

Dr Jürgen Stark
Vice-President
Deutsche Bundesbank

**The Changing Global Economic Structure:
A View from Europe**

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It is both a pleasure and an honour to speak to you here today. My remarks will focus on the changing global economic structure.

What has changed since the early 1990s? An increasing proportion of economic activity is market-determined. Within a period of only 15 years, major centrally planned economies have turned into market economies and several previously strongly regulated emerging market economies have implemented radical reforms.

All of this has stimulated very strong and ongoing growth dynamics. Consolidated and internationalised competitive conditions have ensued from this process, thus continuously placing adjustment requirements on all economies. This challenge is being accompanied in many, predominantly advanced economies by demographic changes which require additional efforts.

I

Under realistic assumptions the US, but in particular also Asia, will remain the centres of gravity of the global economy in the next years. However, without changes in the conduct of economic policy this would also mean that the existing global current account imbalances would become even more pronounced. This could result in an increasing risk of sudden exchange rate and financial markets movements.

Moreover, enormous challenges add to the vulnerabilities connected with the current global imbalances. The changes in the global economic structures in the wake of globalisation are particularly important:

1. Production processes can be regionally fragmented to a greater extent than ever before.
2. The number of tradable goods has risen sharply – many services have become tradable.
3. The financial markets are closely integrated on a global scale.
4. Economic policies, but also tax systems and regulations, are competing with one another internationally for capital investment and savings.

The number of countries affected by today's globalisation processes is far larger than the number involved in earlier phases. This applies particularly to the involvement of emerging markets and developing countries in the global economic integration processes. The shares which these countries have in the world's goods markets, direct investment flows and portfolio inflows have expanded considerably.

The increasing integration of above all large emerging economies into the global economy means that the volume of world trade and global growth prospects will continue to rise. The so-called BRIC countries – Brazil, Russia, India and China – are arousing particular interest in this respect, with the two large Asian countries - China and India - assuming a prominent role.

While China has established itself as the intra-Asian platform for the production of labour-intensive goods – especially for the US – India's strategy is based on the export of services. However: China and India import a considerable volume of goods from other, in particular, Asian countries and record only small current account deficits.

What obviously differentiates India and China from other Asian emerging economies, but also from Brazil and Russia, is their sheer size. Both countries combine a population of roughly 2 ½ billion, representing more than a third of the world's population. The global economy is therefore confronted with an adjustment process of a special type and magnitude that is significantly larger than those witnessed in the past. The growing range of goods and services from China and India, produced and supplied at low cost, will lead to significant changes in global production patterns, trade and relative prices.

The continuous shift in the global economy's centre of gravity towards Asia with its enormous labour reserves also means that the employment prospects for low-skilled workers but increasingly also

for highly skilled employees in the industrial nations will continue to deteriorate. On the other hand, the development of the as yet inadequate infrastructure in these countries and their rising demand for high-quality industrial goods will offer the industrial countries tremendous export opportunities.

If the countries which today are at the leading edge of the global value-added chain maintain their advantages in the development and production of technology-intensive goods and services, they can but profit from the low-cost products from Asia. It is not absolute but comparative cost advantages which decide the pecking order of economies and regions in the context of the international division of labour.

This adjustment process to the changes in the world economy will vary from country to country and may result in economic and political tensions between the trading partners in these countries. Integration of the large emerging market economies involves the risk of increasing protectionism. Countries which see themselves as losers in the globalisation process will resort to short-term isolation measures that endangers both the progress already made and further progress in the global division of labour.

III

The shift in the global economic focus towards East and South-East Asia also raises the question of economic cooperation within Asia

and its possible political implications – including the shift in the balance of power.

One has to bear in mind that rising regionalism is a global phenomenon because countries – big and small alike – have used this to respond to global challenges and developments. They integrate because they do not want to lose out in the global competition for export markets and foreign direct investments. And because of the dynamics in multilateral trade negotiations, small nations resort to regionalism to enhance their bargaining leverage and to gain some degree of international political influence.

In previous years East-Asian countries, in particular the ASEAN member states, have intensified their cooperation. As a whole, the ASEAN region comprises a market of no less than 500 million people, which is a sizeable entity also for foreign investors. In addition, these countries have distinguished themselves as investment locations with attractive business conditions.

In spite of the dynamic developments in Asian economic cooperation integration along EU lines is rather improbable. This is due partly to the diverging levels of economic performance. Another important aspect is the lack of strong political institutions in Asia.

In fact, the various regional organisations in Asia are much less institutionalised than those in the EU. Their chosen mode of

interaction is intergovernmental. The established bodies have nothing more than an advisory function.

However, there is good reason to assume that regional integration will deepen in Asia. This leads to the interesting question: Who will be the main driving force of this process?

IV

What has to be done in the respective regions to cope with the challenges posed by globalisation? A high degree of adaptability will be needed.

The US, with its flexible economy, comparatively favourable demographics and high degree of penetration of the economy with information and communications technology has every chance of successfully overcoming the challenges described. However, the US current account deficit is a clear indication that there is a need for structural adjustment, too. The necessity to finance net around 5 ½ % of US GDP externally in 2004, has made the United States the biggest “debtor” in the world. This credit-financed “overconsumption” cannot be sustained in the long term, not even by the US. A gradual adjustment process, which includes not only exchange rate changes and internal adjustment but also higher growth rates outside the US, would be desirable.

A crucial requirement if the US current account deficit is to be reduced is that the US national savings must increase. The IMF, the US Federal Reserve and also the G7 are therefore emphatically calling for a consolidation of government budgets.

Despite the progress that Japan has made in removing structural rigidities, there is still a need for reform if it wants to restrengthen its economic role in the region. Structural rigidities in the domestic market and, in particular, the age structure of the Japanese population are restricting its economic potential. This is also a reason why the OECD estimates Japan's annual potential growth at only just over 1%. The situation is compounded by the precarious state of public finances with the government debt level at almost 170% of GDP.

In the case of the emerging economies in East Asia, what matters is not the adjustment of existing structures, but rather the creation of new ones. The Asian countries must overcome the prevailing bilateralism to be able to benefit from the international division of labour more than has been the case thus far. This includes establishing an institutional framework for their regional cooperation.

China's political and economic development will depend largely on how the country deals with its growing internal imbalances, for example, the tensions between urban and rural areas to name just one. In China, the most pressing reform project is the creation of a well-functioning financial system able to channel national savings

towards efficient uses and as an important step towards more exchange rate flexibility. Furthermore, it is necessary to create a social security system for which the state-owned enterprises have hitherto been responsible as well as a framework for a market-oriented fiscal and monetary policy.

V

In Europe the process of structural reforms has to continue. Europe has problems. The most pressing problems include high unemployment, a lack of economic flexibility and an ageing population. However, one should not overlook the fact that more than 10 million jobs have been created since 1997. That is two million more than in the US. There has also been a maturing awareness of the need for reform. Reforms have now been introduced in the labour markets and social security systems. Following the accession of 10 new members to the European Union last year, we now have a large single market which unites the purchasing power of 450 million citizens.

However, in view of its possibilities, the euro area's growth potential is low. The OECD estimates it to be about 2% per year; by comparison, the US growth potential is estimated at over 3%. These growth differentials are to a large extent attributable to different rates of population growth.

Even so, I am optimistic. With increasingly flexible economies, greater efforts in R + D, greater willingness to be innovative and for longer working hours, Europe is on the way to becoming an economically more dynamic region over time. Not to forget: The EU is an extraordinary success in terms of stabilising the continent politically. Despite occasional setbacks, integration has made continuous advances and has culminated in a single currency.

VI

Today, globalisation is by some argued to be much of a triadisation. The process of integration is at its most intense among the three regions that contain most of the world's developed market economies: North America, Western Europe and East Asia. But we should also not forget South America and Africa.

On the one hand, the US and the EU continue to be the “traditional” driving forces of the global economy, accounting for more than half of global trade and investment.

At the same time, the most dynamic growth region is non-Japan Asia.

With globalised markets and increasing competition, the integration of large emerging markets are giving rise to structural adjustments in the global economy.

Forces of globalisation and competitive markets are driving Americans, Europeans and Asians together, not apart. This represents a major challenge since geo-economics and geopolitics are deeply intertwined. To rise to this challenge, a sound international framework must be in place in which all parties involved commit themselves to a multilateral approach. We must not allow the integration of large emerging markets into the global economy to lead to increased protectionism. Its consequences would have to be borne by all parties involved. Instead, we must foster the willingness to make adjustments, as the necessity to do so is evident in all of the world's large economic regions.

VII

This brings me to my concluding remarks in raising questions to which we might not have the appropriate answers yet.

1. With the appearance of new economic players on the international scene the global economic structure is changing. The global economic relevance of Japan, Europe and the US might be affected. What might be the impact on the regional and global balance of power?

One important aspect in this context are the huge internal imbalances in the leading Asian emerging economies. These imbalances may absorb much of the political capacities in

order to contain potential regional and social tensions and conflicts.

2. Thus, the US is most likely – if not for sure – to remain the only economic, political and military power! However, it is desirable that the US in its political choice remains open for international cooperation and multilateralism. Isolationism and unilateralism should not be real political options.
3. What is most likely to change globally are alliances and relationships. New alliances and altering relationships might affect the global role of individual countries.
4. What about Europe? Europe has the potential to become internationally more relevant again, economically and politically. Since the early 1990s Europe has primarily dealt with its domestic problems in a rather inwardlooking attitude:
 - the fall of the Berlin Wall, the fall of the Iron curtain and the political and economic transformation process of the former communist states in central and eastern Europe 1989/90;
 - the preparation for EMU in the second half of the nineties;
 - enlargement by 10 new member states in 2004;
 - the structural reform process starting at the end of the nineties.

The future international role of the EU will depend on the speed and the results of the adjustment and reform process. To deepen

political integration and to have a vision about Europe's future role are key.