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Megatrends of the Global Economy of Tomorrow

By Wilhelm Hankel and Robert Isaak

"The *New* New World will be dominated by the sea change of economic dynamism shifting away from the West to the emerging economies, led by the exploding middle-classes in the BRICs…"

Several megatrends will shape the face of the global economy of tomorrow:

1. The increase in the number of world actors. There will be more than the current G-7 (-8) and G-20. Future world directives will involve more nations than this. The increase in the number of players alone implies that the dominant influence of the West will diminish.

2. The importance of globalization for the prosperity of nations will decline. The mercantilist strategies of "export-led growth" are apt to play a far smaller role than in the past 200 years. Adam Smith's patriarchal wisdom, that the prosperity of nations must be prepared at home, will be taken seriously again. It is above all the BRIC and other emerging countries who will give primacy to their internal markets and structures. Their priorities are infrastructure development and job creation.

> **"The old structure of the world economy, in which the industrialized world pulled out its raw materials from the less-developed world and processed them, belongs to the past."**

3. The old structure of the world economy, in which the industrialized world pulled out its raw materials from the less-developed world and

processed them, belongs to the past. The emerging countries process their own raw materials and build their own industries. Under the pressure of growing scarcity and environmental needs, more and more natural resources (particularly fossil fuels) are being replaced with synthetic substitutes. Herein lies the great opportunity for the old industrial countries to maintain their leadership position in the global economy through innovation and technological advances.

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The New New World will be dominated by the sea change of economic dynamism shifting away from the West to the emerging economies, led by the exploding middle- classes in the nations known as the BRICs (Brazil, Russia, India, and China). The West seems old, indebted, and politically stale-mated in comparison to many emerging nations, where an increasing share of the world's economic growth and institutional investment will end up. Indeed, by 2020, the BRICs are forecast to contribute twice as much global growth as the G-3 (the United States, Japan, and Germany). In the sectors of automobiles, mobile phones, and commodities, the BRICs are leading the way. With 40 percent of the world's population, the BRICs already account for 25 percent of global GDP and are intensely increasing their trade with one another, often in local currencies, and becoming more independent. They are much less dependent on exports than most people realize (exports account for less than 15 percent of GDP in Brazil and India, not to mention China). In June of 2009, the BRIC leaders met with representatives of the Shanghai Cooperation Organization (SCO; including a number of former Soviet republics) in Yekaterinburg, Russia. In addition to coordinating on global financial regulations, this meeting also focused on moving away from the dollar as a key reserve currency in an orderly fashion and restructuring the IMF in order to make Special Drawing Rights (SDRs) more significant as a transition to a multipolar basket of currencies as the basis for a new international monetary system. They are also quietly focusing development on environmentally sustainable projects and processes and are likely to surprise the developed world with their competitiveness in sustainability.[1]

The excesses of the financial sector among the rich nations go back to imbalances in the world economy that have long been recognized. Those emerging economies that are most successful in international trade (i.e., the BRICs) are precisely those endowed with large domestic markets and resources capable of being developed. Global imbalances (on the unlikely assumption that causality can be so easily attributed) are largely the result of surreptitious export-led growth strategies of states—above all China, in addition to Germany and Japan. A nation imports the necessary development capital, although it "has it" or could mobilize it at home because the savings are present. It is a new version of the old concept of mercantilism. At that time, gold was lacking, which was needed for the production of domestic money and credit; therefore, a nation had to bring it in through export surpluses in order to succeed—taking money and credit hostage, according to the theories of Hume and Smith, among others. Today the BRICs, OPEC, and other commodity-oriented countries lack essential institutions in order to transform the wealth of savings into productive investments: capital markets and banks, both of which are underdeveloped. Thus, a nation finances a large part of its investments and development through foreign reserves. But the conversion of foreign reserves into domestic money and credits is highly inflationary: pure money and credit creation. Because this process must be kept under control, a large residual basis must remain in accumulated reserves that cannot be used, particularly in China.

These residual reserves serve to finance the huge deficits of the U.S. financial superpower (due to the role of the dollar) as well as the deficit nations of the EU—because these reserves are stored in the currencies of these deficit countries. The overdevelopment of the Western financial system (overbanking connected with risky financial innovations and know-how) resulted in heavily supporting this wrong-headed financial development process of Third World states, diverting them from attacking their own financial underdevelopment. Foreign money and credit was easier and cheaper to obtain than that which was available domestically! And yet it was due to high financial reserves that a nation was deemed credit-worthy. The crisis signals the end of this seemingly comfortable but profoundly uneconomic mode. The indebted United States and European Union countries are no longer credit-worthy or good debtors. The BRICs and OPEC, and others must invent other strategies and investment vehicles for their surpluses. The old mercantilism failed, because not all nations can export at the same time.

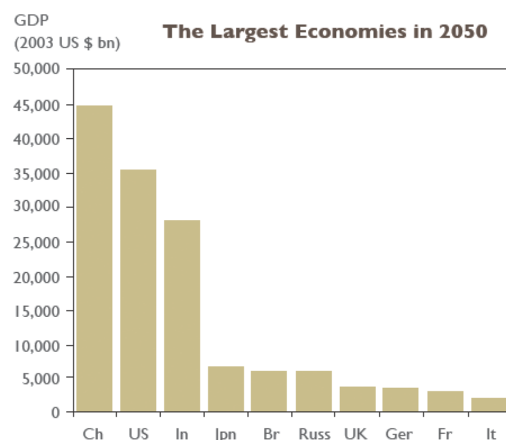

Figure 1 The Largest Economies in 2050
SOURCE: Dominic Wilson and Roopa Purushothaman, "Dreaming with the BRICs: The Path to 2050." Goldman Sachs Global Economics Paper No.99. www.gs.com

The emerging economies have already attempted to imitate those that formerly had "economic miracles" (such as Japan and Germany). They observed the effectiveness of post-authoritarian stability aimed at commercial results through export-oriented growth, trying to keep politics and security issues in the background in order to attract investment and trade. Being underbanked, they were not as hardhit by the near bankruptcy of the global financial crisis in comparison with the overbanked rich countries of the West, which were suddenly weighed down by their domination of

financial sectors that created no new social value, but merely charged higher prices for old capital. The financial reserves of the emerging nations helped to bail out Western institutions with which globalization had permanently interlinked them. The global transformation was underscored at the Copenhagen Climate Summit in December of 2009, where President Obama and his Secretary of State Hillary Clinton found it necessary to crash a private meeting of the BRIC countries in order to solidify a compromise of transparency—a result far less significant than the power shift implied by the process involved in this particular negotiation!

Developing countries are no longer seeking out the old rich nations of Europe or North America for models, but are looking rather to Singapore and China, the "bricks" among BRICs. The only exception, paradoxically, appears to be the financial sector: The underdeveloped countries seek to mimic many of the wealth-creating features of the wealthy, even after witnessing the inevitable booms and busts that must follow from such speculative behavior.

> **"In terms of the classical Western economic model, the question has become whether or not the West can afford to pay for the freedom of its own corporate and government speculations."**

In terms of the classical Western economic model, the question has become whether or not the West can afford to pay for the freedom of its own corporate and government speculations. For example, the debt-to-GDP ratios of the top 20 richest countries are twice as high as that of the 20 largest emerging markets! For how long will the emerging countries be forced to help pick up the tab? The Chinese and other emerging economies are quietly diversifying out of dollar reserves (i.e., buying U.S. treasury bonds, which support U.S. overspending). Indeed, the foreign exchange reserves in Asia and emerging markets—particularly China, Russia, Brazil, India, and Taiwan—have exploded, significantly outstripping those of the United States and Europe. **(See Figure 2)** No longer trusting the United States or the IMF as reserves of last resort, emerging markets have concentrated on savings to the extreme, contributing to significant global economic imbalances matching in proportion the imbalances caused by overconsumption in the United States and developed countries.

> **"A related issue is whether or not the classical model of free trade will fade out as a process of "regionalization" around each of the BRICs is developed."**

A related issue is whether or not the classical model of free trade will fade out as a process of "regionalization" around each of the BRICs is developed. Perhaps the largest controversy here is the aggressive export policy of the Chinese, stimulated by an undervalued currency, against which other developing countries, not to mention developed countries, seek some protection. The Chinese exporters, on the other hand, see the "free trade philosophy" of the World Trade Organization as a cipher for theirindividual freedom and are clearly enthusiastic about it. Shrewd policy-makers in China are exploiting the differences between the free trade rules of the World Trade Organization (WTO) and China pushes for strict enforcement of the free trade rules (for the sake of its exports), while ignoring the IMF because it does not borrow from them and therefore is not officially subject to any of its recommendations in terms of, for example, letting the Chinese currency float upwards (which would hurt its exports by making them more expensive).[2] Neomercantilism comes in many flavors!

From 2000 to 2008, direct net exports contributed just 1.1 percent annually to total Chinese GDP growth (or about one- tenth). However, in the same period, investment rose by about 8 percent—the real driver of GDP growth, helping to explain why China was not hit that hard by the 2007 crisis. But the Chinese dilemma is that to keep high growth rates the nation must either shift toward radical domestic consumption (against a tradition of high savings rates to make up for a weak social safety net, to finance family education and pensions, etc.), or to rely more heavily on an export-growth-oriented model (motivating the government to keep the currency somewhat undervalued in order to keep their exports more competitive). The Chinese are not likely to turn to the West for a domestic policy model.

For Anglo-American globalization has so sped up the capitalist process of creative destruction that the traditional communities of all societies are overwhelmed: citizens who are confronted with more change than they can cope with reach for the comfort of old habits and values, a psychological conservatism, which can also take the form of religious conservatism or extreme nationalism. Moreover, the industrialized "overbanked" peoples of the West most afflicted by the housing bust, the debt resulting from the crisis, and the threat of terrorism are more likely to stay conservatively stuck in place than are people in the more dynamic, emerging growth economies. A poignant example of indigestible change is the daily volume of "high frequency trading" of U.S. stocks that makes up half of the transactions daily: such trades can be carried out in 400 microseconds, or 1,000 times faster than the human eye can blink. No wonder that traditional communities assume that this computerized economy is not only inequitable, but undermines traditional "human" values!

Meanwhile, the shift in global reserves is but one key indicator of the power shift away from the developed to the emerging economies.

Figure 2: Reserves of Foreign Exchanges and Gold
SOURCE: Data: CIA, The World Factbook, Chart: Suyan Jain.

Implications of the Crises in the Middle East and Europe

The contagion of revolutions in the Middle East in 2011 is a reinforcement of the sea change from the importance of the developed to the developing nations. Had it not been for the earthquake and tsunami in Japan, the media of the world would have been totally absorbed by the transformation of the Middle East. And the weakening of the Japanese economy through the tragedy there further highlights the shift in power to emerging economies.

While western nations may try to tilt outcomes with marginal military interventions, the dynamic changes in Arab countries are coming from within. They will develop their own models of economic and political transition and whether or not they will take advice (as opposed to military and economic support) from the West is an open question. Never before has it become so important as to which social capitalist model in the West is worthy of copying. Or, will the Arabs look to develop their own unique models instead, or even use models from Singapore for inspiration? There is a high probability that they will develop their own internal models culture by culture.

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The two current crises around the Mediterranean — the southern European and the North African – do not have common roots. Nevertheless, they could yield a common fruition: a new common market in which the Mediterranean does not function as it does today as a sharp divider, but rather as a traffic hub, binding the two sides together – as in ancient times and the early Middle Ages, before the Atlantic replaced the Mediterranean in this function after the discovery of the New World. The crisis of the EU triggered by the € will not result in the "United States of Europe", but sooner or later in the division of Europe into an industrial (and Protestant) north and an agricultural-dominated (Roman or Greek Catholic) south. One can exclude the possibility that the developed north of the EU will in the long-run be willing to subsidize the under- financed south which is striving to catch up. This would overwhelm its strengths. The future of northern Europe is also determined by making use of its domestic resources and the mastery of their internal problems (the consequences of aging, high social and training standards and stable employment). The dominant focus of its export-led growth is, after all, concentrated outside of Europe in the continually "globalizing" world economy of old and new emerging countries.

North Africa is experiencing a double revolution: that of the young (the average age being 50 percent of that in the old northern Europe) and that of secularization, the separation of religion (Sharia) and state comparable to the Reformation and the Enlightenment in Europe in the 16th to 18th centuries. The resulting, evolving Arab civil society will no longer be one of Islamic fanaticism, but rather a secular middle-class commercial one, which is quite compatible with a secularized Islam. What is decisive, however, is that the economic structures of both shores of the Mediterranean are complementary and are very well suited for reciprocal exchanges (trade in agriculture, industrialization). The Mediterranean will once again

become the infrastructural basis of this exchange and contribute to the revival of old traditional markets and trade routes.

This article is largely excerpted from W. Hankel and R. Isaak, BRAVE NEW WORLD ECONOMY: GLOBAL FINANCE THREATENS OUR FUTURE (John Wiley, 2011).

See: http://Bravenewworldeconomy.blogspot.com

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Prof. Hankel is a consultant to central banks and governments, at the moment of Syria and Iraq, author of 14 books, past Director of the Department of Money and Credit in the German Economic Finance Ministry, and former President of the Hessisches Landesbank in Frankfurt. He has taught monetary theory and development economics at the University of Frankfurt, and at many other universities including Harvard, Georgetown, The Free University of Berlin, Dresden, and Johns Hopkins University SAIS in Bologna, where he published Modern Inflation co-authored with Robert Isaak.

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Previously taught at New York University, the University of Heidelberg, SUNY at Purchase, Franklin College in Lugano, ESC Grenoble, SKEMA School of Management at Sophia Antipolis, and Johns Hopkins University SAIS in Bologna.

Notes

1. Mario Lettieri and Paoloa Raimondi, `BRICs Drive Global Economic Recovery,' *IMF Survey Magazine* (July 22, 2009),1.
2. Keith Bradsher, 'China Uses Rules on Global Trade to Its Advantage,' *New York Times* (March 15, 2010), A1.

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