Jens Thomsen: The global economy in the years ahead

Statement by Mr Jens Thomsen, Governor of the National Bank of Denmark, at the Indo-Danish Business Association, Delhi, 9 October 2007.

*   *   *

Introduction *(slide 1)*

The area I have been asked to address is the global economy in the years ahead. One of the trends in the economy which has been most noticeable – in the media and on the political agenda over the latest years – is globalization. I will therefore examine the economic development from the angle of globalization.

I will start by giving a brief overview of globalization which has been discussed vividly over the past decades and which is influencing an increasing number of areas of our economic and every day live. The increased international coherence has changed some of the characteristics of the global economy on the very big scale. I will address some points regarding these macro trends in a moment.

Following this I will focus on the impact of globalization on the economy of the industrialized countries and especially Denmark so far, the challenges ahead and the answers which have been proposed to these challenges.

1. Globalization basics

Globalization in trade

The most obvious sign of globalization has been trade, meaning an increasing amount of trade relative to production globally. This is, however, not a new trend *(Slide 2)*. The increasing international trade has been a feature of the economic development over the past 140 years interrupted by the world wars and the abolishment of the gold standard.[1]

The speed of trade integration has accelerated over the last decades and I will return to the reasons for this later on. World trade has grown five times in real terms since 1980, and its share of world GDP has risen from 36 percent to 55 percent over this period creating a more competitive global economic environment to the benefit of consumers world wide and economic growth.[2]

Financial globalization

Another important aspect of globalization has been the increased financial integration in the past decades *(slide 3)*. One measure, which can be used to measure the extent of financial integration, is the sum of external assets and liabilities relative to GDP. From the diagram it is obvious financial markets have become much more integrated and that we are moving towards a more global financial market. However the integration has only really took place for the group of high income countries, which probably can be partly attributed to their less restrictive capital controls in this group of countries.

One of the benefits of financial integration, economic theory suggests, is growth facilitation. This owes to the technology transfers linked to investments which help increase efficiency.

---

[1] D.A. Irwin, Long-run trends in world trade and income, World Trade Review (2002), 1:1, 89-100.

[2] IMF, World Economic Outlook October 2007, chapter 4, p.33.

This is often one of the key arguments for the part of financial trade known as foreign direct investment or FDI. Another benefit of financial globalization is the increased scope for consumption smoothing for individuals and countries. As the business cycle of emerging markets often is decoupled from that of industrialized countries, the possibility of global investment should also benefit investors in that they are able to spread their investment.

However financial integration is also associated with a range of risks. These include a possibility for greater volatility as capital inflow can be withdrawn in the face of a crisis or just a change in sentiments and "flight to quality" as we have seen in recent months; however, the effects on emerging economies have been small.

The evidence suggests that the largest benefits from risk-sharing have accrued to advanced economies. Countries with developed domestic financial systems, open trade, good governance and sound macroeconomic policies have not experienced greater volatility due to greater integration. Those without these "thresholds" have.[3]

Reasons for globalization

The shrinking importance of geographical distance due to technological progress is one important aspect of the increased interaction in the world economy *(slide 4)*. This is largely due to the evolution of transportation measures, reduced cost and increased speed. It has been an ongoing process through the century and is thus less likely to be the reason for the recent up-surge in international trade. Communication possibilities through for example the internet has increased markedly over the past decades and has contributed to the increased globalization. However, the most significant change over the past decades has been the inclusion into the world economy of countries which were formerly very closed economies. The integration of China, India and the former communist bloc countries into the world economy and the increasing support for international rules and institutions such as the WTO is thus one important explanation for the recent surge in international trade.

2. Macro trends

Growth contribution

First, the relative importance of the economies in the global economy is changing fast with the (re)emergence of the large and populous countries of Russia, China and India into the global economy. In 2007 the IMF estimates that China will be the largest contributor to global growth and be the fourth largest economy; roughly the same size as the German *(slide 5)*. India is still a much smaller economy than China and only comparable to that of Korea at twelfth in the world. But with the recent high growth rates, edging on 10 percent for India and steadily above for China the contribution to global growth has become pronounced.

In terms of economic size we will – if present growth differences continue – at some point see China overtake US as the largest economy in the world *(slide 6)*. This is however a prospect which probably will not occur in the next twenty years. In this timeframe India is also likely to considerably move up the economic ladder and if the trends continue by 2030 India will possibly be the world's third largest economy. Of course all this is kind of speculative and depends very much on the future economic growth.

Even though the Chinese economy is likely to become the world largest and India the third largest living standards are still very different between China, India and the western countries *(slide 7)*. Today in India the average GDP per capita is roughly two percent of that of the US and roughly 5 percent of that of the US in China. This will go up markedly and a large extent

---

[3] IMF, Reaping the Benefits of Financial Globalization, Discussion Paper, June 2007.

of catching up from these countries will occur *(slide 7/2)* if we look to 2015 and especially if we look to 2030 when the living standard relative to the US will have increased by a factor 4 for India and 6 for China *(slide 7/3)*. If you contemplate that this is over 2 billion people I think it is remarkable.

The trend of increasing importance of these economies will thus most likely continue in the coming years and will turn the world's economic focus to Asia. This trend will hopefully be supported by further lifting of trade restrictions where especially agriculture still has a lot of potential for increased international trade. The largest risk to the process of continued globalization is, taken from history, wars. The interwar period and the 2nd WW reduced the international trade and this was probably the only period in the last 150 years in which global trade grew slower than global GDP.[4]

Demographic trends

The demographic development in past, present and future has been a factor contributing to shaping the world economy *(slide 8)*. China and India have in the last twenty years experienced a decreasing ratio of dependent individuals to individuals in the work force. This has in itself helped creating the economic upturn. In the case of China this profile will, however, start to change around 2020 as the political effort to limit the population growth starts to have an impact on the dependency ratio, due to fewer newcomers to the labour market. In approximately one and a half decade India's labour force will be larger than that of China.

On the other hand most European economies will in the coming years experience an increasing dependency ratio which will strain the public budgets and the economic growth. The US is not set to experience the same level of changing demographics.

These different demographic trends will certainly play a part in determining the future dynamic areas of the world economy.

Growth in inequality

First, the average real wage has gone up for the poorest in almost all countries so if you look at it in an absolute sense globalization has helped benefit the poor. In a relative sense which inequality naturally is the results are more mixed *(slide 9)*. It is always to find fully comparable data on this subject but these are the latest ones presented in a report by the IMF.[5]

All in all globalization might have in itself translated into a slight inequality increase. Trade globalization has generally decreased inequality through increasing demand after the labour supply which has a comparative advantage in each country i.e. unskilled labour in developing countries. Financial globalization and especially FDI is, however, found to have increased inequality. This is caused by the increased demand after skilled labour which FDI creates.[6]

In most developed countries capital and highly skilled labour have increased their real wages and share of income while the real wage of low skilled workers has stagnated or fallen leading to increased inequality as shown by an increased Gini coefficient. In many developing countries, however, inequality has also been rising significantly. In India the increase after the economic reforms in the early nineties has only been marginal while in China inequality has been increasing rapidly. One of the reasons for this increase in China is

---

[4] A. Maddison, Growth and Interaction in the World Economy – The Roots of Modernity, The AEI Press, WASHINGTON, D.C., 2005.

[5] IMF, World Economic Outlook October 2007, chapter 4.

[6] IMF, World Economic Outlook October 2007, chapter 4.

the inflexible labour markets which have contributed to an increased rural-urban divide even against the backdrop of a large migration towards the cities in these countries.

As the increased inequality stems mainly from a share of the population becoming richer it is a sign of the economic growth more than anything else and has been a feature of most economic restructuring processes historically we will hopefully see that the inequality will retract when the economic development spreads to all segments of society in India and China. Horizontally the rising educational level also in developing countries will eventually pull in the direction of decreasing inequality.

3. Denmark in a globalized world

Let me turn my focus away from these very large scale trends on a global scale and to a more local one and give you an overview of the impact of globalization on the Danish economy *(slide 10)*.

The Danish economy has been doing very well these last years, with relatively high growth rates, record low unemployment and surpluses on the current account and the public budget. So on the surface the Danish economy is doing very well against the backdrop of globalization.

As a historically open economy Denmark has for a long period of time been participating in world trade. The change of the Danish agricultural complex from vegetable to animal production in the beginning of the 19th century in the face of cheap grain from the US is an early example of Denmark adopting to globalization and changing trade conditions.

The size of Danish import and exports has in accordance with the global trend been increasing steeply the past decades. The composition of exports is still biased heavily towards our main trading partners in Europe and the US. Only very recently has the trade with the emerging market countries taken off on the exports side. Regarding imports the size of the emerging markets is somewhat bigger but still the main portion of our foreign trade consists of trade with industrialized countries.

Regarding foreign direct investment which is often associated with globalization and the Far East the main part is as for trade directed towards western countries and especially Europe *(slide 11)*. However the Chinese share of the investments has been growing steadily and has overtaken that of Japan. Investments directed towards India has not as of yet really taken of.

Some of the effects of globalization on the Danish economy are less visible, however, in the import export statistics *(slide 12)*. Danish textile production has historically been rather large especially in certain areas of Jutland and the development in this industry branch provides a case in point for the effect of globalization. The production of textiles in Denmark has dropped dramatically in past years, but the value of textile export has been increasing steeply. One should think that this was self-contradictory. But it is an indication that the work carried out in Denmark is now higher up the value chain and that the production itself has been outsourced to low wage countries. This is the success story of globalization and what should be aimed for when tackling the effects of the integration in high wage countries. Of course the change in the structure of the economy is not always as clear cut as in the textile case. But when observed on a broader scale the shift from an economy focusing on industry and agriculture and towards services supported by globalization is visible *(slide 13)*. The employment composition over the past decades has changed rather fast in Denmark.

The movement up the value chain is essential for the Danish economy to benefit from globalization. In direct wage comparisons in the areas of production requiring lesser skilled workers Denmark is clearly not competitive in a strict wage sense *(slide 14)*.

Competitiveness of a business, however, comprises a number of factors and if you try to take account of all these factors Denmark is, unsurprisingly, much more competitive *(slide 15)*. The strong Danish competitiveness in such a valuation is caused by a general strong position in all the measured categories and in particular a high score on effective institutions, low corruption and well functioning infrastructure. The booming Danish economy also benefits the business climate. On the down side is of course high wages and taxes.

The interest in the Danish labour market has increased markedly recently due to the relative success and very low unemployment against the pressure from globalization. This has caused a lot of praise of the so-called flexicurity system *(slide 16)*. The system consists of three legs namely a flexible labour market and a generous welfare system combined with active labour market policies. The system in itself has not changed drastically over the past years; the active labour market policies i.e. activation rules have been tightened somewhat but it is less likely that this has changed the core of the working of the flexicurity system. The system does have some benefits in adapting to the globalizing issues such as the flexible workforce *(slide 17)*. However, it should not be seen as the Holy Grail for all countries.

One of the fears in a time of globalization has been workforce mobility between countries and the risk that a generous welfare system would attract too much foreign labour. As it has turned out mobility in the new EU member states is higher than from in older member states *(slide 18)*. But so far Denmark has in no sense been overrun by immigrants and very recently the government has proposed plans to attract more workers in the face of the tight Danish labour market.

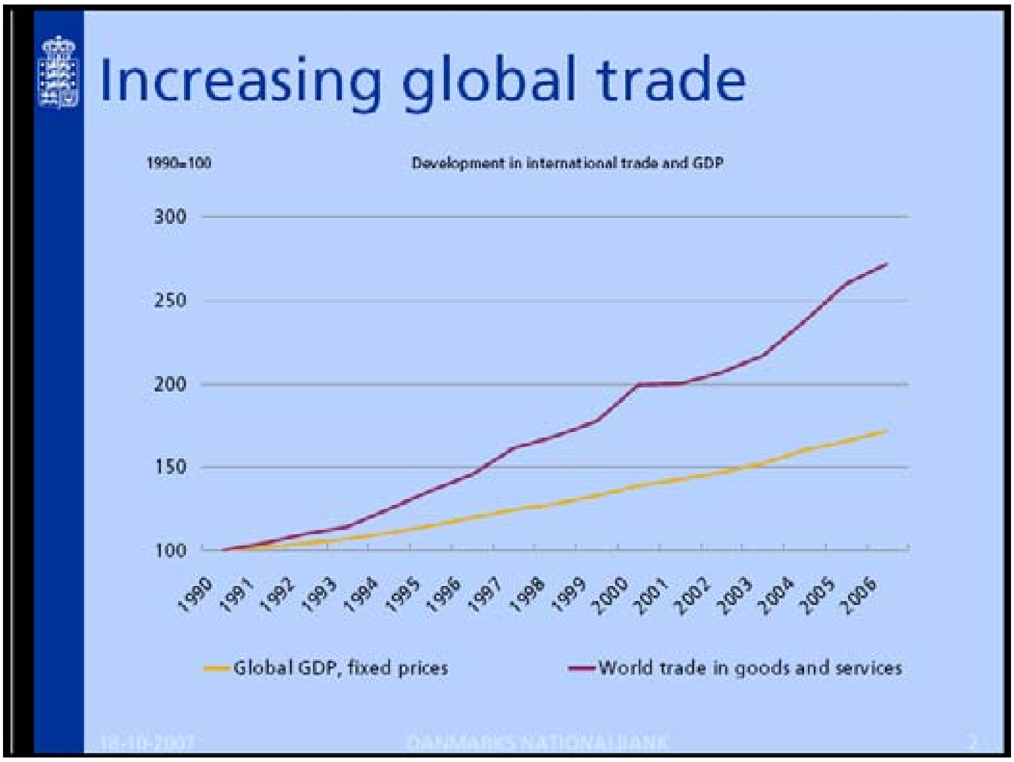
Other factors apart form economy are, however, keeping mobility between EU member states on a much lower level than for instance in the US. These include language, cultural and regulatory barriers.

In the 1970s and 1980s the solution of governments facing industries in difficulties was to provide financial support or subsidies thereby prolonging the pain of restructuring the production. Fortunately this approach has given way to a more dynamic reasoning where the proposed political answer to the challenges posed by globalization to the western economies such as Denmark today is to rely heavily on the education aspect. Education is now perceived as the best way to ensure the crucial movement up the value chain *(slide 19)*. This is obvious in the EUs approach which is called the Lisbon strategy to promote education and research as well as multiple strategies from Danish governments to counteract the negative effects from globalization. This includes the latest proposal from the Danish government. In this race to the top on education the Danish performance has been questioned in the debate.

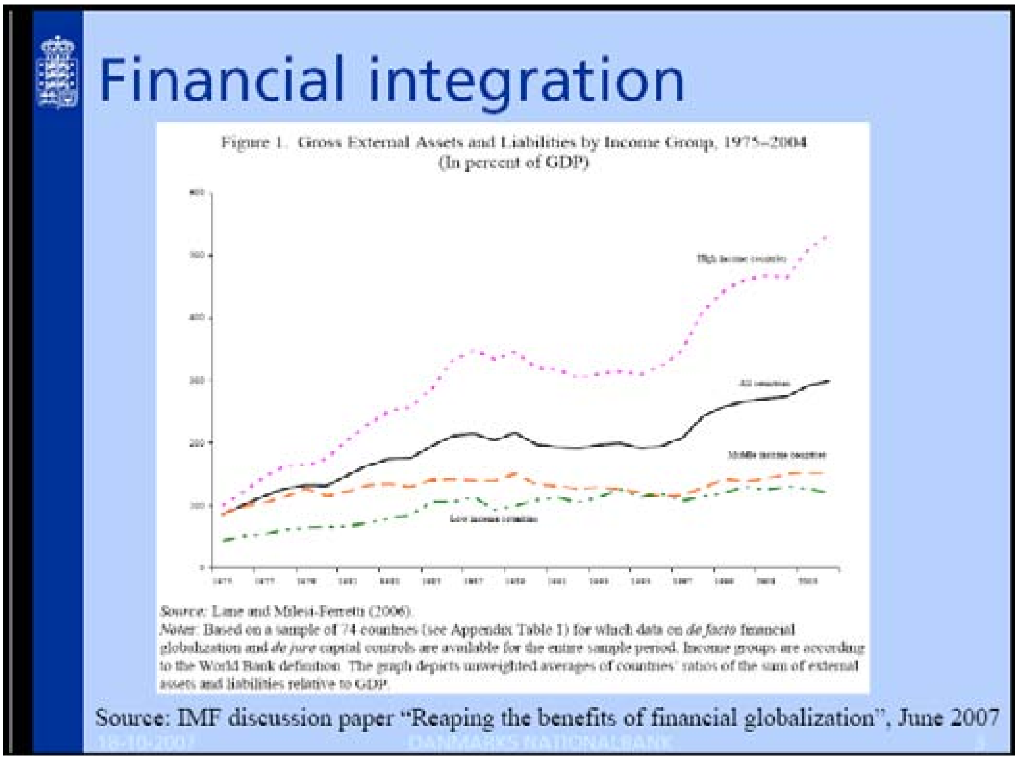
With a free education system and high marginal taxes one of the possible stumbling stones of the education effort is brain drain meaning the emigration of highly skilled individuals *(slide 20)*. The studies on the extent of this problem suggest that the scope is rather small. Denmark has experienced a small net emigration of highly educated labour each year and generally the numbers are not giving cause for concern. In some groups notably PhD's and masters of natural and social sciences the share of emigration is larger and the return probability is lower. The return rate is in general around eighty percent suggesting that the decision to go abroad and come home again is affected by a long range of factors other than purely economical ones.

Slide 1

Slide 2

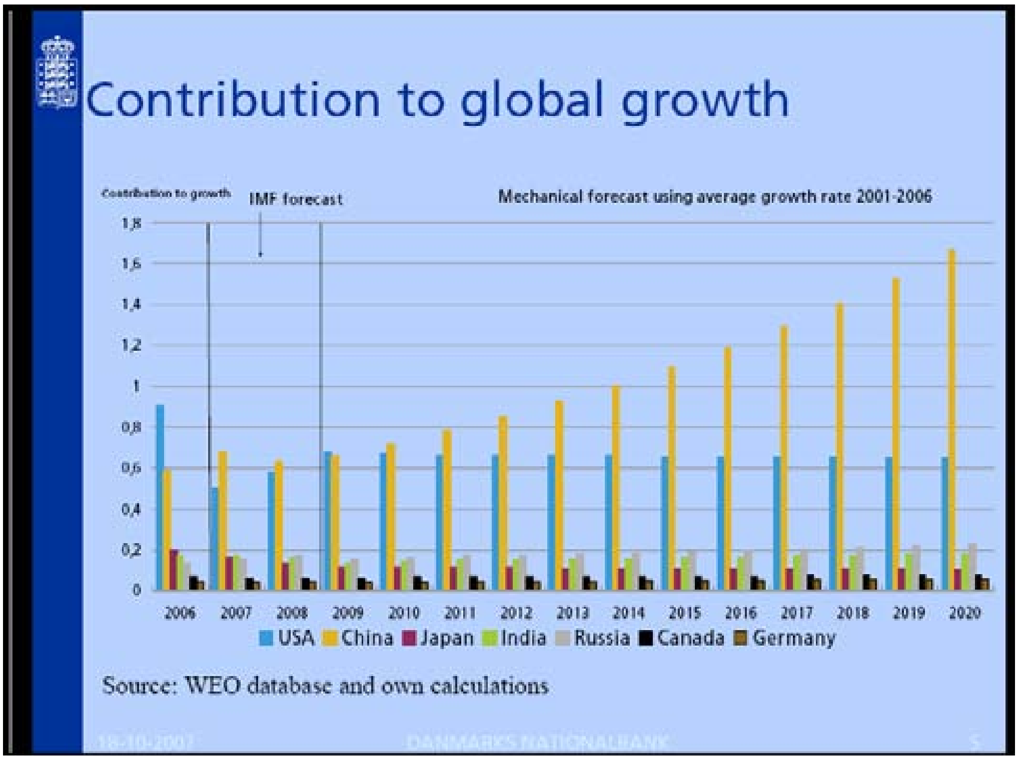


Slide 3

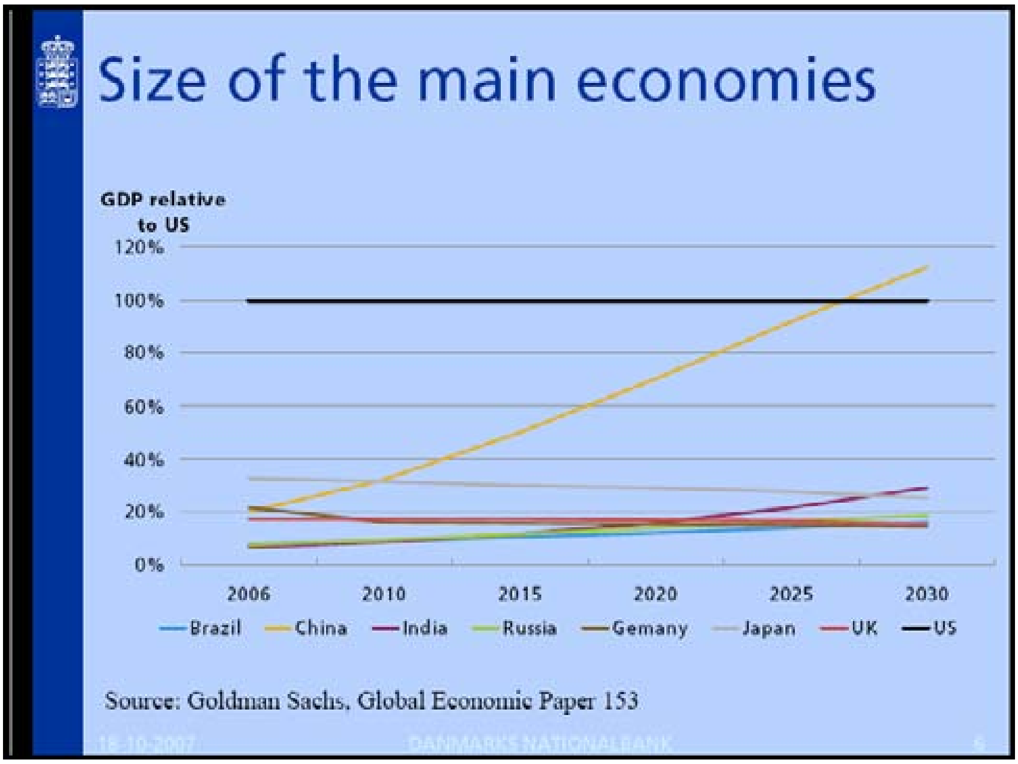


Slide 4

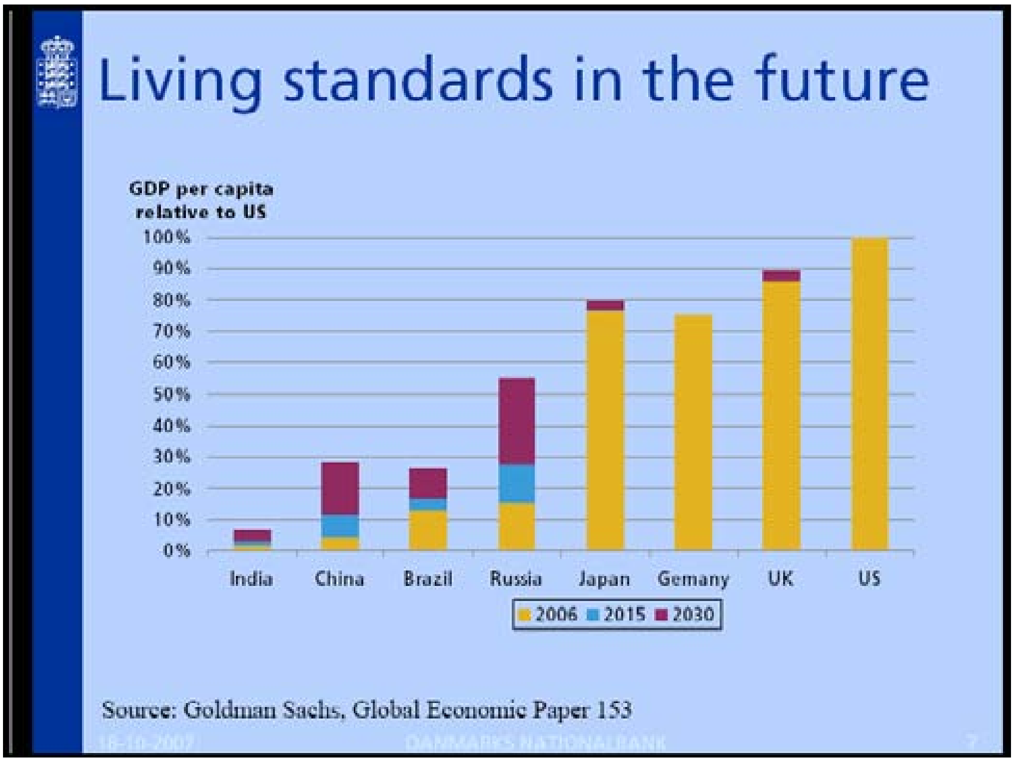
Slide 5



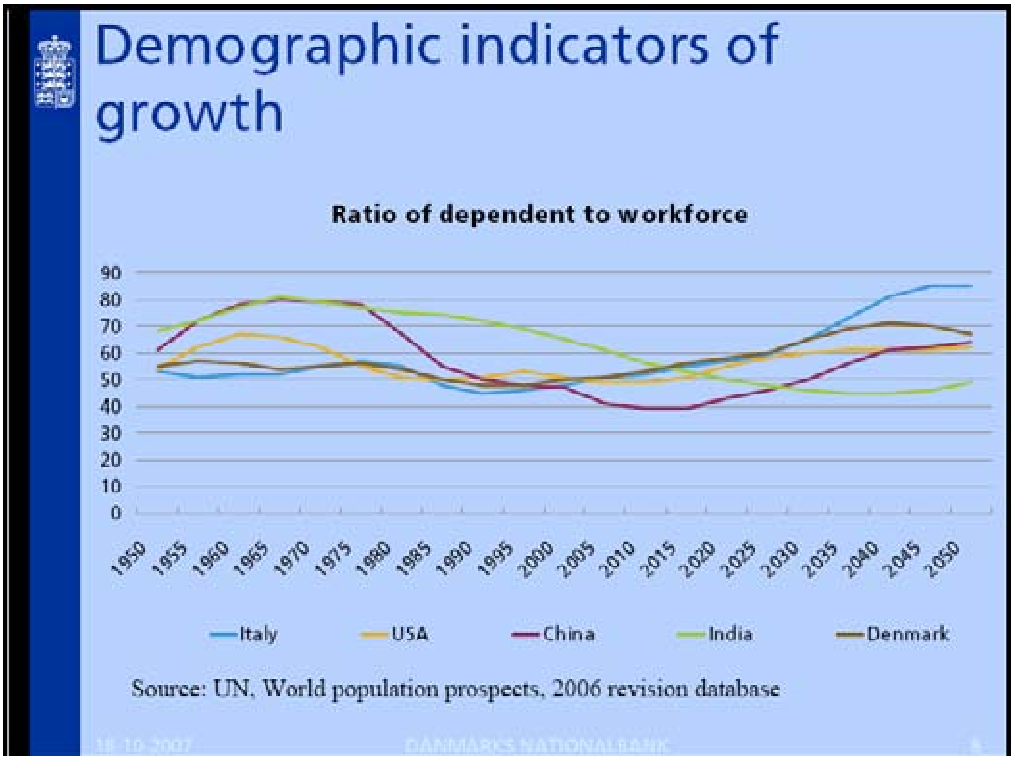
Slide 6



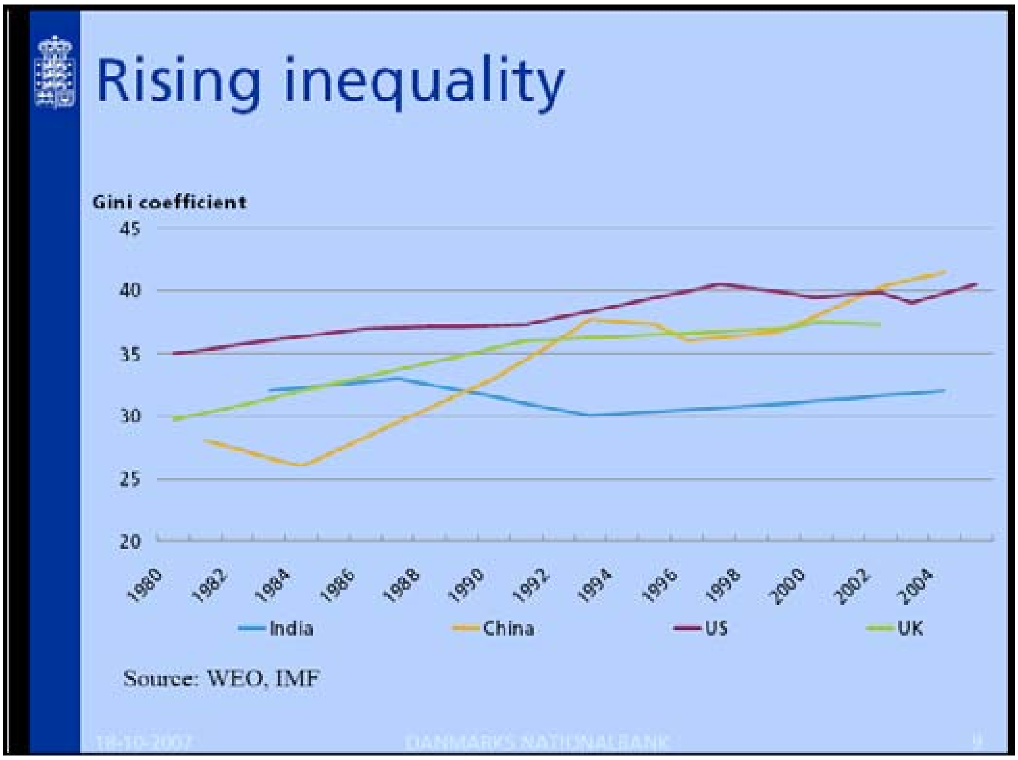
Slide 7



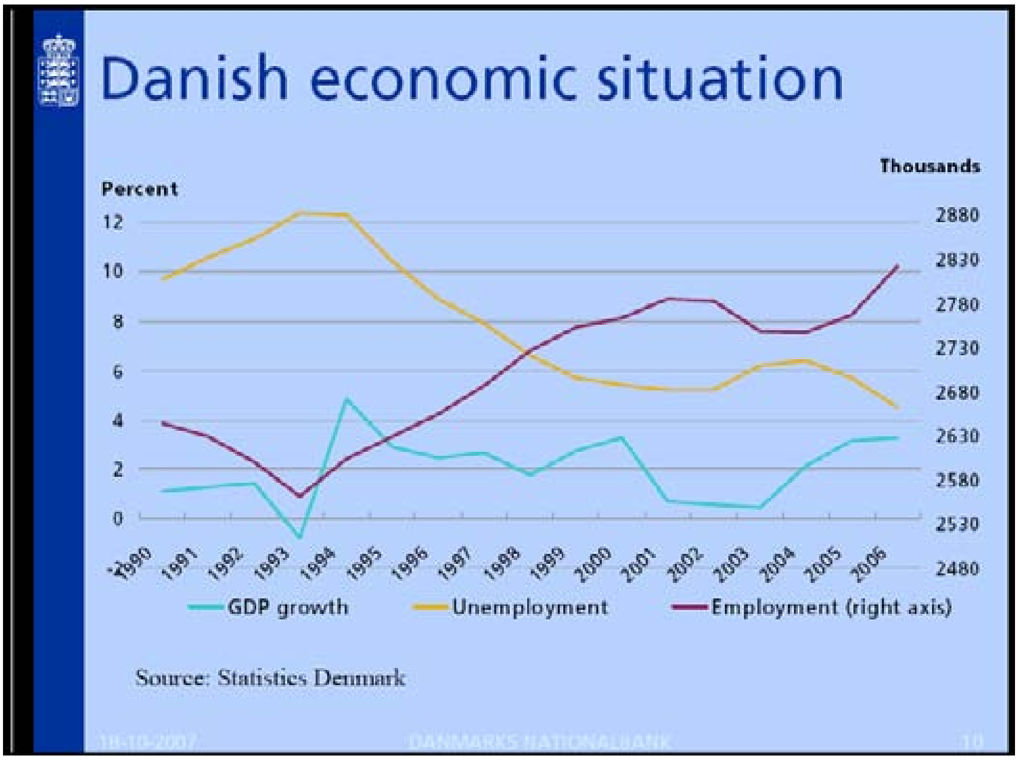
Slide 8



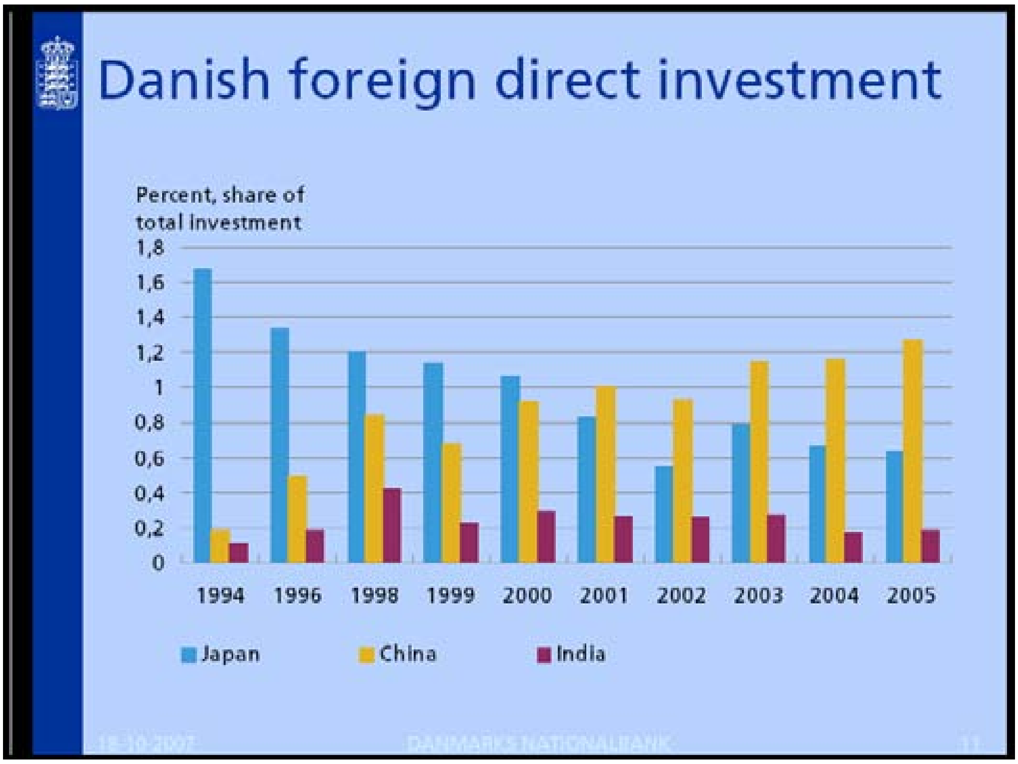
Slide 9



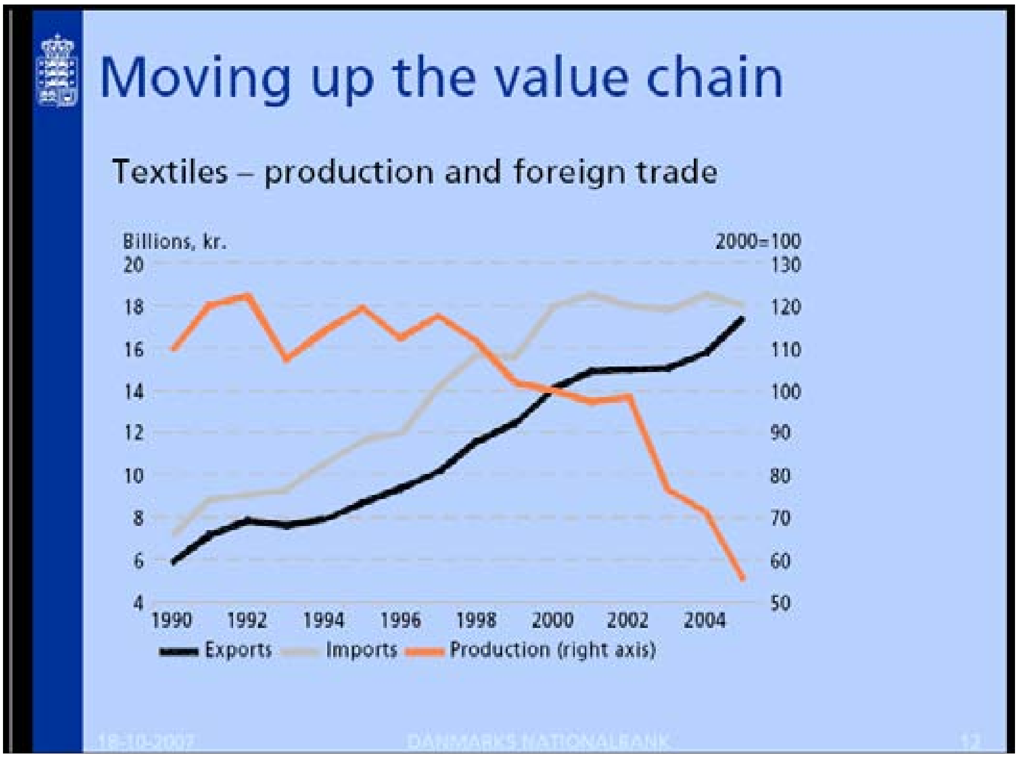
Slide 10



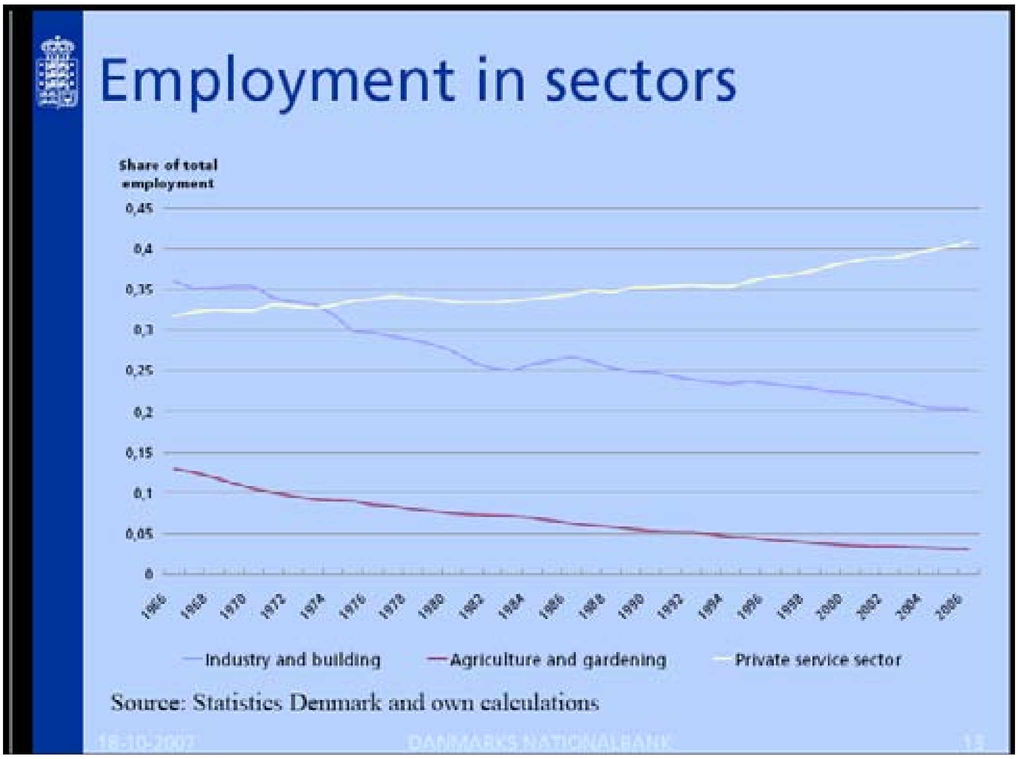
Slide 11



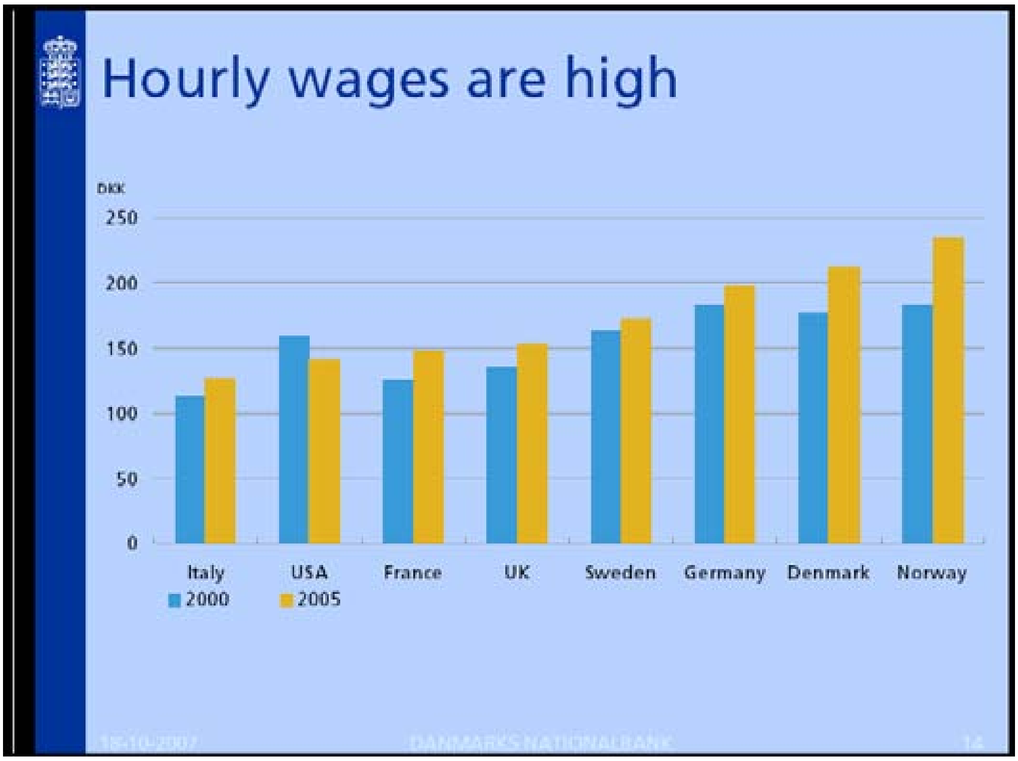
Slide 12



Slide 13



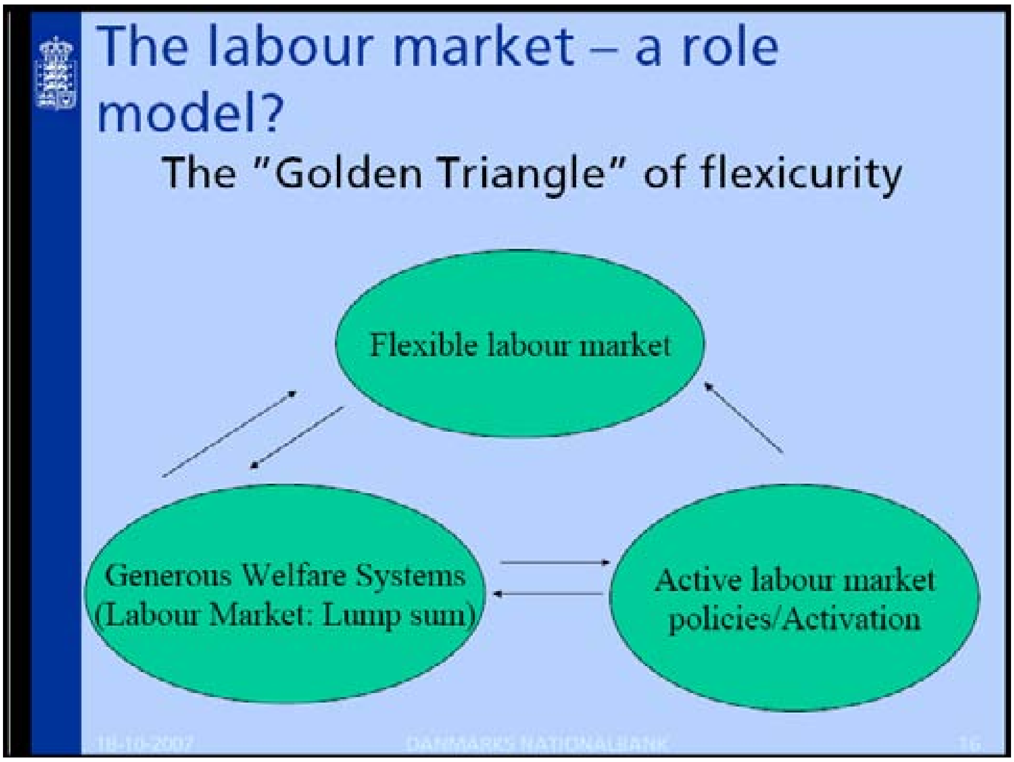
Slide 14



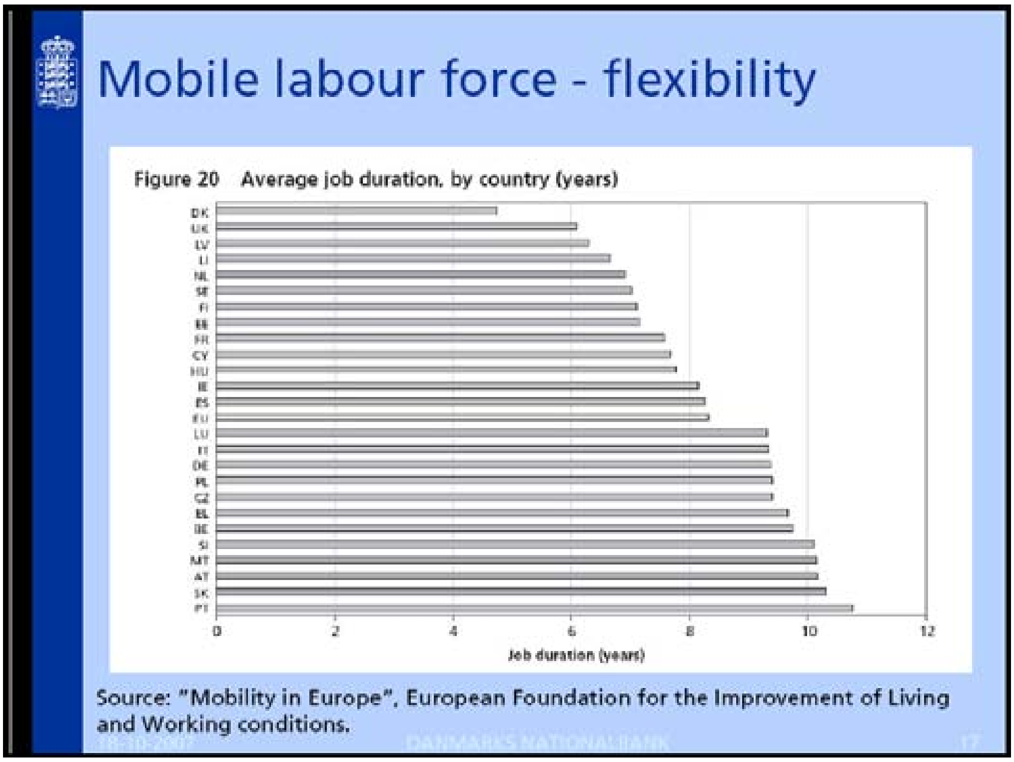
Slide 15

	2006 Placement	2006 Score
Switzerland	1	5,81
Finland	2	5,76
Sweden	3	5,74
Denmark	4	5,7
Singapore	5	5,63
USA	6	5,61
Japan	7	5,6
Germany	8	5,58
UK	10	5,54
Norway	12	5,42
France	18	5,31
China	54	4,24

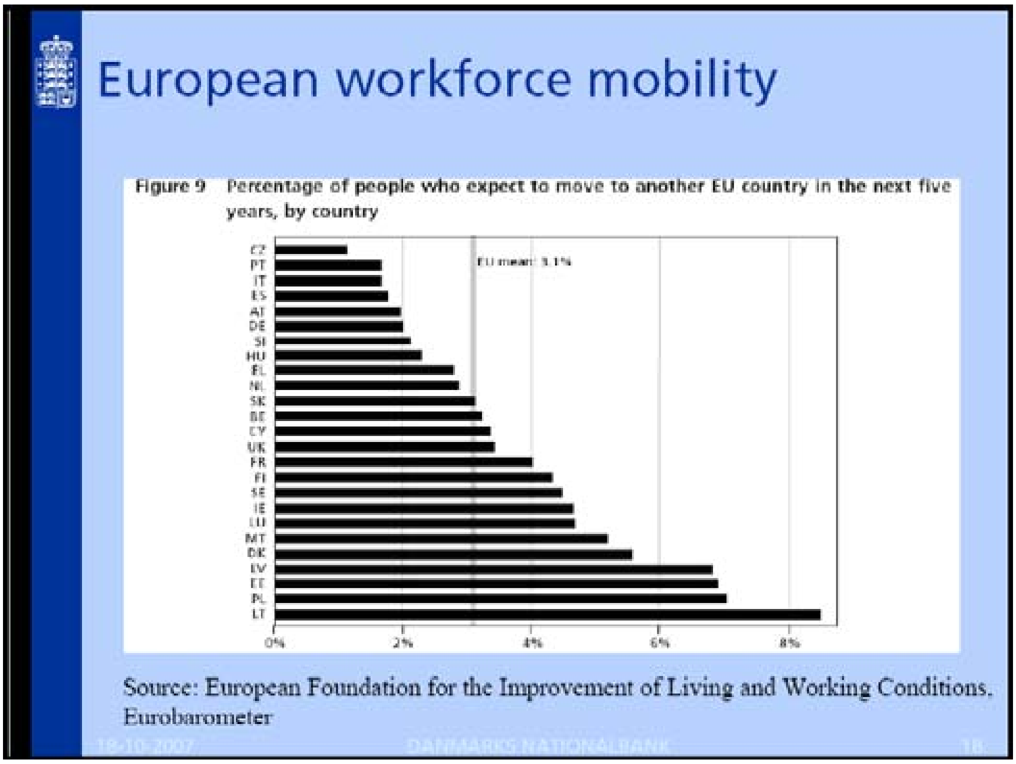
Slide 16



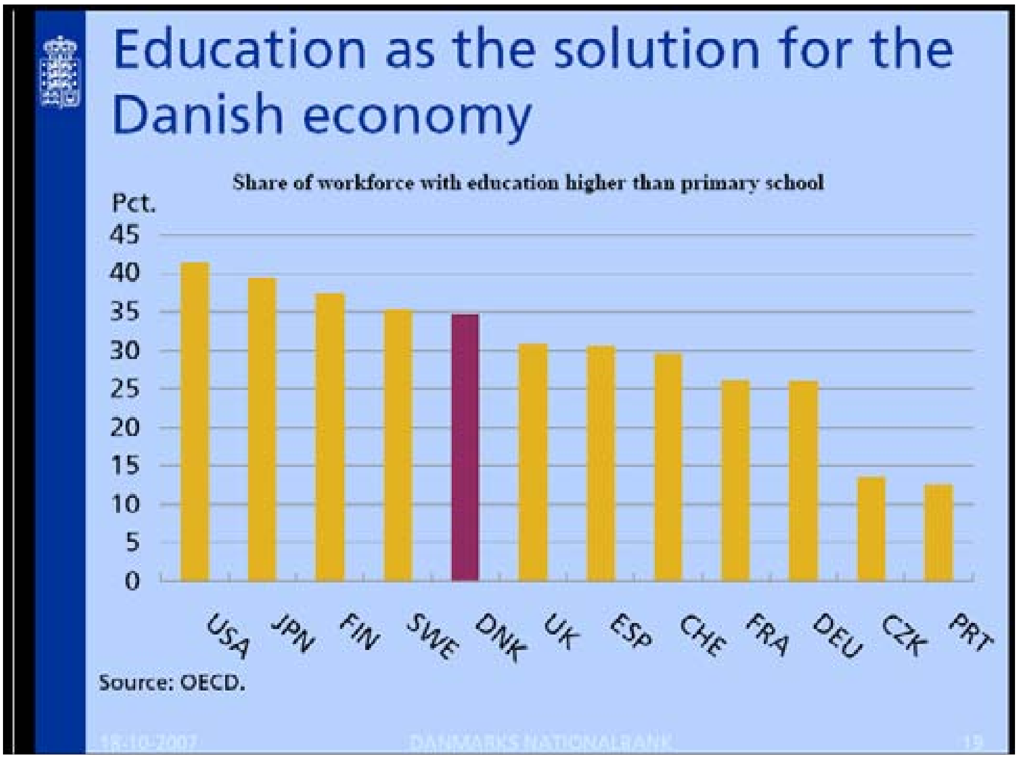
Slide 17



Slide 18



Slide 19



Slide 20