Global Trends and Challenges

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International Forum on City Planning
Beijing
June 2007
Very Long Term Economic Growth

FIGURE 11

Worldwide Growth in Real GDP per Capita, 1000–Present

Globalization – Driving Forces

Globalization

is the unification of many of world’s markets (goods, services and capital) combined with very high growth leading to growing integration and interdependence.

The Driving Forces

The GATT and WTO processes of opening up
The end of the divisions of the cold war
Reduction of transaction costs
Information and communications technology – that reduces transaction costs and partially removes geography as a factor in market definition and segmentation
Unification of some global labor markets
Widening and deepening of global capital markets
Growing awareness of REAL economic interdependence
Global Technological Trends
Network Based Information Technology

Its impacts are evolving very rapidly
   Important part structure of middle and advanced income countries

Impacts are in three classes (more or less in historical order) and all in relatively early stages of a lengthy evolution (decades)
All fit the general description of lowering transactions costs, but in different areas

The headings are

1. Automation of information processing functions

2. Lowering the cost of finding things and of transactions

3. Making remote HR resources much more accessible and therefore valuable in supply chains
1. Automation of Information processing, monitoring, accounting, control and reporting

Labor saving technical change - dramatically

Source of much of the US productivity growth spurt and it is in process in other advanced countries with a lag.
Likely cause of part of the “meddle income” problem in US

The network is critical because it connects disparate databases and users - hence the starting point is the mid 1990's
Evident in macro data and at the micro level of the firm
Technological Change in the Information Service Sector and Productivity Increases

Why are the effects of technological change in the information processing and information services sector large?

It has to do with the input-output structure of advanced economies.
Simple Input Output Structure

INPUT OUTPUT STRUCTURE

LABOR
CAPITAL
RAW MATERIALS

AVAILABLE TECHNOLOGY

GOODS AND SERVICES

CONSUMED BY HOUSEHOLDS

CONSUMED BY BUSINESSES TO ADD TO CAPITAL

CONSUMED BY GOVERNMENT TO DELIVER SERVICES
Input-Output Structure with Feedback Loops

LABOR
CAPITAL
RAW MATERIALS

GOODS AND SERVICES

AVAILABLE TECHNOLOGY

GOODS AND SERVICES

INFO SERVICES

CONSUMER BY HOUSEHOLDS

CONSUMED BY BUSINESSES TO ADD TO CAPITAL

CONSUMED/INVESTED BY GOVERNMENT TO DELIVER SERVICES
2. Search and Transacting Costs

Making markets - buyers and sellers finding each other - eBay
    Quasi natural monopoly
Better informed buyers
Transacting services - banking and financial services
Market liquidity and the geographic boundaries of markets - more buyers
Government Services - the DMV example from California
Finding specific valuable human resources
Education
Measurement of economic benefits is harder than in the automation case
3. Accessing Geographically Disparate Human Resources Efficiently

IT services
Business Process Outsourcing

Much of the opportunity here is DOMESTIC (NOT JUST INTERNATIONAL)

R&D
Other human capital and skill intensive functions (see India below)

In certain kinds of functions, the geographic boundaries of labor markets are breaking down

The nature of this kind of technological progress

Production functions
Transactions costs

Comparative Advantage of the Advanced Countries?
Global Economic Trends: Sustained High Growth

Sustained High Growth
China and India especially because of the size and impact
Sustained High Growth - Unique in History

Somewhat arbitrarily I define it as 7% per year or more for twenty plus years
There are only 11 cases
8 in Asia
They are (Botswana, China, Hong Kong, Indonesia, Korea, Malaysia, Malta, Oman, Singapore, Taiwan and Thailand)
Japan was close in its post war recovery
India is about to join in
All after WW II
All leverage the global economy to generate large increases in productive employment
    Huge elastic demand
    Transfer of knowledge (technology and know-how)
    Comparative advantage
    Surplus labor in traditional sectors initially
Over time the domestic economy becomes bigger and more important in producing growth
In all cases URBANIZATION IS A KEY DRIVER OF GROWTH
China and India

China has been in this high growth mode since 1978
Major challenges in the past have been dealt with effectively - now there are new ones to sustain high growth

Many are familiar

Service industry development, Deepening of capital markets and gradual opening of the capital account, Environment damage, Income inequality, Rural Services and Insurance Systems

The harder ones have to do with the evolution of the economy through middle income to advanced status

Rapid change in the economic portfolio in the next stages of growth
The process of creation and destruction or churn
The shift away from labor intensive sectors as incomes rise and make them uneconomical
Urbanization as an integral part of that process
India

India, having lagged behind, is about to jump into the high growth category. India’s current five year plan which just began, has average growth over 9% accelerating to over 10%. India has real assets with which to fuel growth. There are also formidable challenges:
- Infrastructure
- Literacy
- Education and quality
- Political consensus
India’s Growth will Follow China With a lag of about 12 years

While the macroeconomics will look similar the industrial mix will be very different

India has had earlier development of service industries and supporting institutions (including the export ones) – and later development of labor intensive manufacturing
Leveraging the Global Economy
India’s Engagement will Rise Rapidly and Look More Like China

Openness and Leveraging the Global Economy is essential for sustained high growth
There are no counter-examples
This DOES NOT mean opening everything up suddenly on the current or capital account
India Fell Behind in Manufacturing, Exports and FDI

Manufactured exports growth

$ billion


FDI backed exports
Per cent of total exports

China
India

China
India

Source: CMIE, China Statistical Yearbook, McKinsey CII Report
Also in Infrastructure

China vs India - Infrastructure Formation

Public debt: China 24.4% of GDP (2005 est.)

US$50 bn over the next 3 years

Source: The World Bank; Deutsche Bank; CME
India’s Assets are Significant
They include

Higher Education
New Optimism and Sense of Momentum
IT/BPO Outsourcing
Projected growth is 30% per year and India is the dominant player
Financial Sector and Reserve Bank of India
Growth in Trade in Services
A Lot of Room to Grow
R&D
Medical Services
Political Speeches
Editing of newspapers and TV
Grading exams

OFFSHORING REPRESENTS AN EVEN FASTER GROWTH SEGMENT OF TRADE

<table>
<thead>
<tr>
<th>BPO/IT offshoring to low-wage locations as a percent of total global service exports</th>
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<tbody>
<tr>
<td>$Billion</td>
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<tr>
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</tr>
<tr>
<td>1,697</td>
</tr>
<tr>
<td>2,372*</td>
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</table>

* Estimated at 5% annual growth from 2002 figure.
Source: WTO; McKinsey Global Institute analysis
But

This is not enough to produce and sustain high and inclusive growth.

It does not employ enough people.

India is adding additional powerful productive employment-generating engines.

The need is very well understood by India’s leaders.

Labor intensive manufacturing and exports.

Adding the China strategy to the portfolio.

Open up to FDI.

Special Export Zones (400+)
Global Trends and Challenges
Global Economic Challenges

Global Imbalances

Inequality and resistance to globalization

Capital Market Integration and Deepening

Global Warming

Energy and Commodity Demand and Prices

Urbanization and Sustained High Growth
Global Imbalances: Reserves and USA Savings

Foreign Reserve Holdings at the End of 2006

US Household: Financial Assets and Liabilities

Cityup.org

www.cityup.org
Global Imbalances: USA Housing Prices and Mortgages

Housing Price Index: 100 in year 2000

Source: OFHEO United States Govt

US Total Mortgages

Source: Cityup.org

58933632; chinacityplanning@163.com
Inequality: Globally Since Industrialization Began

**FIGURE 1.4**

**Fraction of World Inequality Accounted for by Differences across Countries**

Source: Bourguignon and Morrison 2002.
Income inequality: Gini Coefficients

<table>
<thead>
<tr>
<th>Color</th>
<th>Gini coefficient</th>
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<tr>
<td>&lt; 0.25</td>
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<td>0.25 - 0.29</td>
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<td>0.30 - 0.34</td>
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<td>0.50 - 0.54</td>
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<td>&gt; 0.60</td>
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<tr>
<td>NA</td>
<td></td>
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</table>
Income Inequality: China, India and the USA
Potential Resistance to Globalization

China: Total Growth and Growth Rate: Per Capita Income: 1995-2004

USA Growth and Growth Rate: Household Income

India: Rural Income Distribution and Growth 1994-2005

India: Urban Income per Capita and Growth 1994-2005
Global Capital Markets: Capital Stock Growing 3 times Faster Than Global GDP

Exhibit 1

COMPOSITION AND GROWTH OF THE GLOBAL FINANCIAL STOCK

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity Securities</th>
<th>Debt Securities</th>
<th>Government Debt Securities</th>
<th>Bank Deposits</th>
<th>Total</th>
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<tbody>
<tr>
<td>1990</td>
<td>12</td>
<td>31</td>
<td>29</td>
<td>23</td>
<td>66</td>
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<tr>
<td>1993</td>
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<td>1999</td>
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<td>2003</td>
<td>119</td>
<td>119</td>
<td>28</td>
<td>27</td>
<td>129</td>
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<td>2004</td>
<td>27</td>
<td>27</td>
<td>27</td>
<td></td>
<td>29</td>
</tr>
<tr>
<td>2010</td>
<td>29</td>
<td>29</td>
<td>16</td>
<td></td>
<td>29</td>
</tr>
</tbody>
</table>

GDP (nominal) $ Trillions:
- 1990: 10.1
- 1993: 23.4
- 1996: 29.9
- 1999: 30.5
- 2003: 36.1
- 2004E: 39.0
- 2010: 4.0

Depth (FS/GDP) Percent:
- 1990: 109
- 1993: 216
- 1996: 230
- 1999: 300
- 2003: 315
- 2004E: 326
- 2010: 400

Note: 2004E shall not add to 100% due to rounding error
Source: McKinsey Global Institute, Global Financial Stock Database; World Federation of Stock Exchanges; Merrill Lynch; Global Insight
**Global Capital Markets: Capital Composition**

**COMPOSITION OF FINANCIAL STOCK, 2003—THREE REGIONAL STORIES**

$ Trillions; percent

<table>
<thead>
<tr>
<th>Region</th>
<th>Equity securities</th>
<th>Private debt securities</th>
<th>Government debt securities</th>
<th>Bank deposits</th>
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</thead>
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<td>US</td>
<td>33</td>
<td>36</td>
<td>12</td>
<td>1</td>
</tr>
<tr>
<td>UK</td>
<td>35</td>
<td>30</td>
<td>7</td>
<td>1</td>
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<tr>
<td>Eurozone</td>
<td>29</td>
<td>21</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>20</td>
<td>3</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>12</td>
<td>35</td>
<td>62</td>
<td>1</td>
</tr>
<tr>
<td>China</td>
<td>17</td>
<td>6</td>
<td>27</td>
<td>5</td>
</tr>
<tr>
<td>India</td>
<td>1</td>
<td>12</td>
<td>12</td>
<td>32</td>
</tr>
</tbody>
</table>

**Depth (FS/GDP)**

- US: 397
- UK: 385
- Eurozone: 314
- Eastern Europe: 99
- Japan: 411
- China: 323
- India: 137

**CAGR (Percent)**

- US: 8.6
- UK: 11.3
- Eurozone: 9.8
- Eastern Europe: 19.3
- Japan: 4.0
- China: 14.5
- India: 11.9

*Note: Some numbers do not add to 100% due to rounding error.*

Source: McKinsey Global Institute Global Financial Stock Database; Global Insight
Global Warming

Decision making under extreme uncertainty
  Very long time horizons
  Large ranges in the estimates of climate impacts
  These will decline over time as the science becomes more precise
The stocks and the flows of greenhouse gases
  The Kyoto impasse
  How to allocate the emissions rights equitably
Three Major Sets of Issues

1. Mitigation
   Allocation of emissions rights across countries
   Efficiency - carbon trading market mechanisms

2. Technology
   Reduction of the costs of mitigation
   Subsidies and rapid transfer globally

3. Adaptation
   Capacity to adapt to climate change that does occur
   Poorer country problem

RESPONDING TO CLIMATE CHANGE IS A MAJOR TEST OF OUR COLLECTIVE CAPACITY FOR GLOBAL GOVERNANCE
Demand for Energy and Commodities

Large incremental demand for raw materials, commodities, and energy with effects on prices (China's construction of the equivalent of the US interstate highway system is an example).

For developing countries with commodity exports, the effect can be beneficial in the short run – but rising commodity prices is not a basis for sustained growth.

Generally rising energy costs hurt poor countries more than richer ones.

Potentially damaging scramble for energy security – because of the size of the demand shock – and the potential for supply problems in unstable regions.
Urbanization and Sustained Growth

In the early stages of rapid growth, the agricultural sector is usually the location of a vast majority of the people. Typically, labor is underemployed in these traditional sectors. People move to cities and new industrial sectors where investment is taking place and productivity is higher. The loss in output in the traditional sector is minimal or zero because of the surplus labor condition, and hence the overall productivity gain is substantial.

This movement of people geographically and across sectors is not an ancillary side effect of the growth process, but rather the essence of it."

Or to put it another way, it is the real micro-economics of high growth

Source: Two articles on sustained high growth by the author in the WSJ, January 2007
Why is orderly urbanization crucial

Advance economies are urban economies (with no exceptions)
   For reasons having to do with the way information flows in an economy
The economic activity that sustains growth in middle and upper-income countries is essentially urban activity – it requires proximity
Urban-rural productivity differentials are large in China
   As they are in India and other countries – this is normal
They will be eliminated by the movement of people to new sectors and to urban environments
Productivity growth in the rural sector results from the exit of people to new productive employment opportunities followed by consolidation and increased capital intensity in agriculture
The agricultural sector, though depopulated, becomes highly productive and enables many economies to be self-sufficient in food
In two decades, China will likely have about 75% of its population in cities, possibly more.
Diversifying The Sources of Growth Requires Urban Development

Capital Markets, financial markets and investment efficiency

Diversifying sources of growth
- Manufacturing sectors up the valued added chain
- The Service sector
- Domestic Market as engine of growth

“China is several different economies at different stages of development”
The most common mistake in growth policy for successful developing economies
- Find what the economy is good at good at and keep doing it too long

Nothing in high speed sustained growth is permanent
Key features of Orderly Urbanization and Growth

Labor mobility
Movement in response to economic and employment opportunity
Push versus pull
  The Latin American problem
Factors that can retard urbanization
  Imperfect markets in property leading to inefficient land use decisions – within the urban area and at the urban-rural boundary
Unsustainable public finance at the city level
Absence of organized and enforced zoning
Absence of affordable housing options
Lack of affordable transportation and mobility
Absence of basic service availability
Environmental quality, congestion and negative externalities
Facilitating Policies and Reforms

To be discussed in great detail in the sessions this afternoon with experts

1. Clear property ownership so that land prices give accurate signals about land use (within urban and rural areas and at the boundaries)
2. A sharp distinction between the municipal balance sheets and income statements (with transparent reporting systems)
   Avoidance of funding expenses through asset sales for sustainability reasons
3. Creation over time of municipal financial markets and instruments
4. Shifting municipal incentive structures to orient them to attracting economic activity and delivering services to residents
5. Educational preparation of rural residents for employment in emerging urban sectors.
6. Enhancement of the aesthetic and cultural life of cities