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# **The ‘New Economy’ and the Old Problems**

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**The 'New Economy' and the Old Problems.**

*Summary*

The „new economy” bubble finally burst. Time has come now to return to common sense, and it has become obvious that there is no such thing as a "new" economy. The economic laws, causalities and mechanisms of old remain as valid as ever and continue to manifest themselves in social, economic and financial developments.

Nonetheless, the „new economy” does offer significant potential for faster growth and higher productivity. Thanks to the Internet revolution, post-socialist countries struggling with market transformation may achieve a technological and infrastructural leap, which would contribute to accelerated economic growth and more rapid reduction of the gap that separates them from developed countries.

However, the precondition for a sustainable diminution of the distance that separates the countries in transition from the "first world" is appropriate economic policy focused on building market economy institutions, improving the quality of human capital, reforming a country's legal framework, protecting intellectual property and, lastly, investing in basic "hard" infrastructure.

The term of "new economy" was coined several years ago to explain a set of new economic, financial and cultural developments, trends and relations entailed by current technological progress stimulated by the increasingly advancing computerization and the development of the global Internet network. A number of economists and politicians have been inclined to believe that the "new economy" was to bring uninterrupted economic growth, the disappearance of business cycles, and the elimination of inflation and its traditional inverse feedback relationship with unemployment. According to some theoreticians of the economy, the "new economy" was also supposed to be subject to "new" economic laws, belying the "old" and recognized truths. It was also to be a "better" economy, meaning greater efficiency and higher effectiveness as compared with the "old" one, often less competitive and too slow to grow.

All things "new" were thus announcing the emergence of a new pattern of rapid economic growth, which was supposed to deliver us "forever" from the traditional problems of social and economic development and cause the inflation-unemployment alternative to die a natural death. But, unfortunately, that did not happen – either in the United States, the most developed country where precisely the "new economy" first emerged and flourished, and where unemployment has surged in the course of the last year<sup>1</sup>, or in Poland, where the ill-timed policy of "cooling down" the economy has brought the economic growth down from an annual average 6.4% in the years 1994-97 to as little as 1.1% in 2001-02.

However, before that had even occurred, the naive belief in the power of the "new economy" had been translated in many countries – especially those most developed, but also with some effect upon the emerging markets – into a stock market boom. In view of the essence of globalization – that is, a progressive liberalization and integration of the various, formerly more or less autonomous markets into a single, increasingly integrated global market – that boom sent the market values of newly established web companies skyrocketing on a global scale to amounts often several times higher than the market capitalization of "old economy" corporations (Shiller 2000).

However, the inflated bubble on the capital markets finally did burst, to some unexpectedly but quite predictably to others. I had been warning of that inevitable effect (Kolodko 2001).

The recent quarters brought a breakdown of the "new economy". The stock market collapse swept up hundreds of individuals who had just been consecrated as the leaders of the "new economy". Time has come now to return to common sense, and it has become obvious that there is no such thing as a "new" economy. **The economic laws, causalities and mechanisms of old remain as valid as ever and continue to manifest themselves in social, economic and financial developments.**

Just as the exploration of space did not wipe out the forces of gravitation, but only proved the genius of man and our great technological and organizational capacities (as well as our financial resources, having in mind the cost of the project!), neither do the discoveries of the "new economy" invalidate the age-old laws of demand and supply. Those laws have survived the centrally planned economy, so will they survive the "new economy". However, the new economy will fundamentally alter the shape those demand and supply curves take on the chart and will have far-reaching implications for finance and the ways of doing business.

This is because the computer, information and telecommunication revolution have given rise to new techniques and technologies, new ways to organize production and services, and new methods in management and marketing. As often in history, it turned out that long-term success (at the level of individual companies, sectors, and the whole economy) is decisively shaped by the profits of enterprises rather than the ups and downs of the stock market.

Could it be, then, that the current preachers of the end of the "new economy" have been right? Interestingly, those are often the same circles or individuals that have just been showing neophyte-like enthusiasm in proclaiming just the opposite view. However, **by no means has the end of the "new economy" come, all the more that its pressure has fundamentally affected the shape of the "old" one.** Those very changes are even more important and consequential than the well-publicized explosion of the "new economy" and its businesses, its subsequent correction and, as one may expect, its future rapid though more balanced growth.

In this light it becomes clear that the concept of the 'new economy' by itself is not really appropriate, but let us stick to it as it is already firmly established. However, it will not be any

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<sup>1</sup> In March 2002, the unemployment rate in the USA increased by as much as 1.4 percentage point as compared with March 2001, reaching 5.6%.

longer the same inflated and irrational "new economy" we have known, where anything related to the Internet was supposed to bring quick profits. At least for some time, the naive belief in technological progress will fade away, just as the hope that technological progress by itself would suffice to solve painful social problems. Old values will be back in fashion. They already are. Just as with the gold fever, so now the Internet rush is over. However, both gold and the Internet, and the information and communication technologies (ICT), have won for themselves – for good – a solid position and importance in the global economy.

Thus the "new economy" remains as a label for the advantages of ongoing rapid technological progress, driven by innovations in the computer and communication technology. However, the "new economy" is no longer an alternative to the "old" one (for actually it has never been one), but has simply become part of the whole economy, without any qualification. There will continue to be a single economy, where the old will be, as usual, intertwined with the new.

If so, the global slump on the stock markets of the "new economy" has by no means marked an end of the digital progress, nor has it even reversed the trends observed in that domain. Just as it has earlier been the case of the steam engine, electricity or the internal combustion engine, it will take some time before the Internet revolution bears its fruit<sup>2</sup>. It is true that some trends have considerably slowed down lately, but this is not simply due to the subsiding enthusiasm of the preceding years. The slow down owes to the ongoing saturation of the market with new ICT and Internet-related products. It is natural that demand for certain goods and services at this stage of the evolution should grow more slowly than before.

For instance, whereas the sales of mobile telephones over the five-year period from 1996 to 2000 had been growing at an incredible average rate of about 60% per annum, in 2001 they fell by 3.2% for the first time in the short history of this invention so strongly related to the "new economy". For all that, almost 400 million telephones were sold in all, and moreover, some companies were capable of increasing their output even in such an unfavorable situation. The market share of Nokia of Finland – already a potentate on the market – grew to 35% in 2001 from 30,6% a year earlier (*The Economist* 2002). However, total sales did not increase because in many places of the global village the market was already all but saturated.

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<sup>2</sup> As we may remember, about 40 years had to pass since the production of electricity was effectively launched before any visible effects of its implementation emerged in the form of increased labour productivity.

In some countries as many as seven persons out of ten already have a mobile phone and any major breakthrough in demand – and consequently in supply and production – may only occur once the new, "third generation" hardware becomes available on the market.

Whether we will all be able to have a share of those fruits is another question. Neither do we know exactly who will be first to take advantage of the blessings of that stage of the technological revolution and inseparable technological progress, and who will fall behind, and why.

There can be no doubt that the USA has already benefited from the "new economy". The proof is the whole decade of the nineties, a period of unprecedented economic growth. Two thirds of that growth was the result of technological progress in information, computerization and telecommunications. Also some other countries, especially Ireland, Finland and Singapore, have achieved considerably accelerated growth thanks to new technologies (OECD 2000, IMF 2001). Among the post-socialist countries, it seems that Slovenia is particularly fit for a similar breakthrough. In Poland a lot remains to be done in that field, but we do have some achievements; we certainly do not stand still.

However, will ICT, especially the Internet and its economic environment, also contribute to accelerated economic growth in the less-developed countries, including post-socialist nations? Is that feasible in a context of enormous shortcomings in infrastructure, the still insufficient degree of maturity of market economy institutions and the inability to furnish sufficient human resources with adequate qualifications to meet the challenges of the "new economy"? In other words, may the "new economy" be put into place if the old problems remain unsolved? Or maybe it is just the other way round; maybe it is up to the new technologies to help overcome those old problems?

Transition from a centrally planned economy to a market economy has made huge and irreversible progress in most post-socialist countries. Prices are now regulated by the interplay of demand and supply, internal and foreign trade has been liberalized, the role of the state in the economy has been redefined, private enterprise has been growing, and dynamic capital markets have emerged. Yet for all those achievements it remains true that transition economies still have many problems to handle. Worse than that, some of those problems

continue to build up instead of disappearing as predicted. Thus transition economies are far from achieving the level of development of the most advanced countries. It is regrettable that for some of those countries the distance to cover has even increased over the past decade<sup>3</sup>.

Post-socialist countries continue to struggle with the problems of insufficiently developed market economy institutions, the shortage of capital for development and investment, and the poor quality of infrastructure, including vital computer and telecommunication infrastructure. That bleak image of transformation is often made gloomier by poor management quality, pervasive corruption and high unemployment. By 2001, only five out of the 27 European and Asian post-socialist countries had succeeded to surpass their GDP level of 1989; those glorious five are Poland, Slovenia, Albania, Slovakia and Hungary. In some countries on the other hand (such as the Ukraine, Georgia or Moldova), GDP had shrunk even below half of its value from the period before the transition had begun (EBRD 2001).

It is thus clear that the way from the centrally planned system to a market economy has proven much more difficult than initially projected. The final destination of that long journey – namely rapid and sustainable economic growth, international economic competitiveness and significant improvement in living standards – still remains a distant perspective<sup>4</sup>. However, that long way might be considerably shortened, since the Internet revolution has created a unique opportunity to significantly accelerate development.

A "New World" of economic expansion has been discovered, this time including also virtual expansion. The Internet has enabled education and research, trade and administration, finance and banking, as well as many kinds of services – including entertainment – to spread within a new, virtual space. We have thus discovered e-finance, e-banking, e-trade, e-administration, and e-entertainment. In the most developed countries, all those new fields of activity have dramatically altered the picture of traditional business.

At the micro-economic level, e-business has reduced the costs of doing business thanks to lower stocks on hand, better price transparency, faster distribution of products or cheaper

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<sup>3</sup> I have extensively discussed the economic, social and political aspects of the systemic transition to a market economy, civil society and democracy in my book "From Shock to Therapy. The Political Economy of Postsocialist Transformation" (Kołodko 1999). See also IMF 2000.

<sup>4</sup> For more on the opportunities and perspectives of bridging development gaps, see Kołodko 2001 b.

supply. The Internet may also provide an additional distribution channel, making it faster and easier for businesses to reach new customers and thus increase their turnover, income and profits.

The Web also provides small companies with an opportunity to make inroads into previously inaccessible markets. All they need is to create their own Internet shop to introduce the whole global community to their products (though it may be more difficult to actually sell them). Lastly, the Internet offers opportunities to improve the quality of products and the comfort of the consumer.

On the macroeconomic scale, all the above micro-economic benefits, by the intermediary of improved labor productivity, translate into an accelerated growth of production. Incidentally, they also bring about a relatively lower unemployment rate and possibly lower inflation rate. Thus, the old alternative inflation versus unemployment still remains true, at least in the short term, but a skillful use of the opportunities created by the "new economy" may mitigate its rigidity. The experience of the United States during the nineties proves just that.

Thanks to the Internet revolution, countries struggling with market transformation may – *toute proportion gardée* – achieve a technological and infrastructural leap from a painful shortage of cable telephones to mobile commerce, from cash to credit cards or from calculators to supercomputers<sup>5</sup>. Such a technological leap would contribute to accelerated economic growth, thanks to which post-socialist countries would be then able to more rapidly reduce the gap that separates them from developed countries.

The "new economy" may thus become a tool for at least partially making up the distance lost in development and eliminating the civilizational divergences, maybe even within the lifetime of a single generation. However, the precondition for a sustainable diminution of the distance that separates the countries in transition from the "first world" is appropriate economic policy focused on building market economy institutions, improving the quality of human capital,

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<sup>5</sup> By the way, when I was recently buying a ticket at Seaward, Alaska, for a boat cruise to Kenali Fjords Natural Park, the travel agent, after a moment of an unsuccessful "fight" with her PC, took a calculator out of a drawer to add a 5% local tax to the price of the ticket. Luckily, there was at least that calculator, for I imagine that an equivalent attribute of the "old economy" in the Russian Big North would rather have been an abacus. In Warsaw, on the other hand, when I was buying an airline ticket at the office of one of world's largest airlines,

reforming a country's legal framework, protecting intellectual property and, lastly, investing in basic "hard" infrastructure (Kolodko 2002a).

Economic policy must support the development of the capital market, whose task is to finance new businesses and increase investment into research and development. R&D is vital both to the absorption of technological innovation created by others and to the creation of original solutions and inventions. Lastly, enterprise should be promoted by reducing administrative barriers (for instance, by the introduction of the *single window* procedure), support for training programs, and favorable tax policy. No less important is emphasis on learning of the English language: as the *lingua franca* of the global economy, English is an indispensable tool for tapping the resources of global science.

The technological progress related to the "new economy" brings more than economic benefits. The Internet may also be used to improve the transparency and efficiency of the work of the government, both central and local. For instance, introducing public procurement in the form of web auctions open to anyone willing to participate may yield more benefits than just reduced costs of purchase of goods and services (this could bring billions in economies on a nation-wide scale); the transparency of the auctions may also significantly contribute to limiting corruption and unfair competition<sup>6</sup>.

The Web is also an opportunity for the development of democracy, since in due time widespread access to the Internet will enable citizens to directly interact with the authorities, just as it was the case in the times of the Athenian democracy. Maybe also in the future the electronic signature will make it possible for citizens to take part in elections by voting at home sitting at their home computer, which would doubtless increase political participation rates (provided that households will be sufficiently equipped with the necessary equipment and Internet connections).

However, the current stage of the technological revolution and its implications are not free from risks or threats. Rapid technological progress may even increase the distance between

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before completing the transaction the agent added up the total amount once again in writing – "just in case". Well, the economy may be new, but the customs certainly are not.

<sup>6</sup> In Poland, for example, that solution has been adopted with excellent results by the National Fund for Environmental Protection and Water Resources Management.

the post-communist countries in transition and the economies most technologically advanced, due to the shortcomings in infrastructure and the gaps in human capital. The risk is great: unless the developing countries are able to absorb the global technological achievements, they will be increasingly marginalized.

The "new economy" is the departing train of progress that is worth catching on time. However, not everyone will be able to board it. If the post-communist countries in transition were to fail to do it, that would put another barrier and another gap between them and the advanced market economies. This time, it will be a *digital divide* between those who have access to new technology and those lacking it. It would be no exaggeration to compare its importance with the gap between those who can read and write and those who are illiterate. If the economic policy of the post-socialist countries turns out to be remote from what is necessary and called for, then even the realistic hopes related to the "new economy" might be disappointed.

To this date the use of the Internet has been limited mainly to developed countries, while the low and medium income countries, including the post-socialist economies of Central and Eastern Europe and the Commonwealth of Independent States, have been using the opportunities the Internet offers to business in a very limited degree, if at all. **The digital divide will prove an insurmountable obstacle to many poor societies, all the more that its size has significantly increased over the last few years** (in all probability there is no other sphere of saturation of the economy by technology where the differences between the richest and the poorest countries are so enormous).

By way of illustration, whereas the richest fifth of mankind creates 86% of the global gross domestic product (GDP), and as much as 93% of their population enjoy access to the Internet, one fifth of the world's poorest inhabitants holds just 1% of global GDP and a mere 0.2% accessibility of the Internet. In other words, while at the one end of the spectrum among the 1,200 million richest inhabitants of the Earth as many as 1,032 millions may use the Net, at the other end there are just 2.4 million Internet users! The relation is thus 430:1, which is a ratio worth remembering when one considers the highlights and shadows of today's globalization and technological revolution.

An important element of the favorable influence of the "new economy" upon the growth of production and improvement in working conditions and living standards is related to the *network effect*, or the additional benefits resulting from the use of a common network to exchange information, data, technology or products. In accordance with the Metcalfe's Law, the benefits from the network are more than proportional to the increase in the number of its users. Thus, if the number of users of the Internet doubles, than the benefits of its existence to its users should more than double.

The question arises, however, what level of usage of the Net is necessary for its benefits to be perceptible at all. Will a community of users of the order of 20 to 30% of the total population be enough – this represents the current level of penetration of the Net in the most advanced post-socialist countries, such as Slovenia – or is it necessary to achieve widespread accessibility of the Internet in businesses and in the majority of households, as it is the case in the USA or Finland? Where does the critical point lie beyond which a country fully enjoys the benefits of the "new economy"?

Analyses show that in OECD countries the extra benefits from the use of communication networks do not adopt a linear progression and that the turning point at which the economy draws the largest benefits from the network effect lies close to the level of universal accessibility to the communication network (OECD 2000). Does this mean that the low penetration of Internet and communication network in post-communist countries will cause the dream of the "new economy" to remain for years a fantasy beyond reach?

In Poland, as it may be estimated, about 700 to 900 thousand jobholders are already employed in the ICT sector (depending on the definition and approach to the "new economy"). Employment in that industry continues growing. The scale of the future progress – including the rates of economic growth and international competitiveness of the Polish economy – will be decisively affected by its ability to progressively move employment in a socially acceptable way from the relatively low value-added industries, sectors and companies of the "old economy" to the "new economy", which comprises a relatively high share of value-added in its output. This process is already underway and the challenge is to intensify and accelerate it as much as possible (Kolodko 2002b).

The Internet revolution has had, and will continue to have an enormous influence upon the financial services sector. The Internet has slashed costs, while dramatically broadening the opportunities for marketing, distribution and service of financial products, and especially banking products. Technological progress has made it possible to develop entirely new kinds of products and services. This is best visible in the case of retail banking, where the network provides access both to existing and new customers, at significantly lower costs than it would have been possible just a few years earlier. The Internet has also contributed to a significant extension of the range of financial services offered and to an improvement in their quality.

More and more of us are experiencing that modern technologies have fundamentally altered the operating environment of businesses, as much on the global scale as regionally and locally. Growing competition, generated precisely by the technological revolution and the progressing globalization process, brings a range of challenges in their further development. Which business models will prove viable in the new reality? Which channels of distribution will turn out to be the most attractive? Who will win and who will lose that technological race? We are still seeking answers to those questions.

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