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A key driving force in the world economy over the next few decades will be the rise of major developing countries as engines of economic growth, sources of capital and ultimately geopolitical powers in their own right. The rise of the developing countries will be a challenge to the present world order which is dominated by the economic and political power of the developed countries. This change in the balance of power poses critical questions for the sustainability of security, stability and good order. The tension between the emerging world and the established developed world is already taking place.

Much of the world's prosperity since the Second World War was built on a consensus, essentially among developed countries, on how international frameworks should be established and operate. In the absence of a consensus among all major players today, the inadequacies of current international frameworks are becoming more evident as can be seen, for example, in the breakdown of recent WTO negotiations or the stress in climate control talks. Further points of conflict will arise as emerging countries seek to re-negotiate the "rules of the game" and the two worlds, developed and developing, compete for resources, markets and influence on a scale never seen before.

Before examining the consequences of this momentous development, it is useful to step back and reflect on how far we have come in the last 25 years, and how benign and unusual past economic circumstances have been.

The economic environment over the past 25 years can be broadly characterized as one of falling global inflation and rising economic growth. In developed economies, the process of disinflation began in the early 1980s as the Volcker Fed and other G-7 central banks resolutely hiked interest rates to bring inflation down. With the fall in inflation, economic growth became less volatile and recessions less severe. Falling inflation has also been a boon for financial investments.

A similar process of disinflation began in emerging economies in the mid-1990s. Since inflation was a much larger problem in these economies, the benefits of disinflation that accompanied major structural and macro stabilization reforms were even greater. This is evident in the boom in emerging market growth, an acceleration of the integration of the developing world into global production, as well as rapidly rising returns from investment in emerging markets.

Major political transitions contributed to and reinforced these positive economic trends. The fall of communism and the end of the Cold War, the integration of Eastern Europe into the West, the formation of WTO, all underpinned greater trade and investment links between countries. The Internet brought the world even closer, potentially globalizing services as well as the production, marketing and distribution of goods.

The coming decades may not be as benign economically. There is growing potential for more severe economic dislocations that could lead to stress and conflicts.



Over the near term, debt deflation and de-leveraging in the US and other major developed economies will exert downward pressure on growth in many economies. Policy responses so far have tried to minimize the likelihood of a Japan-like deflationary spiral but the adjustment could take a couple of years and be very painful. This could lead to protectionist or populist pressures.

At the same time, growth in emerging markets can be expected to remain relatively robust, with the emerging markets accounting for more than half of the world's GDP within the next decade. This has several implications.

First, global growth will be much more dependent on emerging markets. In 2000, for instance, emerging markets accounted for one fifth of global growth, but over the coming decade emerging markets are expected to eventually account for more than half of global growth.

Second, emerging economies will displace the G-7 as the world's largest economies over the next two to three decades, even if per capita incomes still lag behind those of the developed economies.

Third, economic growth will lead to a rapid expansion of the "middle class". This historically unprecedented expansion of the "middle class" will support growth through increasing urbanisation and growing demand for education, transport and healthcare as well as consumer goods and services, and investment in housing, real estate and infrastructure. At the same time, such strong demand will likely put pressure on commodity prices, natural resources, and the environment. The political demands of the middle class will also grow, both at the national and international levels.

If policy-makers in the developed and developing worlds are able to effectively manage these issues and tensions, the dominant trends can underpin a future economic environment with robust growth, led by emerging markets, and moderate inflation. Growth will likely be weak in the next few years due to the debt de-leveraging that is taking place in the US and OECD but should then recover. With a return to stronger global growth, supply constraints will become more evident over time leading to greater inflationary pressures. But credible central banks and prudent macro-economic policies should be able to keep global inflation contained.

This benign scenario requires that governments and decision makers resolutely address difficult policy challenges that could otherwise lead to stagnation or inflation.

If this is not done, a deeper debt deflation and de-leveraging in the US and major European economies could further weaken the global financial system leading to a quasi- "Japan-like" stagnation. If house price declines are significantly greater than expected, larger financial institutions could become insolvent, the credit crunch would be more severe, and economic growth could weaken considerably. A vicious deflationary cycle with falling house prices, failing financial institutions, and weaker growth could then ensue.

With weaker employment and income growth, protectionism could rise medium-term, especially in the US and Europe.



Such a scenario is now more likely than ever, with an ever-growing majority in major developed countries disenchanted with stagnating median real wages and growing income inequality that has worsened over the last 5- 10 years partly because of the globalization of emerging economies' massive excess labour supply and now their competition for finite energy and food resources.

This could slow global trade and investment, as well as cause a backlash against deregulation, liberalization policies and globalization in general. Initially, such a move would be deflationary and have negative consequences for growth and global trade in manufactured products as well as commodities. Longer-term, productivity and growth would suffer as globalization stalls and competition becomes muted.

Another significant risk to global growth would be a return of inflation. A more robust economic recovery in response to reflationary stimulus could result in higher oil and commodity prices. Inflation risks would be heightened as China's excess productive labour supply and rate of urbanization begin to slow markedly and China's heretofore dis-inflationary impact on global inflation could then turn distinctly inflationary. The policy tension will first be felt domestically, as central banks in both developed and developing democracies are challenged to tolerate higher inflation rather than implement a much tighter monetary policy that might be needed to keep inflation from creeping above current low inflation targets.

International tensions could rise as countries compete for natural resources, especially food, energy and water. Commodity-producing countries are likely to exert stronger control over their natural resources, potentially exacerbating supply concerns. In oil, for instance, the bulk of proven reserves are in countries that are not friendly or open to private Western investments.

Countries that are reliant on imports of commodities, such as China, could be more aggressive in their pursuit of predictable supplies of food, oil and raw materials. Countries like Venezuela, Iran or Russia could use the supply of scarce energy as a diplomatic weapon. We have already seen this vividly in recent weeks and could well see it again in coming years. Conflicts within and between countries over commodity-rich disputed territories whether in the Spratlys, Iraq or the Niger Delta may intensify, often with grave global consequences. Some food-producing countries may limit exports to safeguard domestic supply, further worsening global food scarcity. The consequences of such adverse developments would be exacerbated in an environment of food and energy-led inflation which would hurt the poorer populations of developing countries more than the comparatively richer populations of developed countries.

Here again, unless international frameworks for cooperation and global management of scarce food, energy and water resources are developed in time, the potential for conflict and political instability could rise.

To conclude - the economic trends of the last 25 years have been broadly benign. The coming decades could be more challenging. Significant stagnation as well as inflation risks suggest that challenges and potential conflicts arising from both protectionism as well as resource nationalism could seriously jeopardize globalization of production and markets.

The current international system for conflict resolution has been eroded by the recent lack of coherent international leadership from developed economies and the inherent bias of post- WW2, UN-centered institutions and fora towards developed



countries, whether on the issue of slowing carbon emissions or global currency coordination.

The challenge is to evolve new international frameworks for cooperation that can effectively resolve these tensions in the decades ahead. This requires much greater communication, cooperation and ultimately leadership and political will from both developed and key emerging countries. Minimally this requires the strengthening of current multi-lateral international institutions as well as their reform to include major emerging economies as key stakeholders.

It may also require a re-examination, and perhaps re-writing of the rules for the resolution of differences between economies and nations and even building new institutions to do so.

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