



## BEYOND GEOGRAPHY: SHIFTS IN GLOBAL ECONOMIC POWER

### Summary

There are significant shifts in global economic power underway which extend beyond the well-acknowledged geographical shift from developed to emerging economies. They pose significant challenges and opportunities for UK foreign policy:

- **People and wealth are moving to urban areas**, increasing the importance of secondary cities and raising questions about how to best utilise scarce diplomatic resources.
- Urbanisation and population growth are set to lead to a **growing demand for commodities** in such a way that could intensify existing interdependencies, radically alter market structures, and potentially increase the returns to corruption.
- **Higher returns to capital ownership** have led to growing concerns about fairness that, if unresolved, could undermine political stability.
- **A growing wage gap between skilled and unskilled labour** will lead to a rising demand for education, increased competition for skilled workers, and the emigration of low-skilled labour and especially young people in developing economies in search of better prospects abroad.
- **A divergence in incomes between young and old**, particularly in advanced economies, will demand tough choices over spending and taxation and put increasing pressure on existing labour and migration policies.

This paper presents an introductory foray into analysing these important and evolving trends – an area of work we plan to develop further over the coming year.

### Introduction

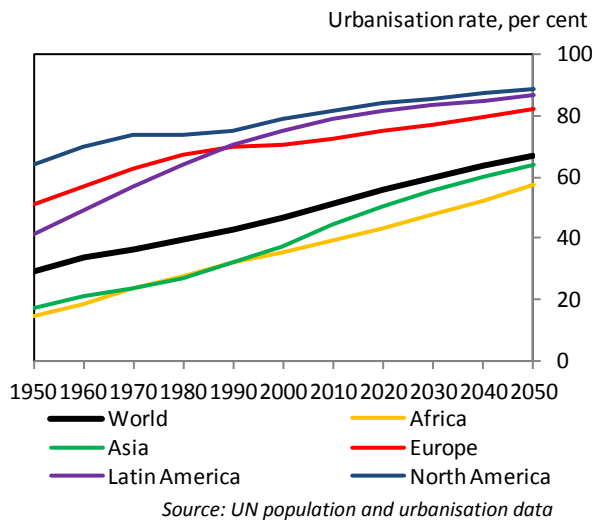
1. There is a wealth of literature documenting the **shift in economic power from West to East and North to South**. By 2030, Asia (excluding Japan) and Sub-Saharan Africa will account for approximately half of nominal global GDP, up from around 20 per cent in 2010, while the contribution of the US, the EU and Japan will halve to around 30 per cent. The development of these large emerging economies is contributing to a fall in global inequality, at least between countries.

2. However, there is more to the story. In this paper we consider shifting power from another perspective, based not on countries but on different groups of agents in the global economy. Viewed from this angle, the picture is more complex and multidimensional. We focus our analysis on 5 key thematic shifts that have implications for foreign policy: shifts in economic power from **rural to urban** areas; from **commodity consumers to producers**; from **labour to the owners of capital**; from **unskilled to skilled workers**; and from **the young to the old**.

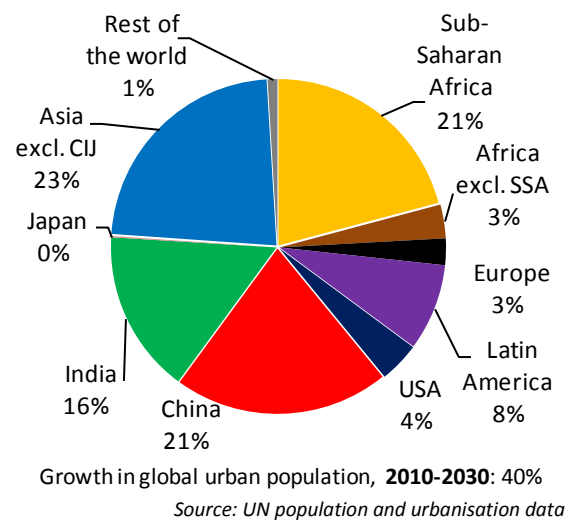
Shift 1: Rural to urban

3. Migration to urban areas in search of improved prosperity and services provision is not a new phenomenon: according to the OECD, urban dwellers overtook the number living in rural areas for the first time ever in 2009 (Figure 1). But **the pace of urbanisation is expected to pick up during the first half of this century, driven by rapid growth in the urban populations of Asia (particularly China) and, increasingly, Sub-Saharan Africa** (Figure 2). Consequently, the global urban-rural ratio will rise to almost 3:2 by 2030, and to 2:1 by 2050.

**Figure 1:** Urbanisation rate by region, per cent, 1950-2050

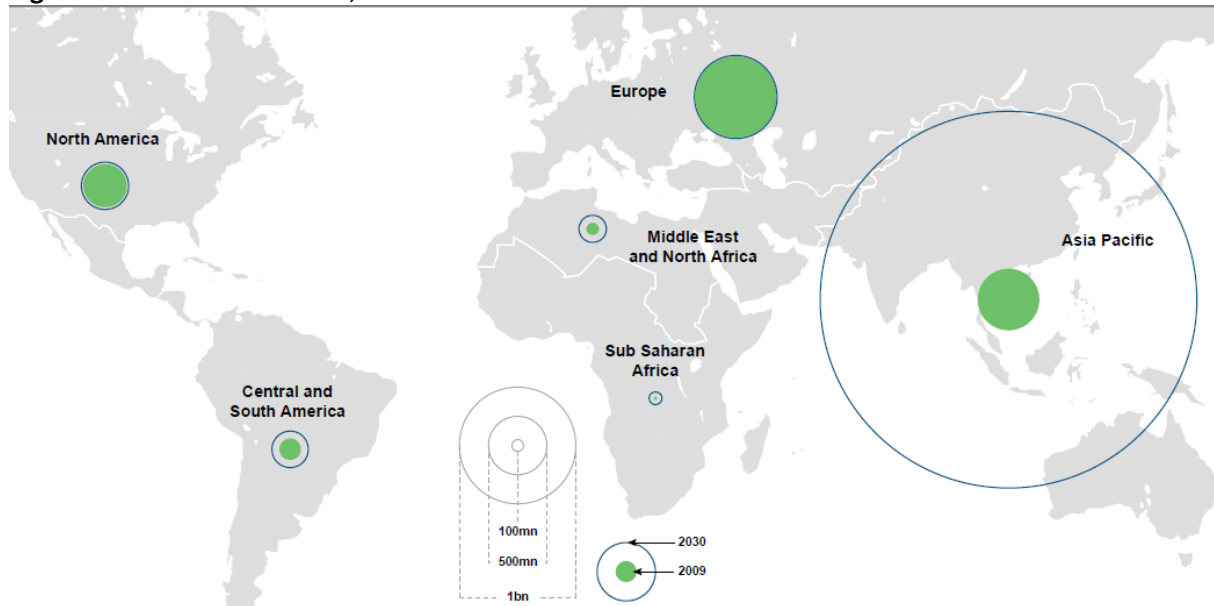


**Figure 2:** Source of growth of urban population, 2010-2030



4. Increasing urbanisation goes hand in hand with **a rapidly growing global middle class**. Cities create commercial and industrial hubs, require investment in infrastructure and new technologies, and provide a concentrated market for agricultural and consumer goods. It is therefore no surprise that those regions driving future global urbanisation –predominantly Asia - are also expected to be the source of the fastest growth in the global middle class (Figure 3).

**Figure 3:** Global middle class, 2009 vs. 2050



Source: *Super Cycle Report 2010*, Standard Chartered

5. **Secondary cities will become increasingly important for economic diplomacy.** Of the ten cities that are forecast to experience the fastest GDP growth up to 2025, only New York is in a developed economy<sup>1</sup>. The other nine are Chinese. The increasing influence of these secondary cities raises questions about how and where scarce diplomatic resources are best deployed.

#### Shift 2: Commodity consumers to producers

6. Urbanisation is a metals- and energy-intensive process, both directly (cities require infrastructure) and indirectly (demand for consumer goods increases with income). Commodity markets, particularly those for agricultural goods and other *soft* commodities, will also be shaped by sustained growth in the world's population, which is forecast to increase to 8.3 billion by 2030 and to 9.3 billion by 2050<sup>2</sup>. Between 2010 and 2030, demand for energy is expected to increase by 33 per cent, demand for steel by 80 per cent, demand for cereals by 27 per cent, and demand for water by 41 per cent<sup>3</sup>. Further large infrastructure projects may be required to redirect increasingly scarce water resources to a global population that is increasingly concentrated in cities.
7. With growth in supply not expected to keep pace with this rising demand, **the real price of many agricultural goods is likely to rise significantly over the next decade** (Figure 4). Food spikes in particular may increase political disaffection.
8. The picture for future energy prices is complex, with **some analysts expecting further increases in the real price of oil over the next 20 years** (Figure 5). For the largest producers, the potential gains are enormous: based on current levels of production, a \$10 increase in the oil price would add \$35 billion per year to Saudi Arabia's GDP. For importers, higher real prices would squeeze

<sup>1</sup> McKinsey, *Urban world: mapping the economic power of cities*, 2011.

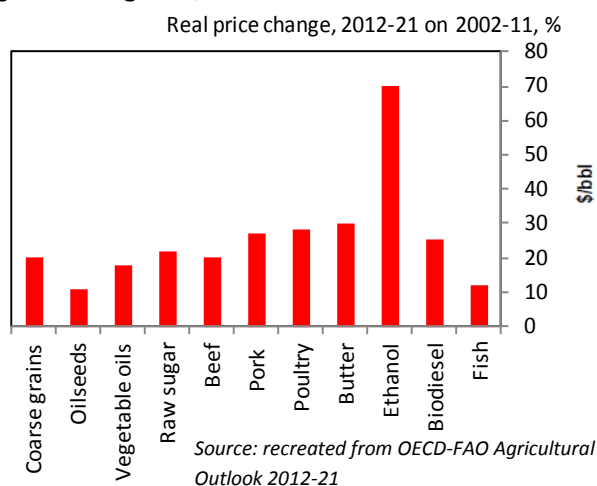
<sup>2</sup> UN population statistics.

<sup>3</sup> McKinsey, *Resource Revolution*, 2011.

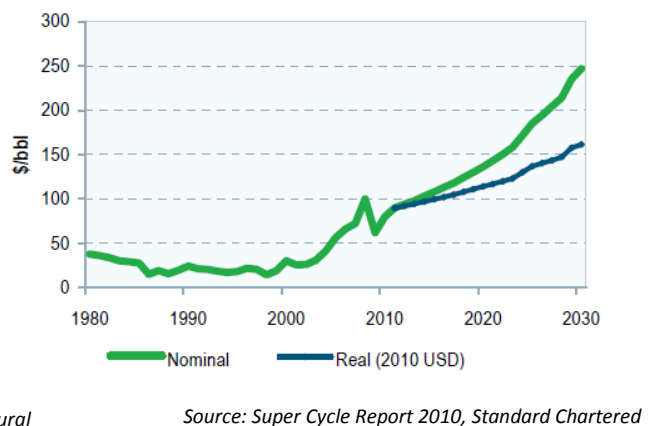
household incomes, or put pressure on government finances where subsidies are prevalent, or both. Producers would increasingly have the upper hand in bilateral relationships. This shift would have a larger adverse effect on China than on the US, which is forecast to become “almost self-sufficient in energy, in net terms, by 2035”<sup>4</sup>.

- The effect *within* commodity-producing countries is less obvious, with the impact of any higher rents on average living standards dependent on how these rents are (re)distributed. Commodity-driven growth does not necessarily create jobs. **Producing countries’ Sovereign Wealth Funds are likely to become increasingly important global investors** and, such as in the case of the Norwegian Fund, may help to preserve some of the profits for future generations. On the other hand, where ownership is highly concentrated income inequality is likely to increase, and **corruption may become increasingly profitable**.

**Figure 4:** Real price change in selected agricultural goods, 2012-21 on 2002-11



**Figure 5:** Forecast real oil price, 2010-2030



- Equally, high prices in some commodity markets - for example energy - may trigger sufficient investment in new technologies to increase supply from alternative sources. **Under this scenario the shift would be less from consumer to producer than between producers.** The development of shale gas and tight oil may dilute power in global energy markets, potentially constraining the ability of OPEC to continue to dominate price setting.

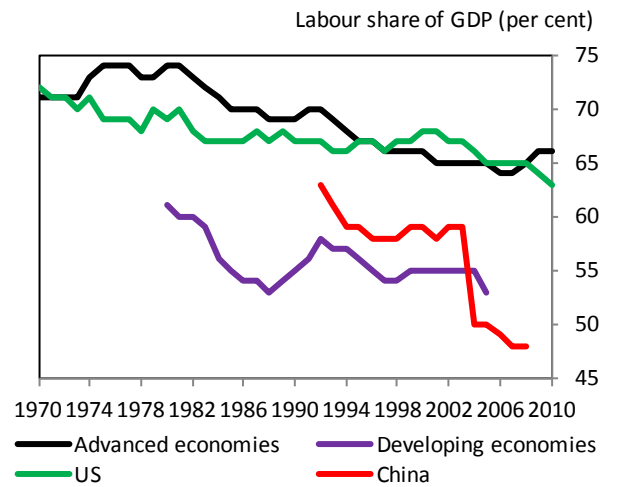
### Shift 3: Labour to (owners of) capital

- It isn’t only commodity producers who have seen increased returns in recent years – the same is true more broadly for the owners of capital. As Figure 6 shows, **in both advanced and developing economies worker compensation as a percentage of total GDP has been falling gradually since at least the early 1980s.**

<sup>4</sup> International Energy Agency, November 2012.  
<http://www.iea.org/newsroomandevents/pressreleases/2012/november/name,33015,en.html>

12. Globalisation and technological progress have been the key drivers of this shift. The **increased mobility of businesses and wealth** have required developed economies, in particular, to make their corporate tax offers more competitive, thereby placing greater burden on taxation of employment and consumption. The global mobility of capital has allowed investors to be increasingly demanding, and has led to the rise of corporate governance systems aimed at maximising short-term profits and share values.

**Figure 6: Labour compensation as a percentage of GDP, 1970-2010**



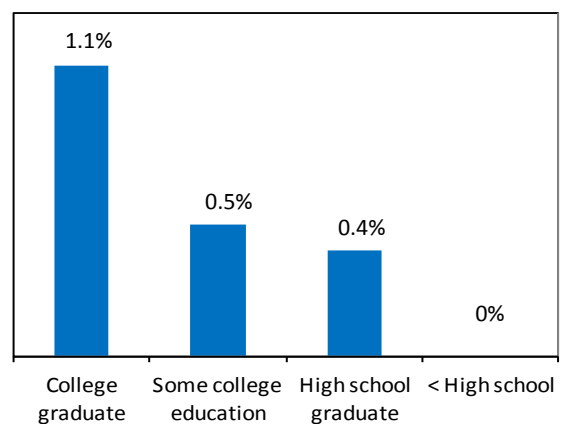
13. **Technological progress, meanwhile, has been capital augmenting and has provided substitutes for some types of workers, driving down the relative return to labour.** Across developed economies, labour productivity grew by nearly 15 per cent between 1999 and 2011, while over the same period average wages increased by only 6 per cent.

14. It is difficult to predict whether this trend will continue, but undeniably there has already been a significant shift in power. Experienced alongside the recent financial crisis and subdued global growth, **this rising disparity has led to growing concerns about fairness.** The Occupy protest movement, which was most prevalent in North America and Western Europe but also spread to Latin America and the wider developing world, is a clear example of this economic tension evolving into civil action.

Shift 4: Unskilled to skilled

15. Digging a little deeper, while total labour compensation has been falling as a share of GDP, it is low-skilled workers who have been hardest hit. In recent decades, skilled workers in a broad range of sectors have seen their wages increase relative to their low- or unskilled counterparts. A study of full-time employees in the US found that real weekly wages of college graduates grew at an average annual rate of 1.1 per cent between 1963 and 2008, while those with no more than high school qualifications saw little change (Figure 7).

**Figure 7: Average annual growth in real weekly wages for full-time workers in the US, 1963-2008**



16. Why has this skills premium been increasing? First, **technological progress** has unfavourably affected low-skilled labour, acting as a substitute for employment in some cases and depressing

wages. At the same time, it has been complementary to those workers who have the skills to utilise it, driving up their earnings. The OECD estimates that technology accounts for around one-third of the widening gap between low- and highly-skilled workers across its members' economies<sup>5</sup>.

17. A second significant factor has been **the “great doubling” of the global labour force** – an enormous increase in the global supply of low-skilled labour that resulted from the collapse of the Soviet Union and the opening-up of emerging economies' labour markets. While this one-off labour supply shock is unlikely to be repeated, **skilled labour is expected to become increasingly scarce during the next decade**, with South-South migration disrupting the supply of skilled labour to developed economies. By 2020, there could be a surplus of 95 million low-skilled workers (10 per cent of the total low-skilled workforce), while highly-skilled and medium-skilled workers are expected to be in shortage by up to 40 million (13 per cent) and 45 million (15 per cent) respectively<sup>6</sup>. This mismatch between labour demand and labour supply suggests that more – and more selective – national-level immigration policies may be introduced to protect low-skilled wages. This trend can already be observed in many advanced economies.
18. The skills premium will not grow indefinitely. Ongoing efforts in regions such as Asia and Latin America to improve education provision will increase the supply of skilled workers in the global labour market, but this will take time. In the long run, higher returns to education will encourage further investment by individuals and governments, allowing the global labour market to adjust to a new equilibrium. **For the UK, this means increased opportunities to export education services and exercise soft power.**

#### Shift 5: Young to old

19. Finally, there has been a shift in economic power, particularly in advanced economies, from young to old. Older generations have profited more from increasing returns to capital – ownership of pensions, shares and investments typically increases with age. In a number of countries they have also seen the benefit of generous welfare and pension packages agreed in the economic good times.
20. This divergence between young and old is perhaps most stark in the United States: between 1984 and 2009 the median net worth of US households headed by individuals aged 65 or over increased by 42 per cent in real terms, while those aged below 35 saw their median net worth fall by 68 per cent<sup>7</sup>. But the trend is observed across the OECD, where between the 1980s and the 2000s the young have lost out relative to their older counterparts (Figure 8).

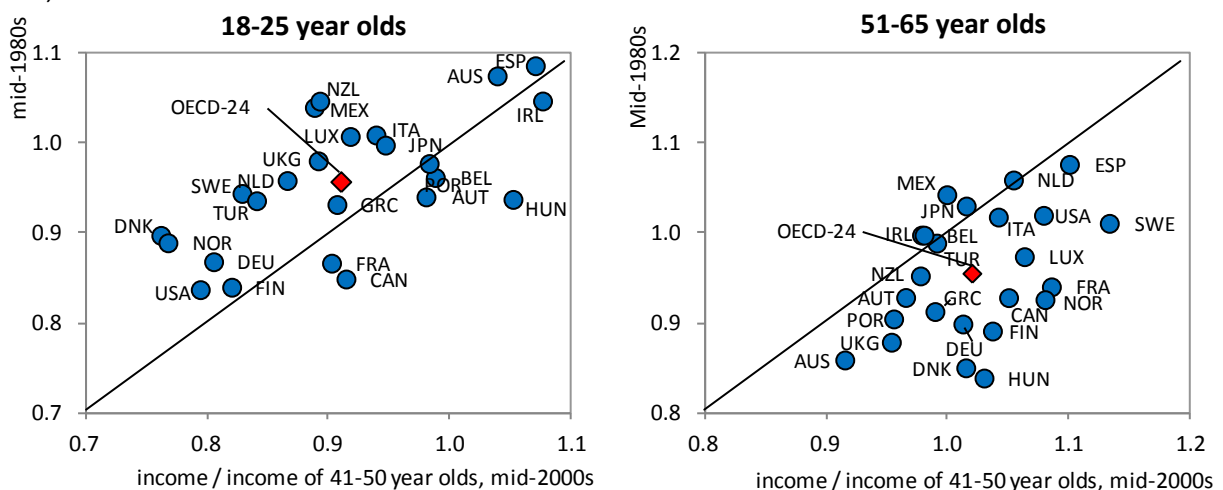
---

<sup>5</sup> Brookings Institute, *The Inequality Challenge*, Jan 2013

<sup>6</sup> McKinsey, *The World At Work*, 2012.

<sup>7</sup> Pew Research Center (2011), *The Rising Age Gap in Economic Well-being*.

**Figure 8:** Change in household disposable income of 18-25 and 51-65 year olds relative to 41-50 year olds, mid-1980s to mid-2000s



Source: *Growing unequal? Income Distribution and Poverty in OECD countries*, OECD, 2008

21. Improvements in living standards and healthcare - as well as declining fertility - are also shifting the balance between young and old individuals, particularly in advanced economies. In Japan, for example, the ratio of working population to elderly is expected to fall from 3:1 in 2010 to 1:1 by 2055. However, ageing is not a problem reserved solely for developed economies: by 2025, Shanghai is forecast to be home to twice as many people aged 65 or over as New York<sup>8</sup>. The income disparity between young and old is likely to increase further if the dominant policy response to ageing is a higher tax burden on employment. If, instead, the elderly bear the brunt through future welfare cuts, this differential may narrow within a generation or two.
22. The **rise and prevalence of youth unemployment in many advanced economies** will have a long term effect on the current generation. At a global level, **around nine out of every ten children under the age of 15 live in emerging economies**, and over two thirds of population growth up to 2050 is expected to occur in just 24 countries, all of which were defined by the World Bank as low or lower-middle income in 2008<sup>9</sup>. These economies are some of those least ready to employ and educate their youth, raising the **risk of significant political disaffection unless opportunities improve at home or are available abroad**.

#### Implications for future foreign policy

23. The shifts in economic power described above are related both to one another and to the broader geographical shift in power from advanced to emerging economies. Some, such as urbanisation, have been in train for decades, while others are newer phenomena. In this final section we offer a number of foreign policy implications that are intended to encourage debate and discussion. These could form the basis of more detailed analysis in future:

- **Population growth and urbanisation will lead to more dispersed sources of power and influence – not just capital cities and not just the G20.** Intra-country migration will become increasingly important. Secondary cities in Asia and Sub-Saharan Africa will be the source of

<sup>8</sup> McKinsey, *Urban world: mapping the economic power of cities*, 2011.

<sup>9</sup> J. Goldstone, *The New Population Bomb*, 2011

some of the fastest economic growth, requiring us to consider the distribution of scarce diplomatic resources.

- **The increasing surplus of unskilled labour in the global economy will provide both challenges and opportunities.** Many of these workers are likely to face inadequate education and employment opportunities, lower returns to employment, and the consequences of increasingly scarce essential commodities – with complex social and political consequences. Low-skilled labour may be ‘pushed’ to migrate to higher income countries in search of better prospects. At the other extreme a rising skills premium will lead to increased competition for skilled workers, who will be ‘pulled’ to migrate to those countries where the returns to their skills are highest. Is the UK’s offer to these high-skilled individuals competitive, and will it remain so? There will also be opportunities as the rising skills premium leads to increased demand for education services. UK universities and skills providers will be able to exploit export potential, and there will be scope to further exercise the UK’s considerable soft power in this area.
- **In advanced economies, there will be a growing tension between protecting the wages of low-skilled workers and counteracting the impact of ageing populations through immigration.** This could have significant impacts on the politics, and labour market and welfare policies, of countries such as Japan and Germany. There is, of course, no guarantee that the surplus of labour in developing economies will be prepared to move to those economies where they are needed most, or that those societies will welcome them. This could inhibit growth in some of the advanced economies.
- **As capital becomes increasingly mobile, large companies and corporations could become more powerful in relation to national governments; the FCO will have a role to play in protecting the UK’s interests.** Greater demands for short-term profits and higher share prices will lead to increased competition between countries to attract and retain investment. British companies may be increasingly prepared to give up their ‘citizenship’ altogether if sustainable rewards are greater elsewhere.
- **Greater scarcity of commodities will shift the balance of power further towards producers, but this power is likely to be distributed *among* producers in new ways.** Bilateral importer-exporter relationships are likely to become increasingly one-sided, which could lead to rising international tensions and greater efforts by some countries to attract external financing. Could investment in new technologies and substitute commodities even threaten established market structures and lead to more competitive pricing strategies?