The World Economy in 2020

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In recent years, an increasing number of non-OECD countries have become sizable exporters of manufactures, in which there is now a flourishing two-way trade with OECD countries; it accounts for a large portion of the growth in commerce. The same trend is observed in capital flows, with an ever-larger share of OECD private foreign investment destined for non-member countries. Brazil, China, India, Indonesia, Russia – the ‘Big Five’ (each with a population over 150 million and GDP larger than $100 billion) – are already substantial importers, producers for world markets, hosts to foreign investment and, more and more, foreign investors themselves. If these and other countries are able to sustain outward-oriented reforms, the non-members of the OECD should play an increasingly prominent role in the globalised economy of the 21st century.

There are a number of forces driving developments in the world economy, chief among them demographic change, technological innovation, international trade and financial liberalisation, and domestic reforms in both OECD and other economies. With the aim of providing a framework for long-term policy planning in OECD economies, the OECD’s ‘Linkages Project’ has designed two contrasting visions of the world economy – one based on the premise of high growth in all countries, the other much less optimistic – to capture how these forces might interact over the next 25 years. Using a computable ‘general equilibrium’ model (the ‘Linkages’ model) designed by the OECD Development Centre, the effects on trade, production and employment patterns, on food and energy markets, and on the global environment have been explored.

Both projections hold that basic resource endowments (population and natural resources) and behavioural relationships will remain broadly similar. The high-growth one assumes substantial further progress with global trade and investment liberalisation and with domestic policy reforms, in OECD and non-member countries alike, with a pay-off principally in the form of improved productivity. It has features which offer the prospect of substantially improved living standards both in OECD and other countries. High growth in the OECD area, combining domestic structural reforms and ever-firmer links with non-member countries, could be expected to offset a potentially strong depressing effect from population aging. This would allow the OECD economies to expand in the next 25 years at roughly the same rate as in the past 25 (somewhat around 3% a year). In the non-OECD economies, the underlying potential is considerably higher and sound policies there should provide an additional impulse for expansion (from an annual GDP growth rate of 4.5% in the past quarter century to a rate of 6.7%). Over the same period, the average growth rate of GDP in the non-OECD economies could be more than twice that of the OECD area.

But slower progress with policy reform in either group of countries – with less trade liberalisation and with less rapid advance on domestic policy reforms, not least in fiscal consolidation, removal of domestic subsidies and structural policies – could result in lower (perhaps much lower) growth rates.

Trade Opportunities

The liberalisation of trade, falling transport and communication costs, and increased international mobility of capital could work together to bring about a further opening-up of economies. In the high-growth assumption of the Linkages Project, trade grows more rapidly than world output, expanding three-and-a-half times in value and rising from 30% of world GDP in 1995 to about 45% in 2020. Trade between OECD countries is expected to expand rather more slowly than that between non-members, partly because inter-OECD trade barriers were already low in 1995, and so the removal of tariffs would provide less of a stimulus (Figure 1).

These trends are reflected in the changes in regional trade patterns. Under both optimistic and pessimistic assumptions, half of the increase in world trade would consist of trade between OECD countries and the rest of the world. Under both optimistic and pessimistic assumptions, half of the increase in world trade would consist of trade between OECD countries and the rest of the world, with

Japan seems likely to specialise the most heavily, with exports of capital goods to non-member economies would be multiplied almost five-fold. In the high-growth projection, OECD industries are crucial to building successful export in-dustries. In the high-growth projection, OECD economies, imports of capital equipment and high-tech intermediate goods from OECD countries would increase. At the same time, domestic sourcing of components and intermediate pro-
gains to domestic producers from international manufactures.

Everybody could reap large benefits from closer trade integration. First, consumers stand to benefit from access to imports that are cheaper than similar goods produced at home, not least through the removal of initially high tariffs on food products and on consumer goods (chiefly textiles and clothes). The relative prices of these imports would fall substantially, particularly in comparison with prices of OECD exports of manufactures.

Second, as production is further globalised, gains to domestic producers from international sourcing of components and intermediate products will increase. At the same time, domestic production structures will tend to favour skill-intensive activities, creating relatively highly paid jobs in OECD economies. As observed during the past two decades in the dynamic Asian economies, imports of capital equipment and high-tech intermediate goods from OECD countries are crucial to building successful export industries. In the high-growth projection, OECD exports of capital goods to non-member economies would be multiplied almost five-fold. Japan seems likely to specialise the most heavily on producing and exporting such goods, reflecting in part the strong expansion anticipated in Asian markets.

Third, the service sector of OECD countries - by far the most important sector in both output and employment - also stands to benefit from closer links with non-member economies. As their own service sectors are liberalised, attractive new opportunities should arise for competitive OECD suppliers (for example, media and information, software, education, financial, insurance, real estate, management consulting and so on). And although trade in services is likely to grow, the main vehicle for OECD firms to exploit these opportunities will be foreign direct investment (as many services, such as tourism, remain nontradable). Since many of these activities require high-skilled professionals, their mobility will enhance the globalisation of the service sector.

The benefits from the global mobility of capital accrue from a more efficient allocation of world savings to the most productive investment opportunities and the possibility of smoothing consumption by borrowing or diversifying abroad. These advantages apply particularly in the interaction between the capital-rich, moderately growing and aging OECD economies and the capital-poor, fast-growing and (still) young emerging ones. Multinational corporations or portfolio investors from OECD countries have the prospect of raising returns (higher profits, dividend payments and interest income) through increasing their exposure in high-growth emerging economies. Many types of asset-holders in OECD countries could benefit from these gains in international portfolio diversification (firms, households and banks), but they may be of particular interest to institutional investors such as pension and investment funds and insurance companies.

Assuming that OECD governments take measures to facilitate the international diversification of investment by pension funds, the higher return that could be expected would make a contribution to solving the fiscal and financial problems looming on the horizon as OECD populations age. The OECD has calculated the increase in the average rate of return of pension assets in the OECD area, assuming different degrees of global portfolio diversification. If the emerging-market share of these assets rises progressively to roughly 10% by the year 2020 (compared to 2% at present), it would yield additional pension benefits of roughly 2.5%. Among OECD countries, the largest gains would thus accrue to countries that quickly build a sizable stock of assets in emerging economies. Nonetheless, even though investing in these markets would make pensioners in OECD countries better off, this gain would not be enough to finance the additional burden fully from rising old-age dependency ratios. Domestic reforms of pensions systems cannot be avoided.

Net inflows to emerging markets are unlikely to increase substantially over the long run. Since investors from emerging markets could also gain from increased diversification into OECD markets, reverse flows may to some extent counterbalance gross outflows from the OECD area. Two additional factors may explain why the historical match between developing-country savings and investment will remain close in the future.

First, declining fertility rates and lower dependency ratios will stimulate household savings, domestic corporate savings will increase in response to higher returns on investment and higher trend growth in output will raise incomes and long-run savings. A modest rise of four percentage points of GDP in the non-OECD economies would be sufficient to meet their additional investment requirements (many East Asian countries experienced much larger increases - in the range of ten to fifteen percentage points of GDP - during their take-off).

Second, financial markets are sensitive to sovereign risk and watch carefully a country’s external debt ratio and the size of current account deficits. Net international indebtedness cannot mount indefinitely as a percentage of GDP and concern arises about the capacity for financing the debt - particularly in developing countries - if insufficient foreign exchange is generated. Governments therefore tend to target the current account by adjusting fiscal or monetary policies to avoid large and protracted deficits. These factors serve to reconfirm that the non-OECD member economies will not absorb foreign savings at a very high proportion of their GDP. Fears about future global capital shortages or massive net capital outflows from the OECD area are thus misplaced.

Natural Resources and the Environment

Under the assumption of high growth, world agricultural production would expand at roughly the same rate over the next 25 years as over the past two decades, with productivity improvements contributing most of it. The bulk of the incremental demand for food from non-OECD countries would continue to be supplied domestically, also in large economies like China and India, though agricultural trade would also expand strongly. The ‘doomsday scenario’ - in which China’s burgeoning demand for food and declining self-sufficiency ratio would cause major increases in world food prices - is not borne out by the results of this modelling exercise. Still, achieving the high implied rates of productivity growth in China will require strengthening of crop research (not least in biotechnology), rural infrastructure, and of farmers’ incentives (through pricing and land-tenure reforms, for example).

A rise in agricultural imports into markets that were once heavily protected - chiefly those of the European Union, Japan and other prosperous East Asian countries - would be supplied largely by exports from North America, Australia and Latin America. Further structural adjustments in European, Japanese and other high-income East Asian agricultural sectors would thus be necessary. Even with increased trade in food, some regions and countries may still experience calorie deficits, but 25 years of broad-based, rapid growth in the world’s poorest countries and regions would go some way to reducing the incidence of malnutrition. High growth will also mean strong energy demand, as the most vigorous expansion of output occurs in some of the more energy-intensive economies (not least China, Russia and to a lesser extent India). In spite of the projected rise in demand (and barring major disruptions in the supply of oil or gas), world energy supplies should prove adequate with only moderate price increases in fossil fuels; oil prices would remain below their historic highs. Abundant reserves of low-cost coal in China and India would provide the primary fuel for their rapid expansion, assuming bottlenecks in transport can be removed. For their oil requirements, most countries will come to depend far more heavily than in the recent past on Middle East suppliers, as other low-cost reserves are depleted. Oil imports into the OECD countries are projected to rise from half to two-thirds of projected consumption between now and 2010. Growing reliance of the major economies on imports of oil (and gas) from a few major suppliers will make them all the more vulnerable to macro-economic shocks from disruptions in supply, which could raise renewed concerns over energy security in years to come - concerns likely to be shared by many non-OECD countries.

One of the major worries raised by the high-growth projection is its environmental implications. Even assuming improvements in energy efficiency of an annual 1% in the OECD area and 2% in non-OECD countries, world consumption of fossil fuels would more than double in the period to 2020 and carbon dioxide (CO₂) emissions would rise proportionately (Figure 2). The risks of accelerated global warming and climate change may come to be perceived as unacceptably high, intensifying pressures for a more forceful global policy response. Few OECD countries are currently on track to meet the non-binding commitment (known as ‘Annex 1’) at the Rio Earth Summit to make best efforts to stabilise CO₂ emissions at 1990 volumes by the
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The vision presented here is indeed an optimistic one, and if realised, could provide the means to tackle current and future challenges - not least poverty, environmental degradation and aging. Achieving global prosperity is a formidable task. It will require sustaining the momentum towards more openness, unleashing the power of competition-led innovation, and improving social cohesion in both OECD and non-OECD economies.

Avoiding Marginalisation

The domestic challenge for OECD countries is to put in place or reinforce growth-enhancing policies while maintaining strong bonds of social cohesion. Enhancing market competition is crucial to generating the innovative behaviour on which the continued prosperity of the OECD countries depends, but competition creates losers as well as winners. The concerns of the losers cannot be neglected, particularly when they are workers with few marketable skills. Sustaining the momentum of competition-enhancing reforms will therefore require that the OECD countries make progress with measures to promote more vigorous job-creation, ensure better-qualified entrants to the labour market, and retrain workers faced with pressures to adapt that arise from technical change or international competition.

Fast, broad-based expansion in low-income countries would do much to eliminate the most abject forms of poverty and would also mark the beginnings of true convergence in global incomes. This trend would help relieve the tensions and instabilities associated with pronounced poverty and inequality that are today a permanent backdrop to political discourse within and between nations. Yet even under the assumption of high growth, ensuring that the least developed countries are not left out of the globalisation process will remain a key issue. Although OECD governments are struggling to live within tighter budgets and development-assistance programmes have been among the hardest hit by budget cuts, such aid will continue to play a valuable role in creating the conditions for integrating other countries into the global economy. Assistance will be required to provide a basic infrastructure and institutional, legal and policy framework to attract flows of private capital and more mobile allocation of domestic resources. Donor support, furthermore, can help improve resource and environmental management.

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