

economics of technical change and information, and international trade and finance. We explain how these approaches are linked together, complementing rather than replacing one another.

Since macroeconomics deals with the economy as a whole, one might well ask how economic performance at the aggregate level is relevant to individual enterprises. Why is the study of macroeconomics a part of the business curriculum? As we outline in greater detail below, business enterprises operate in the setting of the economy. The market for products, supplies and the costs of raw materials and labor, interest rates and financing, and international competitiveness, all influence the performance of the business. Managers need not only react to current conditions, but to understand and, if possible, to forecast them. Business people must be “on top of” the economy, making forward-looking strategy in a precarious world. We conclude this chapter by showing the links between the macroeconomy and the business enterprise as a “cascade,” from the national economy to the industry and the firm.

Case 1.1

Distinguishing Between Developed and Developing Countries

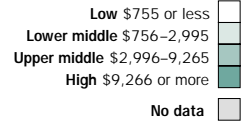
How do we distinguish between developed and developing countries? We may use the terms: *rich* and *poor*, *advanced* and *backward*, *high income* and *low income*, *industrial* and *agricultural*, etc. The literature is full of euphemisms, particularly for the lower income countries, for example, *emerging economies*, *countries on the way to development*. The point is not so much in the name as in the meaning.

Countries range across a broad spectrum of economic development. Map 1.1 provides a geographic perspective. A detailed, statistical discussion of these differences is presented in Chapter 2.

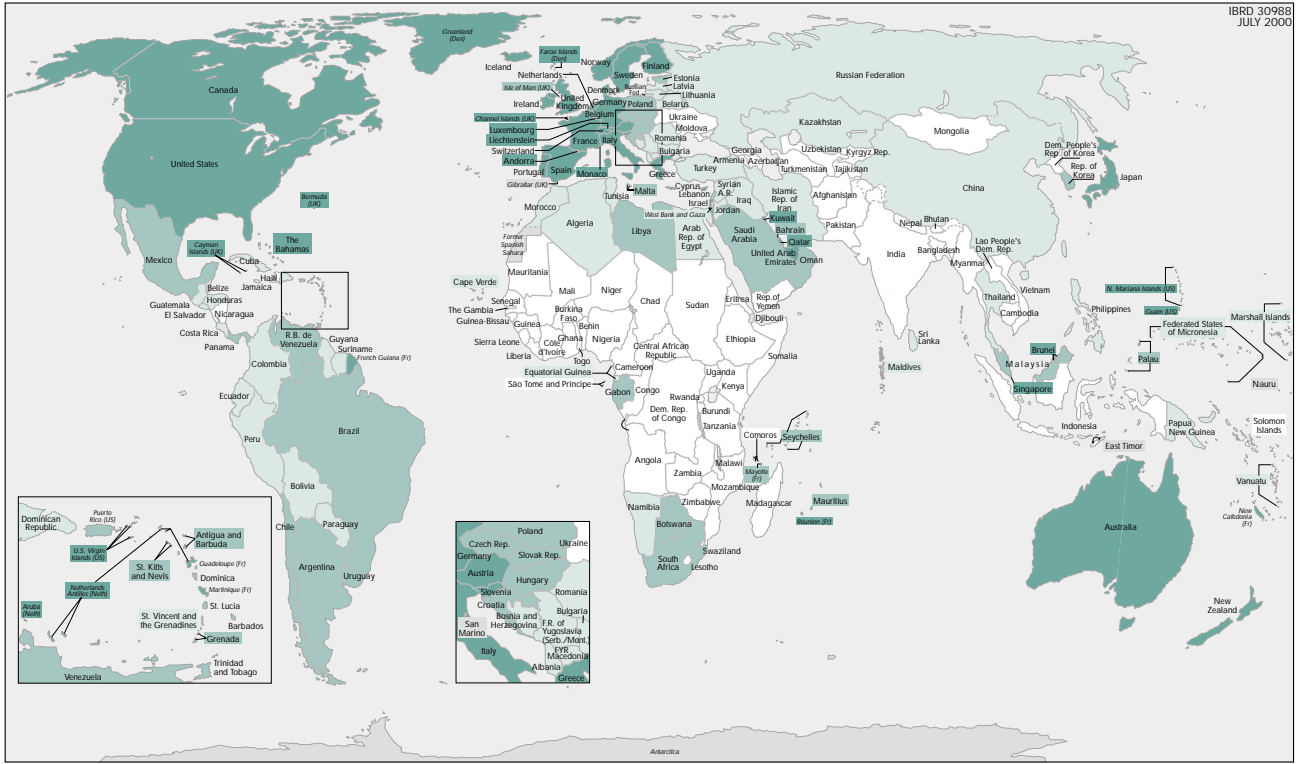
At the upper end are the high income countries, with per capita incomes ranging in the \$10,000 to \$30,000 range (dark colored on the map). These are countries with extensive infrastructure, a largely urban population, an

The World by Income

This map presents economies classified according to World Bank estimates of 1999 GNP per capita. Not shown on the map because of space constraints are French Polynesia (high income); American Samoa (upper middle income); Fiji, Kiribati, Samoa, and Tonga (lower middle income); and Tuvalu (no data).



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Map 1.1

educated labor force, and, frequently, competence in high tech and science. Many of these countries are mature, and consequently, are growing only slowly. Interestingly, where we once could call them industrial countries, increasingly the center of gravity of economic activity in these countries has shifted toward service activities. Included in this category are: in North America, the United States and Canada; in Europe, the countries of the European Union including the United Kingdom, France, Germany, and others; in the Pacific, Japan, Australia and New Zealand. These advanced countries work together in the Organization for Economic Cooperation and Development (OECD).

In the middle is a wide range of developing countries, in terms of the World Bank's terminology, "lower middle and upper middle income" countries. These countries have per capita incomes ranging from almost \$10,000 at the upper end to less than \$1000 per year at the bottom (medium colored). Some of these countries have been growing rapidly for many years, and are approaching maturity. Others are only at the beginning of the development process. East Asia is a good example of the great differences among these countries, ranging from Singapore, Korea and Taiwan at the top, to Indonesia and Vietnam at the lower end. Latin America belongs to this category, as do many countries of North Africa. Many of these countries still lack sufficient infrastructure and education. They are increasingly becoming industrialized, indeed, some of them are now centers of the world's labor-intensive mass production industries. These countries are also rapidly becoming urbanized, creating some of the world's largest cities, like Lagos, Bangkok and Mexico City. On the other hand, many of them still have large rural populations engaged in agriculture. In these countries, development is clearly a primary concern.

Finally, there are the very poor countries, with per capita incomes of less than \$755 (light colored). These countries, for example in Sub-Saharan Africa, are still largely dependent on primitive subsistence agriculture. Many of them lack the infrastructure, education and stable political organizations necessary to begin the development process.

Often, we also refer to the *transition* economies. These are the countries of Eastern Europe and the former Soviet Union that have been in the process of transition from Soviet-style command economies to the free market.

(China is also a transition economy in this sense though it is often dealt with separately.) Many of these countries have substantial industry and had attained a middle income living standard. But many of them have found the transition process difficult and have seen substantial decline in income in the past decade.

In this text, we will distinguish between *developed* and *developing* countries and use these terms as consistently as possible. The *developed* economies comprise the advanced countries. The term *developing economies* will be used to refer to the others.

The Facts of Economic Growth, Development and the Business Cycle

The record of economic statistics over the past two decades illustrates the interplay between economic development and the business cycle.

Until very recently, economic growth in the developed world was relatively slow (Table 1.1). In the United States, during the period from 1980 to 1997, annual GDP growth was only 2.7%, about in line with the long term trend. Only in the late 1990s, was there an acceleration of growth to 4% per year or more. Today many economists are suggesting, perhaps with excessive optimism, that we are in a “new” economy that will grow more rapidly in the future. Europe and Japan also saw sluggish growth, with marked slowing in the 1990s. Allowing for the fact that population was increasing, growth rates of GDP per person averaged only 1 to 2% per year. Consequently, in many countries of the advanced world, living standards had been barely increasing, often not rapidly enough to offset social problems like urban poverty. There is hope now that in Europe the period of low growth and high unemployment, what has been termed “Eurosclerosis,” is over and that increasing internationalization and rapid technical progress will advance these economies more rapidly in the 21st century.

In sharp contrast, the developing countries of East Asia had been in a headlong rush to economic development for several decades. Starting out as very poor countries in the 1960s, they have more than doubled per capita GDPs every ten years. Some of them — Singapore, Hong Kong, Taiwan and

Table 1.1 GDP Growth in Developed and Developing Countries (% per year).

	1980–90	1990–97	1998	1999 (Est.)	2000 (Est.)
Developed Economies					
US	2.9%	2.5%	4.3%	4.2%	4.9%
Germany	2.2%	3.1%	2.5%	1.3%	2.8%
UK	3.2%	1.9%	2.6%	2.1%	2.9%
France	2.4%	1.3%	3.2%	2.9%	3.5%
Japan	4.0%	1.4%	–2.5%	0.3%	1.9%
East Asian Economies					
South Korea	9.5%	7.2%	–6.7%	10.7%	8.2%
China	10.2%	11.9%	7.8%	7.1%	7.7%
Hong Kong	6.9%	5.3%	–5.1%	3.0%	7.8%
Malaysia	5.2%	8.7%	–7.4%	5.6%	6.5%
Thailand	7.6%	7.5%	–10.2%	4.2%	4.2%
Indonesia	6.1%	7.5%	–13.4%	0.2%	3.4%
Singapore	6.6%	8.5%	1.5%	4.9%	6.3%
Philippines	1.0%	3.3%	–0.5%	3.2%	4.1%
Rest of the World					
South Asia	5.7%	5.7%	5.6%	5.7%	5.9%
Latin America	1.8%	3.3%	0.9%	2.6%	5.9%
Middle East	0.4%	2.6%	–0.9%	2.6%	5.9%
Sub-Saharan Africa	1.8%	2.1%	2.2%	2.0%	2.5%

Source: WEFA Group, various publications.

Korea — are close to achieving advanced country status. Even huge countries like China and India are joining the “development ladder.” Other parts of the developing world have not done as well as East Asia, however. Latin America, which looked just as promising as East Asia in the 1960s, has been hobbled by the debt crisis, resulting in a “lost decade” throughout the 1980s and has, in recent years, again been hit by contagion from the East Asian financial crisis. In Africa, there are still countries ravaged by wars and internal conflicts, where people are dirt poor and where little progress is being made. The so-called *transition economies* of the former Soviet Union and Eastern Europe

have gone through a wrenching downward shift. Some, like Poland and the Czech Republic have made good progress, but others, like Russia and the Ukraine, are still trying to find their way.

In the 1970s and early 1980s, sharp recessions following the “oil shocks,” buffeted the world economy, industrial and developing economies alike (Fig. 1.1). The ups and downs of year-to-year growth of GDP are a reminder that economists and policy makers have not learned fully to control the business cycle, after all. That particular events in the developing world, like the rise of petroleum prices, could so sharply affect the economic situation of advanced industrial countries is an example of the complex and increasingly close inter-relationships of the world economy. The late 1980s and early 1990s were a period of upsurge in many parts of the developing world, leading to the hope that many countries would sustain the process of rapid economic advancement. But, the 1997 crisis experience interrupted rapid growth in East Asia. Now, that the situation in East Asia has stabilized, there is hope the East Asian development process is back on track. Before one can make optimistic statements about a resumption of rapid growth — and we are inclined to be optimistic — one must know why the growth trend occurred and why it was interrupted. We discuss these developments in Chapter 5.

The inflationary experience of various parts of the world differs greatly (Fig. 1.2). In the industrial world, inflation was moderate except in the 1970s and early 1980s, a consequence of economic overheating and of the upsurge of oil prices. In the developing countries, inflation has been much higher. Today, even the hyperinflation countries in Latin America, have managed to slay their inflationary dragons. Price increase is once again at moderate rates in the industrial world and in many of developing countries.

In the United States, productivity gains attributed to the “new” economy are widely thought to be offsetting wage increases and therefore easing inflation. Nevertheless, the US Federal Reserve raised interest rates to ward off early signs of inflationary price increases and reduced interest rates again quickly when inflationary pressures faded during the 2001 recession. Central banks in other countries are ever watchful against a resurgence of inflation.

The expansion of trade, fostered by reductions in trade barriers under the World Trade Organization (WTO), has permitted readjustment of world production and exchange patterns (Fig. 1.3). The advanced countries vastly

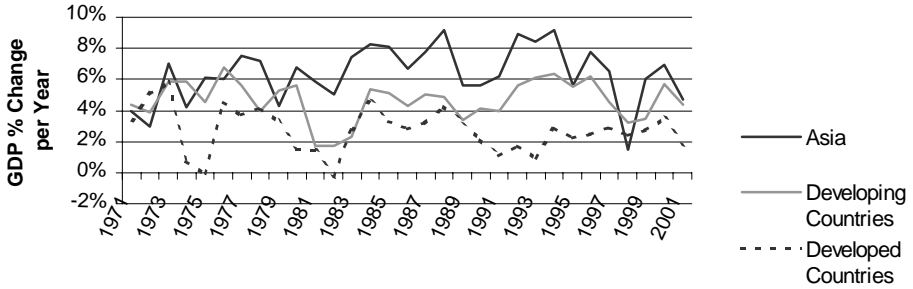


Fig. 1.1 Real GDP Growth (1971–2001).

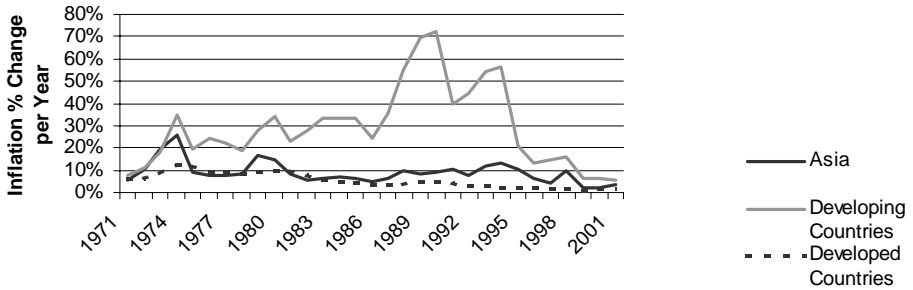


Fig. 1.2 Inflation Rate (1971–2001).

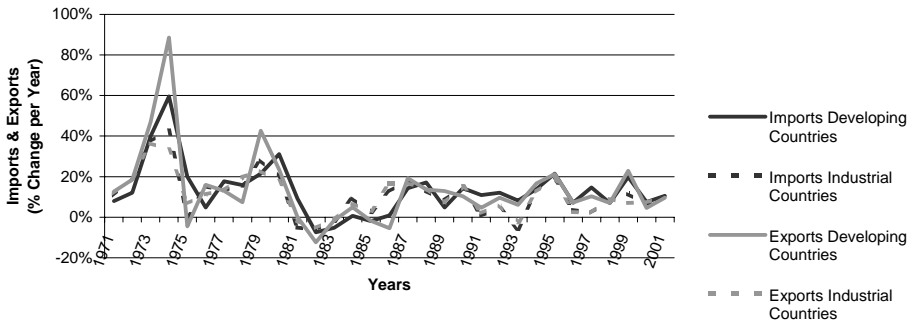


Fig. 1.3 Imports and Exports (1971–2001).

increased their imports of manufactures. They have turned their activities from mass production manufacturing to the production of high-tech capital goods, especially Japan, and high value-added services like entertainment, finance and communications, particularly the US. Trade has turned out to be an engine of growth in East Asia where much of the world's labor-intensive manufacturing is being concentrated. Trade and capital movements have linked the world's economies ever more tightly into a unified trade and financial system. On some occasions, in 1997, for example, these capital flows swung sharply from positive to negative causing financial panic, exchange devaluation, and depression in many parts of the developing world. Some people began to fear that globalization, much touted for its encouragement of competition and efficiency, embodies risks to financial market and exchange rate stability with which international institutions are not yet fully prepared to deal. Fortunately, the crisis passed without worldwide collapse, and rapid growth has been resumed even in many of the hard hit East Asian economies.

Economic Theory and the “New Economy?”

Today, we find ourselves on the threshold of a profound economic transformation to a “new economy” (Case 1.2). The data do not yet provide an unequivocal confirmation of the changes that are taking place. There is not yet agreement about the nature and consequences of the new developments. Some observers are thinking of a total transformation of economic structure and behavior as new technology and global linkages dominate present structures. Others have more modest and realistic perceptions: the “new economy” is simply an extension and broadening of the old. Though the precise meaning of the term still depends on the observer, there is wide consensus that the world economy is undergoing a sea change; domestically as a result of a wave of technical innovation and internationally as a result of globalization. Assuming proper economic policies, we can be quite optimistic about prospects for growth and development even in the face of temporary cyclical ups and downs.

We will conclude: “Yes, there is a ‘new economy’.” The “new economy” has important implications that we must take into account. But the

reader should be warned that, the “new economy” does not replace the macroeconomic structures and behaviors that have existed until now and that will be considered in this book.

Case 1.2

A “New Economy?”

Beginning in the mid-1970s and until quite recently, the advanced economies of Europe and North America grew very slowly. After an initial post-war spurt, output per worker increased at little more than 1% per year. Consequently, living standards showed little improvement. This slow pattern of growth was widely attributed to maturity. The mature economies were losing competitiveness in mass production goods, now increasingly being supplied from East Asia. They were becoming service economies. Most economists thought that because services are labor-intensive, there was little opportunity for improving services productivity and/or for introducing new technology.

The events of the past five years have called this view into question. Suddenly, the US, seen by many as the most mature economy of them all, was growing rapidly. Between 1999 and 2000, GDP grew by almost 5% per year, and output per worker increased at a spectacular 3.5% annual rate. Moreover, this growth record was achieved with very low unemployment, close to 4%, and with modest rates of inflation, between 2 and 3%. Past experience would have suggested slower growth, more unemployment, and much greater inflation at this stage of the business cycle. Have traditional macroeconomic “laws” been suspended? Do we have a “new economy?”

The record of growth on which “new economy” theories are based is very brief. One powerful business recovery does not make a historical trend! Consequently, much effort is going into providing some microeconomic underpinnings to the idea that the observed changes in the economy are real and that they will persist. There has, of course, been a spectacular boom in the use of computers. But, in the mid-1980s, Nobel Laureate Robert Solow said pointedly: “You can see the computer everywhere, but in the productivity statistics.” Since then, Solow has reconsidered this view, but the fact remains