

National upgrading in a regional world

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Between 1995 and 2008 global levels of merchandise trade increased from around 20 percent of global GDP to around 30 percent. The world globalized as goods (and services) traversed the world as never before in human history. The previous 1913 peak in international trade was dwarfed as new transportation technologies — from leviathan container ships to just-in-time air freight — reshaped global supply chains. Now nearly one in three things bought on earth (by value) comes from somewhere else. The era of globalization has arrived.

And departed? Global trade as a percent of GDP has been flat since 2008, and an increasing proportion of that trade is trade in intermediate goods. On average around one-quarter of the value-added embodied in the world's exports actually consists of intermediate goods that are then incorporated into products for re-export. And this doesn't include the oil and gas used to power factories, the food used to feed workers, and all the other indirect inputs into a country's economy.

For countries that are highly integrated into regional production networks the foreign-origin component of exports can be much higher. For Poland it is 32.4 percent, just above the 32.2 percent and 31.7 percent figures for China and Mexico, respectively. For smaller countries on the edges of Germany and Japan the numbers are higher still: 41.7 percent for Korea, 45.3 percent in the Czech Republic, 46.8 percent in Slovakia, and a whipping 48.7 percent for Hungary, according to the WTO's 2015 International Trade Statistics report. Only the city-states of Singapore and Luxembourg score higher.

A tale of three regions

Today's world economy is not really a global economy. It has coalesced around three well-integrated regional economies: East Asia, Western Europe, and North America. Together the countries that make up these three zones have a combined GDP of some \$60 trillion, constituting some 80 percent of global economic output. The combined GDP of all of the countries of the world that lie outside these zones is less than that of the United States or the European Union. In essence, the global economy consists of these three zones, plus a large number of countries that do little more than provide economic feedstocks like energy and foodstuffs to support production in the big three zones.

This regionalization of the global economy is not just about size. It's about integration. Each of the big three economic zones has more within-zone trade among neighboring countries than external trade with the rest of the world. The big three zones are in effect economic units, regional economies, not collections of national economies that trade with each other. This is most visible in Western Europe, where the European Union has merged 28 countries into a single customs area. It is also visible in North America, where NAFTA connects the United States, Canada, and Mexico. But it is also happening in Asia, where Japan, Korea, and Taiwan are among the top investors and producers in China and Southeast Asia.

The East Asian economic zone consists of high value-added offshore centers like Japan, South Korea, Taiwan, Hong Kong, and Singapore combined with the enormous manufacturing base of China. The

offshore centers have extensive production of their own but also coordinate enormous investments in China. Additional production also occurs in the Southeast Asian countries of Indonesia, Malaysia, Thailand, and Vietnam. The East Asian economic zone is highly integrated economically but poorly integrated politically, with the hard international borders in the East China Sea ensuring that intraregional trade and investment is subject to substantial sovereign oversight.

The Western European economic zone consists of high value-added centers like the UK, France, Germany, Austria, Switzerland, Italy, the Benelux countries, and the Scandinavian countries combined with lower-cost manufacturing and services centers in the eastern European Union countries and Turkey. This zone is “Western” European in the sense that it does not include Europe east of the European Union, which is not well-integrated into the value chains that emanate from the high value-added centers of Europe. Additional production for the Western European economic zone occurs in Latin America, Asia, and elsewhere but these production networks are not highly structured. Instead, most production is concentrated within the European Union itself.

The North American economic zone consists of the high value-added centers of the United States and Canada combined with lower-cost manufacturing in the poorer regions of the United States itself and in Mexico. Compared to the East Asian and Western European economic zones, the North American economic zone has a high level of political integration: nearly the entire zone is included in NAFTA, with the United States alone comprising 87 percent of total NAFTA GDP. In addition, the unique history of American dominance of international investment flows in the twentieth century (and beyond) has given the North American economic zone a global reach that far outstrips that of the East Asian and Western European zones.

The rest of the world consists of a mix of rich and poor countries, some of them highly developed, but none of them embedded in extensive, highly structured economic zones. For example, Australia is a rich country of 23 million people but it is not deeply enmeshed in dense transnational production networks in the same way as peer countries like the Netherlands and Taiwan. Similarly, major energy exporters like Russia, Saudi Arabia, and Venezuela may typically export to particular countries along fixed patterns, but their economies are not deeply integrated into the economies of their trading partners. With a population of 1.25 billion, India is perhaps large enough to be considered a minor economic zone of its own, but a very small one, roughly 10 percent of the size of each of the other three zones. The big three integrated economic zones tower over the rest of the global economy.

Strategies for the peripheries

Countries like Korea, Poland, and Mexico have relatively large populations and high levels of GDP per capita but are nonetheless much smaller than the dominant core countries in their respective economic zones. It seems they have no choice but to depend on investment and orders from their larger neighbors. Liberal economic advisors from the IMF, the ECB, and the world’s top business schools all recommend greater economic integration as the key to prosperity. And yet ... the southern states of the United States have been in a monetary and customs union with the north for two centuries, with no apparent catch-up. Why should external peripheries like Korea, Poland, and Mexico be expected to do any better than the internal peripheries of the American south?

Economic self-sufficiency is out of the question. It would be disastrous for any of these countries to try to separate themselves from the regional economies to which they belong. The countries of east-central Europe were deeply integrated into the German economy before World War II and, despite five decades of occupation and external control, they are once again.

Unlike the American south, however, these countries retain a large degree of fiscal independence, policy independence, and (with the exception of Slovakia) even some monetary independence. They should use it. The objective for Poland and the other countries of east-central Europe should be to restructure their economies to resemble those of Germany and western Europe. The alternative is to be the low-wage backwater of Germany and western Europe.

Achieving such a “do as they do, not as they say” economy would require the countries of east-central Europe to dramatically raise their income tax rates, spend much more money on infrastructure, and — ideally — to delink their currencies from the Euro. The keys to growth are high levels of site-specific infrastructure on the supply side and widely-shared prosperity on the demand side. Only when the countries of east-central Europe have infrastructure and consumption levels similar to those of western Europe should they link their currencies to the Euro currency of rich, developed Europe.

South Korea (general government revenue: 37 percent of GDP according to OECD figures) and Mexico (25 percent) make for a stark contrast. Korea has the funds to invest in infrastructure and improving its citizens’ livelihoods; Mexico does not. Poland, with general government revenue standing at 39 percent of GDP, generates sufficient funds but these funds are disproportionately concentrated in the social insurance system. Without cutting social insurance, Poland has to raise government investment in skills and infrastructure. Direct taxes are the most effective way to do this.

Poland and other peripheries can merge into the cores of their respective economic zones, but to do so they must match core economies in fixed infrastructure and domestic consumption. Fixed infrastructure on the required scale can only be paid for through tax revenues, not through borrowing, and domestic consumption can only be increased through devaluation, not through social security. Together a lower currency combined with higher taxes would mean a lot of pain for the middle and upper classes. But in the long run they would mean greater prosperity — and membership in the regional core — for the entire country.