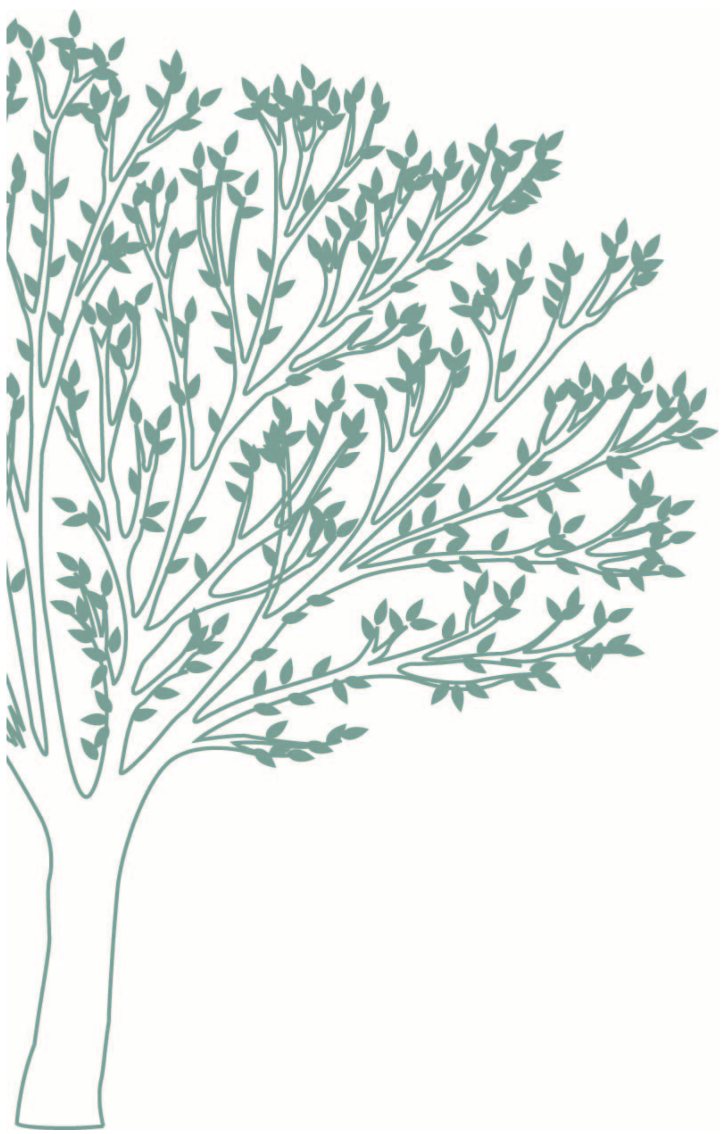
CHAPTER ONE

Building Better Global Economic BRICs



Building Better Global Economic BRICs

- This paper discusses the relationship between the G7 and some of the larger emerging market economies, namely the BRICs—Brazil, Russia, India and China.

- The BRICs' share of world GDP is set to rise. On a PPP basis, the aggregate size of the BRICs was about 23.3% of world GDP at the end of 2000, somewhat higher than that of both Euroland and Japan. On a current GDP basis, the size of the BRICs is just under 8%; this is also set to rise. Some of the BRICs countries are already bigger than some individual G7 economies: China, at 3.6% of world GDP (using current US dollar prices), was slightly bigger than Italy at the end of 2000, and notably larger than Canada.

- We consider four different growth scenarios for the next decade based on various nominal GDP assumptions for 11 countries (the G7 and the BRICs) and different assumptions about exchange-rate conversion. The nominal GDP assumptions reflect our best guess about the likely trend rates of real GDP growth and inflation.

- In all four scenarios, the relative weight of the BRICs rises from 8.0% at present to 14.2% in 2011 (in current US dollar terms), or from 23.3% to 27.0% (at PPP rates). China is the key driver of this increase, although the other three also grow relative to the G7 countries.

- With EU membership set to expand to 25, and EMU membership likely to expand as well, it will be necessary to reform the active membership of the ECB Governing Council. We recommend the introduction of an 'FOMC-like' rotating voting mechanism. This should be accompanied by a reduction in Euroland representation at the G7 from three countries to one.

- The opportunity to reform the G7 should also be taken. In view of the expected continued relative growth of the BRICs, the G7 should incorporate China, probably Brazil and Russia, and possibly India, bringing membership in this key body of global economic policy coordination to eight or nine.

It Is Time for the World to Build Better Global Economic BRICs

Table 1 shows the size of GDP for the 20 leading economies of the world, based on both Purchasing Power Parity (PPP) and current prices at the end of 2000. The table also shows the actual share of world GDP on both estimates, the difference between them, the size of the population and GDP per capita.

As can be seen, there are some very different estimates about the relative size and share of the world economy depending on whether PPP weights or current GDP weights are used. Perhaps not surprisingly, the actual absolute size does not differ much for most of the G7 countries, with the exception of Japan. Given Japan's expensiveness on a PPP basis, the PPP weighting suggests an economy less than 75% of its current GDP weighting.

The relative picture shifts dramatically when important emerging market economies are taken into account, particularly Brazil, Russia, India and China—which we term the BRICs. Table 2 highlights the difference for the four largest emerging economies in both PPP terms and current prices.

In three of the four countries (China, India and Russia), the economies are more than three times bigger when using a PPP weighting rather than current GDP. Indeed, on a PPP basis, China is the second largest economy in the world and India the fourth. All four BRICs are larger than Canada.

Table 1: Size of the World in 2001

	GDP (PPP weights[1]) 2000 US$bn	Share of World Total (%) (1)	GDP (current prices) 2000 US$bn	Share of World Total (%) (2)	Difference in Share (1-2)	Population (mn)	GDP Per Capita (current prices) $
United States	9,963	23.98	9,963	33.13	-9.15	281	35,401
China	5,230	12.59	1,080	3.59	9.00	1,267	852
Japan	3,319	7.99	4,760	15.83	-7.84	127	37,515
India	2,104	5.06	474	1.58	3.49	1,002	473
Germany	2,082	5.01	1,878	6.25	-1.23	82	22,898
France	1,458	3.51	1,289	4.29	-0.78	59	21,890
UK	1,425	3.43	1,417	4.71	-1.28	60	23,810
Italy	1,404	3.38	1,077	3.58	-0.20	58	18,719
Brazil	1,214	2.92	588	1.96	0.97	168	3,507
Russia	1,120	2.70	247	0.82	1.88	145	1,696
Canada	903	2.17	699	2.33	-0.15	31	22,747
Mexico	890	2.14	574	1.91	0.23	97	5,901
Spain	797	1.92	560	1.86	0.05	39	14,190
Korea	770	1.85	457	1.52	0.33	47	9,678
Indonesia	696	1.68	154	0.51	1.16	210	730
Australia	523	1.26	382	1.27	-0.01	19	19,933
Taiwan	477	1.15	310	1.03	0.12	22	13,899
Turkey	437	1.05	203	0.67	0.38	67	3,007
Thailand	430	1.04	122	0.41	0.63	62	1,956
Netherlands	416	1.00	370	1.23	-0.23	16	23,334
World	**41,552**	**100**	**30,073**	**100**	**–**	6,073	4,952
of which: G7	20,555	49	21,082	70	-20	693	30,437
Euroland	7,231	17	6,027	20	-3	304	19,820

These estimates raise important issues about the transmission of global monetary, fiscal and other economic policies, as well as the need for general international economic and political cooperation (which events since September 11th have highlighted) on a truly global basis. Representation at global economic policy meetings might need to be significantly changed.

Table 2: GDP Weight Comparisons

	PPP Weight (1)	Current GDP Weight (2)	Ratio (1/2)
China	12.59	3.59	3.51
India	5.06	1.58	3.20
Brazil	2.92	1.96	1.49
Russia	2.70	0.82	3.29
Total	**23.27**	**7.95**	**2.93**

A simple comparison between China and Italy serves to illustrate the point. Even on a current GDP basis, the Chinese economy is slightly bigger than Italy, so an expansionary monetary or fiscal policy in China would be likely to have a slightly greater global impact than would a similar policy in Italy. This may be particularly relevant if an economic shock such as the 1997-98 Asian crisis affects the neighboring region more than the rest of the world. And if PPP weights are more representative than current GDP, China's economy is about four times bigger than Italy's, which magnifies the relative impact of any policy change.

If the G7 were to become a forum where true worldwide economic policy coordination was discussed, the US, Japan, Germany, France and the UK would be joined by China and India rather than Italy and Canada. This assumes that PPP weights are the appropriate guide, as both we and the IMF prefer.

A further simple example can be seen from the impact on world GDP of China's strong real GDP growth performance. We estimate that in 2002, real GDP in China will expand by 7%. If China's weight in the world economy is 3.59%, then this contributes 0.25% to world growth. However, if China's weight is 12.59%, as implied by PPP weights, China's projected GDP will contribute a significantly higher 0.88% to world GDP growth.

Although we do not really know the 'right' answer as to which method (PPP or current GDP weights) is best, we argue that it may not matter if you look at relative real GDP and inflation trends for the purposes of future global economic policy implementation. In either case, the relative positions of key countries in the world economy are changing. We think China deserves to be in the G7 Club, and, under some scenarios, so do others—certainly Brazil, Russia and India relative to Canada.

World Trade Shares

Data showing the share of each of the 11 countries in world trade yield similar results. The broad modern trade-weighted measure of the US dollar is highly interesting in this regard: China is now the fourth largest individual weighted country, ahead of Germany. Not only does this mean that competitive issues involving the Chinese renminbi are more important than the (disappearing) Deutschemark, but arguably Chinese fiscal or monetary policy changes might be more important for the US than equivalent German policy changes (although the closeness of France and Italy and their responsiveness to German policy change would argue differently).

IMF data on country share of world exports and imports show a similar position. Without including data on re-exports from Hong Kong, China's share of world exports and imports was about 3.9% and 3.4% respectively, comparable to those of Canada and Italy, at the end of 2000. Including re-exports and imports through Hong Kong, China immediately becomes the third largest trading nation. Given China's entry into WTO, this relative position can only grow.

We have estimated that China's recent entry into the WTO will boost China's foreign trade by $800 billion per annum through 2005, and in the process this will allow potential GDP to rise to 7.5%, above the level assumed in our earlier projections. Once more, the case for more direct inclusion of China in major global economic policymaking forums looks strong.

Table 3: 2001 Trade Weights for the US$ Broad TWI

Country or Region	Federal Reserve Broad Trade Weighted Index
Canada	17.2
Euro area	17.1
Japan	13.2
Mexico	9.3
China	7.4
UK	4.6
Korea	4.1
Taiwan	3.7
Singapore	2.7
Hong Kong	2.6
Malaysia	2.3
Brazil	1.8
Switzerland	1.7
Thailand	1.6
Philippines	1.3
Australia	1.2
Israel	1.2
Indonesia	1.1
India	1.1
Sweden	0.9
Saudi Arabia	0.8
Russia	0.8
Argentina	0.6
Venezuela	0.5
Chile	0.5
Colombia	0.4
Total	**100**
Memo	
Euro-area countries	
Germany	5.9
France	3.1
Italy	2.4
Netherlands	1.5
Belgium/Luxembourg	1.4
Ireland	1.0
Spain	0.8
Austria	0.4
Finland	0.3
Portugal	0.1
Greece	0.1
Total	**17.1**

Looking Ahead: Projected Average Ten-Year Nominal GDP

Table 4 shows our nominal GDP, real GDP and CPI inflation assumptions for a ten-year growth path out from 2000. The assumptions have been derived from our best guess of the likely trend growth and inflation path over the next decade. Based on these assumptions, we can show how the relative size of these countries may change.

Table 5 presents a series of alternative rankings and relative sizes based on different estimating techniques. The four alternatives relate to different ways of estimating the size of GDP in the future.

Scenario A simply extrapolates nominal GDP for the next ten years on the very crude assumption that exchange rates will be the same level as at year-end 2000. The most interesting thing here is the rise in the relative position of China to the fifth largest economy. The combined weight of the BRICs—Brazil, Russia, India and China—rises to 12.0%.

Table 4: GDP and Inflation Assumptions 2001-2011

%per year	Nominal GDP Growth	Real GDP Growth	CPI
US	5.0	3.0	2.0
Euroland	4.5	2.5	2.0
UK	5.0	2.5	2.5
Canada	4.6	3.0	1.6
Japan	1.0	1.0	0.0
China	9.5	7.0	2.5
India	10.0	5.0	5.0
Brazil	7.5	4.0	3.5
Russia	10.0	4.0	6.0

Scenario B repeats the basic exercise of the previous scenario but converts the local GDP into current (2011) US dollars using our long-term GSDEER and GSDEEMER values. This scenario raises the relative weighting of the Eurozone countries due to the strong undervaluation of the euro according to our GSDEER model, but generally the results are no different from the current situation. The combined weight of the BRICs rises to 9.1% in this scenario.

Scenario C repeats our expected 2001-02 economic outturn for the next decade. In this, relative nominal GDP growth is higher in the BRICs than the G7 countries. Not surprisingly, the relative ranking of China jumps sharply to joint-third, while Canada drops to tenth. The weight of the BRICs rises to 14.2%.

Scenario D considers nominal GDP growth adjusted for PPP developments, i.e. inflation differentials. Given our assumptions, once more China (not surprisingly) appears very large relative to some other countries, more than twice the size of Japan and larger than the combined

Table 5: Share of World GDP

Country	Current GDP		PPP		Scenarios A		Scenarios B		Scenarios C		Scenarios D	
	Ranking	% of total	Ranking	% of total	Ranking	% of total	Ranking	% of total	Ranking	% of total	Ranking	% of total
US	1	33.1	1	24.0	1	34.2	1	32.5	1	31.5	1	26.5
Japan	2	15.8	3	8.0	2	11.0	2	10.5	2	9.7	3	7.3
Germany	3	6.3	5	5.0	3	6.1	3	7.7	3	6.6	4	5.6
UK	4	4.7	7	3.4	5	4.6	5	4.8	5	5.2	8	3.6
France	5	4.3	6	3.5	6	4.2	4	5.3	6	4.5	6	3.9
China	6	3.6	2	12.6	4	5.6	5	4.8	3	6.6	2	16.1
Italy	7	3.6	8	3.4	7	3.5	7	4.4	7	3.8	7	3.8
Canada	8	2.3	11	2.2	10	2.4	9	2.3	10	2.1	10	2.5
Brazil	9	2.0	9	2.9	9	2.5	8	2.5	8	3.0	9	3.2
India	10	1.6	4	5.1	8	2.6	10	1.2	8	3.0	5	5.4
Russia	11	0.8	10	2.7	11	1.3	11	0.6	11	1.6	11	2.3

size of France, Germany and Italy. This scenario results in a jump in the combined BRICs weight to 27.0%.

In each of the four cases, China's relative standing in the world GDP league tables is considerably stronger than today. In all four, the position of Brazil moves closer to that of Italy, whilst Russia (currently included in the G8 annual summit) remains eleventh in all except in the scenario in which we convert current GDP into US dollars at current PPP levels.

With this global economic environment set to emerge, coupled with the dramatic events of September 11th, it may be an appropriate time for policymakers to regroup.

Who Exactly Is the G7?

The Group of Seven (G7) evolved from the G5, which emerged in April 1973 following a meeting among the finance ministers of the US, Germany and France. This meeting, on the heels of the breakdown of Bretton Woods, focused on the resulting international monetary crisis. This group, with the addition of the UK, began to meet informally, sometimes on the fringes of annual IMF meetings.

Two participants in the April 1973 meeting went on to become the leaders of Germany and France. They were eager to pursue direct contacts of a similar nature on a regular basis. The Helsinki Conference of July 1975 provided an occasion to pursue their G5 agenda. Later that year, France hosted a summit at which it, Italy, Germany, the UK, the US and Japan discussed a range of economic and political issues. The annual heads of state summit from then on took place on a G7 basis, including Canada.

Typically, the finance ministers of the G5 (excluding Italy and Canada) met separately. G5 meetings took place in a somewhat secretive atmosphere, although their subjects and style were prompted by world economic circumstances. Perhaps their most famous act of influence on the world financial stage was the Plaza Accord of September 1985, in which members agreed to deliberately weaken the value of the US dollar.

The G7 as a forum for finance ministers really emerged in 1986-87 through initiatives by James Baker and Richard Darman of the US Treasury, reflecting their discontent with the secretive nature of the G5 and their desire to have regular meetings of finance ministers parallel to meetings of the heads of state of the seven major economies. Italian discontent with being excluded from the Plaza Accord was seen as a valid excuse to broaden the group and as a way of developing a more formal and publicly recognized regular meeting where finance ministers could collectively review their individual economic objectives and forecasts and discuss their mutual compatibility.

Initially planned as just a forum for the G7 finance ministers, the French (encouraged by the EC) objected to absence of EC participation. After much haggling, the EC was 'admitted,' effectively representing another set of European countries (which now includes another 11 countries in addition to the big four). It did not take a long time to figure out that to have an effective policy forum, it would be critical to include central bank leaders and their deputies, who would actually implement much of what was desired by the finance ministers, especially if it were to involve FX intervention. The actual membership of the 'club' rose further with the addition of the head of the IMF and the President of the ECB following the start of EMU in January 1999. The regular meetings have become a feature of the annual economic calendar. Of course, financial markets frequently await their communiqués with anticipation.

In the heady days of the 1980s, the Louvre Accord was the strongest example of active policy coordination where the G7 attempted to manage exchange rates in a narrow range against each other. Whilst the difficulties involved in active coordination of monetary and fiscal policy meant that the Louvre 'experiment' lasted less than six months, there was a period in the late 1980s where the G7 finance ministers tried to use their meetings as an attempt to coordinate policies more actively than they have in more modern times.

There have been other periods since in which the G7 has actively coordinated policies, notably FX management, with the policy-induced strengthening of the dollar in 1995 a good example. The intervention to support the euro in September 2000 represented another, smaller, example.

However, for much of the last few years, the G7 has seemed more of an information-gathering point and has generally refrained from any active influence over world events and markets. At least that is the impression among many market participants.

There may be good reason as to why this has been the case. For most of the 1990s, especially since the ERM crisis of 1992-93, the Europeans have been focused heavily on the introduction and success of EMU. In addition, various shocks to the world economy have appeared from outside the G7, making a coordinated policy response from inside difficult.

EMU Expansion Bolsters the Case

The outlook for the European Union and European Monetary Union adds to the argument for the reform of the G7.

With membership of the EU likely to expand to 25 countries in 2004, and many of the new members likely to join EMU soon after, the economic decision-making process is likely to become unwieldy. We see three reasons why this bolsters the case for G7 reform:

- First, some significant reform, possibly along the lines of the FOMC's rotation scheme, will be necessary at the ECB, with Governors of some of the central banks taking turns at serving as 'official' decision makers. A parallel global representative change would seem opportune.

- Second, Germany, France and Italy make up about 78% of the Euroland economy. As other countries join, the weight of the Big Three will decline. Given that they will all share a single currency and a single monetary policy, why should Germany, France and Italy be represented at the G7 at the exclusion of the other 22% (or more) of Euroland?

- Third, a strong case could be made that the existence of so many national representatives at ECB and ECOFIN meetings tends even now to result in decision-making that is motivated by self rather than collective interest. As the six permanent ECB board members would no doubt argue, the collective interests are best served by thinking in a 'pan-European' way.

Of course, some critics have argued that the Euroland policymaking forum suffers from both too many participants and a lack of continuity, and so to have a rotating European representative at the G7 for both the ECB and ECOFIN would not be ideal. Instead, if a single representative from ECOFIN and the ECB President represented Euroland at the G7, this would probably result in a more effective Euroland voice.

Should a G9 Replace the G7?

It seems quite clear that the current G7 needs to be 'upgraded' and room made for the BRICs—creating a new G9—to allow more effective global policymaking.

By reducing European representation to that of the UK and a Euroland representative (only one if the UK joins EMU, reducing the need for another participant), the G7 could be slimmed back down to a G5.

Looking at each of Brazil, Russia, India and China, the case for the inclusion of China is overwhelming. The case for the other three is less clear-cut, but in many of our scenarios for the future makeup of the world economy, the case for the inclusion of all three is at least as strong as that for Canada, and in some ways, as strong as that for Italy.

Would the BRICs Want to Be in the G9?

In addition to questioning whether a G9 would be more effective than a G7, observers might wonder whether the BRICs would actually want to be in a G9 'club.' Clearly, the four countries under consideration are very different economically, socially and politically. Incorporating all four of them into a G7-style group might not be straightforward (although the existing G20 meetings are arguably an extended version of this proposal).

- **Russia** would perhaps be the most likely, not least as it already participates regularly in the annual heads of state summit (now the G8, which is the G7 plus Russia). Russia's presence might also be valuable due to its role as a major oil producer, in addition to other attractions.

- **Brazil** might be the next most willing, given its large economic weight in Latin America and its closer social and stylistic ties to Europe and the US.

- **China** might not be as eager to join a G9. Despite its enormous economic progress, China's social model is still extremely different to the G7 countries. With its less developed capital markets, China might not appreciate regular G7 type 'advice.' However, China's inclusion would probably be the most important given our earlier arguments. China's involvement might require other members to recognize that not all member countries need to be the 'same.'

- **India** would almost definitely be the least eager to join the G9 club. It might regard any obligations as unwelcome or see its own experiences as limiting its ability to give advice. However, in view of its size, population, geographical location and potential, the possible inclusion of India would be attractive.

What Would the G9 Do?

Just as the G7 finance ministers and central bank governors currently discuss the world economy and policy coordination, the G9 would do the same. What more could that actually achieve?

Most of the world's economic disturbances since the late 1990s and its biggest changes have largely involved countries outside the G7, with the exception of the technology-driven downturn in the US in 2000-01. The involvement of those with stronger locally informed knowledge and their informed consideration of the issues could help to make the fallout from future crises less painful or even help to avoid these crises altogether.

Whilst the 1998 Russian crisis associated with the LTCM collapse might not have been avoided, involvement of China in the 'club' might have resulted in greater awareness of the building economic pressures that led to the Asian crisis. Certainly a single European voice at the G7 instead of those from different large European countries would allow a 'European voice' to be heard on many occasions.

Going into 2002, two interesting test cases exist. One concerns the ongoing remarkable strength of the US dollar, which for many emerging market countries could be a big challenge. In particular, its strength is challenging the viability of the dollar-based currency board in Argentina. The direct involvement of Brazil in the G7 club and its discussions about major exchange rates could strengthen the case for global policy action to strengthen the euro. Similarly, direct Chinese involvement would broaden any debate about the appropriate policy response with respect to Japan's problems and the management of the yen.

Both these issues suggest to the truly global economics analyst that there is an extremely strong case for a policy-induced strengthening of the euro/yen exchange rate. We may need a better global economic forum to help implement this.

It is time for better global economic BRICs.

Jim O'Neill
30th November 2001

Appendix

Which Is Right: PPP or Current GDP Weighting?

According to the IMF, the conversion factors used to convert data expressed in national currencies into a common numeraire currency should reflect each currency's purchasing power relative to the numeraire currency.

This is the accepted practice adopted at GS. As the IMF notes, if market exchange rates diverge substantially and for extended periods from PPPs, conversion at market exchange rates may yield biased GDP weights and hence biased indicators of aggregate economic activity in groups of countries.

In practice, GDP expressed in national currencies are usually converted at market exchange rates. Such conversions may be acceptable as long as differences between market exchange rates and PPPs are small and stable.

Two examples serve to highlight this dilemma, but neither offers much in the way of an obvious solution. Consider the US and Japan. Because the yen is 'expensive' on a PPP basis, Japan's economy is reported to be bigger on a relative basis in US dollar terms when quoted in current dollars than when it is quoted in PPP terms. Which is right? If it were accepted that the comparison should be made in current dollars, what about an environment where the yen weakened by 25% in one year's time? Such an FX move might actually help to strengthen the Japanese economy, but the size of the economy would appear to be 25% lower in dollars than today. On a PPP basis, this problem would not occur.

For the second example, take China and Japan, a very topical issue and a key issue in this paper. On a current GDP basis, the Japanese economy is about four times bigger than China, but on a PPP basis, the Chinese economy is more than 50% bigger than Japan's. Which is right? Does it matter? For other countries, particularly the more open economies, trying to judge the impact of policy changes elsewhere will obviously depend on the true size. For example, does a 2% of GDP change in Chinese fiscal policy matter more than a 2% of GDP change in Japanese fiscal policy for Korea, Thailand or other Asian countries? This is a difficult question to answer. Most people would probably choose Japan—but this might not be correct.