or attempts to prognosticate future events. They are selected logical explications of trends that I believe will shape and influence events.

Low Inflation Political Economy

The distributional effects of low inflation will impact heavily on international creditor-debtor relationships. Current debtor countries could find themselves in the worst of all possible worlds, since they are borrowing money on contracts with inflationary expectations still built in and paying an inflation risk premium in a world that will actually have low inflation. Creditors reap that premium as a windfall profit. "Growing out" of debt will become harder. Some developing countries may succeed in doing that, but there will almost certainly be a much larger number of "losers" (moderate growth countries) saddled with increasingly burdensome debt. Certainly many debtors will find default or re-negotiation and re-scheduling of debt to be their principal options. Does this signal the likelihood of another international debt crisis?

Possibly so, but there are countervailing forces at work. Primary among them is the change in the make-up of financial flows from rich to poor parts of the world. The move away from bank lending toward FDI and portfolio investment means that many losses will be absorbed in equity, rather than threatening the viability of money center banks. Thus debt re-scheduling need not have the "systemic crisis" character that it did during at least part of the early 80's experience. Over the medium to longer term, low inflation will itself repair some of the damage that it inflicts in the short term – since as expectations shift, inflation premiums in lending will decline and there will be new access to money for developing countries as risk/return ratios are clarified. Better bank profits in the developed world will continue to reverse the restrictive effects of the early 1990s banking crisis and further stimulate new lending as balance sheets improve. Overall, steady and low inflation rates should improve the

efficiency of capital allocation around the world by removing noise from the calculations, also contributing to the potential for effective lending. All of this is quite salutary, given the new demands on capital from the developing world.

Low inflation will also affect employment issues in the developed world. The industrial states face an unprecedented challenge of structural adjustment to competition from the NECs. "Lost jobs" are now a major political issue in the G-7 states, even if economists disagree about whether it is low-wage NEC workers or technological change (or some combination) which is driving out those jobs. The question becomes, how will developed countries respond?

Protection, which I discuss later as a possible "de-railer" of my story, will certainly be part of the response. But the greater advantage will go to countries that move to sell products to the developing world while buying cheaper inputs from it. This creates stronger incentives to invest in human capital and training that can differentiate further the work force in the developed world from the work force in the developing world (and thereby maintain the productivity bonus that must be in place to compensate for wage differentials). But even with increased human capital investment, there will certainly be some permanent displacement of labor in the developed world and a likely increase in structural, permanent unemployment relative to cyclical unemployment. This could have significant political repercussions if it means a permanent underclass of long term unemployed, and particularly if that underclass overlaps strongly with racial or ethnic divisions. The implications for societies that view themselves as modern democracies with equal opportunity are troubling, but no one has yet devised a cogent strategy to deal constructively with this issue.

One strategy that some states might find politically alluring is currency devaluation for competitiveness. The logic is simple: in a low inflation but relatively high unemployment world, devaluation makes exports more attractive abroad, raises the price of imports, and thus save jobs at home.⁶⁵ Since many states are similarly tempted,

⁶⁵ In a floating exchange rate system, states do not devalue their currencies per se but they can take steps that induce currency devaluation by the markets, for similar effect. I believe that the US has pursued some variant of this strategy over the last decade or so; others would disagree and say that the value of the dollar reflects market assessments and the

the stage is set for a competitive race to devalue. This downward spiral logic (which would end with no competitiveness gains but only increased inflation) could apply anywhere in the world. G-7 states will want to avoid the possibility of getting themselves into this viscous circle. One way to do that would be to agree a currency scheme, either formal or informal, for dirty or managed floats, targets zones.... perhaps even fixed exchange rates? (I return to this point later).

Within the EU incentives to avoid the downward spiral are even greater, because competitive devaluation would be particularly damaging in Europe. The reasoning is straightforward. Devaluation boosts competitiveness in part by causing a real pay cut for domestic workers, who following devaluation have to pay a higher price for imported goods. If workers demand and receive higher wages that fully compensate, then the competitiveness gain is lost and what remains is inflation. In Europe, workers are likely to demand increased wages quickly because a relatively high percentage of what they buy is imported – hence devaluation raises their costs of living visibly and fast.⁶⁶ European workers are also more likely to receive some of their pay demands, as real wages are far less flexible downward in part due to more effective labor unions. Competitive devaluation within the EU would turn out relatively quickly to be futile, and the political tensions that would undoubtedly accompany it might place at risk the achievements of the single market – along the lines of the French response to British "social dumping" when Hoover Vacuum took French jobs offshore. These particularly intense downside risks in Europe create additional incentives for the EU to move toward fixed currencies or a single currency *sooner* rather than later.

Government Policy

I consider here two areas of impact on government policy in the developed world. Governments will find fiscal policies (particularly deficit financing) and exchange rate policies more tightly constrained

continuing twin deficit problems of America.

⁶⁶ This is less true in America where imports account for only 12% of GDP, whereas in Germany imports are 30% of GDP; in some smaller EU states close to 50%. 1994 statistics from International Monetary Fund, *International Financial Statistics* June 1995.

in a world with subdued business cycles.

Low inflation in principle should affect governments similarly to how it affects other borrowers. But governments have had various ways of dodging fiscal discipline. Markets price government debt under conditions of great uncertainty about the "real" fiscal position of states. One reason is that government deficits are broken down analytically into two components – a structural component and a cyclical component. Adjusting government deficit measures for the business cycle is a little bit like adjusting employment or sales statistics for "seasonal variation" – only much harder.

The cyclical component of a deficit is supposed to reflect changes in spending that governments do in conjunction with business cycles. This includes so-called automatic stabilizers – changes in tax revenue, unemployment outlays, etc. that happen directly through phases of the business cycle. It also includes discretionary spending that is responsive to cycles: infrastructure contracts, public sector wages, industrial subsidies, and the like. The structural component of the deficit is (at least conceptually) the "built-in" overspending that would still be in place after cyclical components were removed. In practice, it has been very hard to determine what the structural components of the deficit add up to, mainly because calculating the cyclical components is hard and made harder by country-to-country variance in accounting procedures, characteristics of automatic stabilizers, and so on. This leads to uncertainty about structural deficits and the real, long term, fiscal position of states. Uncertainty makes debt harder to price and leads to the misallocation of resources by markets.

But the inherent cyclicity of government spending will decline as business cycles dampen. This will clarify the real fiscal position of states, both for the markets and for government decision makers (as well as for voters). A number of interesting effects are possible. As automatic stabilizers diminish in importance, governments will have more room to use discretionary stabilizers in a prudent and effective manner. Government agencies should find it easier to project revenues and expenditures. At one level this is helpful since planning will be made easier. At another level, it complicates governments' ability to hide behind excuses about "cyclical" deficits that would supposedly correct themselves when "the recession ends". Politicians will be challenged to defend budget proposals that incorporate widely

varying assumptions about growth rates, inflation, tax revenues, etc.⁶⁷ Governments (and voters) will know better where state finances actually stand. So will markets, and that knowledge will improve the pricing of government debt. This kind of transparency in turn will yield increased pressure to reduce deficits. It is likely that pressure will fall particularly hard on developed countries with particularly high debt to GDP ratios – such as Sweden, Italy, and Belgium.⁶⁸ If I am right here, then the Maastricht convergence criteria (particularly the 60% debt/GDP limit) *reflect* just as much as they *drive* the need for tighter fiscal policy.

Exchange rate policies will also be subject to additional constraints. I differ here with the common wisdom, which generally sees floating exchange rates as the nearly certain future of international monetary matters and rejects as almost inconceivable the notion of a new arrangement to fix exchange rates among the advanced industrial countries.⁶⁹ I differ also with the thrust of Jeff Frieden's related argument that exchange rate politics will become more contentious in a world with capital mobility.⁷⁰ Both arguments identify important factors and neither is wrong. But there are strong countervailing forces that will push in the other direction, making exchange rate politics less contentious than Frieden expects and the move to some kind of fixed or nearly-fixed rate system more likely than the common wisdom allows.

The incentives states have to fix rates are familiar. Fixed rates reduce transaction costs for international trade and finance; the more interdependent states are in trade and finance the more important the effect. Export-oriented producers of tradable goods gain from

⁶⁷ A classic trick of "deficit cutters" has been to draw up budgets with rosy assumptions about inflation, unemployment, growth, tax revenues, etc.... assumptions which are then attacked as unrealistic by the other political forces.

⁶⁸ Each has debt/GDP ratios over 100%.

⁶⁹ This argument is supported in the political science literature by a broad reading of hegemonic stability theory -- which implies that monetary cooperation (and particularly the very high level of cooperation that would be necessary to create and sustain a new fixed rate system) is less likely in a world without a hegemon. I am using the term "fixed rates" here as a shorthand; target zones or some similar kind of semi-fixed system, managed or dirty float, etc. would fit my argument.

⁷⁰ Jeffrey Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," International Organization 45, Fall 1991. pp. 425 - 51.

fixed rates, as do investors in international bank and bond lending and portfolio investment. Fixed rates have the additional attraction of avoiding the temptations for competitive devaluation that I discussed above. These incentives are all in place.

The argument really turns, however, on the strength of the *disincentives* – the reasons why states shun fixed rates. In a world with capital mobility, the major trade-off with exchange rate stability is monetary policy autonomy. As the EU found out so vividly in its 92-93 currency crises, states cannot have capital mobility, fixed exchange rates, and autonomous monetary policy all at once. The standard argument is that (since capital mobility is generally agreed to be here to stay) states choose autonomous monetary policy and give up exchange rate stability as the necessary cost. But will this choice be quite so clear as business cycles dampen?

Perhaps not. In a world with dampened business cycles monetary policy autonomy could become much less important. The current consensus among central bankers may already reflect some of this effect, since if cycles were making increasingly strong demands on monetary authorities to compensate with the kinds of aggressive policies more familiar in the 1980s it is certain that the consensus would be under strong attack. With dampened business cycles states will have less need for monetary policy autonomy under regular circumstances. Surely there will still be unexpected and exogenous shocks that call for changes in monetary policy. The question then becomes, could necessary adjustments be coordinated successfully within the fixed rate system? There are many reasons to think it would be hard, and many of those reasons would still be operating in a world with dampened business cycles.⁷¹ But there is a significant countervailing force. Cooperation would be easier because the need of one country to change rates would be easier for others to see, evaluate, and understand – primarily because of a higher signal to noise ratio in economic data. I am not saying that cooperation would be easy or that it would happen, but only this: the possibility of agreement to fix exchange rates becomes significantly higher in a world with subdued business cycles.

⁷¹ Ibid, pp. 449 - 451; also Martin Feldstein ed., International Policy Coordination, Chicago: University of Chicago Press, 1988.

North-South Relations

A central question in the political economy of North-South relations is whether the progressive liberalization of developing economies over the last decade or more (which has been a crucial driver of rapid development in the South) will continue. Without necessarily agreeing on the underlying causes of liberalization, it is possible to list a set of conditions that are probably necessary for it to be sustained. These include continued global growth, open markets for trade, stable and substantial capital flows, technology diffusion, and progress on management of environmental problems.⁷² Dampening of the business cycle in the core should contribute positively to at least some of these conditions.

The argument here is simply that continued progress in the South depends heavily upon the scope and speed of adjustment in the North. The economic challenge from the new exporters of the 1990s dwarfs the previous decades' challenge posed by the NICs. South Korea, Taiwan, Hong Kong, Singapore are small countries. In 1965 they had 1/20th of the OECD's population and made up 1/2% of world production and 1.5% of world exports. Twenty years later the NICs had increased their share in world production 5 times and exports almost 6 times. But the absolute numbers remained small – 2.5% of world production and 8.5% of world exports. Contrast this with the new exporters – China, Indonesia, Malaysia, Thailand, Vietnam – which together make up almost a third of the world's population, double that of the OECD. Today they account for about 4% of world industrial production and 5% of exports. But if their growth continues, those numbers could rise to much higher levels than was conceivable for the tiny NICs. The challenge is happening fast, with growth rates in China still hovering around 10%, while Indonesia and Vietnam approach a take-off point (along, perhaps, with the Philippines and India?).

Adjustment to economic change of this magnitude cannot be easy under any circumstances. But there are a number of reasons to think it would be somewhat easier with subdued business cycles. The

⁷² Obviously these are not sufficient conditions. See, for example, UNIDO, *Industry and Development, Global Report 1985*, Vienna: UNIDO, 1985, p. 5.

argument is that moderate growth provides a more auspicious environment for adjustment than does boom and bust (even if the trend line were the same). The main issue for the North is redeployment of capital and human resources. This requires training, education, research and development, and investment. Steady growth with low inflation should facilitate stable expenditures on each and longer term planning by businesses, individuals, and governments. Deep downturns, on the other hand, transfer votes and power to protectionist forces. If there are no deep downturns, protectionist forces can be more easily kept at bay, bought off, re-directed, and conciliated. With steady growth, it becomes possible to foresee progressive (albeit gradual) opening of markets and a more constant companion flow of ideas and technology between north and south. Just as important would be the relative stability of FDI and portfolio investment flows to accompany (and partially drive) the continued growth of stock and bond markets in the developing world.

Immigration remains a potential problem of increasing political significance in the North. Clearly, immigrants are less welcome in stagnant economies and are more likely to be accepted (or even coveted) during periods of growth. How would subdued business cycles change this dynamic? The challenge is severe in any scenario. Developing countries contain around 80% of the world's current population. Since birth rates are stable in the US and declining in much of the rest of the developed world, demographers project that almost all net growth in world labor supply over the next 30 years will take place in developing countries. In an open world economy, capital and labor seek each other out. Two things can happen: either large scale migration of labor from South to North, or outflows of capital from North to South. Immigration (with all its attendant problems) is more likely when capital outflow is low, particularly when it is restricted by factors on both sides. Many of the barriers on the recipients' side have come down. As capital markets deepen in the South, bank lending, FDI, portfolio investment, and so on from the North will be facilitated. Dampening of business cycles should flatten out some of the boom-bust character of capital flows (particularly portfolio money) and promote a more regular and predictable transfer of investment to new productive capacity. The stark truth is that most political forces on both sides of the North-South divide prefer capital flows to immigration, so this "solution" is

likely to grow and immigration could actually become less not more of a problem in the future.

International Institutions

Dampening of the business cycle will affect the roles that international financial institutions play in the world economy. The World Bank and the IMF, for example, may find themselves going "back to the future" and performing functions closer to their original founding ideas.⁷³ Interestingly, recent proposals from the 1995 Halifax G-7 summit track some of these points.

Private flows of capital and information will be facilitated by the changes I have discussed but will retain imperfections. There will likely be more "Mexico 94"-type crises where cascading short term expectations destabilize capital flows.⁷⁴ Such panics should become less likely with subdued business cycles but if they happen nonetheless institutions could usefully provide a second line defense of stabilization through insurance schemes and containment mechanisms. At Halifax, the G-7 made moves in this direction, proposing that the IMF establish a new "Emergency Financing Mechanism" – which would provide faster access to Fund arrangements with strong conditionality and larger upfront disbursements, and asking some members to contribute toward doubling the funds of the General Agreement to Borrow in support of this function.⁷⁵

Institutions will also have added incentives to help states in improving transparency. G-7 and OECD countries don't need much help (since they have elaborate monitoring schemes among themselves), and these will become more efficient as business cycles dampen. But for less developed countries, the Bank and Fund are already an important repository of information and could build on that role to become more efficient, reliable, and comprehensive than private credit/risk rating systems. Information improves the efficiency of markets but also works as an early warning system for potential difficulties. Again, Halifax made very positive suggestions on this

⁷³ For brevity I consider only these two, as examples.

⁷⁴ It is possible to say this about proximate causes without passing judgment on the underlying causes of the crisis, and I intend no such judgment here.

⁷⁵ G-7 Halifax Summit, Final Communiqué, US Department of State, 17 June 1995.

score, urging the IMF to "establish benchmarks for the timely publication of key economic and financial data... establish a procedure for the regular public identification of countries which comply ... [and] insist on full and timely reporting by member countries of standard sets of data" – a proposal to which a number of states have now agreed.⁷⁶

The IMF, established originally as a coordinating club for the Bretton Woods fixed-but-adjustable exchange rate system, is the obvious candidate to manage and provide technical support for any new fixed or semi-fixed exchange rate regime set up among the major world currencies. Its role would be primarily surveillance and information provider, as well as a forum for negotiating changes in rates or target zones.⁷⁷ It is almost inconceivable given the extent of private capital markets that any major countries would turn to the IMF for balance of payments support, so that function (as well as the conditionality that attaches to stand-by agreements) would stay specific to the less developed countries and would continue to overlap with Bank activities. The most likely division of labor here would keep the Bank in the business of facilitating longer term developmental goals, with the IMF refocusing itself on short term response to shocks (oil-prices, commodity prices, etc.).

Even in a world with sophisticated and deep capital markets there will still be a role for development lending through international institutions. But it is unlikely that the Bank can continue to lend as it has principally to governments or government guaranteed projects in less developed countries. An updated rationale would portray World Bank funds as sparking and facilitating private investment through signaling, insurance schemes, subsidies and guarantees, and so on, for projects that private money might miss or sidestep. This would be an explicit way of subsidizing poorer countries for the purpose of easing their economies into global capital markets. Under a similar rationale, the Bank could also play a part in the restructuring of debt that I argued above will be a short-to-medium term consequence of dampened business cycles. These

⁷⁶ G-7 Halifax Summit, Final Communiqué, US Department of State, 17 June 1995.

⁷⁷ I suggest the IMF here because although the countries involved would be primarily the G-7, that group does not have the institutional infrastructure and technical expertise that reside in the IMF.

suggest very large changes in Bank corporate culture, organization, and strategic thinking – changes that are immensely difficult but not impossible in an environment where the bank's most powerful state "underwriters" are demanding change, and increasingly with a consensus voice.⁷⁸

Conclusion

I see three prominent issues that could change dramatically the central arguments of this paper.⁷⁹ The unemployment effect in the core; production blockades; and security problems are sources of possible shocks now foreseeable that could challenge the scenario I've laid out. here. I comment on each issue briefly.

"Adjustment unemployment" in the developed world will continue to generate pressures for trade protection, restrictions on immigration, and similar measures. These pressures will almost certainly get worse before they get better. Neither declining real wages for the working class nor extensive long term unemployment is politically sustainable for long in modern democratic societies. The upside is that much of what needs to be done here – at least in terms of setting incentives – to encourage investment, re-tooling, and re-training is within reach of government policy.

Clearly, developed country governments need to do more to address the fears and the real consequences of unemployment at the low-skill end. The US now invests a pitiful 0.05% of GDP in labor programs and training (compared to 0.25% GDP in Germany and 0.22% in UK). The auspicious signs here include the G-7's new focus on this problem, symbolized by the jobs summit held in Detroit in 1995. The Clinton administration's emphasis on "economic security" could lead to policy initiatives (particularly in the wake of failed health care reform) that focus on other labor market measures (like education and training) that contribute more directly to productivity.

⁷⁸ The European Bank for Reconstruction and Development (EBRD) provides an interesting example of an updated rationale for development lending.. See Steven Weber, "Origins of European Bank for Reconstruction and Development", International Organization 48 pp. 1-38; and the Halifax Summit Communiqué, particularly page 5, where proposals for the Bretton Woods Institutions reflect new approaches to lending that were pioneered by EBRD.

⁷⁹ Obviously this is not a comprehensive list.

It is unfortunate that there was no single post Cold War conference to dramatize the importance of this challenge, but there have been a series of smaller successes – from the Maastricht treaty to the conclusion of the Uruguay Round to the passage of NAFTA. Leadership, particularly in the US and France, will be an important factor in how quickly and with how much strife this issue is managed. Leadership is inherently unpredictable, but the structural forces driving adjustment are not and they are getting stronger. A decisive shift toward policies of protection seems unlikely in this environment, but it is not impossible.

"Production blockades" will certainly arise in both the developed and the developing world; the question is, will they be severe enough to de-rail continued growth. Capital shortages, a common concern a few years ago, now seem unlikely. Capital markets are growing as or more quickly than demand for capital, and new calculations show that Asia could very well finance much of its growth through savings. Energy shortages are possible. An oil price shock that lasted for more than a short time would be a serious problem. But that seems increasingly unlikely given the state of the market and the improving political situation in the Middle East. A moderate, gradual, appropriate rise in energy prices reflecting increased demand (particularly in Asia) would be manageable, and arguably even good for a number of other reasons – including the environment. It is the environment which seems most likely to throw up unforeseen production blockades, and possibly on a scale large enough to derail my argument. Although no sign of environmental disaster on that scale looms, the possibility cannot be dismissed.

Finally, "security problems" have the potential to wreak havoc with any scenario of the international political economy. The question really is one of magnitude. The border disputes and aggravated civil wars that have so far been the stuff of post-Cold War security seem unlikely to spread (geographically, or in political repercussions) so as to threaten the basic processes I have outlined in this paper. The larger and more dangerous issues remain abstract.

The next decade will witness dramatic changes in the location of economic power around the world. As in previous eras, race, religion, and ideology are overlaid on top of shifting wealth. I have not addressed in any detail here the potential consequences for major international conflict; it is too soon to do that satisfactorily. Some

questions, however, are clear. Cooperation among the G-7 on a range of issues, which I find more likely in a world with diminished business cycles, is important – but is it sufficient and decisive? China, Russia, and similarly unstable situations lurk in the background and will likely provide at least a dose of nervous uncertainty. As still-developing countries, however, their prospects for stabilization should improve just as other "Southern" countries benefit from a world with dampened business cycles in the core.

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BOOK REVIEW ARTICLE

**The "Warp-Speed" Transformation of the World Economy:
A Discussion of Ten (of the Many) Recent Books**

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Government commission reports in the United States often seek to capture public attention by opening with dramatic and highly exaggerated warnings. I am aware that I am about to start this article in much the same "alarmist" tone. If there were a way to understate what I am about to discuss and yet relate accurately to it, I would do it.

The point will be that at the close of the twentieth century we live in the period of the most rapid scientific and economic – and, therefore, we must understand, social, political, ideological and institutional – change in human history. Change is taking place on a scale heretofore unimaginable and is accelerating at what science fiction calls "warp speed."

This is change full of the most astonishing promise, with goods and services soon to become available of a type and on a scale never before dreamed of. The hopeful implications of the promise are by themselves enormous. Bill Gates' book, one of those reviewed here, shows a whole new world of possibility. Simultaneously, however, the change is chewing up and spitting out much that is central to the lives of individuals and of peoples as they now exist. Despite much anxiety about layoffs and "downsizing," Americans have just begun to feel its effects.

This radical change marks a sharply accelerated advance of a process underway for centuries. With the Industrial Revolution, hundreds of millions of people worldwide migrated from agriculture into industry (without, by the way, any slackening of the increase in agricultural productivity). As recently as the past half-century, advanced economies have seen a migration from industry (which also has nevertheless continued to grow in productivity) into service occupations. And now science and computerization are quickly