

PERSPECTIVES

**OUR CONSENSUS FUTURE:
THE LAY OF THE LAND IN 2025**

MARK THIRLWELL

S E P T E M B E R 2 0 1 0

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**Our consensus future:
The lay of the land in 2025¹**

Mark Thirlwell

The perils of forecasting

The recent financial crisis is a powerful reminder of how bad we are at forecasting. I suspect that nearly every analyst falls into at least one of three camps: (1) those who didn't see any crisis coming; (2) those who were in fact expecting a crisis, but were expecting either a different crisis from the one we got, or were expecting a particular aspect of that crisis, rather than the whole shocking package; (3) and those who regularly forecast crises that have failed to materialise, but who got lucky this time. In relative terms, that leaves (maybe) a handful of honourable exceptions.²

As Nils Bohr, the great physicist, famously noted, 'Prediction is very difficult, especially if it's about the future.' Or to put it another way, and borrow from John Kenneth Galbraith: sometimes it seems that the only function of economic forecasting is to make astrology look good.

Indeed, since it turns out that, for example, macroeconomic forecasters trying to predict US GDP growth and inflation just *one* year out do about as well as tossing a coin, you are certainly not going to want to put too much weight on a forecast that tries to go out 15 years.³

Still, there is a crumb or two of comfort to be found. If we really want to use forecasts (and it turns out that we do, for a whole bunch of reasons but not least because we have to make a series of crucial decisions – such as long-term investments – that are conditional upon our

¹ Originally delivered as comments to a panel discussion at the Australian Economic Forum, 6 August 2010, Sydney.

² The author, alas, falls into the second category.

³ Michael F Bryan and Linsey Molloy, *Mirror, mirror, who's the best forecaster of them all?* Economic Commentary, Federal Reserve Bank of Cleveland, 15 March, 2007.

view of the future) then it seems that consensus or median forecasts are often the best way to go.⁴ And I'm going to argue that we now have a pretty clear consensus view on what the world economy is going to look like over the next couple of decades. Moreover, this is a consensus forecast that has just come through a major shock – the GFC – relatively unscathed.⁵

Our consensus future

So what does our consensus future look like? Let's start with some of the basic building blocks – the areas of greatest consensus, if you like.

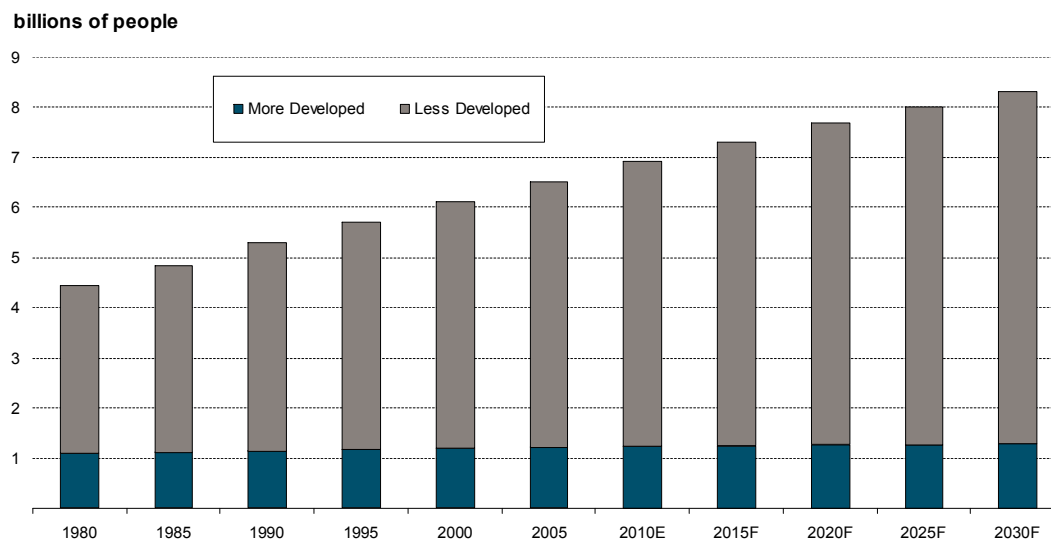
First up is population.

Here the clear consensus is that by 2025 we will have a world economy that has a larger global population, a population with a median age that is higher than now, and a population that is more urban. Most of this global population will (still) be found in what we call developing countries, although the latter's share of the world total will be even higher than it is today. There is of course plenty of scope for disagreement about the precise numbers, which can vary quite significantly depending on the precise assumptions made about changes in fertility rates, but I would argue that the broad trends are not controversial.

⁴ The classic reference here is Stephen K McNees, *Consensus Forecasts: Tyranny of the majority?* *New England Economic Review* November/December 1987. For comparative forecasting performances see: Michael J Artis, *How accurate are the IMF's short-term forecasts? Another examination of the World Economic Outlook*. IMF Working Paper WP/96/89. Washington DC, IMF, August, 1996; Prakash Loungani, *How accurate are private sector forecasts? Cross-country evidence from consensus forecasts of output growth*. IMF Working Paper WP/00/77. Washington DC, IMF, April, 2000; Roy Batchelor, *The IMF and OECD versus Consensus Forecasts*. London, City University Business School, August, 2000; and Allan Timmermann, *An evaluation of the World Economic Outlook*. IMF Working Paper WP/06/59. Washington DC, IMF, March, 2006. On the statistical properties of consensus forecasts, see Christopher Crowe, *Consensus forecasts and inefficient information aggregation*. IMF Working Paper WP/10/178. Washington DC, IMF, July, 2010.

⁵ For a previous take on this, see Mark Thirlwell, *All change or plus ça change? The global financial crisis and four key drivers of the world economy*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, February, 2009.

Figure 1: World Population, 1980 – 2030F



Source: United Nations Department of Economic and Social Affairs Population Division, *World population prospects: The 2008 revision*. (2009).

So, for example, if we look at the United Nations Population Division forecasts (I'll cite the median version), then the world's population is forecast to increase from around 6.9 billion this year to about 8 billion by 2025 (Figure 1).⁶ By way of comparison, the US Census Bureau's International Data Base has the world's population rising from almost 6.9 billion in 2010 to about 7.9 billion by 2025.⁷

Nearly all of this increase in population is forecast to occur outside the developed world (Figure 1).

Meanwhile, the UN thinks that the median age of the world's population will rise from 29 to almost 33, with a rise in the old-age dependency ratio from 12% to 16%.⁸

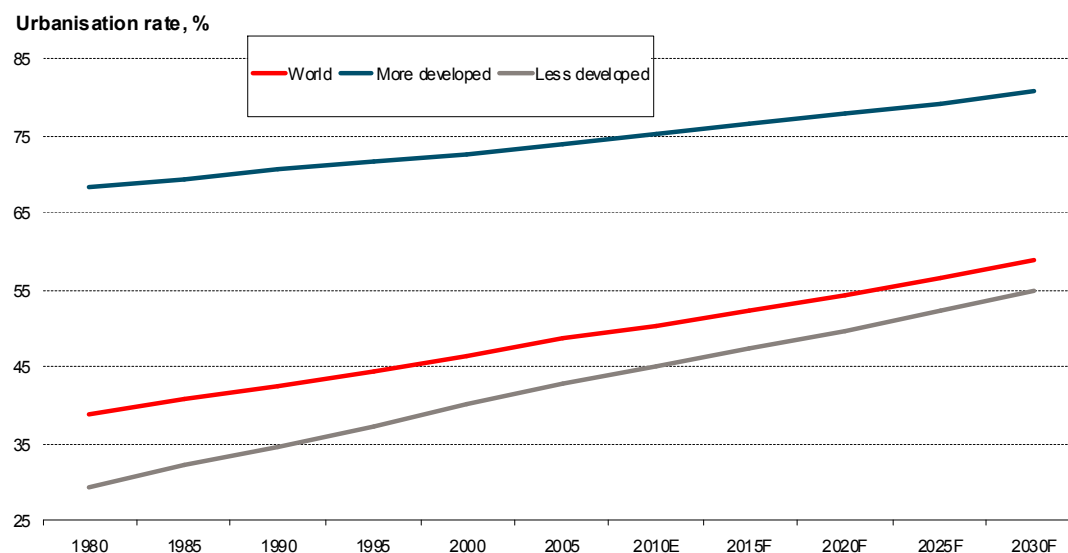
Finally, while a slight majority of the world's population is urban today, that position is expected to be consolidated by 2025: (about a 56% urbanisation rate on the UN's forecast (Figure 2).⁹

⁶ According to the low variant, world population will increase to 7.7 billion by 2025, while the high variant has 8.3 billion by the same year. United Nations Department of Economic and Social Affairs Population Division, *World population prospects: The 2008 revision*. New York, United Nations 2009.

⁷ US Census Bureau Population Division, *International Data Base (IDB)*. Washington DC, US Census Bureau, 2010.

⁸ The old-age dependency ratio is the ratio of the population aged 65 years or over to the population aged 15-64. United Nations Department of Economic and Social Affairs Population Division, *World population prospects: The 2008 revision*.

Figure 2: World urbanisation rate, 1980-2030F



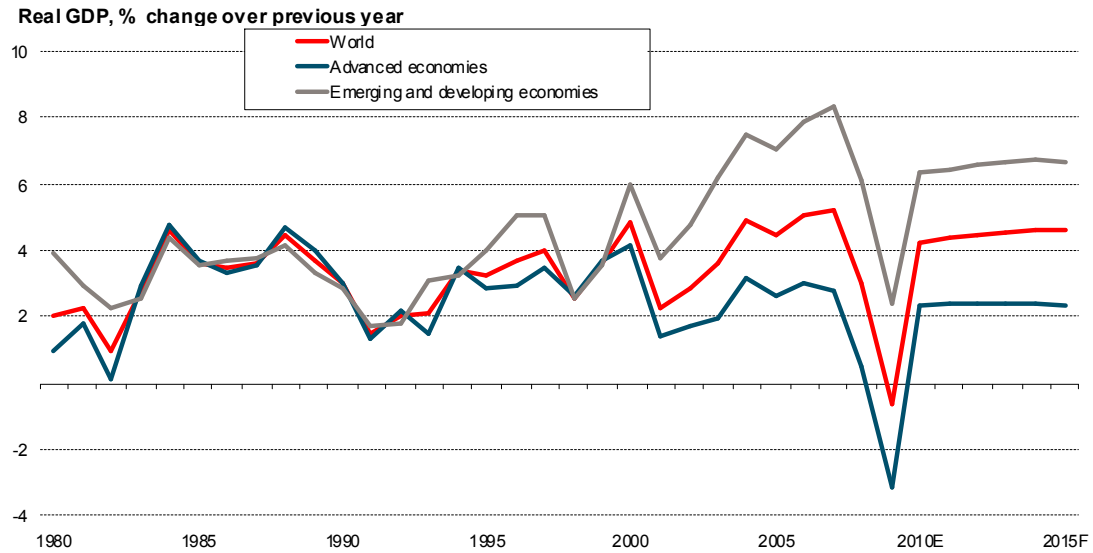
Source: United Nations Department of Economic and Social Affairs Population Division, *World urbanization prospects: The 2009 revision*. (2010).

Many of these people will be living in mega-cities (with a population of 10 million people or more) and meta-cities (more than 20 million). The UN identifies 21 such cities in 2010, including one city with more than 30 million people (Tokyo) and three with more than 20 million (Delhi, Sao Paulo and Mumbai). By 2025 the number of mega-cities is projected to have increased to 29, and while Tokyo remains the only city projected to have a population of more than 30 million (although Delhi is expected to get fairly close), eight cities are expected to have more than 20 million inhabitants, with the original three joined by Dhaka, Ciudad de Mexico, New York-Newark, Kolkata and Shanghai.

Next up is economic growth. Once again, while there might well be rather large differences in growth projections for individual economies out there, sitting above this there exists a broad consensus on the 'big picture': The recent (post-2000) pattern of growth out-performance by developing economies / emerging markets relative to developed economies (Figure 3) is widely expected to continue.

⁹ United Nations Department of Economic and Social Affairs Population Division, *World urbanization prospects: The 2009 revision*. New York, United Nations 2010.

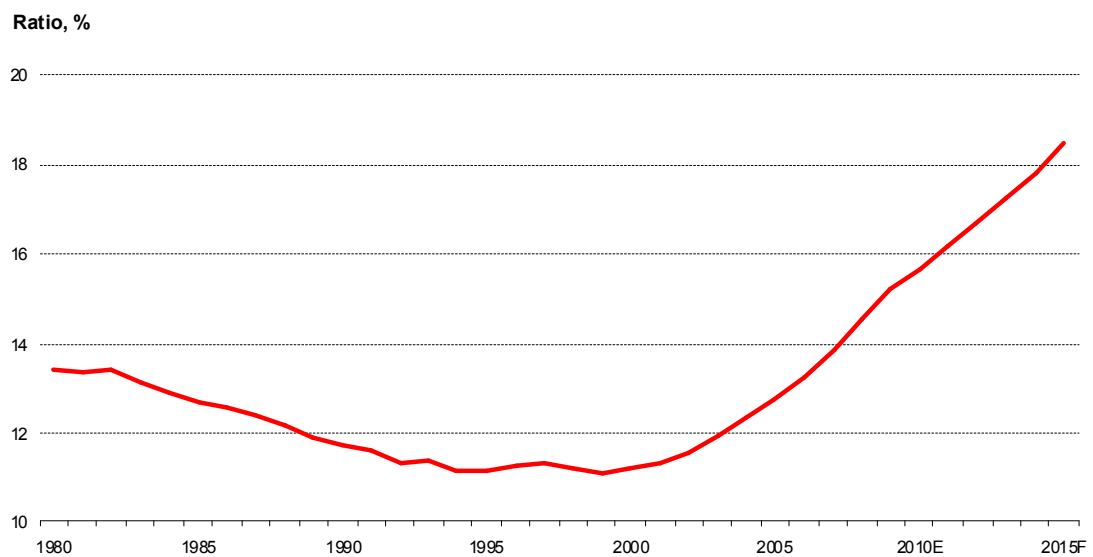
Figure 3: World real GDP growth, 1980-2015F



Source: International Monetary Fund, *World Economic Outlook Database April 2010*. (2010)

It follows that the consensus view is that the process of gradual convergence in levels of GDP per capita (Figure 4), and the rather more rapid convergence in levels of absolute GDP, are both going to continue for at least the next two or three decades.

Figure 4: GDP per capita in developing and advanced economies, 1980-2015F



Source: International Monetary Fund, *World Economic Outlook Database April 2010*. (2010).

Evidence for the pervasiveness of this consensus is available in the form of the various studies and reports produced by a range of bodies, including international institutions like the OECD and World Bank,¹⁰ investment banks,¹¹ accounting and consultancy firms,¹² and think tanks.¹³ Arguably the most famous of these projections are the Goldman Sachs forecasts for the so-called BRICs.

Many of these studies use a similar and by now familiar methodology: Start from the Cobb-Douglas production function to get an equation along the lines of $y = a + \alpha l + (1 - \alpha) k$, where y is growth in output, a is the change in technical progress, l is the change in the labour force, k is the change in the capital stock, and α is the income share of capital. Labour force projections are then based on forecasts of the working-age population (typically from either the UN or US Census projections referenced above), α is assumed to be 2/3 in line with historical experience, and k is derived from forecasts of changes in the investment rate and a starting estimate of the capital stock. Finally, make an assumption about the rate of technical progress for the leading economies (in several cases the assumption is that the rate is constant at around 1.3%), and then adjust this again to account for the pace of convergence in follower or 'catch-up' economies.)¹⁴

¹⁰ OECD, *Perspectives on Global Development 2010: Shifting Wealth*. Paris, Organisation for Economic Co-operation and Development, 2010. World Bank, *Global economic prospects 2007: Managing the next wave of globalization*. Washington DC, World Bank, 2007.

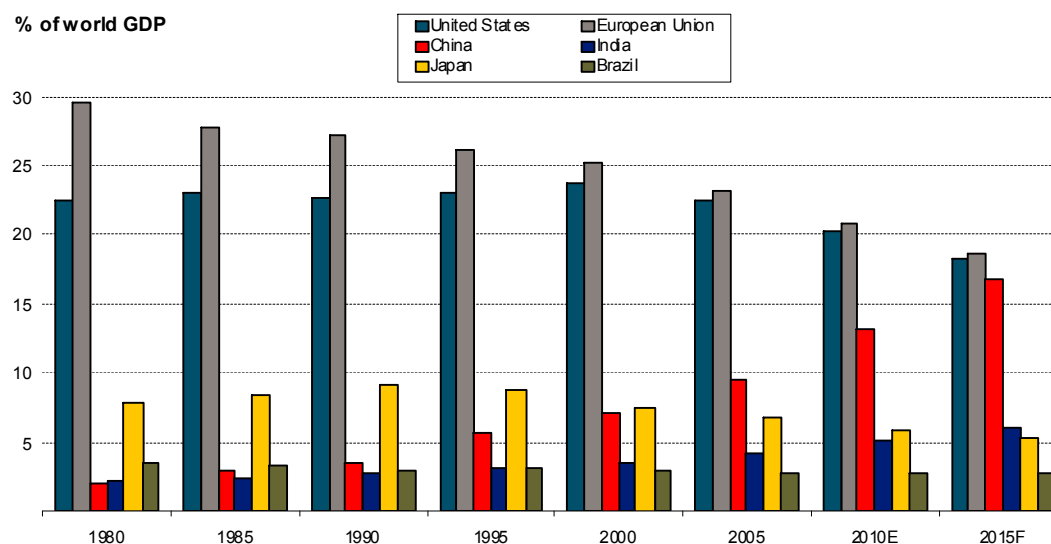
¹¹ Probably the most famous paper here is Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: the path to 2050*. Goldman Sachs Global Economics Paper No.99, 2003. For a more recent update see Jim O'Neill and Anna Stupnytska, *The long-term outlook for the BRICs and N-11 Post Crisis*. Goldman Sachs Global Economics Paper No. 192, December, 2009.

¹² For example John Hawksworth, *Convergence, Catch-Up and Overtaking: How the balance of world economic power is shifting*. London, PricewaterhouseCoopers, January, 2010.

¹³ For example Uri Dadush and Bennett Stancil, *The World Order in 2050*. Washington DC, Carnegie Endowment for International Peace, April, 2010.

¹⁴ While we might hope that this will deliver a superior result to simple extrapolation, I suspect that for any significant time horizon neither approach produces anything other than glorified guess-work. One involves a bit more work than the other, of course, but also has the benefit of being more transparent and hence open to challenge (or adjustment) on the underlying assumptions.

Figure 5: Share of world GDP 1980-2015F



Source: International Monetary Fund, *World Economic Outlook Database April 2010*. (2010).

If the methodologies are similar, so are the results. Basically all of these forecasts suggest a world in 2025 where:

- (1) Emerging markets account for a significantly increased share of world GDP along with a greater share of global growth;
- (2) The gap in income per capita between these new economic powers and the established developed economies has closed somewhat, but still remains substantial; and
- (3) The group of the world's largest (top) economies comprises a mix of high- and middle-income economies, with the number of representatives of the latter crowding out members of the former.

Note also that these forecasts and outcomes fit in quite nicely with current short-term outlooks for the world economy. So, for example, a glance at the forecasts for global growth contained in the latest IMF World Economic Outlook database – which goes out to 2015 – tells a story that is completely consistent with these longer-term projections (Figures 3 and 5).¹⁵

¹⁵ International Monetary Fund, *World Economic Outlook Database April 2010*. Washington DC, IMF, 2010.

Finally, it also appears that the aftermath of the GFC has reinforced this consensus view, albeit with the more depressing feature that the convergence process is likely to be aided by a weaker economic performance in the developed world. According to this still-emerging element of our consensus future – a view of the world sometimes known as the ‘New Normal’ – we now face a medium-term outlook for much of the developed world where growth is limited by continued adjustment to a post-crisis environment characterised by budgetary austerity in the face of heavier public debt burdens, a more stringently regulated financial sector, and some chastened, and hence more cautious, central bankers.¹⁶

Of course, this close connection between the present and the forecast future should be no surprise: as the fake mystic Kehlog Albran says in *The Profit*, ‘I have seen the future and it is very much like the present, only longer’, an idea that (as many analysts have pointed out) does a pretty good job of summarising both the process of forecasting and one of its major weaknesses.

A third – and closely related – building block to add to population growth and economic growth relates to the global income distribution. Taking the consensus view about economic growth and making some basic assumptions about the distribution of national incomes gives us a forecast of a world economy in 2025 that is marked by a significantly lower rate of absolute poverty, as well as by a global middle class that is larger than it is today, and which is increasingly comprised of people from middle-income economies (Figure 6).¹⁷

Figure 6: Estimates of the Global Middle Class

Table 2. Numbers (millions) and Share (percent) of the Global Middle Class

	2009		2020		2030	
North America	338	18%	333	10%	322	7%
Europe	664	36%	703	22%	680	14%
Central and South America	181	10%	251	8%	313	6%
Asia Pacific	525	28%	1740	54%	3228	66%
Sub-Saharan Africa	32	2%	57	2%	107	2%
Middle East and North Africa	105	6%	165	5%	234	5%
World	1845	100%	3249	100%	4884	100%

Source: Kharas, *The emerging middle class in developing economies*. (2010)

¹⁶ See for example Mohamed El-Erian, *A new normal*. Secular Outlook, PIMCO, May, 2009 and Kenneth Rogoff, The 'new normal' for growth. *Project Syndicate*, 5 May 2009.

¹⁷ Dominic Wilson and Raluca Dragusanu, *The Expanding Middle: The exploding world middle class and falling global inequality*. Goldman Sachs Global Economics Paper No. 170, July, 2008. Homi Kharas, *The emerging middle class in developing economies*. OECD Development Centre Working Paper No. 285. Paris, OECD, 2010. Wilson and Dragusanu assume that income follows a lognormal distribution (such that it can be described by the mean and standard deviation). Mean per capita incomes then come from the basic GDP forecasts while the standard deviation is derived from historical income distributions. Kharas uses World Bank data to calculate Lorenz curves which are assumed to remain constant over time.

Getting more ambitious

If we want to get a bit more ambitious, we can then take these three basic building blocks of our consensus future and pile some further assumptions on top of them.

Here are some examples which follow on quite reasonably from the previous exercise:

- Simple gravity-style models of trade would suggest that our consensus future will produce a world in 2025 where both North-South and South-South trade will be much more important components of total international trade.¹⁸ Applying a similar logic to cross-border financial flows delivers a similar outcome.
- Likewise, the *location* of production – a product of decisions involving both domestic investment and FDI flows – will also (continue to) be influenced by this evolving international economic geography.
- There are also going to be parallel shifts in the international currency system. In particular, and despite the fact that the GFC has dealt a fairly severe blow to the Euro (which pre-GFC was thought to be the US dollar's major competitor for international reserve currency status), the more multi-polar world economy of 2025 is going to be one with a more multi-polar international currency system.¹⁹
- These quantitative changes in cross-border trade in goods, services and financial assets and international shifts in the location of production will produce other transformations, including a shift in the relative competitiveness of international financial centres (China has ambitious plans for Shanghai by 2020, for example), changes in the nature of the demand for, and hence type of, 'global' products, and adjustments in the relative importance of trade routes, trading partners and ports towards emerging markets.
- A more populous, more urbanised, and more middle class (that is, a richer) world has implications for the demand for commodities. The 2003-2008 commodity price boom was longer and stronger than any 20th century boom, and for many observers

¹⁸ The gravity model of international trade proposes that the volume of trade between two countries is an (increasing) function of the GDPs of the two economies, and a (decreasing) function of the distance between them.

¹⁹ For a nice take on this, see Barry Eichengreen, *Managing a Multiple Reserve Currency world*. April, 2010.

heralded a structural change in the price of commodities (an idea at the heart of the so-called Commodity Super Cycle).²⁰ The ‘other’ GFC – the global food crisis – also served to sound alarm bells about sustainability. The subsequent crash has since reminded us that commodity prices (like economies in our post-Great Moderation world) are still susceptible to booms and slumps. Despite this correction, however, our consensus future is one where the relative price of commodities is higher, and where old-fashioned commodity pessimism has been replaced by commodity price optimism.

All of which gives us a world in 2025 that is richer, older, more populous and more urbanised. It’s also a world where the centre of economic gravity has shifted (further) to the developing world, and where the world’s largest economies are increasingly middle-income countries. It’s a world where South-South and North-South trade and investment flows are both quantitatively and qualitatively more important than they are today, where there have been parallel shifts in financial and economic centres, where the US dollar faces new competitors, and where commodity price optimism has replaced commodity pessimism. It’s also a world where the very definition of ‘developing’ or ‘emerging’ economies is going to be in question.²¹

We can be more ambitious still, and pile a few more assumptions on top of our set of building blocks, albeit at the cost of a more rickety structure.

- Our more multi-polar world economy in 2025 will – by definition – be a world where economic leadership is more contested. This will have consequences for the provision of international public goods, including, for example, free trade.²² In contrast to the tectonic adjustments in the geography of economic power, our consensus future does not seem to assume any related seismic shifts in the structure of the current economic order when it comes to global markets. Nevertheless, the current institutional supports of that order (the WTO, the IMF and so on) are not going to retain their existing importance and roles, or at least, not without radical changes in their nature. Similarly, it seems highly unlikely that existing ways of

²⁰ World Bank, *Global economic prospects 2009: Commodities at the crossroads*. Washington DC, World Bank, 2008.

²¹ See for example Robert Zoellick, *The end of the Third World? Modernizing multilateralism for a multipolar world*. Speech at the Woodrow Wilson Center for International Scholars. Washington DC, 14 April, 2010.

²² There is a nice discussion of this in Adam Posen, Who will sustain globalization? *Current History* 108 (72) 2009.

delivering international economic agreement (such as giant Doha Round-style trade negotiations) are still going to be with us in 2025.

- This multi-polar world economy will be one in which there is a greater diversity of economic models among the ‘leading’ economies. While talk of the death of the Washington Consensus and its replacement by a Beijing Consensus can often be overly simplistic,²³ it nevertheless captures an important development: that the (very) rough agreement on economic policy and economic management that prevailed up until 2007 has departed, and by 2025 it seems quite unlikely that there will be a single dominant replacement. Instead, Chinese state capitalism will be brushing shoulders with US market capitalism, Indian capitalism and the several varieties of European models. We might even have a Brazilian or an Indonesian competitor. Note, however, that this still assumes that markets will remain a central feature across all of these models, with no emergence of a radically new way of organising economic activity – there’s that ‘no seismic shifts in the current economic order’ assumption, again.
- Finally, since this is an economics conference, it’s worth thinking about what the discipline might look like in 2025. At the moment, economics continues to be US-dominated: the big debates tend to take place in US accents,²⁴ at US universities, and using US concepts (for example ‘saltwater’ vs. ‘freshwater’²⁵). I think that it follows from the previous two predictions that this is much less likely to be the case in the consensus future of 2025. Instead, we are likely to have a world where the cutting-edge professional debates will be more contested (more multi-polar, if you like) and will be conducted in a broader range of locations, and accents, than is the case today.

Why we won’t get our consensus future

So that’s a broad description of what the world economy might look like in 2025, based largely on what I have argued is reasonable to describe as the current consensus view of our future, along with a couple of more adventurous guesses thrown in at the end.

²³ A past offence to which this presenter also has to plead guilty.

²⁴ Note that this does not mean that all those involved in these debates are US citizens. The fact that the US is the world leader means that its universities can attract the best talent from across the globe.

²⁵ See for example Paul Krugman, How did economists get it so wrong? *The New York Times Magazine*, 6 September 2009. On the one hand, this is a powerful (if contentious) critique of economics post-GFC. On the other, the picture it paints is very much a US-centric one – not a surprise given where it appears, of course.

It's also – not surprisingly – a reasonably good description of what I would consider as my own base case scenario.

And, as implied back at the start, given the usual track record of forecasting, it's almost certainly going to be wrong in one way or another.

So *why* is it going to be wrong? By way of a conclusion, here are some possibilities to consider, grouped into two broad categories.²⁶

First, there is the risk of a shock that is large enough that it shifts the world economy onto a different trajectory.

- Perhaps the most obvious candidate here is another major financial accident. It turns out that the current global economy is rather prone to large financial crises. Despite the shift to greater financial regulation in the near term, my suspicion is that there is nothing in the consensus future described above that is likely to change this – we will still be (more or less) as prone to the financial sector running off the rails in 2025 as we are today. A big enough financial accident could yet derail our consensus future. Arguably, we have already come close.²⁷
- Alternatively, it is possible that a major technological innovation goes into production in time to usher in a new cycle of growth and investment that dramatically reinvigorates growth prospects in the developed world within our forecast period.
- Then there are all the other kinds of exogenous shocks – a pandemic, an international security crisis (think Iran or North Korea), or possibly even an extreme climate event – which could also potentially push the world economy off course.

Second, there are the risks that are endogenous to the consensus forecast described here.

- For example, the consensus future sketched out above not only assumes quite big (and ongoing) shifts in the international distribution of economic power, but it then (usually implicitly) assumes that the world will manage that in a relatively orderly fashion. That second assumption could turn out to be wrong.

²⁶ This list is intended to be indicative, not exhaustive.

²⁷ Indeed, it's quite plausible to make the case that since we do not yet know the ultimate consequences of the current crisis, it too could end up undermining our consensus future.

- Similarly, our consensus future not only assumes big structural shifts within the world's key emerging economies, but it also assumes that these shifts will be successfully accommodated without major destabilising consequences for the prevailing social and political arrangements. Once again, that assumption could well turn out to be incorrect.²⁸
- Finally, there is the risk that resource sustainability issues bite sooner (and with more severity) than assumed by the consensus projections.²⁹

²⁸ This criticism is made, for example, in Ian Bremmer and Preston Keat, *The Fat Tail: the power of political knowledge for strategic investing*. Oxford, Oxford University Press, 2009. They argue that 'the BRIC story has one fundamental flaw.' That is, it assumes political continuity when a glance at the history of the BRICs would make this assumption look highly questionable. Bremmer and Keat stress that back in the 1950s nobody was predicting that the Soviet Union would be transformed into a bunch of capitalist successor states, or that China would have become a capitalist powerhouse. 'We simply cannot know how leaders in Brazil, Russia, India and China will define their political and economic interests half a century from now.' Ibid.

²⁹ It's worth noting that this risk has a flip side for Australia in particular. If one of the other adverse risks materialises, then we might find out that our current commodity price optimism has been misplaced.

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