
Introduction

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A look at the future development of the world economy: deviating from conventional wisdom

Forecasts of the world economy are regularly produced by a host of international organisations. The International Monetary Fund (IMF) has been publishing its *World Economic Outlook* since 1980. Similarly, the World Bank produces a series of *Global Economic Prospects*, which focus on developing countries. Such publications usually present a core set of short-term economic projections for the world economy, regions and individual countries. It is also quite common to produce rankings of countries based on the size of their GDP or on key indicators such as GDP per capita. This Policy Report, however, takes a somewhat different approach, as will be evident in subsequent chapters, but first it is worth highlighting several important facts about the world economy.

(i) China 2nd, India 11th in total GDP at market exchange rates

Table 1 shows a number of key indicators for the world's 20 largest economies in 2011. Column 1 measures the size of economies by their total GDP at market exchange rates, the prime measure of the market size for businesses operating in these countries. By this measure, the United States is still by far the largest economy in the world. Its 21.67% share in world GDP is more than double that of China, the world's second-largest economy. These two countries are followed by Japan, Germany and France – three G7 economies. Brazil lies ahead of the United Kingdom and Italy, which are followed by Russia, Canada and India. Overall, the world's 20 largest economies make up 80% of world GDP.

Table 1: Key economic indicators for the world's 20 largest economies

Country	Total GDP at market exchange rates (million USD) in 2011	Total GDP at market exchange rates (world rank) in 2011	Total GDP at purchasing power parity (million USD) in 2011	Total GDP at purchasing power parity (world rank) in 2011	GDP per capita at market exchange rates (USD) in 2011	GDP per capita at market exchange rates (world rank) in 2011	GDP per capita at purchasing power parity (USD) in 2011	GDP per capita at purchasing power parity (world rank) in 2011	Country share in world GDP at market exchange rates (USD) in 2011	Country share in world GDP at purchasing power parity (USD) in 2011	Population (million people) in 2011
US	15,094	1	15,094	1	48,387	14	48,387	7	22	19	312
China	7,298	2	11,300	2	5,414	88	8,382	92	10	14	1,348
Japan	5,869	3	4,400	4	45,920	18	34,740	24	8	6	128
Germany	3,577	4	3,099	5	43,742	20	37,897	18	5	4	82
France	2,776	5	2,218	9	44,008	19	35,156	23	4	3	63
Brazil	2,493	6	2,294	7	12,789	53	11,769	75	4	3	195
UK	2,418	7	2,261	8	38,592	22	36,090	22	3	3	63
Italy	2,199	8	1,847	10	36,267	25	30,464	29	3	2	61
Russia	1,850	9	2,383	6	12,993	52	16,736	53	3	3	142
Canada	1,737	10	1,396	14	50,436	9	40,541	13	2	2	34
India	1,676	11	4,458	3	1,389	137	3,694	127	2	6	1,207
Spain	1,494	12	1,413	13	32,360	27	30,626	28	2	2	46
Australia	1,488	13	914	18	65,477	6	40,234	15	2	1	23
Mexico	1,155	14	1,662	11	10,153	62	14,610	63	2	2	114
Korea	1,116	15	1,554	12	22,778	35	31,714	25	2	2	49
Indonesia	846	16	1,125	15	3,509	109	4,666	120	1	1	241
Netherlands	840	17	704	21	50,355	10	42,183	10	1	1	17
Turkey	778	18	1,074	16	10,522	61	14,517	64	1	1	74
Switzerland	636	19	340	36	81,161	4	43,370	9	1	0	8
Saudi Arabia	578	20	683	22	20,504	38	24,237	39	1	1	28

Sources: IMF, *World Economic Outlook*; World Bank, *World Development Indicators*.

(ii) China 2nd, India 3rd in total GDP in purchasing power parity (PPP) terms

Foreign businesses often use market exchange rates to translate the value of their operations abroad into their home currency (or into US dollars, if that is their unit of account). GDP at market exchange rates, however, does not always correctly reflect the purchasing power of a country's income or, for that matter, the standard of living of its citizens. This fact has received considerable popular attention via the "Big Mac Index" of *The Economist* and similar kinds of cross-country comparisons of PPP for specific goods. Market exchange rates are volatile and can take a while to reach a value that correctly reflects the standard of living in a country and cross-country differences in productivity. Political and financial factors play a role in the sluggish adjustments of market exchange rates. Furthermore, they tend to understate systematically living standards in poor countries owing to the Balassa–Samuelson effect.¹ GDP figures at PPP have the advantage of taking this into account and yield a common yardstick. While the United States remains on top by this measure, ahead of China, the gap between the two countries is much

1 The Balassa-Samuelson effect refers to the observation that, while tradable goods cannot vary greatly in price by location, most services are delivered locally (e.g. cleaning), and many manufactured goods have high transport costs, so price differences in the latter two cannot be easily arbitrated away, leading to persistent PPP-deviations. The so-called Penn effect says that PPP-deviations usually go in the same direction: where incomes are high, average price levels typically are high, thereby overstating the purchasing power of rich countries relative to poor ones.

narrower in PPP-adjusted terms. While the United States still makes up roughly 20% of world GDP, China accounts for 14.32% in PPP terms, 4 percentage points more than GDP measured at market exchange rates. The most striking difference in the position of the top economies is that India ranks third in PPP terms, with 5.65% of world GDP, ahead of both Japan and Germany.

(iii) The world's top 11 economies: G7 plus the BRICs

While the G7, the (formerly) seven largest economies – the United States, France, Germany, Italy, Japan, United Kingdom and Canada – are still in the top ranks, China, Brazil, Russia and India are now also among the world's biggest. In 2001, when Jim O'Neill of Goldman Sachs coined the acronym BRICs, he predicted that over the first decade of this millennium their weight (especially China's) in world GDP would grow, raising important issues about the global economic impact of fiscal and monetary policy in the four countries. In this context, O'Neill argued that world policymaking forums should be reorganised and the G7, in particular, should be modified to include BRIC representatives. At the time his paper created quite a stir, especially with respect to China, which he predicted would soon overtake the United States as the world's biggest economy.

China's rise is often thought to be unstoppable. Nobel Prize winner Robert Fogel (2010), in a paper entitled "\$123,000,000,000,000", predicted that the Chinese economy would reach \$123 trillion by 2040, or nearly three times the economic output of the entire globe in 2000. He also predicted that China's per capita income would overtake that of most of the Western world, doubling that forecast for the European Union (EU) by 2040. Fogel's bullish projection is at the upper end of the forecasting spectrum; more conservative forecasts by the OECD (2012) predict that by 2050 GDP per capita in China and Russia will be about half of that of leading Western countries, while in Brazil it will amount to about 40% and in India and Indonesia to about 25%.

Some observers think the BRICs concept has outlived its usefulness, not least because it focuses on total GDP growth. Citigroup (2011) predicts that over the coming years the most promising candidates in terms of per capita growth – the so-called global growth generators (3G countries) – will not be Brazil and Russia, but rather Bangladesh, China, Egypt, India, Indonesia, Iraq, Mongolia, Nigeria, the Philippines, Sri Lanka and Vietnam.

(iv) Belarus ahead of China; Republic of Congo ahead of India in per capita GDP

So long as China's GDP continues to grow faster than that of the United States, China might, indeed, soon overtake the US in terms of total GDP. However, there is no guarantee that this will happen. Total GDP is driven by population growth as much as by productivity growth. China's one-child policy is already slowing down its population growth and will also hamper its total GDP growth. The case of China is instructive in that it illustrates quite clearly the differences between various ways of measuring the development of economies. In addition to the different picture that can be painted by measuring total GDP at market exchange rates and at PPP, China is also an interesting case in that its GDP is small in per capita terms. While China's total GDP growth is likely to slow, it has a great deal of scope to grow in per capita terms. In fact, in per capita GDP at PPP, China ranks only 92nd and India ranks 127th in the league tables (IMF, *World Economic Outlook*). By comparison, the United States is in 7th place, behind a number of small open economies – Qatar, Luxembourg, Singapore, Norway, Brunei Darussalam and Hong Kong.

It is interesting to note that this interplay between population dynamics and technological catch-up might lead to a situation whereby China's share in the world economy stabilises or even shrinks, while its economy continues to catch up with the West in per capita terms. Indeed, this report highlights additional aspects of China's growth prospects and notably focuses on a number of political economy issues.

The BRICs, and in particular China and India, receive a great deal of attention mainly because they are so enormous. China's population (and India's, too) is larger than that of the entire African continent. But both countries are well behind countries such as Belarus and Ecuador in terms of per capita GDP, and India is even behind the Republic of Congo. This demonstrates that total GDP is not a very good measure of a country's welfare, or indeed of that of its citizens.

(v) China and India: low wages, low productivity

How does one explain why China and India are still so far behind the United States in per capita GDP? While labour costs per hour may look low in China, unit labour costs, which take into account productivity differences, show that the cost advantage of production in China is not that significant (see Table 2 for a comparison of China's productivity, wages, and relative unit labour costs compared with a number of selected countries). One reason for the low productivity in India is a large degree of factor misallocation. Hsieh and Klenow (2009) argue that when capital and labour are hypothetically reallocated to equalise marginal products to the extent observed in the United States, total factor productivity gains in the manufacturing sector in China could be in the order of 30-50%, and 40-60% in India.

Table 2: China's productivity, wages and relative unit labour cost vis-à-vis selected countries, latest available year (as a percentage of comparator country levels)

	Relative productivity	Relative wage	Relative unit labor cost
UNIDO sources			
Brazil (2007)	85.5	40.4	47.3
Chile (2006)	19.2	25.3	131.7
Czech Republic (2007)	51.0	30.9	60.7
Hong Kong (2008)	57.3	18.6	32.5
Hungary (2007)	49.7	29.6	59.5
India (2007)	132.1	158.3	119.9
Indonesia (2007)	155.9	223.5	143.3
Malaysia (2007)	105.6	59.3	56.2
Mauritius (2007)	191.8	66.9	34.9
Mexico (2009)	68.1	48.7	71.6
Philippines (2006)	187.2	114.6	61.2
Poland (2006)	46.0	40.9	88.9
Russia (2006)	147.5	82.6	56.0
Singapore (2008)	30.3	13.4	44.1
South Africa (2008)	83.9	30.4	36.2
Thailand (2006)	188.7	166.5	88.2
United States (2008)	12.1	8.2	67.5

Source: Ceglowski and Golub (2012), based on data by the UN Industrial Development Organization (UNIDO).

(vi) Reversals of fortune?

Of particular interest in this report are the potentially seismic shifts that are expected to take place between different areas of the world economy. Will some developing countries inevitably catch up with the developed economies in the West? Will the United States genuinely be challenged as the world's leading economy? Is the rise of China and India inevitable? Can Europe maintain its place in the world economy?

Naive projections of future growth often use a simple growth rate – be it the current growth rate or an average of the recent past – and project it into the future. If this logic was to be applied to project GDP per capita for China and the United States, the following picture would emerge (see Table 1). In terms of per capita GDP at PPP, the figure for China was \$8,382 in 2011, compared with \$48,387 for the United States. If China was able to continue growing at a rate of 9.5% per year (roughly equal to its average annual growth rate in 2000-10) and the United States' per capita GDP growth remained at 2.5% per year, it would take China 27 years to overtake the United States in per capita GDP terms (at PPP).² It is highly unlikely that China would be able to keep up such a high growth rate in per capita GDP (at PPP) for another three decades.

Alternatively, if China's GDP growth rate was only 6.5% per year in the coming decades and the growth rate in the United States remained at 2.5%, it would take China 46 years to overtake the United States. With an annual per capita GDP growth rate (at PPP) of only 4.5% for China – still very high in light of the performance of developed economies in recent decades – it would take China 91 years to overtake the United States. More sophisticated forecasts allow for a decline in growth rates over time as economies approach the technological frontier, and no doubt include a mix of the simple linear projections described above, but even simple projections reveal how far China and other developing countries still have to go before attaining the prosperity of Western economies.

It is fair to ask, therefore, whether predictions of a rapid catch-up or even an overtaking of the leading economies are realistic. This report provides evidence that such reversals of fortune have been extremely rare in world history. The transition from imitation to innovation and assuming the leadership in frontier innovation is a challenge that even the most promising candidates (notably Japan) have failed to achieve. Economic change needs to go hand in hand with institutional change. A growing middle class demands its share in political decision-making. The political economy of change is thus a key factor in the analysis contained in this report. Based on the experiences of countries opening up to globalisation and their policy response to the ongoing financial crisis since 2008, the likelihood that the right economic and social decisions are taken at every turn is rather low.

(vii) How far has growth lifted people out of poverty?

This report argues that even a GDP per capita analysis gives only a limited picture of the average stage of a country's development. While many developing countries have seen phenomenal growth rates in recent years, poverty still affects millions of people around the world. The World Bank's concept of a "dollar-a-day" global poverty line was based on the proposition that several developing countries defined basic needs as the equivalent of about \$365 per year. The current definition of the dollar-a-day concept uses \$1.25 per person per day in 2005 international dollars as the reference value for strong poverty. Against

² For China, $\$8,382.01 * (1.095)^{27} = \$97,169.37$. For the United States, $\$48,386.69 * (1.025)^{27} = \$94,247.60$.

that measure, the global headcount ratio – the share of the world’s population living below the poverty line – decreased from 51.9% in 1981 to 25.2% in 2005. Hence, despite a further increase in the world’s population and thus higher demand for food around the globe, poverty levels have fallen significantly. Yet, large parts of the world are still very poor.

(viii) In India, more than 800 million people live on less than \$2 per day

A closer look at China and India reveals that vast numbers of their citizens still live below the poverty line (see Table 3). A key issue for economic policy, therefore, remains the fight against poverty. According to the World Bank data in Table 3, 13.06% of China’s population lived on less than \$1.25 per day in 2008, so out of a total population of 1.3 billion people, some 176 million people lived below the poverty line. Although slightly smaller in total population (1.2 billion inhabitants), India had more than twice as many people (394 million) living below the poverty

Table 3: Poverty in selected countries around the world

Country	Population (million people) in 2011	Share of population living on less than 1.25 USD a day in 2008 (a)	Share of population living on less than 2 USD a day in 2008 (a)
United States	312.0		
China	1,348.1	13.1	29.8
Japan	127.8		
Germany	81.8		
France	63.1		
Brazil	194.9	6.0	11.3
United Kingdom	62.6		
Italy	60.6		
Russia	142.4	-	0.1
Canada	34.4		
India	1,206.9	32.7	68.7
Spain	46.2		
Australia	22.7		
Mexico	113.7	1.2	5.2
Korea	49.0		
Indonesia	241.0	22.6	54.4
Netherlands	16.7		
Turkey	74.0	-	4.2
Switzerland	7.8		
Saudi Arabia	28.2		
East Asia & Pacific (developing countries only)	1,974.0	14.3	33.2
Europe & Central Asia (developing countries only)	407.6	0.5	2.2
Latin American & Caribbean (developing countries only)	589.0	6.5	12.4
Middle East & North Africa (developing countries only)	336.6	2.7	13.9
South Asia (developing countries only)	1,656.0	36.0	70.9
Sub-Saharan Africa (developing countries only)	874.8	47.5	69.2

Note: (a) Poverty data for India refer to 2010.

Sources: IMF, *World Economic Outlook*; World Bank, *World Development Indicators*.

line. Using a different threshold of \$2 per day, these numbers are, of course, even larger. In China, 401 million citizens lived on less than \$2 per day, while the number in India was 829 million. Such numbers always need to be taken with a grain of salt (see Deaton 2010; Easterly 2010), since they are obviously estimates and not based on an actual headcount of the world's poor. But the order of magnitude suggests that India has nearly as many poor people as the entire population of the African continent, rich and poor. Similar poverty rates of about two-thirds of the population are to be found in many developing countries (see Table 3 for groups of developing countries).

All of this highlights that a look at world rankings in terms of total GDP provides a very distorted picture of how far removed vast sections of the Chinese and Indian population are from living a life at levels approaching those in the West. This ties into a long-standing debate regarding the conditions under which growth is pro-poor. While it is often argued that pro-growth policies are the most effective way to alleviate poverty (see, for example, Kraay 2006), alternatives to general macroeconomic policies in countries stricken by poverty come in two broad forms: foreign aid, and more specific interventions targeted at the poor.

With respect to foreign aid, the evidence is mixed. Starting with Burnside and Dollar (2000; 2004), it has been argued that foreign aid does not automatically lead to more growth. Dalgaard et al. (2004) argue in favour of an aid-growth link, and Easterly (2003) questions the effectiveness of aid with respect to economic growth. Doucouliagos and Paldam (2009), carrying out a meta-analysis of 40 years of research on aid effectiveness, conclude that aid, overall, has not been effective. Moreover, the literature agrees that key factors which undermine the goal of aid transfers are low levels of education and bad institutions (such as corrupt politicians, bad administrations etc.). In fact, aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policies, but has little effect in the context of poor policies. The conclusion is that it is vital for aid to be conditional on good policies in the receiving countries, although Rajan and Subramanian (2008) even call into question whether aid works better in a favourable policy or geographical environment.

The allocation of aid to different groups of the population is an equally important issue. Collier and Dollar (2002) analyse the efficiency of aid allocation in terms of alleviating poverty. They argue that the actual allocation of aid is radically different from poverty-efficient allocation. Indeed, with a poverty-efficient allocation, the productivity of aid would nearly double. Easterly and Williamson (2011), however, find no evidence of increased "poverty selectivity" in foreign aid priorities.

Over the last decade the attention of development economists has shifted towards more targeted interventions at the micro level. The mission of academic initiatives, such as J-PAL, the poverty action lab led by Abhijit Banerjee and Esther Duflo, is "to reduce poverty by ensuring that policy is based on scientific evidence", where "scientific evidence" is based on randomised control trials. This approach gives a treatment to a group of the population – for example, school meal vouchers to children in a village in order to study the effect of this intervention on outcomes (school attendance) – by comparing treatment and control groups in a randomised setting. This approach and some key findings are summarised in Banerjee and Duflo (2011). While some of this work has been criticised for being too focused on the micro level (see Ravallion, 2012), it does have the advantage of being able to target policy interventions and to roll them out only after they have been shown to work in a randomised control setting.

(ix) Helping the world's poor with tight budgets at home?

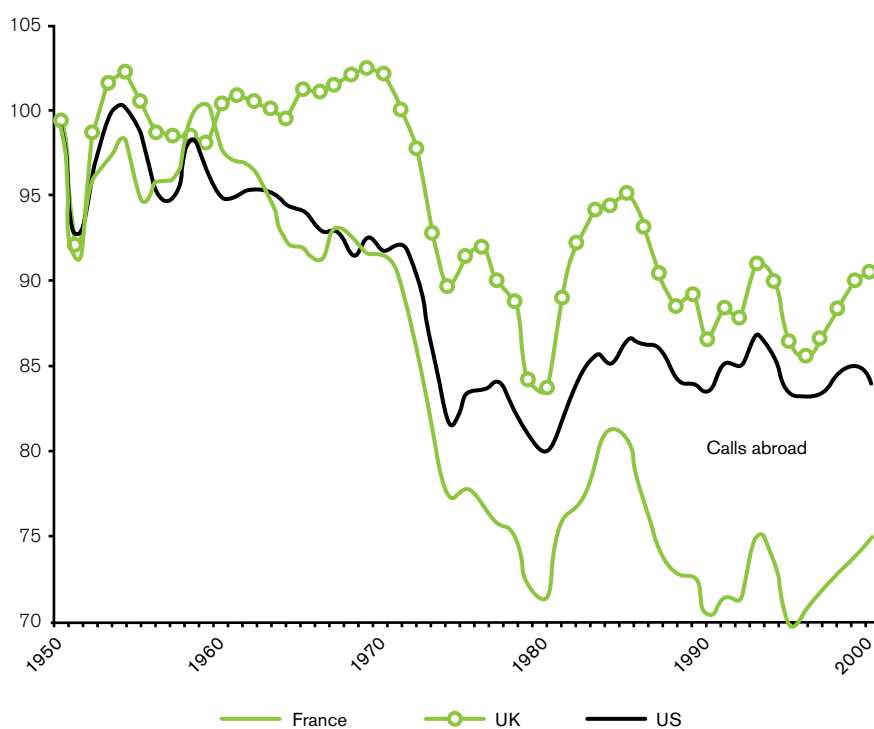
One of the key challenges in developing countries is to alleviate poverty. The World Bank's mission has been carved in stone at its headquarters in Washington, D.C. as an ever-present reminder: "Our dream is a world free of poverty". To attain this goal, multilateral agencies, international organisations, NGOs and development ministries around the world have been spending vast amounts of money to help the poor. Yet nearly 1.3 billion people remain below the extreme poverty line with an income of \$1.25 or less per day, according to World Bank figures. Another 2.6 billion live on less than \$2 a day. Therefore, it is not too surprising that in 2010 the British government decided to ringfence the foreign aid budget from budget cuts because it wanted to show its continued commitment to helping the developing world. Bearing in mind, however, the debate about the effectiveness of development aid, the conventional approach to aid is likely to continue to fall well short of realising its full potential. Hence, a more detailed look at unconventional ways to achieve more with the same (or even a smaller) aid budget is instructive.

(x) Massive changes as a result of globalisation

Globalisation, the process leading to the closer integration of countries and peoples around the world, brings with it both benefits and challenges – and is the focus of an important part of this report. The recent wave of globalisation has been brought about by the enormous reduction in the cost of transport and communication and the removal of artificial barriers to factor flows across borders. Indeed, trade costs have also come down considerably since World War II, as Figure 1 illustrates for the United States, the United Kingdom and France.

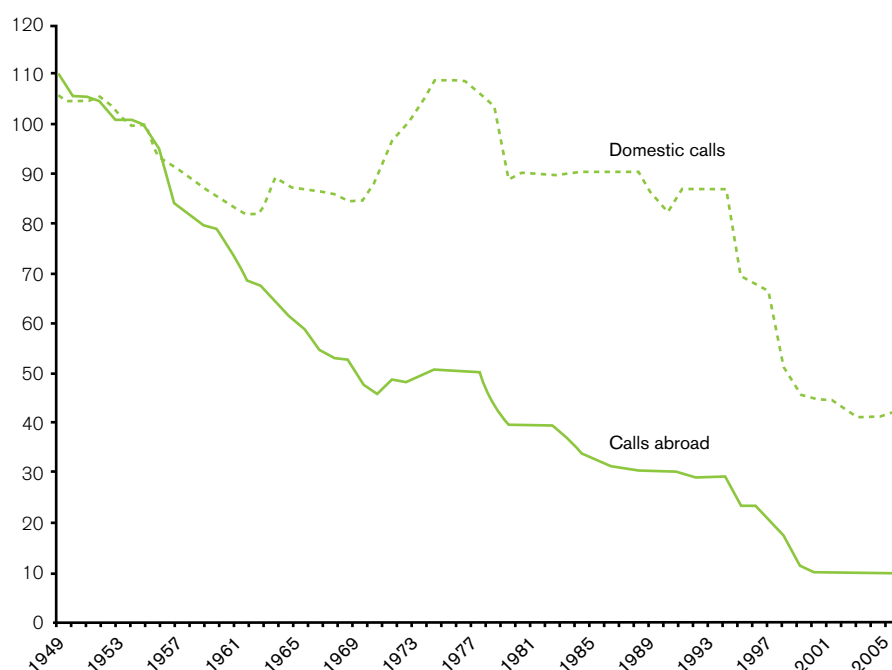
Similarly, the costs of communication have fallen considerably. The costs for telephone calls from Germany, for example, are a good illustration of this trend (see Figure 2).

Figure 1: Trade cost indices, 1950-2000 (1950=100)



Source: Jacks, Meissner, Novy (2008).

Figure 2: Prices for domestic and foreign phone calls in Germany, 1949-2007 (1995=100 in local currency at current prices)



Source: *World Trade Report 2008*, Chart 11.

The drop in trade and communication costs, meanwhile, brought with it a substantial increase in the crossborder flow of goods. The expansion in trade exceeded GDP growth in all periods reported in Table 4, with the exception of the inter-war period (not reported), when trade collapsed.

In similar fashion to the increase in international trade after World War II, international capital mobility increased substantially. Quinn et al. (2008) report that for their 120 country pairs (pair-wise combinations of the 16 countries in their sample), between 1950 and the turn of the millennium their index of capital mobility went up from 45 to 97 on a scale from 0 to 100, where zero denotes a closed economy and 100 represents a completely open economy. The table also reveals the complete openness in the early period, around 1900.

Table 4: Globalisation waves in the 19th and 20th centuries (% change unless otherwise indicated)

World	1850-1913	1950-2007	1950-73	1974-2007
Population growth	0.8 ^a	1.7	1.9	1.6
GDP growth (real)	2.1 ^a	3.8	5.1	2.9
Per capita	1.3 ^a	2.0	3.1	1.2
Trade growth (real)	3.8	6.2	8.2	5.0
Migration (net) Million				
US, Canada, Australia, NZ (cumulative)	17.9 ^a	50.1	12.7	37.4
US, Canada, Australia, NZ (annual)	0.42 ^a	0.90	0.55	1.17
Industrial countries (less Japan) (cumulative)	-	-	-	64.3
Global FDI outward stock, year			1982	2006
FDI as % of GDP (world)	-	-	5.2	25.3

Note: (a) refers to the period 1870-1913.

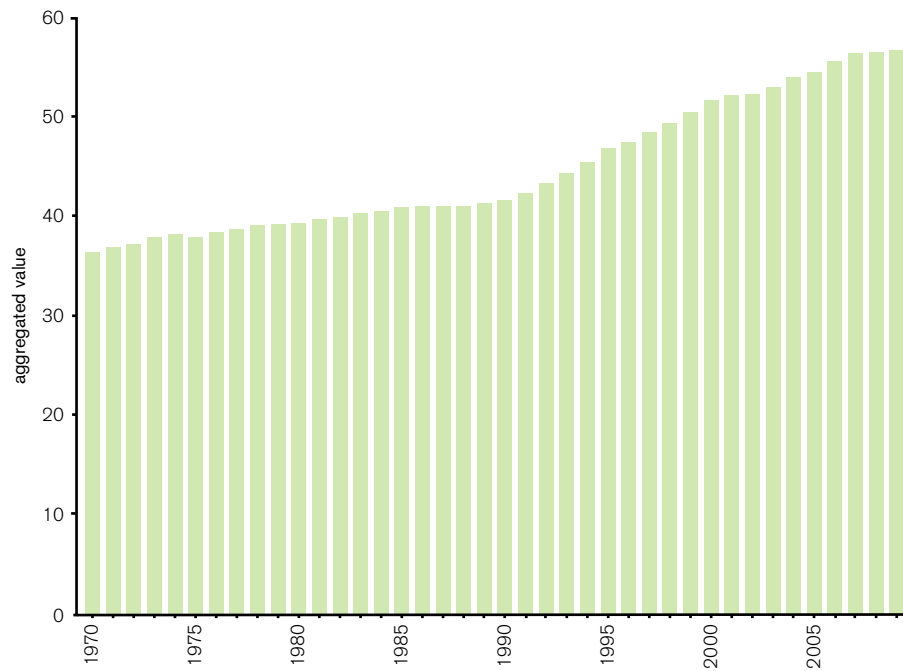
Source: *World Trade Report 2008*, Table 1.

Table 5: Capital account openness over the last century

Period	Mean	N	Minimum	Maximum
1890	96	114	50	100
1894	100	114	100	100
1898	100	114	100	100
1898	100	114	100	100
1902	100	114	100	100
1906	100	114	100	100
1910	100	114	100	100
1914	93	114	75	100
1918	66	120	42	94
1922	57	120	19	90.5
1926	85	120	19	100
1930	70	120	15.5	100
1934	56	120	0	90.5
1938	50	120	0	87.5
1942	NA	NA	NA	NA
1946	25	105	0	100
1950	45	120	3	100
1954	57	120	11	100
1958	65	120	22	100
1962	67	120	25.5	100
1966	66	120	31.5	100
1970	67	120	38	98.5
1974	68	120	38	100
1978	72	120	48.5	98.5
1982	77	120	53	100
1986	85	120	64	100
1990	93	120	75	100
1994	95	120	75	100
1998	97	120	81.5	100
Total	76	3,183	0	100

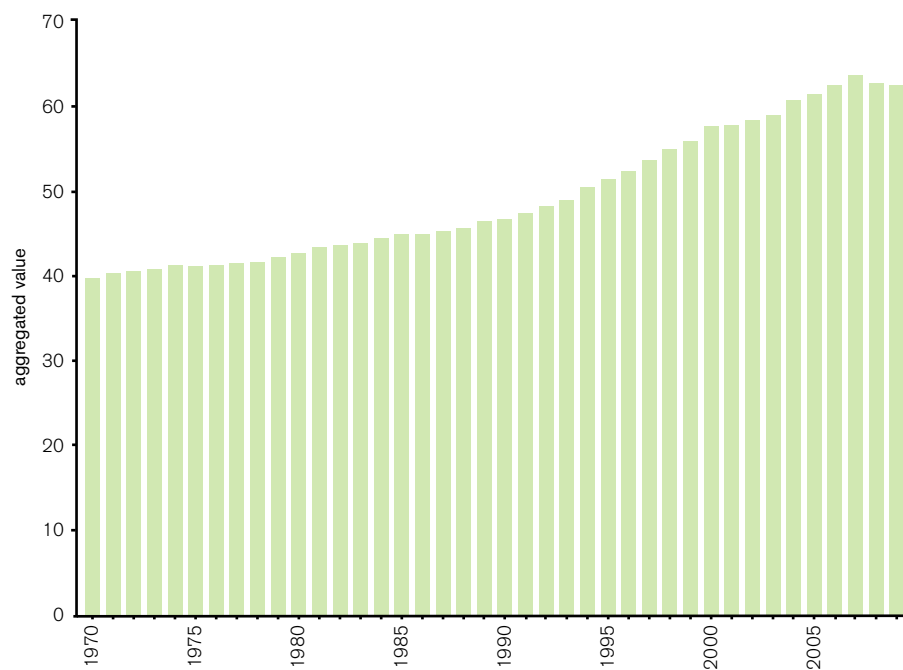
Source: Quinn and Voth (2008).

Globalisation, of course, has many dimensions. Increases in trade, foreign direct investment and financial investment are merely the most prominent. The KOF Index of Globalisation attempts to capture these dimensions of globalisation, but also others, namely social globalisation (foreign population as a share of total population; the number of McDonald's restaurants in a country etc.) and political globalisation (e.g. participation in UN missions and membership of international organisations). In constructing the indices of globalisation, each of the variables introduced is transformed to an index on a scale of 1 to 100, where 100 is the maximum value for a specific variable over the 1970-2009 period and 1 is the minimum value. Higher values denote greater globalisation (see Dreher, 2006). Figure 3 displays the development of the overall KOF Index of Globalisation (note that migration is counted under social globalisation) for the period 1970-2009 for the world as a whole, which confirms the fact that the world has generally become more integrated in economic, social and political terms.

Figure 3: KOF Index of Globalisation (1970-2009)

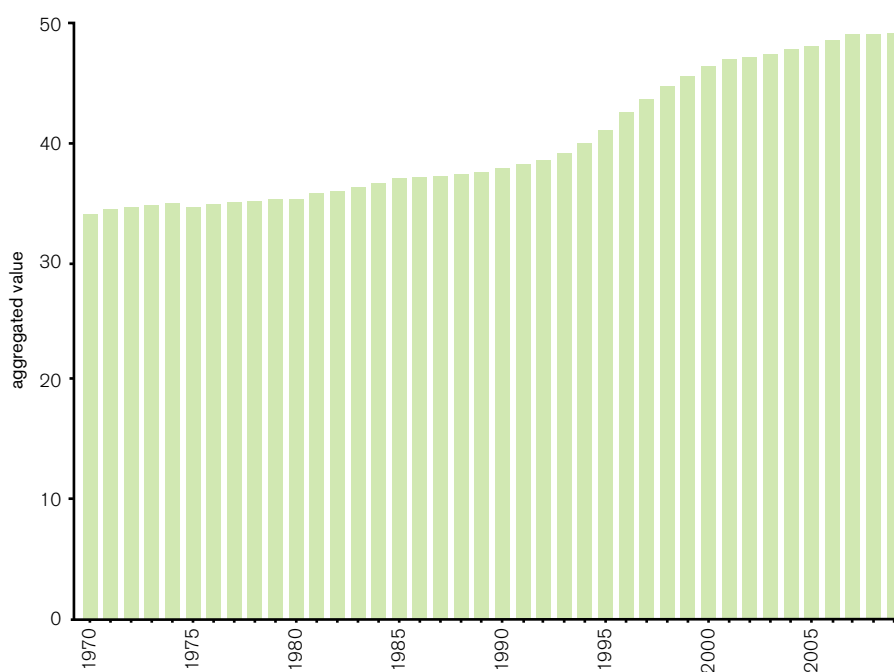
Source: <http://globalization.kof.ethz.ch>

Looking more specifically at the various sub-indices, it becomes clear that economic and political globalisation has advanced further than social globalisation (see Figures 4, 5 and 6).

Figure 4: Economic globalisation

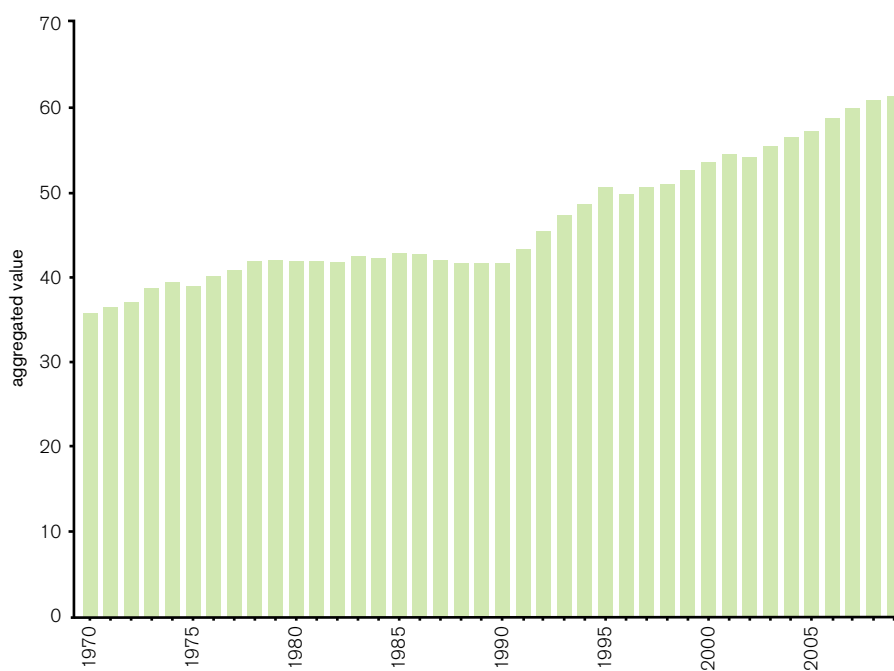
Source: <http://globalization.kof.ethz.ch/>

Figure 5: Social globalisation



Source: <http://globalization.kof.ethz.ch/>

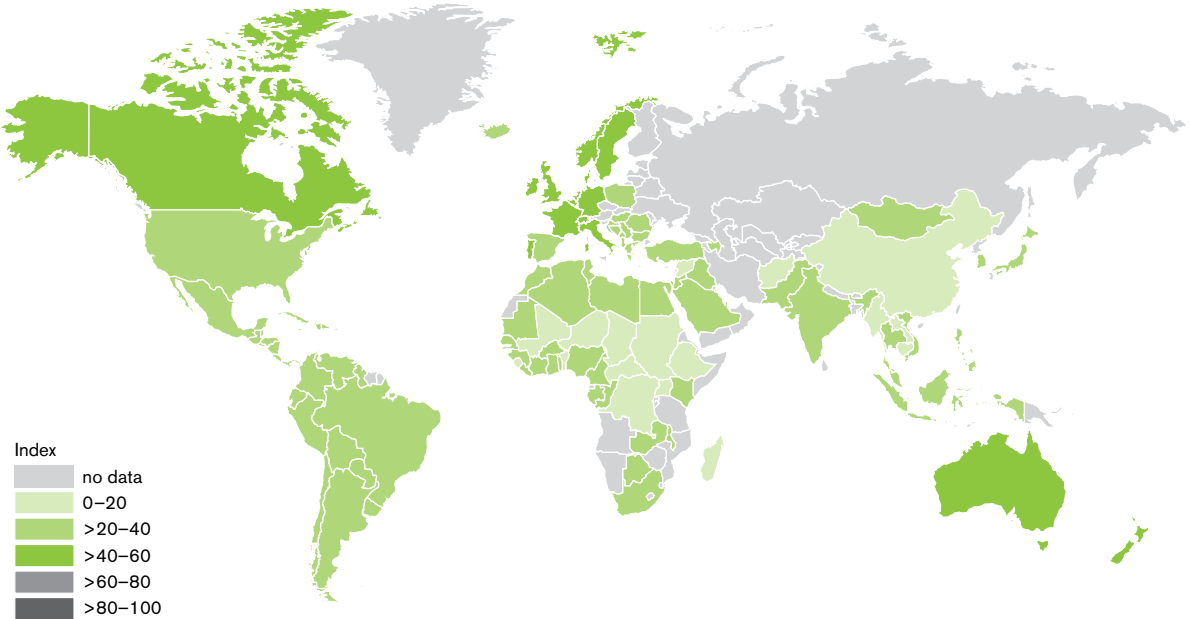
Figure 6: Political globalisation



Source: <http://globalization.kof.ethz.ch/>

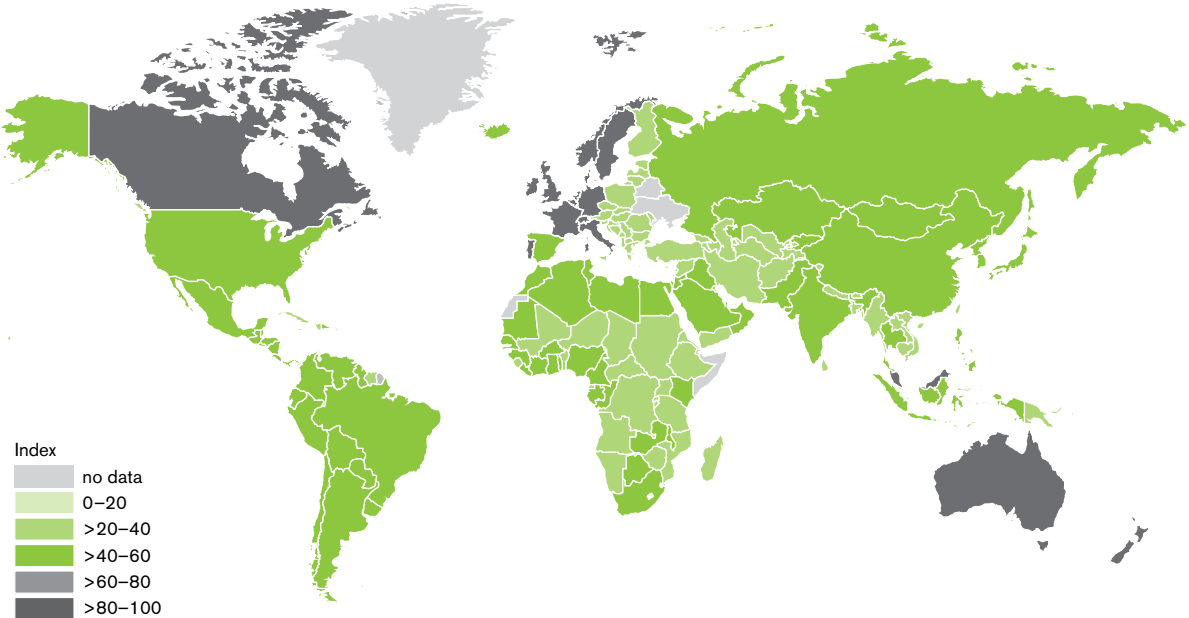
It is instructive to compare the degree of globalisation across different countries of the world in 1970 and 2009. Indeed, as Maps 1 and 2 clearly demonstrate, nearly all countries became more globalised during that period, although the effect has been even more pronounced in developing countries.

Map 1: KOF Index of Globalisation (1970)



Source: <http://globalization.kof.ethz.ch>

Map 2: KOF Index of Globalisation (2009)



Source: <http://globalization.kof.ethz.ch>

(xi) Worries about globalisation and untapped potential

Despite the potential benefits from an increase in globalisation, there are also concerns stemming from the integration of the larger developing countries into the world economy. These worries arise primarily from the more limited nature of the policy options available to developed countries. Indeed, the authorities of a closed economy generally have greater control over economic policy than a government in a world where capital and labour are mobile.

First, at the macroeconomic level, the sheer size of some of these economies, such as China and India, has major implications for the international transmission of unexpected shocks. In the aftermath of the 2008 global financial crisis, growth in the developing world has helped to offset the impact of the recession in the developed world. However, a slowdown in growth in developing countries or changes in trade policies could have important adverse effects on developed economies in the West.

Second, a key characteristic of a more globalised world is not only an increase in trade, but also the fact that capital is more mobile. Capital mobility leads to concerns in developed countries, in particular that globalisation reduces their policy options. One fear is that international tax competition will force them to lower their corporate tax rates in order to attract firms to the country. Developed countries with their more elaborate welfare systems might then have to relinquish an important source of revenue.

Third, and perhaps more surprising, while financial and goods markets have become more globalised, labour markets are still much less integrated. In fact, it can be argued (Vásquez, 2000) that migration played a greater role a century ago, during the first wave of globalisation, than it does today. This lack of international labour mobility points to an untapped potential to reap further gains from globalisation. There are, of course, a host of political reasons for restrictions on immigration, including its potential impact on the welfare state, but a more clever design of migration policies might enable developed countries to reap further benefits from globalisation without undermining the very existence of welfare measures.

(xii) Is Europe's role in the world likely to increase or decrease?

While this Policy Report takes a global perspective, Europe obviously has a major role to play in shaping future world events. At present large parts of Europe are struggling with twin crises – a banking crisis and a sovereign debt crisis. In the eurozone, these crises threaten the very existence of the single currency, the euro. The short- and medium-term issue for these countries is to keep budget deficits under control and to maintain or regain their access to international capital markets. However, the crisis also reveals structural issues that require an institutional response well beyond short-term fixes to enable the eurozone to recover. The conventional wisdom with respect to Europe speaks to the steps that are necessary to resolve the ongoing banking and debt crisis on the one hand, and to factors influencing Europe's long-term growth prospects on the other.

Regarding the short-term response to the crisis, a common view is that Europe needs a new Marshall Plan similar to the American programme to aid Europe after World War II. This is often (mis)understood as a large (unconditional) cash handout to countries in trouble. While such an approach might indeed help countries fill holes in their budgets, the medium- and long-term effects are less clear. This report re-evaluates the idea of resorting to a Marshall Plan by looking

at its historical origins and discusses what a “real” Marshall Plan would look like and whether it could attract the political support required to implement it.

European leaders are well aware that they need to look beyond short-term policy responses to the crisis. The EU’s Europe 2020 agenda makes the case for an increase in the EU labour force and for more investment in R&D and human capital. However, despite such initiatives, most analysts highlight the risk that European economies will not only lose pace compared with other Western economies, but will fall behind key emerging economies.

This Policy Report puts the macroeconomic challenges facing European economies into perspective by drawing comparisons with the Great Depression of the 1930s. It discusses how European policy responses might turn out to be utterly wrong, but it also points to the most promising avenues for growth in the future. Although the EU is very heterogeneous, it is fair to say that the majority of its member states have adopted a social model that is quite different, for example, from that of the United States. Indeed, most European countries have quite generous welfare provisions and, in response to the crisis and ensuing budget cuts, are now trying to find a new balance between giving support and making demands on its citizens. As a result, an important element in the discussion is how far the welfare state needs to be cut back and whether a race to the bottom in corporate tax rates is unavoidable as a consequence of globalisation. This is a key focus of this Policy Report.

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