Perspectives by Ruth Lea

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The global economy in transition: a two-tier world

Introduction

It is has become almost hackneyed to talk about the shifting "tectonic plates" of the global economy.[1] But shifting they are. As the Eurozone crisis rumbles on and the Standard and Poor's rating agency downgrades US debt from AAA to AA+ (on 5 August) there is a very distinctive air of the inexorable relative decline, though not quite the eclipse, of the developed world as the emerging economies gain importance. The deep 2008-09 recession, which disproportionately affected the developed economies, and the more recent travails of the "west" have highlighted just how fundamentally the global economy is changing and how western hegemony is slipping away.

The longer-term trends are inextricably intertwined with the short to medium-term prospects of the developed economies, on the one hand, and the developing on the other. Many developed economies, hamstrung by high indebtedness, are struggling to grow whilst the emerging economies are, if anything, overheating.[2]

The changing global economy

Before discussing some more specific issues, it is instructive to note just how significant the changes have been over the past 20 years. Charts 1a and 1b show the impact that a rapidly growing China has had on other major countries' shares of world GDP. India is much less significant.

Chart 1a comprises the 12 largest economies, as in 2010, as shares of total world GDP compared with the equivalent shares 20 years earlier. The US retains its position as the biggest economy though its proportion of the world total has dropped a little from 26% in 1990 to 23% by 2010. China's economy has leapfrogged the largest European economies and Japan to account for over 9% of the total by 2010. The biggest "loser" over the period is undoubtedly Japan, comfortably the second largest economy in 1990, but after 20 years of relatively slow growth it slipped behind China in 2010.

Chart 1b comprises the 12 largest economies in purchasing power parity (PPP) terms, which allows for the differences in the purchasing power of different currencies for a given basket of goods and services, including non-tradeables. The discrepancies between the GDP data using market exchange rates and in PPP terms, can also be part explained by the undervaluation (or overvaluation) of the currencies of the countries under examination. As can be seen from the chart, the relative size of China, India and Russia are significantly lifted by using PPP estimates, whilst Japan falls back even further. Canada and Spain drop out of the "top 12" to be replaced by Mexico and South Korea. The PPP data confirm the dramatic increase in China's significance.

Chart 1a: 12 largest economies (in 2010), GDP, nominal, % share of world total

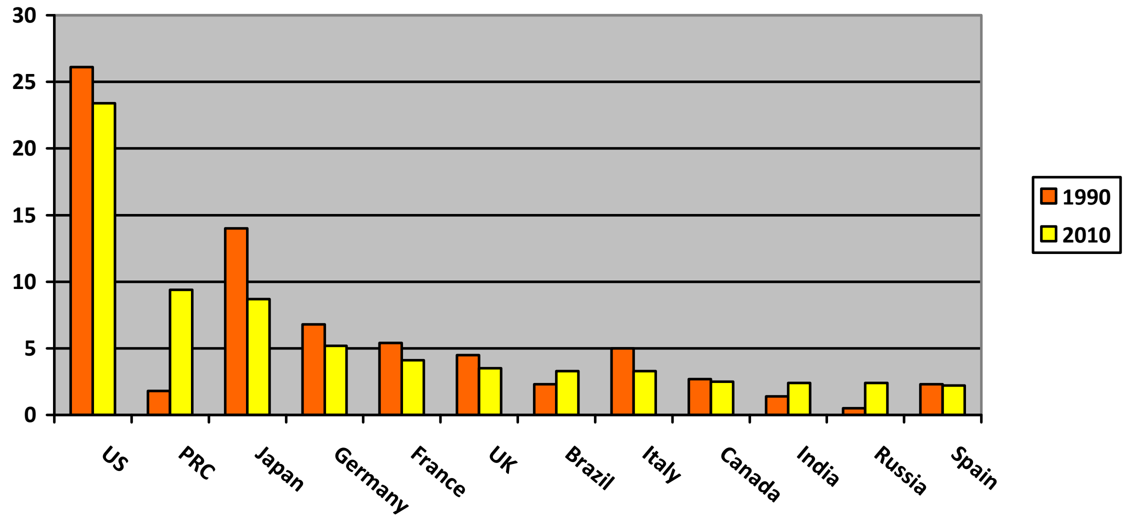
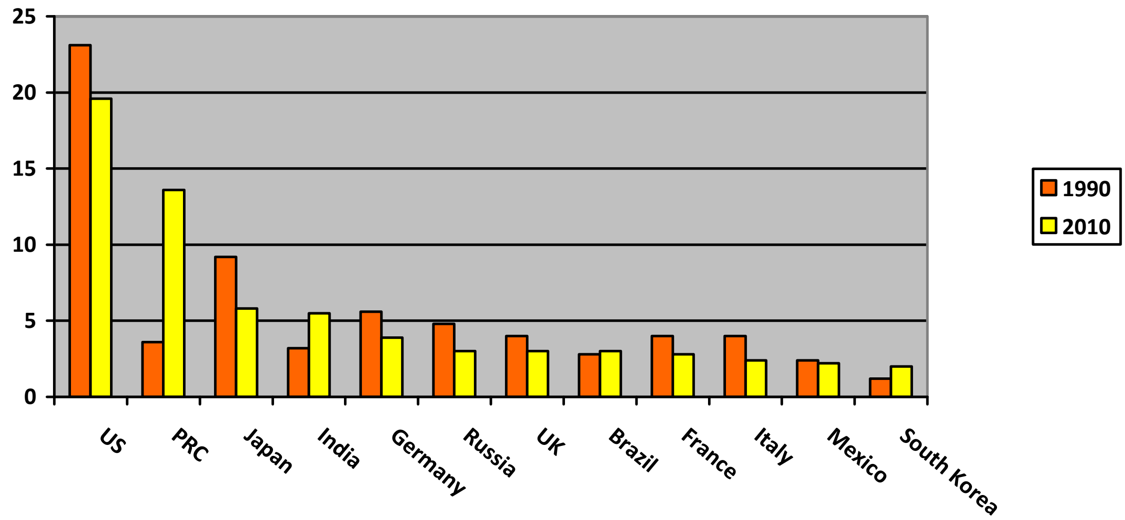


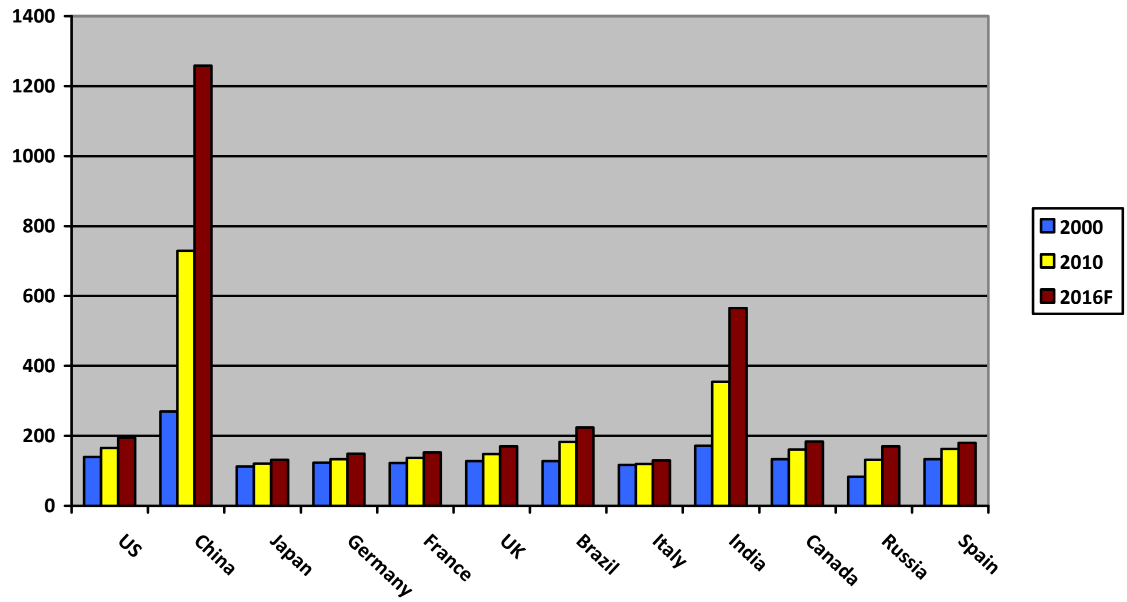
Chart 1b: 12 largest economies (in 2010), GDP, PPP basis, % of world total



Source: IMF database, www.imf.org. The underlying current prices GDP data are in US dollars, converted using market exchange rates (chart 1a), and international dollars for the Purchasing Power Parity basis (PPP, chart 1b). Data for Russia start in 1992.

Another approach to measuring the changes in the world economy is to compare the relative growth rates in constant prices. Chart 2 confirms the spectacular growth performance of China, the creditable performance of India and the laggardly showing of Japan between 1990 and 2010. The IMF's forecasts to 2016 suggest China's stellar growth performance will continue. See annex table 2.

Chart 2: 12 largest economies (chart 1a), constant prices, 1990=100



Source: IMF database, www.imf.org, latest data and forecasts. Note that for Russia, 1992=100. The underlying data are shown in annex table 2.

Looking further out, several economies are set to face a "demographic challenge" in forthcoming decades.[3] Annex table 3 shows that the following countries are projected to show quite substantial falls in working population between 2010 and 2050: Japan (31%), Germany (25%), Italy (21%), Spain (14%) and Russia (27%) – and indeed China (19%). China could well get "old" before it gets "rich".

The *Economist* magazine recently assessed the enormous strides made by the developing world in order to "appreciate the true shift in global economic power".[4] They defined the developed world as the original members of the OECD excluding Turkey whilst all other countries, including the newly industrialised Asian countries such as South Korea, were counted as "developing". They concluded:

- The combined output of the developing economies accounted for 38% of world GDP (at market exchange rates) in 2010, twice its share in 1990. On reasonable assumptions it could exceed the developed world's within 7 years.
- The emerging economies' exports edged above half of the world total in 2010, up from 27% in 1990. Their rising income also sucked in more imports, which jumped to 47% of world imports last year. They attracted over half of all inflows of FDI in 2010, with foreign firms increasingly lured by these countries' fast-growing domestic markets as much as lower wages.
- The emerging economies are likely to account for over half of all capital spending, up from 26% in 2000.
- Even though they still "punched well below their weight" in commerce and finance, they were catching up fast. Almost a quarter of the Fortune Global 500 firms, the world's biggest by revenue, came from emerging markets. In 1995 it was only 4%.

- All in all, the outlook was bright for emerging economies, with less debt than the developed world, more favourable demography and a huge potential to lift productivity. Their "greater weight and speed" meant that the emerging markets would "drive global growth, commodity prices and inflation" – a profound turnaround in economic fortunes and not always fully appreciated.

As the *Economist* noted the emerging world is notably less indebted than many countries in the developed world. Much of Europe and the US have been living beyond their means for decades with a rapid build-up of private sector debt (in the US, the UK and Spain for example) as well as public sector debt. This overhang of debt will act as a drag on growth for several years. The current growth underperformance of the US, the UK and several Eurozone economies (the Eurozone crisis apart) is, therefore, unlikely to be just a temporary factor and will be yet another factor behind the relative decline of the developed economies.

US-Chinese relations
Turning from generalities to the specific issue of US-Chinese economic relations, which polarises the developed-developing world's stresses, China's reaction to Standard and Poor's US downgrade was somewhat critical. The official Xinhua news agency declared "the US government has to come to terms with the painful fact that the good old days when it could just borrow its way out of the messes it has made are finally gone". It went on to call for an end to US sovereignty, advocating "international supervision over the issue of the dollar". China has, of course, an interest in US government debt. It has more than $3.2tn in currency reserves, about a third of which is invested in US government debt. Any fall in the price of the debt and/or depreciation in the dollar against the renminbi will of course result in Chinese losses.[5] But Chinese complaints about excessive US borrowing seem misplaced if not disingenuous.

China's export-driven growth model, with its objective of fostering growth and employment almost at any cost, has partly relied on maintaining an undervalued renminbi in order to push growth. And there is little doubt that the renminbi is undervalued. According to the IMF the currency is up to 23% undervalued, the precise estimate depending on the approach taken to calculate the degree of undervaluation.[6]

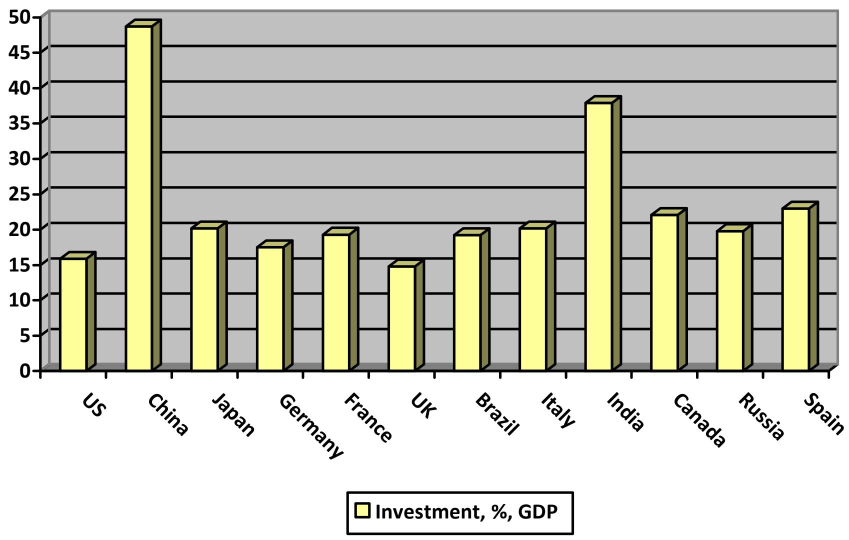
China has therefore artificially held down its export prices, incidentally pricing many competitors out of the manufacturing market, and accumulated huge current account balances. The resulting huge international reserves have been partly invested in US bonds. (And, given the absence of viable alternatives, will continue to be invested in US bonds.) US-Chinese trading relations can therefore be seen as "goods-for-bonds" trade and the rise in China's dollar holdings merely a by-product of its growth strategy. In other words, the almost inevitable consequence of China's export-led model has been its huge holdings of US assets. And the Chinese authorities must surely have realised that there was a significant risk that these US assets could depreciate.

The other side of the coin of China's trade surplus is, of course, the US's huge current account deficit and increased American indebtedness as the US authorities sought to maintain US consumption and growth with expansionary policies. The biggest beneficiaries of the US's debt-financed consumption have been Chinese exporters.

But as the US struggles to grow China, and the other export-dependent emerging markets, will find life tougher.

China's export-driven growth model is therefore, arguably, running out of road and the Chinese authorities will have to rebalance the economy towards domestic consumption, if rapid GDP growth is to continue. The model has, in any case, resulted in growing distortions in the Chinese economy. As chart 3 shows investment was nearly 50% of GDP in 2010, which is extraordinarily high and quite unsustainable.

Chart 3: 12 largest economies (chart 1a): investment (% GDP), 2010



Source: IMF database, www.imf.org

There are possible signs of rebalancing in China's development model, but the IMF has recently argued that much more needs to be done:

- "…there has been much progress on a number of fronts and the 12th Five Year Plan lays out a comprehensive strategy to advance the transformation of China's growth model. [But] to achieve these goals, a range of measures will be needed including improvements in the social safety net, policies to raise household income, a liberalisation of the financial system, a stronger currency and increases in the costs of various factors of production."[7,8]

One of the most contentious aspects of the IMF's policy prescription is, of course, the appreciation of the currency. But there have been tentative signs recently that Beijing is prepared to let the renminbi rise. In the week beginning 8 August the currency strengthened by 0.7% against the dollar, ending the week at Rm6.39 against the dollar and some 3.3% higher than at the beginning of the year.[9] Of course these are small moves by the standards of most currencies but relatively large ones for the managed (some would say manipulated) Chinese currency. The motivation for the recent move remains unclear. It could be to curb China's troublesome inflation (6.5% in July) or perhaps it was a tentative move in rebalancing the economy away from exports and the need to recycle the surplus proceeds in US debt. It is also unclear whether the move marks the start of an appreciating trend, or it is a one-off, or it could even be reversed. But if the move does mark the start of an appreciating trend then this could be a very significant indeed.

Global trading imbalances: a long-standing problem
The US-China trading relationship is part of the more general problem of global trading imbalances between debtor and surplus countries. Chief debtor country is the US (the US current account has been in deficit since early 1980s, with the exception of 1991) but, as charts 4a and 4b show, of the "top 12" economies, France, the UK, Brazil, Italy, India, Canada and Spain are also in the red. The surplus countries are China, Japan, Germany and to a lesser extent Russia.

Chart 4a: 12 largest economies (chart 1a): current account balances ($bn), 2010

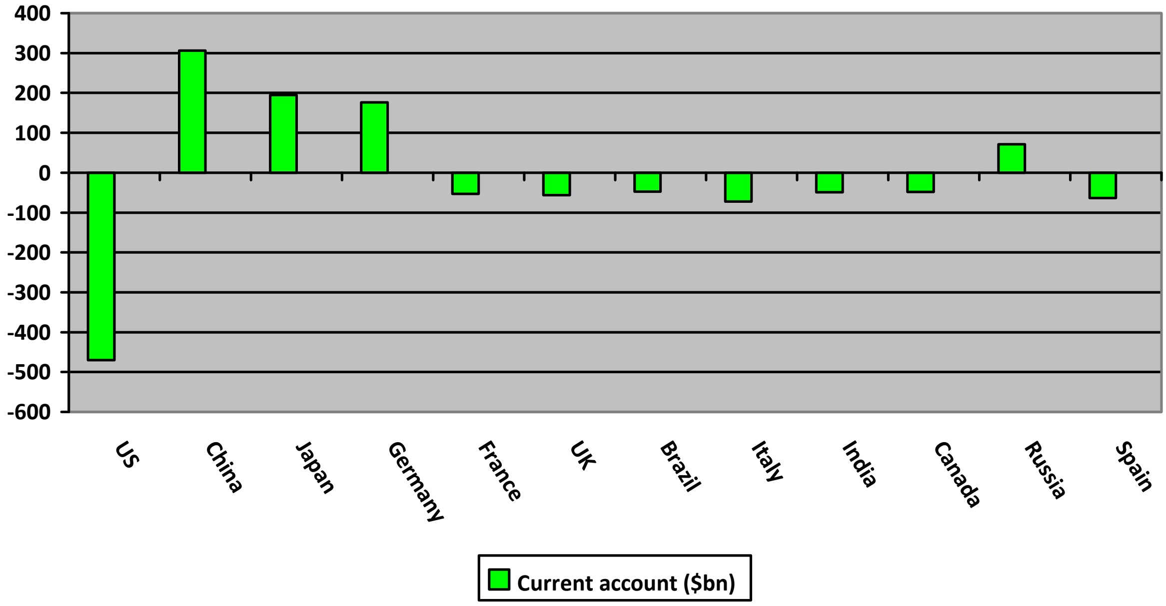
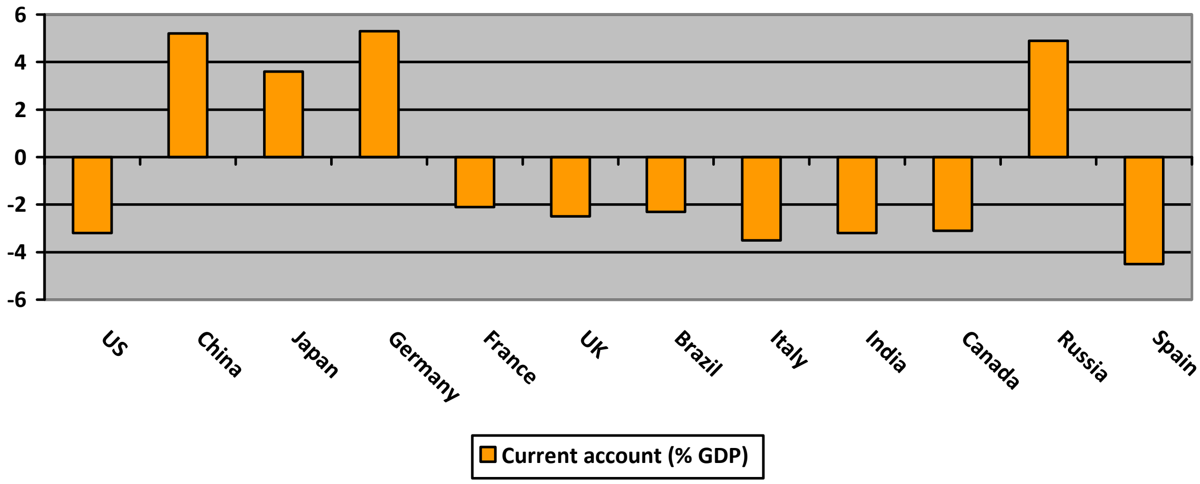


Chart 4b: 12 largest economies (chart 1a): current account balances (% GDP), 2010



Source: IMF database, www.imf.org

The observations made above about the US-Chinese situation can be applied (partly) to debtor and surplus countries in general. The surpluses of the net exporters are being recycled into the unsustainable debts of the over-consuming nations.

These imbalances are not being resolved in any managed way, yet another example of the world's major economies muddling through with G20 and G7 seemingly impotent, though the various fiscal retrenchment packages in the UK, for example, should ameliorate the situation. As it is necessary for China to rebalance its economy towards domestically-led growth, so too should Japan and Germany aim to stimulate domestic demand in order to boost global demand and help rebalance the global economy. Higher domestic growth in Germany might also alleviate some of the imbalances within the Eurozone.

References

1. See also Ruth Lea, "The changing global landscape: G20 comes of age", Arbuthnot Banking Group, 5 October 2009. G20 was active in 2008-09, but has been relatively quiet since.
2. IMF, *World Economic Outlook Update*, June 2011, concluded that there was a "mild slowdown of the global expansion, and increasing risks. Growth in many advanced economies was still weak, considering the depth of the recession. Growth in the emerging and developing economies continued to be strong. Risks drew from persistent fiscal and financial sector imbalances in many advanced economies, while signs of overheating are becoming increasingly apparent in many emerging and developing economies."
3. Ruth Lea, "Adverse demographic trends in Europe: ageing populations and relative economic decline", Arbuthnot Banking Group, 1 March 2010.
4. *Economist*, "Why the tail wags the dog", 6 August 2011.
5. The renminbi (RMB) is the official currency of the PRC. The primary unit of renminbi is the yuan. The UK equivalents of the renminbi and the yuan are sterling (the official currency) and the pound (the primary unit of sterling).
6. IMF, *People's Republic of China, 2011 Article IV consultation*, July 2011, reported that the "main near-term risks…are from higher-than-expected inflation (most likely from domestic food supply shocks), a property bubble that inflates and then bursts, or a decline in credit quality linked to the post-crisis expansion in lending."
7. IMF, *People's Republic of China, 2011 Article IV consultation*, July 2011.
8. BBC website, "IMF urges China to 'rebalance' its economy", 21 July 2011.
9. *FT*, "Renminbi's surge raises questions on Beijing stance", 12 August 2011.

Annex

Table 1: 12 largest economies (chart 1a), nominal GDP and on PPP basis ($tn)

	GDP ($tn)+			GDP, PPP ($tn)	
	1990	2010		1990	2010
US	5.8 (26.1)	14.7 (23.4)	US	5.8 (23.1)	14.6 (19.6)
PRC	0.4 (1.8)	5.9 (9.4)	PRC	0.9 (3.6)	10.1 (13.6)
Japan	3.1 (14.0)	5.5 (8.7)	Japan	2.3 (9.2)	4.3 (5.8)
Germany	1.5 (6.8)	3.3 (5.2)	India	0.8 (3.2)	4.1 (5.5)
France	1.2 (5.4)	2.6 (4.1)	Germany	1.4 (5.6)	2.9 (3.9)
UK	1.0 (4.5)	2.2 (3.5)	Russia+	1.2 (4.8)	2.2 (3.0)
Brazil	0.5 (2.3)	2.1 (3.3)	UK	1.0 (4.0)	2.2 (3.0)
Italy	1.1 (5.0)	2.1 (3.3)	Brazil	0.7 (2.8)	2.2 (3.0)
Canada	0.6 (2.7)	1.6 (2.5)	France	1.0 (4.0)	2.1 (2.8)
India	0.3 (1.4)	1.5 (2.4)	Italy	1.0 (4.0)	1.8 (2.4)
Russia+	0.1 (0.5)	1.5 (2.4)	Mexico	0.6 (2.4)	1.6 (2.2)
Spain	0.5 (2.3)	1.4 (2.2)	South Korea	0.3 (1.2)	1.5 (2.0)
World total	22.2 (100.0)	62.9 (100.0)		25.1 (100.0)	74.3 (100.0)

Source: IMF website, the % of the world total is shown in brackets.
+ Russia, data start at 1992.

Table 2: 12 largest economies (chart 1a): GDP constant prices, growth projections (to 2016)

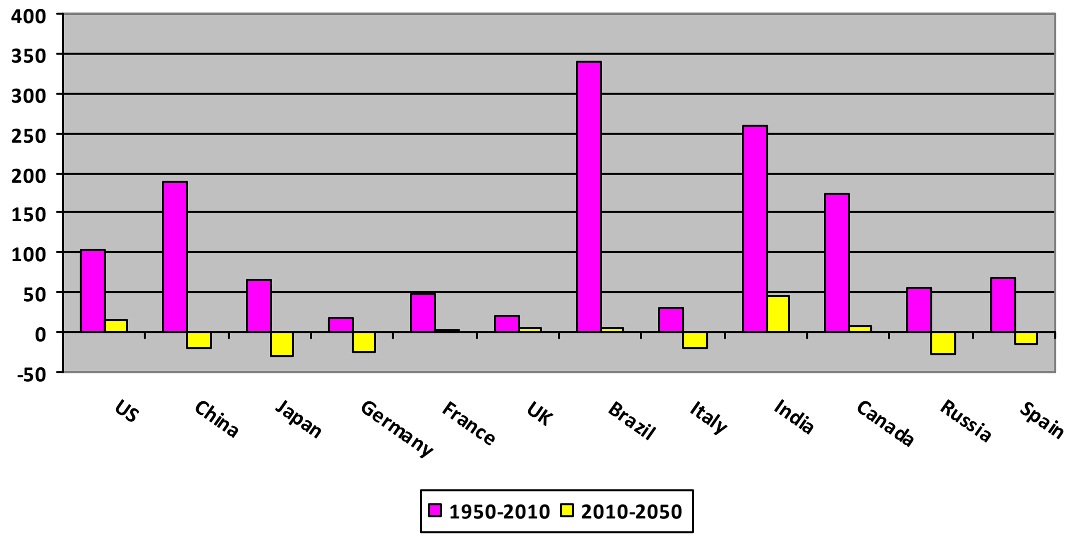
	GDP, 1990=100+			Average annual growth rates (%)		
	2000	2010	2016F	1990-2000	2000-10	2010-16
US	140	165	194	3.4	1.7	2.7
PRC	270	729	1,258	10.4	10.4	9.5
Japan	112	121	132	1.1	0.8	1.5
Germany	123	133	149	2.1	0.8	1.9
France	122	137	153	2.0	1.2	1.9
UK	128	148	170	2.5	1.5	2.3
Brazil	128	183	224	2.5	3.6	3.4
Italy	117	120	130	1.6	0.25	1.3
India	172	355	566	5.6	7.5	8.1
Canada	133	161	184	2.9	1.9	2.25
Russia+	83	132	170	-2.3	4.7	4.3
Spain	133	163	180	2.9	2.1	1.7

Source: IMF website for GDP in constant prices, national currencies, and author's calculations.
+ 1992=100 for Russia.

Table 3: 12 largest economies (chart 1a): working population projections, % changes (to 2050)

	1950-2010	2010-2050
US	+103%	+16%
PRC	+188%	-19%
Japan	+65%	-31%
Germany	+19%	-25%
France	+48%	+2%
UK	+21%	+5%
Brazil	+340%	+6%
Italy	+31%	-21%
India	+258%	+45%
Canada	+175%	+9%
Russia+	+55%	-27%
Spain	+69%	-14%

Chart 1: Working population (15-64 years old), % changes



Source: UN, *World Population Prospects*, medium variant, 2010 revision (data are for working populations), author's calculations.

IMF world groupings

World
Composed of 184 countries: 34 advanced and 150 emerging and developing countries.

Advanced economies (9 of G20 countries)
Composed of 34 countries: **Australia**, Austria+, Belgium+, **Canada***, Cyprus+, Czech Republic, Denmark, Estonia+, Finland+, **France*+, Germany***+, Greece+, Hong Kong SAR#, Iceland, Ireland+, Israel, **Italy*+, Japan*, Korea#,** Luxembourg+, Malta+, Netherlands+, New Zealand, Norway, Portugal+, Singapore#, Slovak Republic+, Slovenia+, Spain+, Sweden, Switzerland, Taiwan Province of China#, **United Kingdom*, and United States***.

* = G7
+ = Eurozone (17 countries)
# = Newly industrialized Asian economies (4 countries)
"Other advanced economies" excludes G7 and euro area (13 countries)

Emerging and developing economies (10 of G20 countries)
Composed of 150 countries: Republic of Afghanistan, Albania+, Algeria, Angola, Antigua and Barbuda, **Argentina**, Armenia, Azerbaijan, The Bahamas, Bahrain, Bangladesh, Barbados, Belarus, Belize, Benin, Bhutan, Bolivia, Bosnia and Herzegovina+, Botswana, **Brazil**, Brunei Darussalam, Bulgaria+, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Chile, **China**, Colombia, Comoros, Democratic Republic of Congo, Republic of Congo, Costa Rica, Côte d'Ivoire, Croatia+, Djibouti, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eritrea, Ethiopia, Fiji, Gabon, The Gambia, Georgia, Ghana, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Hungary+, **India**, **Indonesia#**, Islamic Republic of Iran, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kiribati, Kosovo+, Kuwait, Kyrgyz Republic, Lao People's Democratic Republic, Latvia+, Lebanon, Lesotho, Liberia, Libya, Lithuania+, Former Yugoslav Republic of Macedonia+, Madagascar, Malawi, Malaysia#, Maldives, Mali, Mauritania, Mauritius, **Mexico,** Moldova, Mongolia, Montenegro+, Morocco, Mozambique, Myanmar, Namibia, Nepal, Nicaragua, Niger, Nigeria, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, The Philippines#, Poland+, Qatar, Romania+, **Russia**, Rwanda, Samoa, São Tomé and Príncipe, **Saudi Arabia**, Senegal, Serbia+, Seychelles, Sierra Leone, Solomon Islands, **South Africa**, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sudan, Suriname, Swaziland, Syrian Arab Republic, Tajikistan, Tanzania, Thailand#, Democratic Republic of Timor-Leste, Togo, Tonga, Trinidad and Tobago, Tunisia, **Turkey**+, Turkmenistan, Tuvalu, Uganda, Ukraine, United Arab Emirates, Uruguay, Uzbekistan, Vanuatu, Venezuela, Vietnam#, Republic of Yemen, Zambia, and Zimbabwe.

+ = Central and eastern Europe (14 countries)
# = ASEAN-5 (5 countries)

Note: G20 comprises 19 countries, in bold above, and the EU.

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