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Economic Globalization and Reform Experiences in Transitional Countries

Manuskript eines Vortrags von Prof. Dr. Wolf Schäfer, Präsident der Hanse Universität Rostock, anlässlich der internationalen Konferenz "30 Jahre Reform in China: Rückblick und Perspektiven", die am 17. und 18. November 2007 in Haikou, Provinz Hainan, stattfand.

1. Globalization: Irreversible and wealth increasing

Globalization is a world-wide irreversible phenomenon. It represents a development of an increasing international interdependence of economic activities and thus creating market economies. Because of the simultaneously intensifying international competitive forces markets become increasingly contestable. National patterns of economic reasoning are more and more substituted by global dimensions. In general terms, globalization is nothing else than a development towards removing protectionism, i. e., the elimination of obstacles to the free movement of people, trade in goods and services, and of capital and knowledge.

Though there are winners and losers in the short run globalization is generally wealth increasing. This is because a world of free trade enables specialization of every country, every location, and every firm in line with the patterns of comparative advantages. This increases the world production of wealth.

What are the driving forces behind globalization? Besides others, two basic forces should be emphasized: First, there is a secular trend of reducing the costs of overcoming geographic distance and time by technical progress which has been enforced especially in the last three or four decades. The reduction of transaction costs is especially evident in telecommunication, satellite using, and information processing. The second driving force of globalization is the world-wide movement to reduce transaction costs of overcoming the national borders of the countries , e. g., to abolish tariff and non-tariff barriers to trade.

This driving force is prominently represented by WTO and its underlying free trade philosophy. And of course, the expansion of regional integration areas such as the European Union, Nafta, Mercosur, Asean etc. should be mentioned here as regional backing forces of the globalization process.

And let me add that the fall of the Berlin wall with the following integration process of the former communist Central and Eastern European countries into the political and economic system of the European Union countries has been part of the driving and pushing forces of globalization.

2. The New Systems Competition

Globalization implies global locational competition which is, synonymously speaking, systems competition, regulations competition, governments competition. All this means that locations or countries with their immobile factors compete for the internationally mobile factors from all over the world.

Countries and locations, therefore, have to make themselves attractive enough or even more attractive than other countries to stimulate the internationally mobile factors like, e. g., financial or high powered human

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capital to complementarily link to the internal immobile factors like, e. g., infrastructure, local services, legislation, political system, ethics and morals of the people and rulers as well as other formal and informal institutions which represent the special shaping of a location, of a country, of a jurisdiction.

In this context, governments competition is focused on the fact that governments are put in international competition with their regulations and institutional arrangements which they put into force versus other arrangements in other countries. We call this a world of global monopolistic systems competition.

Apparently, global systems competition is beneficial. Why? Because it implies at least two of the most important functions of competition as such. The first is that competition is the most efficient knowledge increasing discovering force, i. e., the best stimulating instrument to find out new and better future solutions where- and whatsoever which we do not know until now. By competition we increase our knowledge and learn. Thus, systems competition is innovation competition in the field of regulations, of institutional arrangements. This is beneficial for every individual and for every society. That is why societies which protect themselves from outside competition and suppress inside competition will become sklerotic and lose their international competitiveness sooner than later.

This was the most important economic reason of the former breakdown of the Central and Eastern European countries (CEEC). The now running transformation process in these countries is, therefore, heavily shaped by introducing competition as a knowledge increasing vehicle and standing forcefully in international systems competition as regards, e. g., tax competition, wage competition and broad competition in any field. In the European Union which meanwhile nearly every CEEC is a member of, these countries have been blowing fresh wind and new ideas into the Community which whirl up much skleroticism within the EU which tends to jeopardize its own success by shaping Europe more and more into the direction of centralization and harmonization and, thus, suppressing institutional competition between the member states.

The second important function of competition is that it limits monopolistic power in economic and political terms. Thus, systems competition not only limits the power, e. g., of the USA and Russia to dominate the world markets and politics but also the power of Germany, Japan, India and of course the People`s Republic of China to do the same. Systems competition describes a world of strategic games in which rivalry and interdependence of the players prevail.

3. Winners and losers of globalization

Who are the winners and who are the losers of globalization and systems competition? This is a complex question but it generally holds that the more a country is open to the outside competition forces, i. e., the more it forces itself to achieve competitive strength and to get integrated into the international division of labour, the more it profits from globalization by specialization and fragmentation of production chains and networks. Thus, especially those transformation countries have been profiting from globalization which were most protected before opening – despite the somewhat heavy valley of tears which they are or were going through in the context of the so-called J-curve development in which after opening there is in the first instance a significant reduction of GDP going hand in hand with increasing unemployment, decreasing wages and rising inflation, but after a time period of reshaping the economic and institutional structure of the country there is a significant recovery and gain of competitiveness which generates significant growth rates and wealth increases.

It is interesting to observe that from the European perspective the opening of China and India, the most populated countries in the world, more often than not is looked at as a serious threat to the European workers, especially those with low skills. As with China and India almost one half of the world potential of workers is going to be integrated into the world labour market, wages in Europe – and other industrialized countries – are under pressure. And because of too inflexible wages, this pressure will force higher unemployment. This is why the Europeans` view generally evaluates their working force as losers of globalization. (One famous newspaper in Germany even put the question to the public: "Are German wages going to be determined in Peking?")

The Chinese` view should be just the contrary because with the increasing opening of the Chinese economy Chinese workers can integrate their competitive advantages into the international division of labour. This creases higher production, higher wages, and higher wealth in China. And by the way, this is not necessarily at the costs of European labour but could go hand in hand with higher wages and employment also in Europe if the tendency of neoprotectionism is stopped and an economically efficient and deregulating labour market policy is persued which, i. a., implies human capital enrichment. Regrettably, this is somewhat lacking in Germany, France and many other old EU member countries. Therefore, China, India and other takeoff countries seem to be a competitive threat to Europeans whereas, in my view, it should be accepted as a competitive challenge.

4. Globalization and transitional countries

China`s way of transforming its centrally planned system into a market economy could be best understood when contrasted to the experience in the post-communist CEEC with the difficulties of their transformation processes. First of all, it should be clear that there are three areas of reform in any transformation process: the creation of a new institutional framework, macroeconomic stabilization, and on the microeconomic level a real adjustment of firms and

sectors. In the institutional framework, the rules and incentives

of central planning have definitely to be replaced by

institutional arrangements which follow market principles, i. e., that they allow market transactions in the sense that firms decide on their production and their investments autonomously and that households determine their consumption, savings, and labour supply on their own.

A reliable general legal framework is imperative, particularly the law of contract and the law of enterprises. Trustable property rights are essential for long-term effects to be taken into account in economic calculations because they are crucial for the incentives of individuals to do business and for decentralizing economic decisions. And above all, property rights establish an area of decisions in which the individuals can move without being interrupted by government.

Therefore, in the transformation process it is essential for establishing a market economy to decide from which responsibilities the government withdraws for leaving them to the private sector. Finally, a two-tier banking system, in which the responsibilities of monetary policy and intermediation are separated, can be seen as an important aspect of institutional framework. This view should be completed by stressing that informal institutions like corruption and crime are destructive for a sound functioning of a market economy.

On the macro-economic level, the experience of the CEEC`s show that monetary instabilities have definitely to be prevented. One typical problem in the CEEC was the existing excess of money supply which was generated already before the beginning of the transformation process. Mostly, the way was by letting the price level increase to do away with the excess money supply. But inflation is never a sound solution because it generates disturbing effects in the real sphere of an economy, and it leads to devaluation of the currency. In such a situation, a currency reform is needed with a massive currency cut. That is what the CEEC were forced to do, and many countries introduced new currencies to show their independence, e. g., of the former Soviet Union area. Furthermore, a successful institutional design for the monetary sector needs in particular that the central bank is independent and is prohibited to finance government budget deficits.

On the core, any transformation has to be performed on the microeconomic level, i. e., inside the existing firms and by creating new firms. In the CEEC, one could observe that after the state-owned enterprises had been converted into separate legal entities – which is called commercialization – and had been privatized, the real adjustment process then had to take place inside the privatized firms. This is the adjustment pattern that globalization is pressing for in any transformation process.

5. Big bang or gradual adjustment?

In the CEEC there was a broad discussion whether the transformation process should be shaped as a big bang or as a gradual adjustment. From the psychological and political economy aspect, there was much to argue in favour of a big bang approach. In the spirit of the saying: "You cannot cross a gorge with two leaps", there is much truth in stating that after the collapse of their centrally planned economy people were more or less prepared to accept the new challenge and to make sacrifices for it. As an example, real wages in Poland (1990) and the Czech Republic (1991) fell by more than 30 percent within one year. The mood was that the quicker the necessary and painful steps of adjustment were carried out, the quicker the country succeeds to get out of the "valley of tears". One should stress the fact that when the CEEC introduced the new economic system, they simultaneously changed their political system and introduced democratic institutions. No doubt, there is another important argument in favour of the big bang approach: the narrow time window for reform. If the fundamental social consensus for reform loses momentum and acceptance, the government can be replaced. Then, the reform approach may stall or fail.

The alternative approach of a gradual adjustment is in favour of those who argue that the transformation process would turn out to be less painful if the steps of reform were stretched over a longer period of time. But this requires a deep breath for the transformation, particularly a prolonged willingness of people to stand the necessary reform steps. If the willingness to reform is lost in the course of time, the transformation process can stop. The same may hold when a new government comes into power.

The Chinese philosophy of – as it could be defined – "crossing the river by feeling the stones under the feet" was and still is a cautious approach to transformation. China has to go through and solve the same three areas of reform which are mentioned above. However, it proceeded gradually by first opening some coastal provinces in the south of China to the free market and perhaps extending the liberalization to the coastal regions in the North and then eventually to the whole economy. It seems that this approach, in a away, is more successful than that of Russia as the former heart of the Soviet Union.

6. The valley of tears in the CEEC

It is well-known in economics to speak of a so-called J-curve development of a transformation process. By this, the collapse of national output and other linked variables like employment , wages etc is meant which takes place relatively quickly after the beginning of transformation processing. After a certain period of time, however, it will come to a recovery of the economy with an upwards development of national output. A crucial reason for the breakdown in the CEEC was that the capital stock of the transformation countries which was adjusted to the old conditions of a centrally planned economy had become obsolete to the new scarcity relations and real trade-offs. Therefore, the CEEC had to rebuild their capital stock. This process took time and, moreover, involved adjustment costs.

Additionally, the existing human capital had to be integrated into the new factor allocation. Another aspect of the economic breakdown was the institutional vacuum at the beginning of the transformation process which implied uncertainty over the rules for a longer time.

All CEEC experienced this development. Poland, Hungary, the then still unified Czech and Slovak Republic which started the reforms in 1989 had to face a breakdown of roughly 20 percent of their GDP. In Russia where the reform started in 1991, it was even more than 40 percent. In the Baltic countries, especially in Lithuania, the decrease was still stronger. Whereas the breakdown took place in a similar fashion, the Czech Republic, Hungary and Slovakia needed more time to recover than, e. g., Poland. In East Germany, there was a massive breakdown with industrial production falling to one third of the former level. It should be stressed that the voters in the CEEC influenced the transformation process since, as it was pointed out, nearly every CEEC introduced democratic structures.

China did not have a J-curve development like the CEEC: In China was and still is a continuous growth of GDP with real rates of approximately nine percent per year since the beginning of the reforms at the end of the 1970s. Two main reasons could be mentioned. One was the gradual cautious approach with a long breath. Another factor seems to be that China as still a developing country at the beginning of the reforms had only a relatively small capital stock and a weakly developed industrial sector. Thus, it was possible to generate substantial efficiency gains by introducing property rights for land in the rural areas, even though valid for only 30 years and not really unquestionably defined.

Of special interest is the transformation of the Soviet Union because the transformation crisis became particularly apparent in the majority of the successor states of the Soviet Union which as a union of 15 so-called republics dissolved at the end of 1991. The individual states declared themselves independent from the Soviet Union as the political and economic center and pushed through their own laws instead of the rules of the Soviet Union.

This, however, presupposed that each country created its own institutional arrangements including tax systems, security systems as well as introducing a new own currency. Thus, the rouble zone dissolved in 1992 which was accompanied by an almost total collapse of the system of payments between the successor states followed by a significant suffering of the trade relations. As the successor states showed particular and more or less politically determined patterns of specialization within the former Soviet Union but maintained only minor trade relations with the rest of the world, they were severely hit by the breakdown of trade flows among themselves. The necessity to adapt their production structure to the changed trade-off conditions of scarcity and to divert their trade to the world markets is therefore even greater for the successor states of the Soviet Union than for other transformation countries.

7. Globalization: A global claim for market forces

The experiences of the CEEC and other transition countries impressively show that within a globalized world there is for individual states no way to escape from the forces demanding market economy structures. In the short run, protectionism seems to be a successful solution to preserve or even build up economic systems off the international patterns of labour division. But protectionism is like a drug which narcotizes consumers and investors and misleads them with blandishments as regards the long-term needs to restructure the economy in order to get or not to lose international competitiveness. This, by the way, implies that the exchange rate policy of a transition country should go in line with following the market forces. As regards the Chinese Yuan, there is much to say about undervaluation and realignment requirements. Be it as it is, shaping the economy in a globalizing world of wealth production is a really fascinating challenge.