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"Perspectives on the New Structure of the World Economy"

Distinguished Guests,
Ladies and Gentleman,

I would like to begin by sincerely thanking Mr. T C Venkat Subramanian, Chairman and Managing Director of the Exim Bank, and Exim Bank for their very kind invitation to give their 23rd Annual Commencement Day Lecture. I would like to also thank them for the very kind and generous hospitality afforded to me and my delegation. I am particularly happy that Chief Economic Adviser Dr. Arvind Virmani, a friend and colleague of many years, is presiding over this evening's event. It really is a great honour and a great pleasure to be able to share my perspectives on the world economy, and India's role in it, with such a distinguished audience here in Mumbai. India has been present throughout my life, through teachers, colleagues, students and friends, many today active in India in government, academia or think-tanks. Time does not allow me to mention them all. But as the Administrator of the United Nations Development Programme allow me to pay a special tribute to Professor Amartya Sen who, with the late Mahbub Ul-Haq, is the father of our Human Development Reports. India is a country I love to study, to learn from and to enjoy. It is a country where I feel at home.

My last visit took place in the autumn of 2005. I recall that at that time my Indian friends were debating whether an 8 percent growth rate was a sustainable medium term target – or whether perhaps 7 percent was a more realistic and likely goal. International experts were generally projecting a somewhat lower growth rate for India, closer to 6 percent over the next decade or so. Today the debate has shifted: most projections, national or international, have climbed into the 8 to 9 percent range, for the coming years at least.[1]

[1] Government of India Planning Commission (2006) and Ahluwalia (2007).

India has joined China as one of the two new emerging giants in the world economy, bringing great hope to its own people, but also hope to hundreds of millions of citizens of developing countries who now can start to believe that it is actually possible to catch up with the rich advanced countries, that the world will not forever be divided between have and have not countries, that our new 21st century can be one of economic convergence rather than further divergence.

There have been cases of very rapid growth before: Japan in the four decades following World War II, and the Republic of Korea more recently. But the scale of these examples was limited and did not result in an improvement in the world size distribution of income if we view the world "as if" it was one country.[2] Such an improvement is now occurring, although the often massive rise of within-country inequalities almost everywhere in the world is counteracting the equalizing effect of Indian and Chinese growth. The lack of progress in many of the poorest countries, most in Sub-Saharan Africa, is a further factor contributing to the stubborn persistence of worldwide inequality.

Since the summer of 2007 a different type of hope has emerged in connection with the rapid growth of India and China: could this "Asian growth" help avoid a significant world economic slowdown, even if close to recessionary conditions were to prevail in 2008 and 2009 in many of the rich economies, particularly in the United States, after the spread of the sub-prime mortgage crisis?

These are some of the big questions debated worldwide. I cannot at all pretend to have the answers. History should have taught us economists to be very prudent when making predictions. In the mid-1990s very reputable people were predicting an oil price of less than 10 US dollars for the beginning of the 21st century! In the year 2000, just before the burst of the dot com bubble many economists, mostly of the market fundamentalist variety, were propagating the view that the sky high stock values in the dot com sectors reflected assured future profits in the unfolding "new economy"; never mind that for some of these companies no profits at all had yet materialized.

[2] To borrow some vocabulary from Surjit Bhalla, "*Imagine There's No Country: Poverty, Inequality, and Growth in the Era of Globalization"* 2002. Contrary to my friend Surjit, however, I do not think that it is the size distribution of income of all "world citizens" that is necessarily the most compelling aspect of global income distribution. Differences between country averages as well as within-country distributions are as relevant and as important. More on that below.

And in the middle of our current decade, just three or four years ago, when huge fiscal deficits and low interest rates provided a formidable Keynesian boost to the still dominant US economy, with the ensuing resource gaps financed from abroad, many economists and analysts in the financial sectors worldwide still preferred to take the optimistic view that it was an underlying and sustainable acceleration in technological progress and associated improvements in efficiency that caused the rapid growth, rather than acknowledging the at least as important role of the Keynesian stimulus. We are currently witnessing a deep reassessment of the experience of recent years which naturally affects our evaluation of the nature of globalization and also spills over into predictions about the future. It is therefore with a lot of modesty that I would like to share some perspectives on the world economy with you today, knowing that it is always very hard to understand the reality that is unfolding and aware of the fact that history teaches us that surprises are often just around the corner.

I will focus on two dimensions of the world economy today which also have some relevance to India. First I will share with you some thoughts on the role the financial sector has played in recent world economic events and on what some call "financial capitalism" as opposed to the "industrial capitalism" of earlier times. Analysts from across the world are wondering and debating how, what started as the sub-prime mortgage crisis in the United States and has since developed into a serious financial sector crisis in the US and parts of Europe, will affect for the world economy as a whole and the developing countries including India in particular. So I wanted to share some personal thoughts with you tonight on the recent financial sector events within a longer term perspective. I then would like to address another aspect of the recent debate, relating to the changing structure of the world economy and look at the increasing share of the "emerging South" in macroeconomic aggregates and what this means for both income distribution and growth in the world economy. Finally, in conclusion, I will say a few words about the global economic governance issue in light of recent developments and the new structure of the world economy.

I. Global growth acceleration and the financial sector

Before looking at our recent experience it may be useful to remind ourselves that significant growth in per capita incomes is a relatively "modern" phenomenon in a long term historical perspective. For many centuries humanity essentially "subsisted" at very low income levels without any significant growth. An essentially Malthusian mechanism seemed to have been at work.

Population growth kept up with whatever productivity increase there was. In good times, population increased to absorb any income growth. In bad times it declined. History changed rather dramatically in the early 19th century with the industrial revolution. Figure 1 and Figure 2 show that economic growth is a fairly recent phenomenon, triggered by the technological progress of the industrial revolution, and associated with increased integration of the world economy. It is also quite clear that for the world as a whole, there has been an underlying accelerating growth trend from 1820 to today.

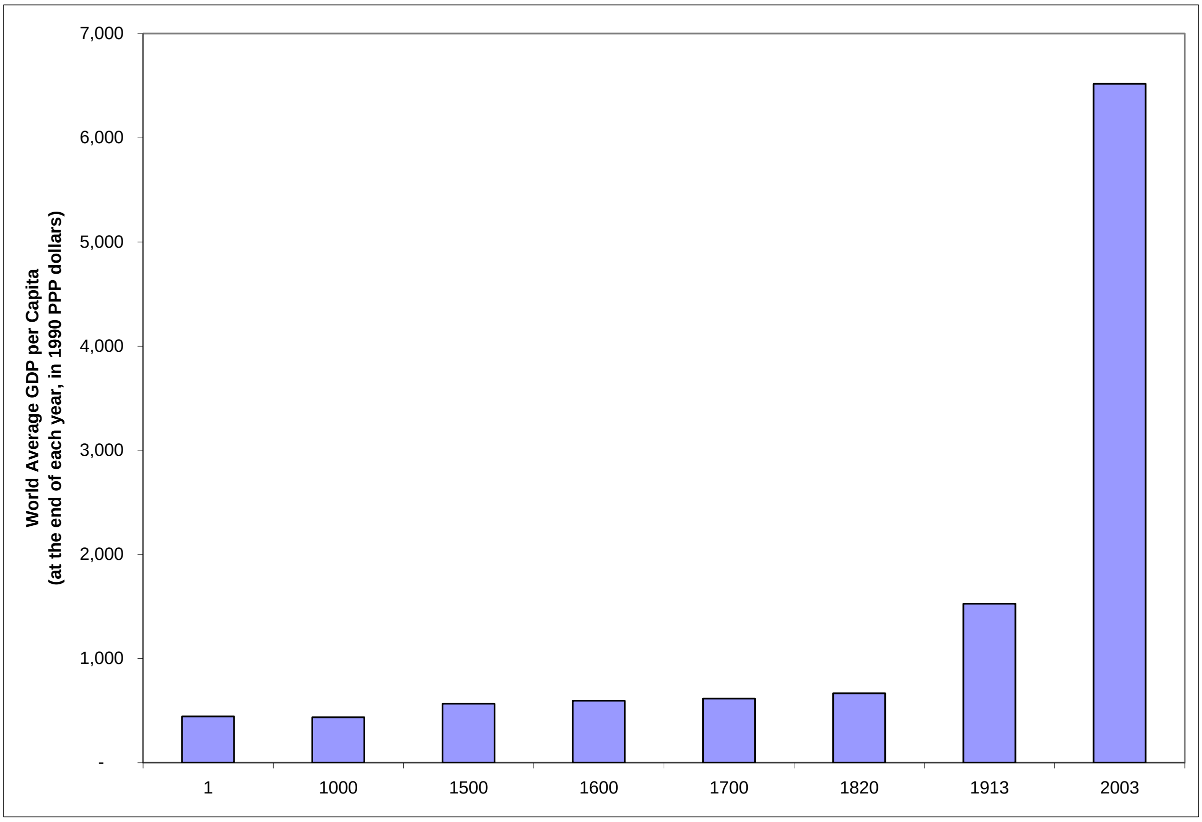

Figure 1- Worldwide Real GDP per Capita in Constant 1990 PPPs, 1-2003
Source: Maddison (2007b).

There are fluctuations around the trend, however, with periods of marked slowdown, the most severe caused by the series of human catastrophes starting in 1914 with World War I, continuing through the years of the great depression and only ending after World War II. That was also a period of "disintegration" when the share of trade declined due to war and increased trade barriers. Another relative slowdown is associated with the big oil price shocks of the 1970s. Overall, however, the last two centuries have been a period of unprecedented economic advance and it seems clear that it has been the combination of technological progress, capital accumulation and access to ever increasing market size that has allowed this remarkable progress. These productivity increases allowed humanity to escape the Malthusian trap and to advance without having to give back the gains as population expanded.

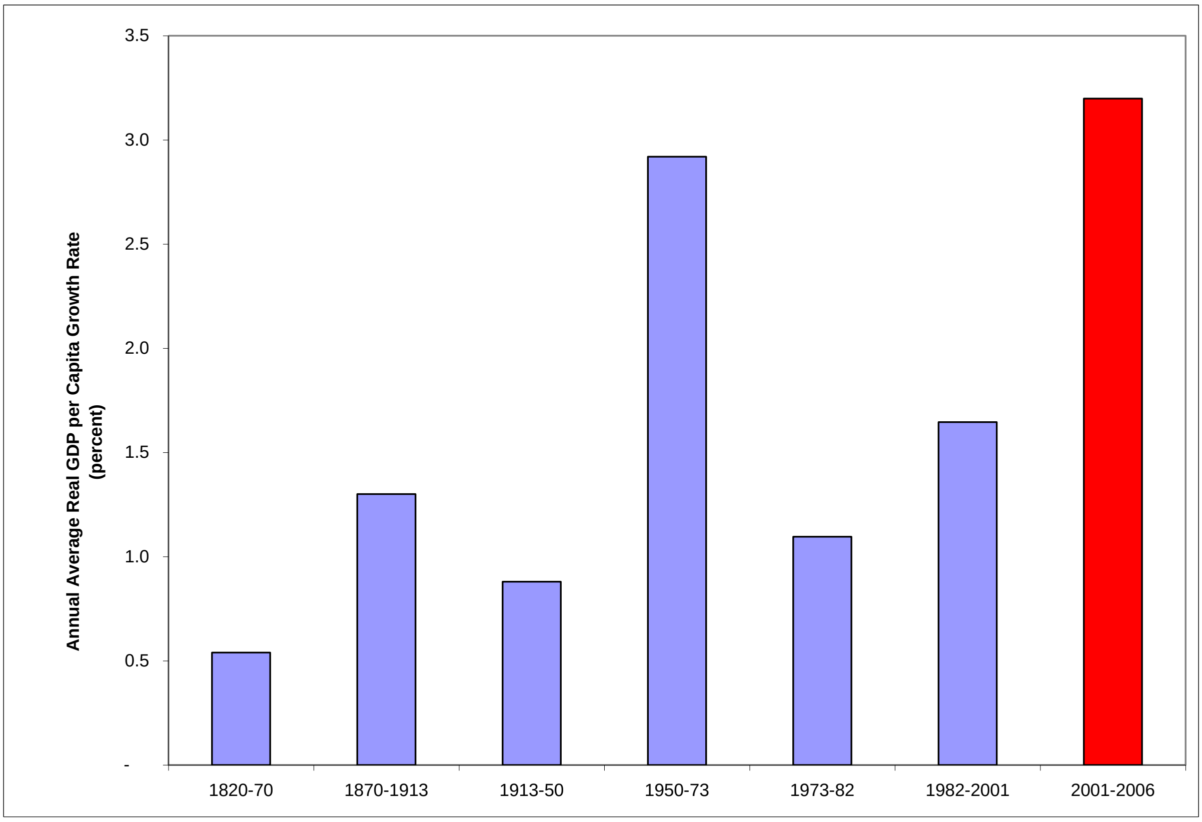

Figure 2- Annual Growth in Worldwide Real GDP per Capita, 1820-2006
Source: Up to 2001 Maddison (2007b). For 2001-2006 World Bank (2008b).
Note: GDP expressed in constant purchasing power parities (base year 1990 up to 2001 and base year 2000 for 2001-2006).

This is not the time, however, to go deeply into far away economic history. I would like to concentrate on more recent experience. Many argue, plausibly given the amazing nature of the advances in information technology that we are witnessing another "industrial revolution" since the late 1980s. It is interesting, therefore, to focus attention on the recent period since 1990. Figure 3 plots world economic growth in terms of two year rolling averages from 1990 to the present. For the two year averages that include 2008 and 2009, I am of course relying on projections rather than factual data (and for 2007 on an estimated value).

It seems clear that the last two decades have been characterized by rapid and accelerating world growth, with the trend interrupted three times: around 1997, around 2001 and now again around 2008, although we do not know yet how serious this interruption will be. These recent interruptions are not associated with wars or periods of trade disintegration. Instead all three of them have been caused by financial sector difficulties of a more or less global nature. The first of these financial sector shocks was the Asian Financial crisis that spread to Russia and Latin America.

It led to a marked slowdown, in some cases substantial contractions, of middle income country growth, but because of the small impact it had on rich country growth, the overall slowdown in the world economy was small. The second shock came from the burst of the dot com bubble in the rich country economies, notably the United States. The terrorist attack of September 11, 2001 occurred at the same time, and no doubt contributed to the slowdown by affecting some industries such as aviation and tourism. Both interruptions turned out to be very short in duration. The five year period from 2002 to 2006 inclusive was one of the fastest five year periods of global growth on record, the fastest in per capita terms, excepting some of the post-World War II recovery period driven by physical reconstruction and therefore not really comparable. This remarkable growth acceleration at the beginning of our century has now been interrupted by another financial sector based crisis rooted in the sub-prime mortgage and securitized investment vehicles debacle that has spread in the rich economies.

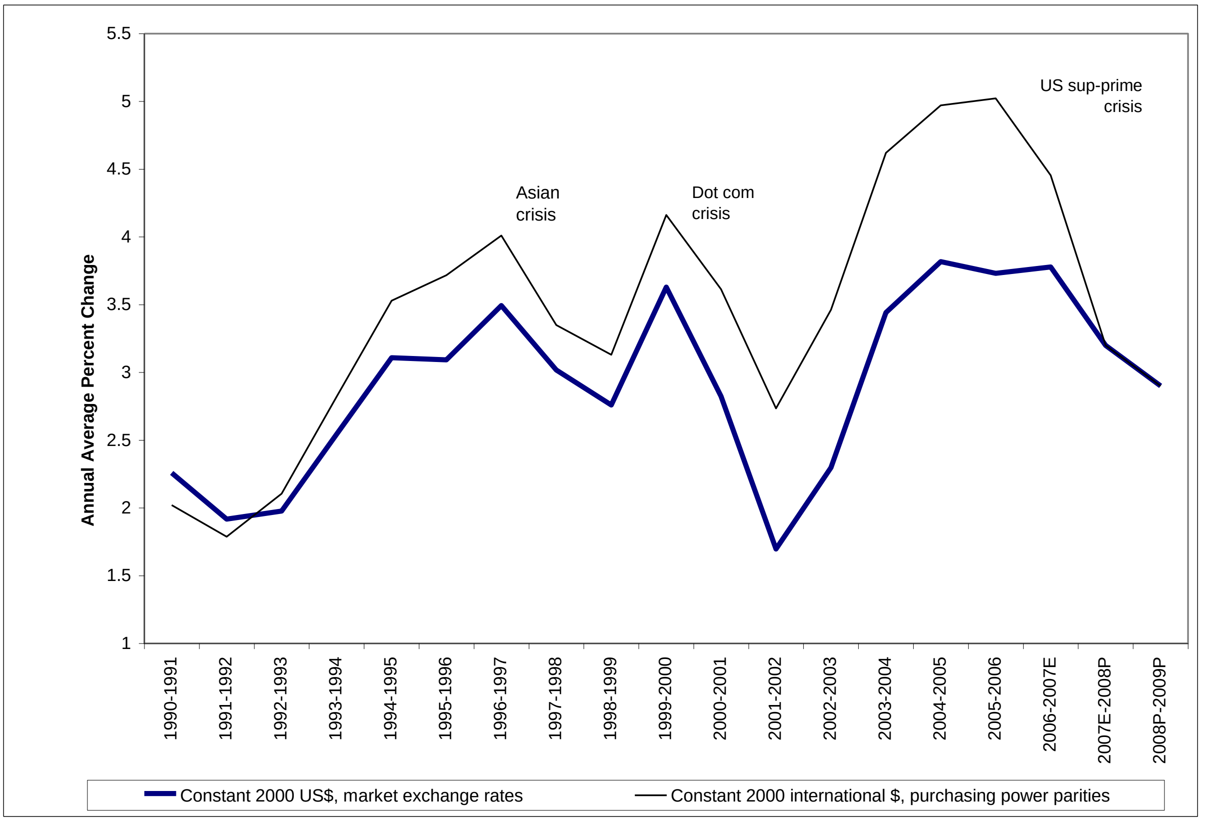

Figure 3- Global Annual Growth Rate, Two Year Rolling Average, 1990-2009.

Source: World Bank (2008a,b) and own projections.

Note: Global growth projections of 2.8% for 2008 and 3% for 2009. Estimate for 2007 from World Bank (2008a).

The ensuing decline in asset prices, both financial assets and real estate, as well as the confidence crisis in the banking sector, is leading to both a decline in the supply of credit and a negative wealth effect, both threatening aggregate demand and growth. We do not know yet how deep and lasting the effects of this shock will be, and how much of the world economy they will reach.

Before looking in a more disaggregated way at the structure of the world economy, I would like to emphasize the common financial sector nature of these shocks. In all three cases it was a certain “irrational exuberance” in the financial sector that led to the shock. The Asian crisis was caused by excessive private capital flows to the emerging markets with very open capital accounts and excessive appreciation of assets in or relating to these emerging markets. The ensuing capital flow reversals and depreciations led to a growth collapse in these economies. India and China, not having very open capital accounts were not strongly affected, and as the group of these “other” emerging market economies represented less than about 9 percent of world GDP their growth collapse did not have a big global impact. Moreover, the financial losses taken by rich country investors were moderate, both because the share of the assets affected in total global financial sector assets was small, and because IMF and G7 intervention limited these losses as the ensuing stabilization programmes resulted in the value of many of these assets being protected through fiscal austerity and the generation of balance of payments surpluses in the former recipient countries of these capital flows. The biggest losses for rich country creditors were due to the moratorium on Russian public debt which did cause substantial problems.

The dot com crisis was caused by a similar type of exuberance, but this time focused on the new high-tech and start up enterprises linked to the information technology revolution, mostly in the United States. When the bubble burst the crash was quite severe in that sector. But at the end of the day the sector represented only a small share of total asset values in the advanced economies. Moreover, as had been the case with the Asian crisis, there was a vigorous policy response in the form of greatly expansionary fiscal and monetary policies in the United States. The fiscal balance changed from a 2.4 percent of GDP surplus in 2000 to a smaller surplus of 1.3 percent in 2001 and a deficit of 1.5 percent in 2002 and almost 3.5 percent in 2003 (US CBO 2008). The federal funds rate set by the US Federal Reserve was lowered from 6 percent in early January of 2001 to 3.75 percent in late June of 2001 to 1.25 percent by November of 2002 and further to 1 percent by June of 2003 (US Federal Reserve Board 2008).

We are still in the middle of living through the third financial sector shock the world economy is experiencing since the early 1990s. A good part of the liquidity that was provided to the world economy by the expansionary fiscal and monetary policies following the dot com bubble burst and 9-11 went into the housing sector. The amount of available liquidity worldwide increased further with the huge accumulation of oil and gas wealth from 2004-2005 onwards. The combination of liquidity, in part due to low interest rates in the US and Japan, new complex investment instruments and serious regulatory failures with regard to the financial sector in the rich economies, allowed a new asset bubble, focused this time on the housing sector and associated financial instruments to develop. The new crisis has hit us in mid-2007 and is still unfolding. Almost every month since the summer of 2007 growth projections are revised downwards. In several steps, huge losses surfaced in the financial sectors of the US and Europe leading to equity market declines, confidence and credit problems and declines in effective demand. The World Bank's Global Economic Prospects 2007, released in January of that year, had predicted 2.8 percent real GDP growth for the high income countries in 2008 (World Bank 2007). The 2008 version published this January lowered this projection to 2.2 percent (World Bank 2008a), still way too optimistic. I personally think that we would be very lucky indeed if growth on average in the high income countries reached 2 percent in 2008. It is more likely to be well below that. While this does not mean an actual recession defined as negative growth in at least two of the four quarters of 2008 for the rich countries as a whole, it does mean a very serious slowdown.

Before turning to a more regional analysis of the structure of growth and the place of the emerging South in the world economy, I would like to draw attention to the role of the financial sector in the events of the last two decades. Over this period capitalism in the rich countries has increasingly changed its nature from one where the lead sector was manufacturing, to one where the role of traditional industries has declined, the share of services has increased and the financial sector is playing a leading role.

New economies of scale facilitated by the information revolution, global financial integration, regulatory changes in the US allowing commercial banks to engage in investment banking and other previously restricted activities, the emergence of hedge funds and private equity have all resulted in a very dominant financial sector. Figure 4 presents a rather amazing picture. In the early 1980s the share of the financial sector in both, corporate value-added and profits in the American economy, was about 5 to 6 percent. The share of financials in value added has steadily increased and has reached about 8 percent in 2006-2007. The share of profits, however, climbed to reach an extraordinary 40 percent and more!

It is almost unbelievable : 40 percent of total corporate sector profits in recent years went to a sector that in itself does not "produce", such as is the case for automobiles, clothing or machinery, but that "intermediates and organizes" the resources that do produce.

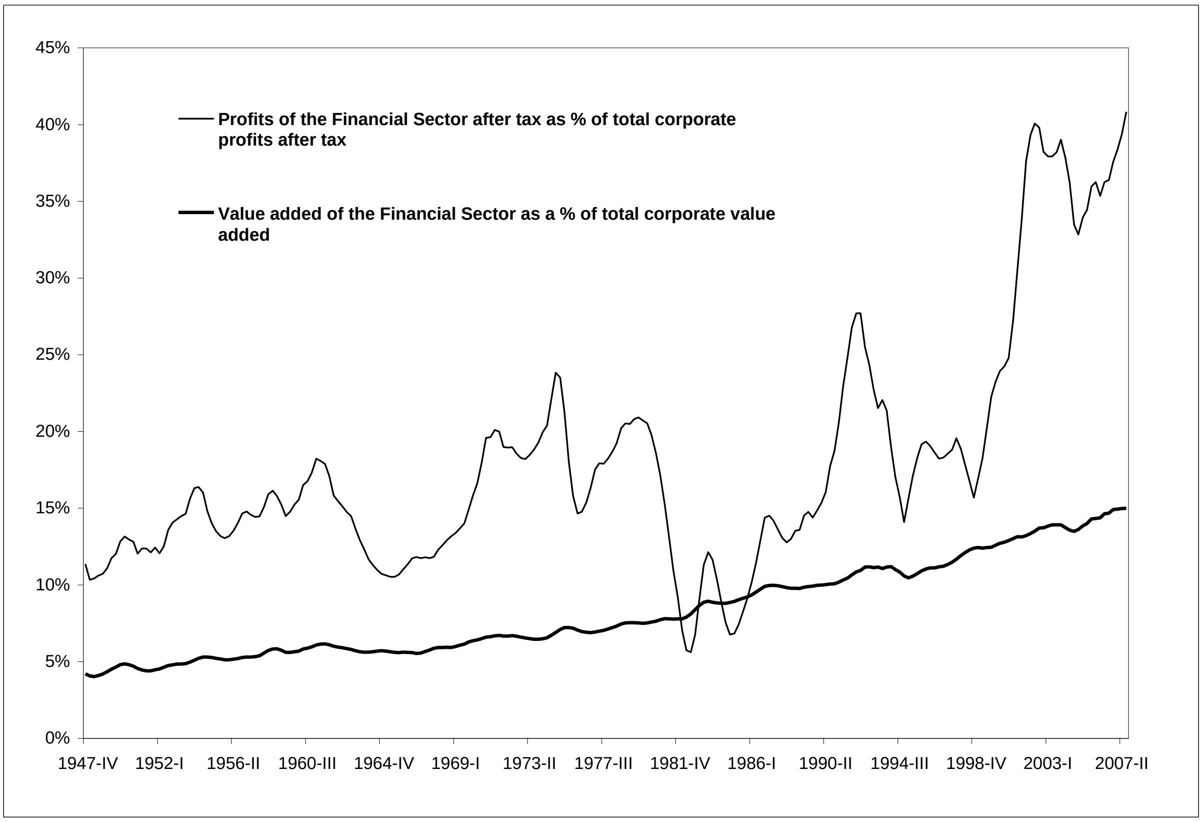

Figure 4- Share of Profits and Value Added of US Financials, 1947-2007 (4-quarter rolling)
Source: Own calculations based on US BEA (2008).

Some managers of large industrial conglomerates continue to attract attention, but it is the super-bankers, hedge-fund managers and owners of private equity firms that have become the new "barons" of 21st Century capitalism in many countries. Even the largest industrial enterprises are not immune from "unfriendly" takeover attempts engineered by private equity operators. Many believe that this much increased role of the financial sector works in favour of greater efficiency, by forcing out lethargic managers, encouraging a relentless search for greater productivity and profits, and allowing a constant restructuring and adjustment that increases flexibility and innovation throughout the economy. All this may be quite true but the pre-eminence of the financial sector also imparts a greater amount of "short-termism" to the system, with immediate profits a more important driver than long term considerations.

If many productivity increases require long-term investments and substantial up-front costs, with benefits accruing over many years, it is not likely that such investments can receive sufficient support in an environment where short term incentives dominate. Modern capitalism as it has evolved in the richest countries seems to face the challenge of reconciling the "organizing" role of the financial sector with it's certain benefits, in terms of encouraging efficiency, with a need not to let extreme short-termism drive the whole system.

The very drive for ever greater profits, which is what propels the system forward and many consider its greatest virtue, often reaches unreasonable dimensions. At the end of the day, the rate of return on financial assets on average and over the long term, must reflect the rate on return in the real economy. That rate of return can be higher than the growth rate, but it cannot be expected to be multiple times the real growth rate of GDP. If real growth in an economy is 3 percent, which is the maximum rate at which most analysts say potential output can grow in the most advanced economies, than it is simply not reasonable to insist on 12 or 15 percent profit rates. Of course globalization means capital can escape from domestic constraints. But then the real growth of the world economy sets long term limits on what kind of return is, on average, feasible. I cannot help feeling that the periodic asset bubbles that we have experienced in various forms reflect an unreasonable pressure in the financial sector to promise returns that in the aggregate cannot be achieved. These promises keep being made, however, and the assets bubbles keep being encouraged, because the incentive structures that exist inside the financial sector are asymmetric. Managers reap great personal benefits from short term-profits but pay very little personal penalty when the bubble bursts. Moreover because asset bubble bursts affect the entire economy, there is always irresistible political pressure to socialize the losses when they become too threatening.

This socialization of losses took place in the Asian and the dot com crises; it is again about to happen: directly, when banks are being rescued with public money, and, indirectly, when very loose monetary policies lead to increased inflation, the cost of which will be borne by society as a whole. I do not at all mean to imply that I am against expansionary fiscal and monetary policies to forestall an even more dramatic slowdown in the American and the world economy that would lead to painful unemployment and losses for the most vulnerable citizens everywhere. I am just pointing out that large parts of the financial sector losses are again being socialized, and that may encourage the next asset price bubble.

To avoid this constant repetition of the same scenario, it would seem to be highly desirable to regulate and supervise the financial sector in such a way that incentives become more symmetric, so that losses also have serious personal financial consequences for those whose decisions cause them, and that rewards are tied to long term success, rather than quick short term gains. This requires a degree of intrusive public policy that is not necessary in other sectors and will be resisted.

The fact, however, is that the financial sector can never be a purely private affair. It is at the heart of the modern market economy and plays an organizing role that is a public good. Its failure affects the whole economy and all citizens. The public policy maker cannot let the financial sector fail in a systemic manner and has to, in one way or another, rescue it. It is important and fair, therefore, that it is regulated in a way that encourages responsibility, a longer term horizon and an evaluation of risk by its managers, that is not truncated by the unavoidable need for the socialization of large losses.

These considerations are based on events in the most advanced and richest economies as well as on the capital flow reversals experienced by many emerging market economies in the past. They are perhaps not yet directly applicable to a country like India, where the financial sector is being liberalized only gradually, where public financial institutions still play an important role, and where the capital account is still only partially open.
India is likely to be affected by the turmoil, however. Moreover, for India's own development, a further strengthening of the financial sector's ability to mobilize and intermediate resources, including foreign resources, to support growth will be beneficial. In doing so it may be useful to analyze some of the excesses that have occurred worldwide and to build a modern regulatory system that combines incentives for dynamism and innovation with incentives for responsibility and longer term horizons.[3]

II. The Changing Structure of the World Economy

Let me now turn to some remarks on what the current slowdown in the rich economies means for world growth and growth in the developing economies in light of the structural changes that have taken place.

[3] I have read the excellent N.P Sen Memorial Lecture by Vijay Kelkar (2008) given to the Administrative Staff College in Hyderabad in January, as well as the recent column by Suman Bery (2008), who is a member of the Committee on Financial Sector Reform chaired by Professor Raghuram Rajan, on financial sector issues in India. There is no doubt that the debates on these matters have crucial importance.

Some argue that despite the serious nature of the slowdown in the advanced economies triggered by the financial sector difficulties referred to above, the worldwide slowdown will be very limited because of the new economic weight gained by the “emerging South”, and by India and China in particular. Let us look, therefore, at changes in structure and convergence trends in the world economy.[4]

Since the turn of the century globalization and the rapid growth of the “emerging South” have been seen as a powerful force of convergence gradually equalizing incomes in the world. It is hoped that the new weight of the South may now also protect the world economy from a major recession. It is of particular interest, therefore, to look more closely at the evolving structure of the world economy. First, is globalization leading to a convergence of incomes? How are the incomes and weights of different regions and countries changing? Second, do these changing weights imply that world economic growth has become much less dependent on growth in the advanced rich economies? An in depth quantitative analysis of these issues is of course beyond the scope of this single lecture tonight, but I will try to briefly share with you my perspective on these issues, before turning in the concluding remarks to what all this means for the international system and for global governance, in particular.

To look at the convergence issue, it is useful to come back briefly to Figure 1, looking at what has happened since the beginning of the modern growth adventure. While the data do not allow very precise statements, it is possible to compare the path of countries over the last two centuries thanks to the painstaking work of Angus Maddison. Table 1 shows the ratio of per capita income of the richest ten countries compared to ten of the “emerging South” countries that have grown most rapidly in recent decades. We can see that the income gap first widened during the colonial period, going from about 2 to a peak of about 6 in the post World War II era.

At the start the ten richest countries were only about twice as rich on average as these ten comparator countries. The difference tripled over a century and a half. Starting in the 1960s, however, these ten fast growing countries did start to catch up, however and the income gap has now been reduced to three and is continuing to fall.

After a long period of divergence, there have now been several decades of convergence for these countries.

[4] For more detailed analysis of the changes in the structure of the world economy see, for example, Fischer (2006) and Maddison (2007a).

Table 1- Income (GDP per capita) Ratios 1820-2005: Top 10 Richest to 10 Fastest Converging Countries Since 1950

	1820	1870	1913	1950	1960	1970	1980	1990	2001	2005*
Mean of Top 10 to Mean of Converging 10 Countries	2	4	5	6	6	6	4	4	3	3

Source: Own calculations. Up to 2001 Maddison (2007b). For 2005 only (noted with *) World Bank (2008b), comprising a somewhat different set of countries than Maddison.
Note: GDP expressed in constant purchasing power parities (base year 1990 up to 2001 and base year 2000 for 2005). The 10 converging countries selected for the denominator are developing and transition countries that grew the fastest from 1950 to 2001 and for which there is data in Maddison from 1820 to 2001 and in World Bank (2008b) for 2005. The 10 countries are: Brazil, China, Egypt (Arab Rep.), Indonesia, Malaysia, Singapore, Republic of Korea, Thailand, Tunisia, and Turkey.

India was not over this long period one of the ten fastest growing countries in the "South". Table 2 compares Indian per capita income to the same ten richest countries over the same period. The gap started with an income ratio of 2 and widened to 17, peaking around 1980. More recently, the story for India too is one of convergence. Lord Meghnad Desai (2008) ends his wonderful recent UNU-WIDER lecture saying that "the half millennium inaugurated by the discoveries of Christopher Columbus and Vasco de Gama has now ended. A new millennium will see a new global economy with a smaller disproportionality between population shares and income shares."

Table 2- Income (GDP per capita) Ratios 1820-2005: Top 10 Richest Countries to India

	1820	1870	1913	1950	1960	1970	1980	1990	2001	2005*
Mean of Top 10 to India	2	5	7	12	12	15	17	15	12	10

Source: Own calculations. Up to 2001 Maddison (2007b). For 2005 (noted with *) World Bank (2008b), comprising a different set of countries than Maddison.
Note: GDP expressed in constant purchasing power parities (base year 1990 up to 2001 and base year 2000 for 2005).

Can we say, therefore, that the modern era of globalization, is one of convergence? Unfortunately the story is not as simple. Table 3 compares the per capita income in the same ten richest countries to the ten and this time also twenty poorest countries in the world, as measured by recent data.

Table 3- Income (GDP per capita) Ratios 1820-2005: Top 10 Richest to Bottom 10 Poorest Countries

	1820	1913	1950	1960	1970	1980	1990	2001	2005*
Mean of Top 10 to Mean of Bottom 10 Countries	3	7	21	21	23	27	34	47	50
Mean of Top 20 to Mean of Bottom 20 Countries	2	5	14	15	18	22	27	35	37

Source: Own calculations. Up to 2001 Maddison (2007b). For 2005 (noted with *) World Bank (2008b), comprising a different set of countries than Maddison. Note: GDP expressed in constant purchasing power parities (base year 1990 up to 2001 and base year 2000 for 2005).

The story here is one of massive and persistent divergence. Whatever is allowing some of the developing countries to profit from globalization and "catch up" with the richest countries is not "happening" in a large number of countries, many, but not all in Africa.
One key point, therefore, about the world economy is that there has been both, convergence and divergence. It is not true to say that in general and across the board the developing countries are catching up. Many countries and hundreds of millions of people are being left far behind, certainly in relative terms. Worse, quite a few countries are worse off in absolute terms at the beginning of the 21st century then they were in the 1960s!

Nonetheless, thanks mainly to the huge populations of India and China, and the economic performance of these two giants, it is correct to say that the convergence trend, certainly when weighted by population, is stronger than the divergence trend and that for large parts of the emerging South, there is at last a "catch up" of per capita incomes. Our mission in the United Nations Development System is to help accelerate that catch-up and to work towards its extension to those parts of the world that have continued to diverge. Let me now ask the question whether the convergence trend has been strong enough to affect significantly the structure of the world economy and whether the new structure of global income means that the world economy is substantially less sensitive to a rich country slowdown.

Structural shifts can be analysed in various ways and notably in prices adjusted for buying power (purchasing power parity) or at "market" exchange rates. Table 4 describes the evolution of shares in global GDP since the beginning of the 1960s in current prices and at "market" exchange rates. Table 5 presents the same shares for GDP measured at purchasing power parity exchange rates. The shares in current prices and "market" exchange rates for the 1960s are problematic.

Most developing countries had highly protected trade and exchange rate regimes so that the comparisons at the "market" exchange rates actually reflect overvalued exchange rates substantially overstating both developing country (and the then Soviet Union's) real incomes and also the real market value of their tradable sector outputs. The current price estimates become more reliable in the 1980s and today broadly reflect the true relative weights of the tradable sectors. The purchasing power figures adjust real incomes to take into account that non-tradable prices remain much lower, in lower income countries, even though international trade and open market policies equalize tradable prices.

Table 4- GDP Shares in Current US$ and Market Exchange Rates

	1961-1965	1981-1985	2006-2009P
United States	38%	31%	26%
Japan	4%	10%	8%
EU 15	28%	27%	28%
Other high income	6%	8%	10%
Low & Middle income	24%	24%	28%
China	-	2%	6%
India	-	2%	2%
Soviet Union - CIS	..	..	3%
LDC	-	1%	1%

Source: Own computation based on World Bank (2008b).
Note: Estimates of real GDP growth rates for 2007 are based on World Bank (2008a).
Own projections for 2008 and 2009 growth rates based on World Bank (2008a) and IMF (2008). Estimates for inflation and exchange rates for 2007 and 2008 are from the IMF (2008). Those rates for 2009 are the same as for 2008.

Table 5- GDP Shares in Constant Prices and Purchasing Power Parities

	1961-1965	1981-1985	2006-2009P
United States	24%	21%	19%
Japan	5%	8%	6%
EU 15	26%	24%	18%
Other high income	8%	7%	8%
Low & Middle income	37%	37%	49%
China	4%	4%	17%
India	4%	4%	7%
Soviet Union - CIS	10%	..	4%
LDC	2%	2%	2%

Source: Own computation based on World Bank (2008b) and Madison (2007).

Note: Average shares over the period in constant 1990 $PPP for 1960-1965 and constant 2000 PPP$ for 1981-1985 and 2006-2009.[5]
Estimates of real GDP growth rates for 2007 are based on World Bank (2008a).
Own projections for 2008 and 2009 growth rates based on World Bank (2008a) and IMF (2008).

Both sets of figures show that there has been a significant structural change leading to a reduced share of the rich countries in global GDP. At purchasing power parity exchange rates the developing countries as a whole would, in recent years and according to growth projections for 2008 and 2009, account for about one half of global GDP compared to about 37 percent in the early1960s. It must be stressed, however, that this increase is entirely due to a set of middle and lower middle income "emerging" countries. The so-called least developed countries share has and remains marginal, reflecting the divergence part of the convergence-divergence story told above. At market exchange rates the emerging South has also gained weight, although the rise is not yet as dramatic and still largely reflects the increasing share of China. It is interesting to note that between the 1960s and 1980s the "big" story was the rising weight of Japan. The very slow growth of Japan over the last 15 years has led to a partial reversal of that story, particularly at purchasing power parity exchange rates.

At market exchange rates the recent near collapse of the dollar has led to a precipitous decline in the share of the US in the most recent years, although that decline relative to the EU-15, is of course much less in purchasing power parity exchange rates.

The bar charts in Figure 5 and Figure 6 present structural change in terms of contributions to growth, i.e. to changes in output, rather than shares in output for the more recent period since 1990. As the share of the "emerging South" increases, naturally its contributions to growth increase. What we can say with force now is that in terms of purchasing power parity, the "emerging South" has become the dominant contributor to world growth, with a share greater than two-thirds of the total.

[5] In December 2007 the International Comparison Programme (ICP) released new purchasing power parity (PPP) exchange rate estimates. The new estimates result in downward GDP revisions for large and fast growing economies, especially China and India. As a result, GDP shares of these countries are lower using the new estimates than those shown here, which are based on the earlier PPP estimates. Similarly, the global growth rate as well as the contribution of developing countries to global growth when GDP is expressed in PPPs is also likely to be revised downward.

If we think of growth in terms of increases in real incomes including the ability to purchase non-tradables, it is fair to say, that in a purely arithmetic sense, what happens in the rich "North" is no longer that important for overall world growth.

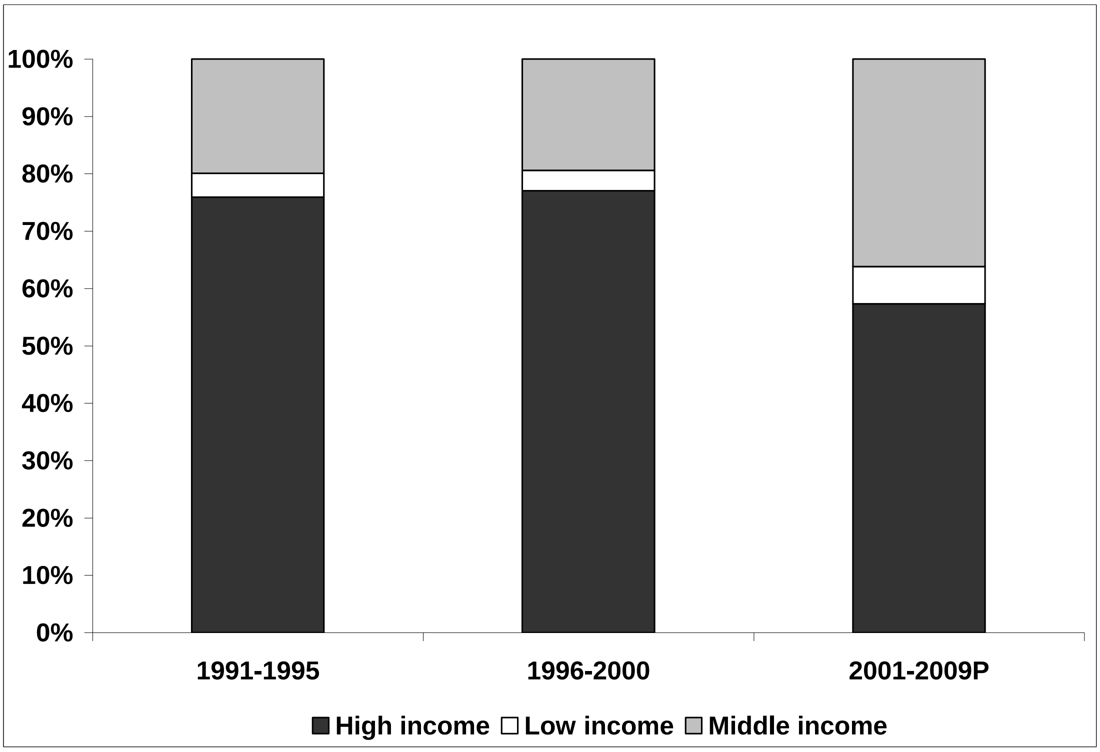

Figure 5- Contributions to Cumulative Real GDP Growth in Market Exchange Rates

Source: Own calculations based on World Bank (2008b).
Note: Estimates of real GDP growth rates for 2007 are based on World Bank (2008a). Estimates of real GDP growth rates for 2007 are based on World Bank (2008a). Own projections for 2008 and 2009 growth rates based on World Bank (2008a) and IMF (2008).

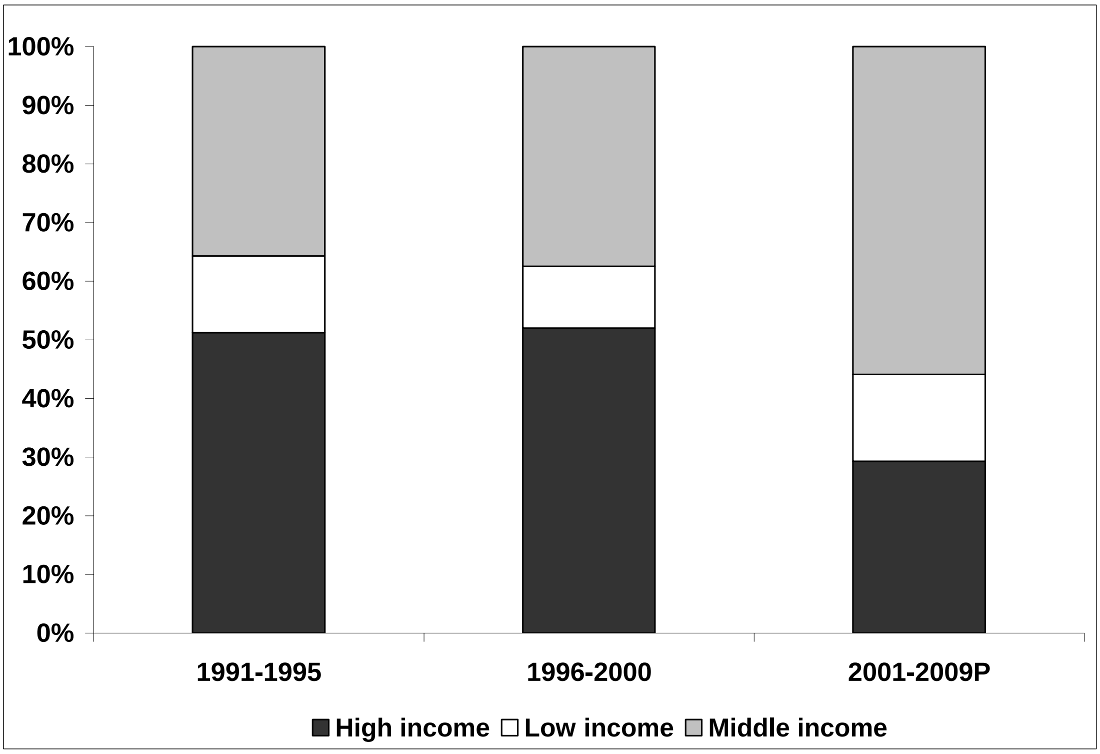

Figure 6- Contributions to Cumulative Real GDP Growth in Purchasing Power Parities
Source: Own calculations based on World Bank (2008b).
Note: Estimates of real GDP growth rates for 2007 are based on World Bank (2008a). Estimates of real GDP growth rates for 2007 are based on World Bank (2008a). Own projections for 2008 and 2009 growth rates based on World Bank (2008a) and IMF (2008).

The purely arithmetic part of this story is interesting, but it cannot, of course, help us very much in predicting how the dynamic growth processes in the North and South are linked or de-linked. A pre-diction of "de-coupling", projecting Southern growth as continuing unaffected by a Northern slowdown, which would be based simply on the fact that the "emerging south" has greatly increased its weight in the world economy and is becoming a larger arithmetic contributor to world growth, would not make sense. Other things equal, a larger share of the South does mean that the South itself as well as the world economy as a whole are less vulnerable to negative impulses from the North. But other things are not equal.

The more trade and financial integration there is in the world economy and in particular, the stronger are the linkages between the North and the "emerging South", the greater will be the impact of impulses originating in either group of countries on the others and on the world economy as a whole. To arrive at a moderately reliable prediction of how much a Northern slowdown will affect the "emerging South" and individual countries such as India within the South, one needs a detailed analysis of the quantitative linkages working through trade, investment, financial sector linkages including wealth effects, and also the most difficult of all variables to model, expectations. There is also the increasing and impressive role of "Southern" multinationals, many of them Indian, and the role they will play in the world economy. Such an analysis is beyond the scope of my lecture tonight and indeed while there is much academic and professional work along these lines, the North-South linkages which have gained such an importance in recent years, appear to remain under-analysed.[6]

Let me just stress, at this point, that the fact that the "emerging South" has gained much weight in the world economy, does not mean that there will be de-coupling of growth in the coming months and years. If the rich North experiences a more serious slowdown than what is currently projected, with growth averaging less than 1.5 percent in the 2008-2009 period, the consequences will be severe also for the "emerging South". It is important to remember in this context that the internal American market may shrink even if US GDP growth remains significantly positive, given the fall of the dollar and the likely reduction in the US current account deficit that is part of the overall adjustment process. I do not think we fully understand the complex linkages that are at work. In modelling exercises, much depends on what is assumed exogenous and what is treated as endogenous. Much will also, of course depend on policy reactions. As was recently pointed out by the new Managing Director of the IMF, there are many countries in the world with reasonably strong fiscal positions and these countries could help counteract the forces pushing the economy into a slowdown. This statement surprised many, coming from the head of an institution known for its fiscal conservatism, but I think Dominique Strauss Kahn was quite right in stressing the need for an international approach to fiscal policy, with countries that have more fiscal headroom having a greater ability to help protect the world economy from recession.

We are at a moment of considerable uncertainty. Since the summer of 2007 almost every week has brought further bad news from the financial sector in the US and Europe, with the disease deepening and spreading across financial institutions. In an increasing number of cases, it now appears not just as a liquidity problem, but also as an insolvency problem. On the other hand, given the size of the financial sector turmoil, the real sector seems to be resisting rather well, so far at least.

[6] The debate on decoupling has taken place mostly in the media. Some research emanating from investment banks is attempting to make more formal tests of the decoupling hypothesis. The IMF has also recently contributed to debate on "growth spillovers" between the North and the South (see, for example, IMF 2007 and Akın and Kose, 2007, and the references therein).

Rather surprisingly, we also see a continued upward surge in commodity prices, unprecedented in recent times, which in itself could be seen as another kind of "de-coupling": not a "de-coupling" of the South from the North, but a "decoupling" of real sector expectations from the mood in the financial sector! After all very rapid price rises in raw materials and commodities should signal strong future growth rather than a recession. I will not be imprudent enough to make strong predictions tonight. But it seems to me that as has been the case in the two previous recent financial sector rooted crises referred to above, the strong policy response triggered by financial sector panic, particularly in the United States, may help stop a slide into recession.

It may also be the case that the "autonomous" or purely regionally driven part of effective demand, particularly investment demand, has risen substantially, in China and India, and other parts of Asia. This deserves careful analysis. On balance chances are that this contribution from the "emerging" South, coupled with a truly vigorous Keynesian mix of expansionary policy in the Unites States, will have a strong effect and halt the slide some time during 2008, despite a much more conservative stance by the European Central Bank which is stubbornly sticking to its "inflation control is our only mandate" approach. So world growth may continue in the 2 to 3 percent range in the coming two years. Not the surge we saw in the growth acceleration of 2002-2006, but enough to stay away from a global recession and avoid the terrible pain it would bring to the world's poorest and most vulnerable people. This would allow Indian growth also to be hurt less by global circumstances and hopefully maintain a pace not too far from the 8 percent neighbourhood over the next two years, which would of course be a great achievement in a world economy that grows only in the 2 to 3 percent range (at market prices).

The strongly expansionist US macro-policy response does of course carry with it the dangers of an inflationary impulse and of causing again what happened three times in the last ten years: replacing one asset bubble by another. After emerging market debt in the mid-1990s, dot com stocks at the turn of the century and mortgage backed securities in the 2004-2007 period, it may well be commodities that are now rising in price at an unreasonable and unsustainable rate, fuelled again by the underlying huge investment resources and accompanying liquidity available in Asia because of high savings rates, in the Middle East because of the oil bonanza and in the advanced economies because of a significant rise in the share of profits and high incomes in GDP. Each of these bubbles has had a root in real economic changes. Emerging markets did become more attractive destinations for investment as their governments undertook market friendly reforms and opened their economies to global forces. The dot com sector did open up new prospects for doing business and increasing productivity.

The impressive growth of India and China has increased the demand for raw materials, food and energy in a lasting way. But each time, financial markets overshoot and macroeconomic policies are forced to react to the ensuing bust by encouraging, unwittingly, another bubble somewhere else!

I would not be surprised, therefore, that two or three years from now we realize that the liquidity and macro-boost generated to fight the sub-prime housing crisis ended up fuelling a commodity bubble, and that we may again, then, be faced with fighting the negative consequences of an unforeseen downward adjustment, this time in commodity prices! Which brings me, again, to what I started with: if we want to reap the benefits of technical progress and global opportunities in a more steady fashion, rather than being subjected to continuously recurring shocks from the financial sector, it may be time to attack the root causes of these shocks in terms of financial sector regulation that focuses on the nature of the structural problems in the financial sector, rather than using rather blunt macroeconomic instruments which may work in the short term by bailing everybody out, but often prepare the next financial storm.

Concluding remarks

All this matters to India and to the developing world: regulatory troubles in the developed world may cause India's growth rate to decline substantially. It may rob Africa of the first real chance in decades to accelerate its progress. It may mean that hundreds of millions of vulnerable people are denied the chance to escape extreme poverty. I do believe, therefore, that the "emerging South" must weigh in, using all peaceful means at its disposal, to change the nature of global governance. It is also essential that the LDCs can increase their voice. It is difficult to understand that the Security Council of the United Nations reflects the world as it was in 1945. It does not seem right that Brazil and India have less of a vote in the Boards of the IMF and the World Bank than very small European countries. It does not seem right that the Financial Stability Forum remains a rich men's club. It does not seem right that countries such as India are invited to G8 meetings just for lunch. It does not seem right that the "emerging South" still is allowed only a minor role in the big decisions on the top management positions in the international system, including the chairmanship of committees such as the International Monetary and Financial Committee (IMFC).

On the one hand it is argued that the "emerging South" should save the world economy from recession, that it should accept and adapt to all the policies elaborated in the rich North, that it should now also take major responsibility in the fight against the very real challenge of climate change, and, at the same time the South is denied its natural place and weight in the decision making and coordinating institutions of the international community. I do believe it is time for change. I do believe that the rich countries cannot have their cake and eat it too. I do hope that India will engage in the overdue effort to build better and more equitable global governance, not least relating to the financial sector. I do hope India will lend its increasing weight to a reform and strengthening of the United Nations and the Bretton Woods institutions, so that the interdependent world we live in can provide benefits to all, can be regulated in a prudent and responsible manner, and so that the interests of the poorest women and men on our planet can receive equal attention to the interests of the richest and the most powerful. I do believe this is what the Mahatma Gandhi stood for when he fought for the new, modern, independent India.

Heartfelt thanks for the privilege of being able to share my thoughts with such a distinguished audience.

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