

## Democracy, an Economic Review – Open Market Economies Under Pressure

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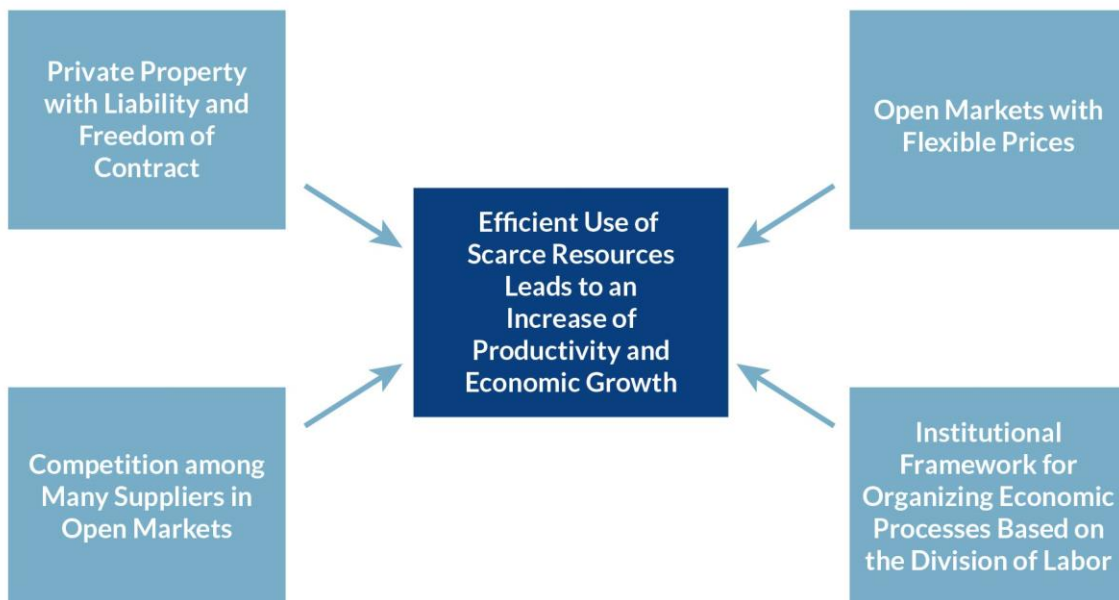
### I Introduction

The political model of a liberal and cosmopolitan democracy is coming under increasing pressure in many Western industrialized nations. This also applies to the economic model prevalent in liberal democracies, which is based on core elements such as private property, competition, open markets and the international division of labor. Although criticism of some economic developments in Western industrialized nations is justifiable, the market-based economic system is still an extremely successful model that is superior to all other existing economic systems.

#### 1. Core Elements of an Open Market Economy

The economic systems found in highly developed industrialized nations such as Germany, France, the United Kingdom and the United States are all market economies exhibiting different characteristics. Nevertheless, these countries share a number of core elements inherent to a market economy. The most important are private property combined with the principle of liability; competition among many suppliers in open markets with flexible prices; and an institutional framework set by the government for organizing economic processes based on the division of labor.

Core Elements of an Open Market Economy



Source: Author's own diagram.

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#### Private Property with Liability and Freedom of Contract

Every society needs property rights, i.e. rules that determine who may use a certain object (also to generate income), who may transfer it to others (sell, rent or give it away) and who may modify it. Private property thus also includes freedom of contract. It allows each member of society to enter into binding agreements on the exchange of property rights with other persons. In societies organized as market economies, these rights essentially lie with individual citizens.

This form of property ownership has several economic advantages which, however, can only come to fruition if the principle of liability also applies. This principle must ultimately be understood as a system of rewards and punishments:

- If a person uses his property, which includes his labor, to provide goods or services that are valued by other members of society, the person will earn a relatively high income. This income is the basis for a high level of material prosperity. If, in addition, the person treats his property with care, he can earn this income on an ongoing basis.
- If, however, a person uses the property at his disposal to provide goods or services that consumers do not want, he will not earn an income or only a very limited one. This will have a negative effect on the person's material wealth. If the person uses his property to cause damage to others, he must pay to redress the damage he has caused, which will reduce his disposable income and his prosperity.

Private property in combination with the principle of liability is thus a driver ensuring the provision of goods and services, increases in efficiency and quality, and prudent use of scarce resources.

### **Competition on Open Markets with Flexible Prices**

Production processes based on the division of labor are what generate a high level of economic prosperity. That means that every person or region specializes in the production steps or products for which they have the greatest relative productivity advantages compared to the rest of the world. This ensures that a society can use the productive resources at its disposal to bring forth the greatest possible quantity of goods and services for its citizens. This also means that the larger the market, the greater the opportunities for the (international) division of labor and the associated gains in specialization. Economically successful market economies are therefore those that integrate into the global economy and take advantage of the potential offered by the international division of labor.<sup>1</sup>

If people no longer produce only what they need themselves, but instead make use of the division of labor to provide goods and services for others, then what consumers plan to consume must be brought into line with what producers intend to produce. Theoretical reflections and historical experience both show that markets with flexible prices do the best job of coordinating these two aspects. Flexible prices fulfill a number of functions in this context:<sup>2</sup>

- A flexible price ensures that the factors of production present in a society are distributed in such a way that they provide consumers with the greatest possible benefit. For example, suppliers of goods that are highly valued by consumers are able to pay higher wages. Labor will thus be directed toward those sectors producing these goods. Ultimately, more of the goods highly valued by consumers will be produced.
- To put it in negative terms, the price has a sanctioning effect: Prices fall for those products not desired by consumers. Profits decline as well, so that the owners of capital experience a loss of income. If the price falls so far that it no longer covers the cost of production, losses occur. The price thus ensures that companies that do not offer what consumers want will disappear from the market.

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<sup>1</sup> See Bertelsmann Stiftung. Globalisierungsreport 2018. Gütersloh 2018.

<sup>2</sup> See Thieß Petersen. Preise und ihre Funktionen. Das Wirtschaftsstudium (45) 2016, pp. 1098–1101.

- Closely linked to the incentivizing and sanctioning function is the innovation effect. In a competitively organized market, every company must fear being squeezed out of the market by its competitors if the latter can offer goods at a lower price. Each company therefore has an incentive to reduce its costs of production through technological advances and thus not be driven out of the market. Falling prices for goods produced by competitors force every company to innovate in order to either improve the quality of its product or to reduce the costs – and, with them, the price – of its product. For consumers, this means that, as the result of advancing technology, they can consume greater amounts of goods while paying a lower price. This increases people's material well-being.
- The price's coordinating function in effect means that the price reconciles supply and demand in such a way that companies' production plans correspond to consumers' consumption plans. If, for example, suppliers produce a product that does not reflect customers' desires, the result is an excess supply. The subsequent fall in price would signal to suppliers that they should limit production of this good. That, in turn, would bring production and consumption plans back into alignment.

If the positive effects of a flexible price as described above are actually to occur, no market participant can have power over the market. If individual suppliers (or even demanders) are so large that they are, for all intents and purposes, monopolists, they could exploit their market power. A sole vendor of a product can, for example, set the price at which he sells his product. Since there are no other competitors to which consumers can turn, the price mechanism becomes ineffective. The monopolist could then offer a smaller quantity goods while demanding a higher price. The resulting increase in profits would take place at the expense of consumers. In macroeconomic terms, what results are known as welfare losses.

### **Governmental Framework for Organizing Economic Processes Based on the Division of Labor**

Every market economy needs a minimum of framework conditions set by the government if economic processes based on the division of labor are to run smoothly. These conditions include having a legal framework in place that guarantees enforcement of contracts and property rights. The government must also provide a minimum level of public goods (above all infrastructure in the areas of transport, education, health, energy and water supplies, and internal and external security).

Intervention in the price system is needed if market prices do not include all costs and benefits. If the market price does not cover the total cost to society of, for example, environmental pollution resulting from greenhouse gas emissions, then the overall social costs are higher than the costs covered by the market price. This contravenes the liability principle. In this case, which economists call a negative external effect, the government must increase the price by imposing a tax. The amount of the tax corresponds to the overall economic damage caused by greenhouse gas emissions.

Finally, the government must redistribute income if the income distribution achieved by the market does not reflect society's preferences. This includes ensuring the welfare of those whose market income is not sufficient to lead a decent life. There are no objective criteria for determining the extent of the government's redistribution efforts. For example, in terms of social preferences there is a lower threshold in Germany for what is considered an acceptable level of income and wealth inequality compared to the United States, which means there is a greater redistribution of income in Germany.

## 2. Interim Conclusion

Every society faces the fundamental question of how to deal with the fact that people have unlimited needs, but only a limited amount of goods and services are available to satisfy them. The aim is to reduce the tension between unlimited needs and limited resources as much as possible. In order to achieve this goal, a society is faced with numerous questions: Which products should be manufactured? Who will manufacture these products and how? And for whom will the products be manufactured, i.e. how are the scarce goods to be distributed among the members of society?

These questions can be answered either centrally via governmental plans and decision-making or decentrally via markets and prices. Both theoretical considerations and real-life experience suggest that markets and prices can answer these questions better than central plans. The core elements of an open market economy outlined above ensure that companies adapt to the wishes of consumers while also ensuring economic dynamics. The result is an improvement in the material prosperity of a society over time. The focus is on citizens in their role as consumers: Consumers benefit from a market economy by being able to buy a growing quantity of goods and services at falling prices. Historical experience shows that centrally planned economies are not in a position to achieve this.

## II Economic Superiority of Open Market Economies

Growing criticism of the globally oriented market-based economic system found in Western industrialized nations has led to doubts about the superiority of the market economy. Yet market economies with the core elements outlined above are still proving to be the superior economic system. Here are three examples.

### 1. The Historical Example of Korea

Korea provides a historical example of the economic superiority of liberal democracy's market-based economic institutions.<sup>3</sup> In the summer of 1945, Korea was divided into the South, administered by the United States, and the North, administered by the Soviet Union.

- A market economy based on private property was introduced in South Korea. The South Korean government ensures an effective educational system is in place, along with a well-functioning banking system that facilitates saving and lending. Private property has a positive, incentivizing effect for the country's citizens. They can be confident that performance, entrepreneurial risk and investments in their competencies will pay off. All of these activities lead to higher incomes which result in a higher material standard of living for individual citizens and their families.
- North Korea, in contrast, has a command economy that allows neither private property nor official markets. Incentives to produce and to innovate are therefore lacking. Instead of markets and prices coordinating economic activity, corruption and black markets are the rule. Without economic progress, the government is not in a position to provide effective infrastructure.

The economic successes are clear: The people of South Korea have now reached a standard of living equal to that of Portugal and Spain. The standard of living in North Korea is ten times lower

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<sup>3</sup> For the following, see Daron Acemoglu, and James A. Robinson. *Warum Nationen scheitern*. 2nd ed. Frankfurt am Main 2014, pp. 100–108.

than in the South, corresponding to that of economies in sub-Saharan Africa. The low level of material prosperity corresponds to a low non-material standard of living. The average life expectancy in North Korea, for example, is some ten years shorter than in South Korea.

The two countries had a shared history until 1945, which means the economic differences cannot be explained by cultural or religious differences. Geographic factors, moreover, cannot be the cause. South Korea's considerably better economic development compared to the North can be traced back instead to the two nations' different economic institutions.

## 2. Key Socio-Economic Indicators

In recent decades, a number of autocratic societies have exhibited high rates of economic growth – far above those seen in Western economies, a phenomenon which could be interpreted as demonstrating the weakness of Western market economies.

Top 10 Ranked Emerging Markets 2012-2017



Source: Global Intelligence Alliance, Business Perspectives on Emerging Markets 2012-2017 Survey.  
Qn: Which are the top 5 Emerging Markets for industry over the next 5 years? N=34

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Yet it must be noted that Western industrialized nations continue to enjoy the highest levels of material prosperity. This becomes clear if, as an indicator of economic performance, one looks at gross domestic product (GDP), i.e. the value of all the goods and services produced in a country within one year (see Figure "Gross Domestic Product per Capita (Constant Prices) in Selected Countries"). For example, when adjusted for differences in purchasing power, the real (meaning adjusted for inflation) GDP per capita that Turkey and Russia achieved in 2017 corresponds to the per capita figures that Germany, France, Italy and the US exhibited as early as 1980.

### Gross Domestic Product per Capita (Constant Prices) in Selected Countries

Information in US Dollars, Purchasing Power Parity, 2011 International Dollars

	1980	1990	2000	2010	2017	Change
China	722	1,515	3,682	9,443	15,175	+2,003%
Korea	5,084	11,633	20,757	30,352	35,919	+606%
Turkey	8,127	10,834	13,258	17,249	24,496	+201%
United Kingdom	20,671	27,136	33,646	36,782	40,185	+94%
Japan	20,769	30,607	33,875	35,883	39,014	+88%
USA	29,277	36,999	45,964	49,309	54,198	+85%
Hungary	14,792	17,099	18,023	22,485	26,847	+81%
Germany	26,246	32,067	37,646	41,694	45,931	+75%
France	25,059	30,421	35,975	38,054	39,860	+59%
Italy	24,546	30,969	36,085	35,485	34,741	+42%
Russia	no data	20,801	14,092	23,107	25,353	+22%
Venezuela	18,247	14,786	14,469	16,837	11,034	-40%

Source: International Monetary Fund, World Economic Outlook Database, April 2018.

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The high level of material prosperity in Western industrialized nations thus also leads to an improvement in non-material living conditions. This can be seen, for example, in health-related indicators such as infant mortality. In developed industrialized nations such as Germany, France and Italy, the infant mortality rate is currently (2017) between 3.0 and 3.5 deaths per 1,000 births and in Japan only 1.9 deaths. In Russia the corresponding figure is 6.0, in Turkey and China 10.0 and in Venezuela 12.5.<sup>4</sup>

<sup>4</sup> See Population Reference Bureau. 2017 World Population Data Sheet. Washington DC 2017, pp. 10–17.



## Human Development Index and its Components for Selected Countries

HDI rank	Country		HDI value		Life expectancy at birth (years)	Expected years of schooling (years)	Mean years of schooling (years)	Gross national income per capita (2011 PPP \$)
1	Norway		0.949		81.7	17.7	12.7	67,614
2	Australia		0.939		82.5	20.4	13.2	42,822
2	Switzerland		0.939		83.1	16.0	13.4	56,364
4	Germany		0.926		81.1	17.1	13.2	45,000
5	Denmark		0.925		80.4	19.2	12.7	44,519
5	Singapore		0.925		83.2	15.4	11.6	78,162
7	Netherlands		0.924		81.7	18.1	11.9	46,326
8	Ireland		0.923		81.1	18.6	12.3	43,798
9	Iceland		0.921		82.7	19.0	12.2	37,065
10	Canada		0.920		82.2	16.3	13.1	42,582
10	United States		0.920		79.2	16.5	13.2	53,245
:	:		:		:	:	:	:
33	Qatar		0.856		78.3	13.4	9.8	129,916
:	:		:		:	:	:	:
42	United Arab Emirates		0.840		77.1	13.3	9.5	66,203
43	Hungary		0.836		75.3	15.6	12.0	23,394
:	:		:		:	:	:	:
49	Russian Federation		0.804		70.3	15.0	12.0	23,286
:	:		:		:	:	:	:
59	Malaysia		0.789		74.9	13.1	10.1	24,620
:	:		:		:	:	:	:
71	Turkey		0.767		75.5	14.6	7.9	18,705
71	Venezuela		0.767		74.4	14.3	9.4	15,129
:	:		:		:	:	:	:
90	China		0.738		76.0	13.5	7.6	13,345
:	:		:		:	:	:	:
185	Burkina Faso		0.402		59.0	7.7	1.4	1,537
186	Chad		0.396		51.9	7.3	2.3	1,991
187	Niger		0.353		61.9	5.4	1.7	889
188	Central African Republic		0.352		51.5	7.1	4.2	587

Source: UNDP 2016: 198–201.

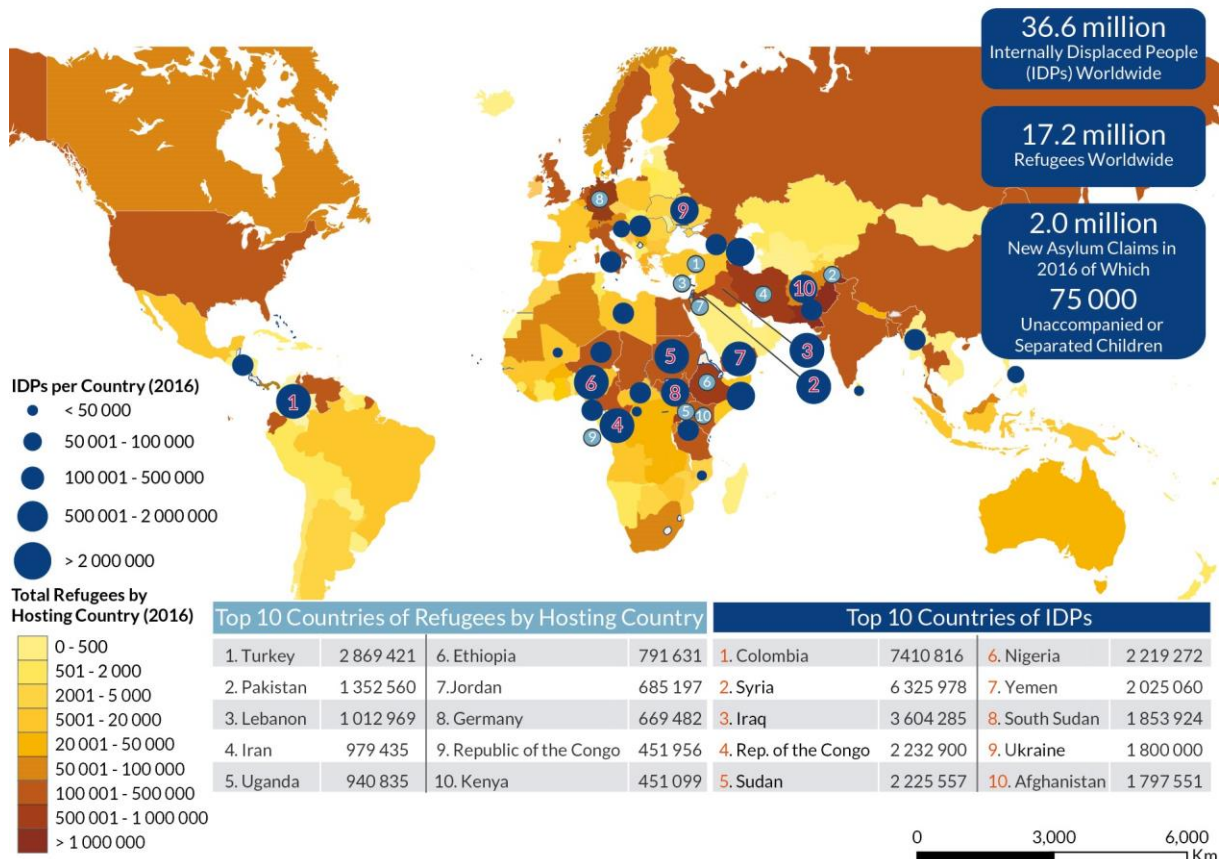
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Finally, the 'Human Development Report 2016' (more recent data not available) shows that Western market economies also perform better in indicators of life expectancy and the length of school attendance.

### 3. Global Migration: Voting with their Feet

Perhaps the strongest argument at present for the superiority of an open market economy is the destination chosen by international migrants. Regardless of whether people are leaving their native countries due to armed conflict, persecution, environmental pressures or poverty, the nations that international migrants are trying to reach are the Western liberal democracies with their market economies, and not countries such as Russia, Turkey, Hungary and China – at least when people are free to choose their destination countries.

Refugees by Hosting Countries in 2016



Sources: GISCO, UNHCR Global Trends report 2016.

The boundaries and names shown on this map do not imply official endorsement or acceptance by the European Union.  
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## III Criticism of Economic Development in Western Industrialized Nations

A central element of Western industrialized market economies is the openness of markets, an essential factor for the international division of labor. The inclusion of industrialized nations in the global division of labor – including a cross-border exchange of goods, services, capital, workers, technologies and knowledge – increases GDP and, with it, the material well-being of all countries involved.<sup>5</sup>

As a correlation of this economic globalization, the opening of borders for goods, services and production factors also changes the level of scarcity in each participating country and, with it, prices. Price adjustments lead to diminished income opportunities for certain social groups. In Western

<sup>5</sup> See among others Bertelsmann Stiftung. Globalisierungsreport 2018. Gütersloh 2018.



industrialized nations, this applies above all to the workforce, whose wages tend to move toward the global average as a result of the international division of labor and the growing accessibility of markets.

## 1. Globalization and Worldwide Wage Convergence

There are two key mechanisms that tend to reduce employment and wages in developed economies with open borders:

- Immigration of labor from less developed economies: Wages are considerably higher in developed industrialized nations than in less developed economies. This serves as an incentive for workers in countries with lower wages to emigrate to the developed economies. In the ideal global labor market, in which changing one's place of employment and residence is possible without any transaction costs, migratory movements of this sort lead to identical wages in all of the world's regions. This global wage would lie between the higher wages found in industrialized countries such as Germany and the US and those in Asian low-wage countries. This would mean lower pay for employees in developed economies, since their wages would fall to the global average.
- Imports of goods from low-wage countries: As the international division of labor occurs, a global realignment of wages also takes place since individual economies begin specializing in certain products and those products are subsequently traded among countries. Due to the low wages found in populous countries such as China and India, those economies have an international competitive advantage in the production of labor-intensive goods. They thus specialize in manufacturing these products. This, in turn, increases the demand for labor, since greater production volumes require more labor. The higher demand for labor causes wages to rise. Highly developed economies such as Germany and the US, conversely, concentrate on producing capital- and technology-intensive products. Thus, they limit the production of labor-intensive products and the demand for labor falls. The reduced demand for labor results in lower wages. Under ideal conditions, wages would converge worldwide, as would interest rates, i.e. the price of capital as a production factor. This development is also known as factor price equalization.<sup>6</sup>

These basic economic considerations thus lead to the conclusion that opening borders for goods, services and factors of production in developed economies results in a decline in employment and wages. These labor market developments are reinforced by technological progress taking place in competitively organized markets.

## 2. Labor-Saving Technological Progress and Global Wage Convergence

Employment- and wage-reducing effects also result from technological advances, which replace human labor in developed economies with capital and technology. This technological progress stems from the need to reduce costs as described above: In a market economy based on competition, companies must permanently reduce their costs of production in order to remain competitive with other players and not be forced out of the market. An effective way to reduce costs is to deploy modern technologies, which increase overall productivity and thus lower production costs. Because wages are relatively high in developed industrialized countries, these economies have an incentive to reduce labor costs by availing themselves of technological advances. In highly

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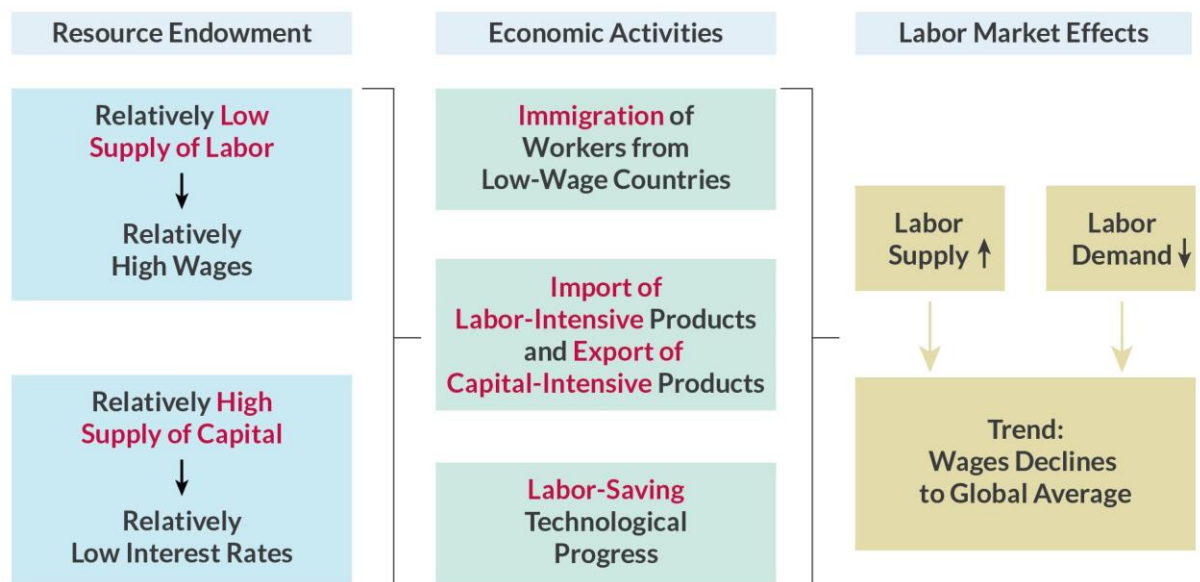
<sup>6</sup> See Horst Siebert. *Außenwirtschaft*. 7th ed. Stuttgart 2000, pp. 62–67.

developed economies such as Germany, these advances become evident as one production factor, capital, replaces another, labor. This results in a decline in employment, downward pressure on wages and an increase in income for the production factor of capital.

In less developed economies, on the other hand, the considerable supply of labor means there is no great economic incentive to implement measures that would achieve labor-saving technological progress. Consequently, there is no downward pressure on wages and employment.

The need to reduce costs – and the associated incentive to realize labor-saving technological progress – applies even in an economy that is completely isolated from the rest of the world. Globalization, however, increases the pressure to cut costs since it leads to a considerable rise in the number of potential competitors.

#### Impact of Globalization on Developed Industrialized Countries



Source: Author's own diagram.

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### 3. Empirical Evidence of the Impact Globalization and Technological Progress on the Labor Market

Empirical evidence of the wage-reducing effect international migration has in Western industrialized nations is relatively weak. For example, the negative impact of immigrant workers on the job market in Germany has been negligible.<sup>7</sup> This is undoubtedly because labor migration in Germany is very limited. The influx of workers is therefore too small to produce noticeable macroeconomic effects. However, the impact is different if subsections are examined instead of the job market as a whole. An analysis of how migrant workers affect wage levels in different industries (e.g. manufacturing versus simple services) shows that the influx of workers from abroad is causing wages in the simple services sector in particular to fall.<sup>8</sup>

<sup>7</sup> See Holger Hinte, Ulf Rinne and Klaus F. Zimmermann. "Flüchtlinge in Deutschland: Herausforderungen und Chancen". *Wirtschaftsdienst* (95) 1991, pp. 748; see also Amelie F. Constant. "Do migrants take the jobs of native workers?". *IZA World of Labor* Nr. 10. Bonn 2014, pp. 9.

<sup>8</sup> See Max Friedrich Steinhardt. "The wage impact of immigration in Germany – New evidence for skill groups and occupations". *The B. E. Journal of Economic Analysis & Policy* (11) 2011, pp. 24.

Conversely, evidence of the wage-cutting effects of trade with low-wage countries is much stronger. There are numerous empirical studies showing that imports from low-wage countries – especially China and Eastern Europe – tend to lower employment and wage levels in industrialized nations such as Germany and the US.<sup>9</sup>

Studies on the labor market effects of technological progress also show the consequences described above for employment and wage levels in developed economies.<sup>10</sup> The use of robots has – until now – only had a minor impact on the job market. For example, one study that examined the influence of robots on regional labor markets in the US between 1990 and 2007 comes to the conclusion that a newly deployed industrial robot eliminates three to six jobs. That represents a loss of 360,000 to 670,000 jobs for the US economy as a whole. Every additional robot per 1,000 workers reduces wages by 0.25 to 0.5 percent.<sup>11</sup> This wage pressure is likely to increase over time, however.

The few studies outlined here on how the labor market is affected by the international division of labor, the associated cross-border trade and the increased deployment of capital and technology in production processes have been confirmed by numerous other studies. For developed economies such as Germany, this has an impact on the distribution of income and opportunities for social participation. In brief, two trends can be identified for earned income:

- In terms of professional qualifications, those individuals who have undergone little or no occupational training will see a decline in their income and employment prospects.
- In terms of economic sectors, employees in manufacturing in particular are affected by lower employment and wage levels, since that is where many routine manual tasks can be replaced by machines and robots, and since the manufacturing sector workforce in low-wage countries competes with these employees.

These two aspects have an impact on living conditions for people in developed economies. On the one hand, there are actual losses in employment and income for some individuals in the groups described above. On the other, those individuals who might be impacted in the future start to fear that they could soon be without a job or have a reduced income – something that might even be the more important factor underlying the growing criticism of liberal, cosmopolitan democracy. The result is greater economic uncertainty for these individuals. Globalization adds to this uncertainty to the extent that it becomes difficult if not impossible for national governments to regulate global markets. This economic uncertainty gives rise in turn to growing criticism of the economic system found in liberal, cosmopolitan democracies.

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<sup>9</sup> See among others John McLaren, and Shushanik Hakobyan. Looking for local labor market effects of NAFTA. NBER Working Paper Series (Working Paper 16535). Cambridge, MA 2010, pp. 21–23; David Autor, David Dorn and Gordon Hanson. The China Syndrome: Local Labor Market Effects of Import Competition in the United States". American Economic Review (103) 2013; Bertelsmann Stiftung. Effekte des internationalen Handels auf das verarbeitende Gewerbe. Gütersloh 2016, pp. 12; and Südekum, Wolfgang Dauth and Sebastian Findeisen. Verlierer(-regionen) der Globalisierung in Deutschland: Wer? Warum? Was tun?. Wirtschaftsdienst (97) 2017.

<sup>10</sup> See Tarron Khemraj, Jeff Madrick and Willi Semmler. Okun's Law and Jobless Growth. Policy Note of the Schwartz Center for Economic Policy Analysis. New York 2006, p. 3; Mark J. Perry. The US economy is now producing 2.2% more output than before the recession, but with 3.84 million fewer workers. Blog post on AEIdeas. November 6, 2012.

<sup>11</sup> See Daron Acemoglu, and James A. Robinson. Warum Nationen scheitern. 2nd ed. Frankfurt am Main 2014.

#### 4. Populist Response by Autocrats

There are two basic approaches to dealing with the negative economic consequences of globalization and technological progress on certain social groups in developed economies: first, preventing globalization-induced income changes through economic isolation and preventing or at least forestalling technological advances and the associated structural change; second, compensatory measures for those individuals whose employment and income opportunities are diminished due to globalization and technology.

Populist governments often choose the first approach. Their economic policies frequently exhibit the following characteristics (excerpted from Petersen 2018):

- Populist economic policy wants to make it possible for people to live beyond their means here and now. To solve economic problems, the government implements simple, fast-acting measures while disregarding the medium- and long-term costs. Necessary economic reforms are ignored in order not to endanger the government's popularity.
- The costs of this short-term increase in prosperity are left to burden future generations, who will have to repay debts to foreign creditors and face the reduced long-term growth caused by the lack of technological progress and structural change.
- Economic actors are divided into the native population, whose prosperity and jobs are threatened by the prevailing economic system, and a small opposing group of profiteers (domestic political and economic elites as well as foreigners).

This economic policy's most important instruments include massive tax cuts and permanent increases in debt-driven public-sector expenditures; high trade barriers on imports coupled with subsidies for businesses exporting goods and services; massive intervention in the pricing system through the introduction of subsidies and price ceilings and floors; and indebtedness of the entire economy to foreign creditors. These steps violate basic principles of the market economy. The interventions in the pricing system interfere with the role prices play as outlined in Section 1.3, thereby overriding the market mechanism at least in part. Burdening the entire economy with debt invalidates the principle of liability to the extent that people living today purchase goods and services from abroad, for which future generations will have to pay by consuming less. Limits on imports result in higher prices for the affected goods and services. This, in turn, reduces the purchasing power of domestic consumers and increases production costs for domestic businesses.

Thus, past experiences with this sort of economic policy – known mostly from its implementation in Latin American countries in the 1970s and 1980s – all ended in economic disaster:<sup>12</sup>

- Tax cuts and greater government spending gave a short-term boost to growth and employment while increasing public debt. High domestic demand could not be met by domestic production, which led to higher credit-financed imports and to incurring debts abroad.

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<sup>12</sup> For the following, see Rüdiger Dornbusch, and Sebastian Edwards. *The Macroeconomics of Populism. The Macroeconomics of Populism in Latin America*. Rüdiger Dornbusch und Sebastian Edwards (Ed.). Chicago und London 1991, pp. 11–12.

- Increases in demand led to higher prices. Growing current account deficits caused a devaluation of domestic currencies which made imports more expensive. Greater inflation led to wage increases (wage-price spiral). Government subsidies mitigated the losses in purchasing power caused by inflation. This, however, increased both government deficits and the debt owed to foreign creditors.
- Government efforts to curb inflation and prevent currency devaluations were unsuccessful, however. Current account deficits grew, as did foreign and public debt. Real wages fell since nominal wage increases could not keep pace with inflation. Capital flight led to less investment. Production and employment declined and GDP shrank. The growing shortage of foreign currency and worsening credit ratings limited import opportunities. Everyday goods and services became scarce as a result.
- Hyperinflation and increasing debt ultimately led to massive economic collapse and to failed governments. Financial support from abroad, e.g. from the IMF, was necessary to get the affected economies going once again.

#### Four Phases of Populist Economics According to Dornbusch and Edwards (1980s and 1990s)



Source: Dornbusch, Rüdiger, and Sebastian Edwards. "The Macroeconomics of Populism." in: The Macroeconomics of Populism in Latin America. Rüdiger Dornbusch and Sebastian Edwards, eds. Chicago and London 1991. pp. 7-13.

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Current manifestations of such an economic policy will have more or less the same results. In Turkey, the consequences of the massive government intervention in the economy are already visible. Greater public spending, tax cuts and government loan subsidies and credit guarantees led to a short-term economic boom. The negative repercussions of this policy are now being felt, with the country's growing public debt tarnishing its credit rating. The devaluation of the Turkish lira is causing the inflation rate to rise rapidly. Inflation and devaluation are leading to capital flight, which is having a negative impact on investment and production.<sup>13</sup>

<sup>13</sup> See Thieß Petersen. Turkey's economy – to boom or not to boom?. Blog post on GED-Home. December 27, 2017.



Economic policy in the United States also has populist elements. Massive tax cuts combined with planned higher government spending will lead to an increase in public debt. Punitive tariffs on imports are reducing the purchasing power of the country's consumers and the competitiveness of its companies. Over the short term, this will increase economic growth in the US. Over the medium- and long-term, however, the growth-dampening effects will predominate.

Thus, a policy based on economic isolation and massive government intervention in the market is not capable of generating long-term economic prosperity for a country.

## 5. Economic Policy Implications

Despite all the legitimate criticism about the effects economic globalization and technological progress in developed countries are having on various groups and regions, an open, competitively organized market economy remains an extremely efficient economic system.

At the same time, the negative effects on employment and income described above cannot be ignored. This is true not for reasons having to do with social justice, but social acceptance. Certain groups of people in developed economies such as Germany suffer disadvantages in terms of income and employment because of advancing globalization and technological progress. However, whether or not justice demands that they should be compensated for those disadvantages is, ultimately, a value judgement.

Declining social acceptance of the social and economic system, in contrast, represents an objective threat to the system's long-term functioning. Without this acceptance a number of dangers loom, including social tensions, strikes and protests, not to mention an increase in property crime and other illegal activity. Not only is there reason to expect a decline in acceptance by those individuals who actually experience reduced income and employment opportunities (e.g. loss of a job, involuntary reduction in daily working hours, reduced wages), but also by those people who fear that they or their families might be negatively impacted.

As described in Section 4, a departure from market-based principles would be the wrong way forward. It would make more sense to retain an open, dynamic market economy and continue benefitting from the advantages of specialization and the productivity increases made possible by the international division of labor and technological progress. To ensure that social acceptance does not decline, the gains from globalization and technological advances must be broadly distributed throughout society. Many policy areas will have to be involved to achieve this goal: the tax transfer system, the entire educational system, structural and regional policies and all areas relating to social security.

This way forward leads to an inclusive solution, since it aims to ensure everyone in society benefits from the advantages of an international division of labor and technological progress. The goal is thus to achieve a more equitable distribution of the greater opportunities for social, political, and economic participation that result from open economies. If these efforts are not successful, political and societal tensions could arise, putting more pressure on the entire social and economic system present in liberal democracies.

## 6. The EU's Options for Taking Action

In view of the noted advantages offered by a market economy and considering how globalization and technological progress are affecting labor markets in Western industrialized nations, the EU has, in my opinion, two basic options for taking action.

On the one hand, it would be advisable to strengthen the central principles of the market economy in order to increase growth and innovation in Europe. The following measures should be considered, especially in view of the international division of labor: completion of the European single market (above all in the areas of trade in services, cross-border mobility of labor, and the digital single market) and conclusion of regional free-trade agreements (primarily with countries whose economic systems are also based on market principles).

On the other hand, the dividends resulting from globalization and technology must be distributed in Europe in such a way that everyone, if possible, benefits from them. This would include implementing measures that increase the mobility of the EU's citizens for professional purposes, making it possible for them to move into those sectors that are benefitting most from the international division of labor. One instrument that has existed since 2006 is the European Globalisation Adjustment Fund, which aids workers who have lost their jobs because of changes in global trading patterns. It funds measures such as needs-based training and retraining; support for people looking for work; career counseling and coaching; and assistance for business start-ups.<sup>14</sup>

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<sup>14</sup> See Lucian Cernat, and Federica Mustilli. Trade and labour adjustment in Europe: What role for the European Globalization Adjustment Fund?" Chief Economist Note (2). Brussels May 2017, p. 2.

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