New Economics

Speech delivered by Drs. A. Romero, Executive director, at the meeting of Lions Club of Curacao October 14, 1999

Today, I would like to introduce you briefly to an increasingly common concept in economic theory. It is called: ‘New Economics’. This theory is being adopted by more and more successful countries around the world as a way to renovate their economic and financial processes.

In keeping up with the many publications in the field of economics, one is repeatedly confronted with the ‘New Economics’ as an approach for addressing financial and economic crises around the world.

International organizations, such as the International Monetary Fund (IMF), the World Bank, and the Bank of International Settlements (BIS), are using the success stories of this new thinking in economic theory to structure troubled countries and restore failing financial and economic systems.

During my presentation today, I will do several things. First, I will give you some perspectives on the concept of "New Economics". Second, I will use the examples of the United States and Dutch economies to show how these countries have adapted and changed the way they organize their production processes in a rapid and successful manner. Third, I will discuss the cases of Ecuador and Japan, where various institutional weaknesses have led to sluggish change which has resulted in major economic and financial problems. Finally, my ultimate purpose is to show you that countries can implement change in many ways. Some countries act with purpose and direction; others drift. Some countries are quick at seizing new opportunities; others watch these opportunities slip by. Clearly, change is a free choice — the choice to become an outstanding success or a dismal failure.

Introduction

This concept of "New Economics" is gaining in popularity as major changes are taking place in the global markets. These changes are being propelled by important globalization trends resulting in low-cost, market opportunities and trade relations between major economic blocs.

In fact, technological changes and the use of computers are intensifying international trade and competition between economic blocs. The larger markets for products and services result in growing productivity and lower costs.

Similarly, as we enter the third millennium, governments’ role in economic and social life is becoming less pronounced than in the 60s and 70s and individual responsibility for one’s own welfare is being embraced. The concept that the government should take care of its citizens from the moment of their birth until their death — or what Nobel Price winner for Economics, Professor Milton Friedman, called "a system that would safeguard the people from cradle to grave" — has now become part of traditional economic theory.

This is because of the financial burden and distress that a big government causes to certain groups in a community and the resulting high tax burden that all economic agents have to bear in the long run which obviously poses a dilemma.
Besides, privatization and corporization are new challenges governments face when dealing with non-financeable activities in the public sector.

Through these processes, the governments should focus on their core tasks and shift away from all other activities that can be accomplished better and more productively through the private sector.

These trends have been important solutions to governments seeking ways to reduce their participation in the economic production and income-generating process.

These developments and new views on organizing production processes have resulted in major shifts in economic thinking. In turn, these shifts have led to other ways to manage economic and financial affairs, allocate resources optimally, stimulate productivity gains, reduce production costs, enhance the time needed to receive information to conduct business, and finally temper inflationary and wage pressures.

Economic markets for goods, services and labor have become flexible in the sense that rapid changes in the availability of products, services, and production factors have triggered rapid adaptation in prices and the organization of the production process in many countries. These are all welcome results of a competitive global environment.

On one hand, these new challenges have shown us excellent examples of major success stories in the world economies of the United States and some European countries. On the other hand, failure to embrace these changes and resistance to adapt the new economic system have produced crises and disasters around the world in economies that until recently were seen as perfect examples of sound management of their countries' economic and financial affairs. The Asian crises in the former economic tigers is a good example of this.

The "New Economics" in the US and the Netherlands
The concept of "New Economics" was first used and introduced in the United States. How do we define and characterize the "New Economics" theory?

The easiest way to define this concept is to compare it with traditional economic theory and particularly the view of economists who support the "business cycle theory" that was introduced by the British economist Keynes. According to the business cycle theory, economic development passes through stages of expansion and growth — tight labor market combined with high wages, followed by a recession coupled with high unemployment.

According to the advocates of the 'New Economics' theory, economic cycles cease to exist, and one observes only times of consistent economic growth controlled with inflation and moderate interest rates.

The United States success story is a case in point
As you know, the United States economy is now experiencing the longest economic expansion of this century. This expansion started in 1991, over 100 months ago. The first signs of the effect of this expansion is the consolidation of the country's fiscal position. For the year 2000, the federal government in the United States is expecting a budget surplus of 142 billion US dollars. For the fiscal year that ended on October 1, 1999, the budget surplus in the United States was approximately 99 billion US dollars, the single largest recorded surplus since 1951.

The U.S. President, Mr. Clinton's economic advisors have calculated that with a continuation of the current economic bonanza in the country, a low inflation rate and a low interest rate, the US public debt of approximately 5600 billion US dollars will be completely repaid by the year 2015.

The jobless rate currently stands at 4.5%. Job growth has been healthy in all sectors except for the manufacturing sector, which was affected by weak exports. The annual productivity growth of 1.3% has restrained inflationary pressures in the last few months.

The major factor behind this consistent economic growth in the United States is the increasing use of information technology in the private sector, which results in growing productivity gains, healthy employment in all sectors, low costs, and moderate inflation and interest rates.

Furthermore, during this period of economic expansion, the stock markets will record higher and explosive market index prices and gains to the consumer in the form of wealth accumulation and earnings ratios for securities.

The ensuing welfare effects of the rising security market will spur consumer demand for goods and services.
The second success story is the case of the Netherlands, which I assume is well known to most of you here because of the intense economic relations between our country and the Netherlands.

The model of the "New Economics" in the Netherlands is now well-known around the world and in Europe as the 'polder model'. This 'polder model' came about in the 90s, but the groundwork for the economic success started in the 80s when the economy of the Netherlands was suffering from the 'Dutch disease'.

Important elements that triggered these changes were the flexibilization of the labor market, stimulation of the exports, outward-looking policies to promote exports and sell product and services abroad, and reduction of government involvement in the economic process.

In the second quarter of 1999, the Dutch economy recorded an economic growth of 3.2%, its thirteenth consecutive quarter of expansion of over 3.0%. Consumer spending of over 3.7% and exports of 3.5% have been the engine behind this extraordinary growth. The Dutch confidence index for consumers and producers is high while the unemployment rate is dropping, recently reaching 3.4 % in contrast to the average unemployment rate of 10.2% in the 11 countries of the EURO.

The Dutch inflation rate at the end of the second quarter of 1999 reached 2.1%, while inflation in the EURO area was 0.9%. The interest rate on the 10-year Dutch government bonds, an indicator of the long-term interest rates, was on average 5.48%. This is still significantly below the rates that, for instance, our own government is borrowing today.

According to calculations of the Netherlands' Central Planning Bureau of the Netherlands (CPB), the budget deficit in the country will reach a negligible 0.2% in 2000, and turn into a surplus in the year 2001.

This budget surplus is the first for the Netherlands since 1973. With this surplus, the Dutch government will save approximately 1.5 billion Dutch guilders on public debt servicing. The public debt ratio[1)] which was 75.3% in 1996, has been dropping dramatically and will reach 64.3% by the end of 1999.

For the year 2000, the Central Planning Bureau expects a further reduction in the public debt ratio to 61.6%. It has taken the Dutch 26 years to reach these goals, a process that has entailed enormous sacrifices from the Dutch people during the five cabinets of former Prime Ministers Lubbers and Kok.

Even though Dutch Prime Minister Kok came originally from the labor union, he has become well-known in the Netherlands as the Minister of Finance who became engaged in the most extraordinary process of public-sector reduction through public-expenditure savings.

The remarkable performance of both the US and Dutch economies has been centered around the common wisdom that the keys to long-term success are a flexible labor market, opening of markets to foreign competition, reduction of the public sector presence in economic life, and tight monetary policy aimed at controlling inflation.

As I have indicated, the economic booms in the United States and the Netherlands have not taken place overnight. In fact decades have been required for reduction in public expenditures.

Moreover, much attention has been given to enhancing productivity through the implementation of technological advances and focusing on a redistribution of labor through flexible working hours and payments.

These good economic outcomes reflect years of diligent work by the United States and the Netherlands government and are perfect examples of how political authorities can manage their own economic and financial affairs.

The Cases of Japan and Ecuador

I will turn now to Japan and Ecuador. Since the beginning of 1999, the economy of Ecuador has tumbled into a deep crisis. This crisis was caused by a combination of factors.

The first signs of trouble appeared with the devaluation of the Ecuadorian 'Sucre' by 45.0 % to 14,575 per dollar from 6.780 per dollar on the first day of this year. Subsequent to this devaluation inflation in the country rocketed to 50.0%.

The second factor that contributed to the crisis in Ecuador was inundation that caused over 2.5 billion US dollars in damages to the infrastructure and transportation sector.

The third factor was the sudden drop in oil prices to almost 9 dollars during most of the year [2)] . Because the Ecuadorian economy is heavily dependent on oil exports, this drop in prices has aggravated the country's economic problems.

The fourth and last contributing factor is the political turmoil in the country. The opposition is dominating the Parliament, and the President of Ecuador Mr. Mahuad, has not succeeded in making a major overhaul in the budget of the country. The result has been increasing budget deficits in only a few months to 4.0% of the country's GDP.

Furthermore, the key economic indicators of Ecuador show that the debt has reached 16.3 billion US dollars, or 112.0% of GDP (15.5 billion US dollars). For comparison purposes I refer to the Argentinean economy, which also is facing serious economic problems. Argentina's public debt ratio is only 40.0%.

I also want to emphasize that one of the big problems currently facing Ecuador is that the country has failed to meet the interest payments on its debt of 94,0 billion US dollars on Brady bonds. These Brady bonds were introduced in the 1980s by Mr. Brady (US Treasury Secretary) to help resolve the Latin American debt crises, and they bear the guarantee of the US government.

Another interesting case is the Japanese economy.

The Japanese economy is still struggling following the collapse of its asset price bubble in the late 1980s. Following that collapse, financial institutions were left with huge portfolios of nonperforming loans. The loss of wealth and confidence following the collapse suppress growth, which ranged between 0.3% and 1.4% from 1992 to 1995. The economy looked as if it had turned the corner in 1996 with growth picking up to 4.1% in response to fiscal and monetary stimulus; however, the rapid growth was short-lived.

In 1997, the Japanese government embarked on a program to reduce the country's fiscal deficit, which had ballooned under the fiscal pump of the previous years. A rise in consumption and income taxes in April 1, 1997, sent the economy plunging at an annual rate of 10.6% in the second quarter of 1997.

The government's approach to the collapse of the asset price bubble was to protect and prop up financial institutions so that they could reduce their problem loans. Consequently, after nine years, the financial sector has lost the confidence of both the Japanese people and the market because the lack of transparency means that the strong institutions cannot be differentiated from the weak.

The planned 'Big Bang' financial sector reforms and Prompt Corrective Action (PCA) measures, which were implemented on April 1, 1998, were aimed at increasing competition, making the accounting system more transparent, making capital requirements more stringent, and strengthening supervision.

There also are also concerns that the turmoil in Asia could precipitate a Japanese financial sector meltdown, seriously undermining confidence in the Japanese economy.

The Japanese Ministry of Finance recently revised its estimate of the financial sector nonperforming loans from 27 trillion Yen (250.9 billion US dollars) to 77 trillion Yen (715.6 billion US dollars).

The Asian crises have further deteriorated the financial sector balance sheets. The most direct negative impact would result if the Japanese financial institutions are unable to recover the money they have lent to companies in East Asia — about 3.4% of their loan portfolio.

We can envision several situations in which the Japanese economy would experience a deeper recession marked by a further decline in the GDP. These include:

- a further deterioration in Asian growth prospects accompanied by currency devaluation's;
- a flare up of US protectionism; and
- a failure of the Japanese government and the Bank of Japan to stabilize the crisis in the Japanese financial sector.

The fragile state of the Japanese economy leaves it vulnerable to external shocks. A worsening of the situation in Asia or a flare up in US protectionism would depress Japanese net exports, the mainstay of its current sluggish growth, pushing the economy into a pronounced recession.

A further deterioration in Asia also might precipitate a string of collapses in the financial sector. Although consumer savings would be little affected by a shakeout in the financial sector because the government promised to protect deposit holders and insurance policyholders, shareholders would lose their investment and a marked rise in unemployment would lead to drops in income and, hence, consumer spending.

Finally, there is a risk that conditions in the Japanese financial sector are worse that we currently believe and that the Japanese government will not be able to prevent a string of collapse from taking place in the financial sector.

At this moment, the Japanese economy is experiencing a negative trend in production, demand, income, employment, and prices. The country is in an economic even though the short-term interest in Japan was 0.5% for years and has in recent months been reduced to 0%.

Nevertheless, this serves to show that even at extremely low interest rates, the economy does not pick up when you have a crisis of confidence. The Japanese interest rate has been the lowest of the industrialized world for the last thirty years.

Concluding remarks
What would you say has been my purpose today with respect to this theory called "New Economics" ?

It was basically two-fold. First, we have seen the success stories of countries that have embraced "New Economics" and have worked consistently on resolving their economic problems. The cases of the United States and the Netherlands also have shown that changes do not come overnight and that the process of reform can take decades.

Second, the cases of Ecuador and Japan, on the other hand, also have shown that the more democratic the process of discussing the problems without working on the solutions, the deeper the crisis in the country will become.

In the case of Japan, the financial sector reforms are very costly and, therefore, painful for the Japanese population, but Japan has learned that there is no other way around the problems.

Unfortunately, our country also is experiencing problems — political, economic, and financial problems. As you hear us speak, it appears that we know what we should have done long ago, but we have not done it. We have even been offered assistance by many international organizations, but we have not taken it.

It seems that the only thing we can agree upon is discussions, and more discussions. This reminds me of a famous Dutch comedian, Mr. Wim Kan, who characterized the political discussions going on in the 1980s in the Netherlands in one phrase: "Laten we afspreken dat we niets afspreken."

The credibility and the confidence crises in our country is overgrown. Today, I have provided examples of two extreme situations.

These contrasts in mindsets are striking and instructive in terms of about do's and dont's. So, the choices are left to us: either we work hard and chart a course for success, or we don't and we automatically end up in the valley of disaster.

I am convinced that even though the prospects may look dim, the chances are excellent. Working together we can chart a course for success that can save this country.

1 Public debt as percentage of the Gross National Income (GNI)
2 Today oil prices fluctuate around the 23 US dollars