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Shaking the World?
China and the World Economy

Mark P. Thirlwell

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Shaking the world?
China and the world economy[1]

Mark P. Thirlwell

A favourite cliché of China watchers has been a Napoleonic aphorism: 'Let China sleep; when she wakes, she will shake the world.' So is a resurgent China 'shaking' the world economy and reshaping our international economic environment?

History certainly tells us that the emergence of a major new economic power is almost certain to reshape the international environment in several ways, transforming the economic and geopolitical landscape. One stark example of the potential involved for dramatic, system-shifting change is the emergence of the United States as a major player in the international economy in the late nineteenth century. This was a development which had a substantial impact on trade flows and relative prices in the Atlantic economy, changes which in turn had important implications for economic policy and performance, and arguably for the stability of the international order as it was then constituted.[2] It is therefore reasonable to wonder whether China's economic emergence carries with it the same potential to reshape the geography of today's international economy. Certainly, it is no coincidence that the subject of the challenges to the status quo posed by rising powers is now one that is drawing growing interest across the world, and in particular in the United States.[3]

In what follows I plan to focus on just three aspects of China's current interaction with the world economy: (1) China's role in world output; (2) its role in world trade; and (3) its role in world financial markets. By definition, this approach with its external focus neglects a huge

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[1] This *Perspectives* is based on a speech delivered at the conference *The Chinese economy – impact on Korea and Australia*, held at the Lowy Institute in Sydney on 5 August 2005. It also draws in part on an earlier essay, Mark P Thirlwell, China and the international economy. *CEDA Growth 55: China in Australia's future* (May) 2005. This essay is also available in the *Perspectives* series.
[2] See for example Kevin H O'Rourke and Jeffrey G Williamson, *Globalization and history. The evolution of a nineteenth-century Atlantic economy.* Cambridge, Massachusetts, MIT Press, 1999.
[3] See for example Greg Ip and Neil King Jr, Is China's rapid economic development good for US? *The Wall Street Journal*, 27 June 2005, p. B1.

amount of territory, including the many and substantial social, political and economic challenges that still face policymakers in Beijing: the sheer scale of some of these challenges certainly needs to be kept in mind when attempting to map out possible futures for the world economy.

(1) China and world output

The table below sets out the position of China in the world economy in terms of GDP and population as of 2004, and compares this with two other economies, the United States and India.

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Comparisons: GDP and population

(2004)	**China**	US	India
GDP (market exchange rate)	**US$1,649.3b**	US$11,667.5b	US$691.9b
% of world total (rank)	**4.0% (#7)**	28.5% (#1)	1.7% (#10)
GDP (PPP)	**$7,123.7b**	$11,628.1b	$3,362.9b
% of world total (rank)	**12.7% (#2)**	20.8% (#1)	6.0% (#4)
Population	**1,296.5m**	293.5m	1,079.7m
% of world total (rank)	**20.4% (#1)**	4.6% (#3)	17.0% (#2)
GNI per capita (MER)	**US$1,290**	US$41,400 (#5)	US$620
GNI per capita (PPP)	**$5,530**	$39,710 (#3)	$3,100

Sources: World Bank on line indicators. Rank reported for top 20 economies only.

This set of comparisons raises (at least) two questions.

First, what is the appropriate metric for comparing output across countries? The choice clearly matters: in 2004 China was either the seventh largest economy in the world (when output is measured using market exchange rates, or MERs) or it was the second largest economy (output measured using Purchasing Power Parity or PPP rates).[4] On either comparison China is a significant player in the world economy (it is also the world's largest

[4] PPP rates are used to equate the cost of a 'typical' basket of goods and services across countries, by adjusting for the fact that the price of non-traded items (such as haircuts) tend to differ significantly across countries. By attempting to correct for this, PPP-based measures award developing economies like China a much higher share in global GDP.

economy by population, home to one in five of the planet's inhabitants). But China's *relative* importance differs markedly in the two comparisons: the PPP-based measure cited here implies that China is a much more significant player in the world economy than does the MER-based one: on the former basis the US economy is a little more than one and a half times bigger than the Chinese one, for example, while on the latter it is about seven times larger.

Which comparison better captures the underlying reality? We don't seem to have a consensus on this. For example, in a recent IMF survey on the global implications of Chinese growth, the authors argue that when the focus is on China's impact on other countries, then since that impact arises mainly through trade and other flows that are conducted at market exchange rates, MER-based comparisons are more appropriate.[5] In contrast, Ian Castles and David Henderson have recently made a strong case that the *only* appropriate way to compare GDP across countries is to use PPP rates.[6]

The second question relates to the choice of appropriate comparator economies. On PPP-based measures of *total* GDP, for example, it makes sense to compare the world's second largest economy with its largest, the United States. But a look at gross national income (GNI) per capita reminds us that China is still a relatively poor economy (ranked 116th in the world using PPP rates) and hence the relevant comparator may be other developing economies (here I've chosen India as my second comparator since it is the world's other billion-people-plus economy).

What about the relationship between Chinese and world growth? Given the size of Chinese GDP and a real GDP growth rate running at an average of more than 9%pa for the past two decades, it is not surprising that China has now become an increasingly important determinant of world growth prospects. Simple back-of-the envelope calculations (using IMF data and based on PPP weights) show that China accounted for around 28% of total world GDP growth in 2003, and about 24% last year. By way of comparison, the US accounted for around 16% and 18% respectively. (Using MERs would reverse the relative degrees of magnitude.)

China's growth performance has been powered in large part by the transfer of previously underemployed labour from the rural sector to the modern sector. With this labour transfer

[5] See footnote 18 in International Monetary Fund, The global implications of the US fiscal deficit and of China's growth, in *World Economic Outlook April 2004.* Washington DC, International Monetary Fund, 2004.

[6] Ian Castles and David Henderson, International comparisons of GDP: issues of theory and practice. *World Economics* 6 (1) 2005.

taking place at an annual rate of around 20 million, the process has been likened to the addition of a medium-sized emerging market economy to the world economy every year.[7]

Thus one basic conclusion that we can draw is that an economically successful China has been good news for world economic growth. This is of course what we would expect, since the international integration of an increasingly efficient Chinese economy should augment global supply and boost the world economy's potential growth rate.

Sustained, rapid rates of economic growth will obviously have implications for China's share of world output over time. This chart attempts to take a long term perspective on this, drawing on historical estimates constructed by Angus Maddison.[8] According to Maddison, China accounted for roughly one third of world output in 1820 (based on PPP-measures). By 1950 that share had fallen to about 4½% of world GDP, before climbing back to more than 12% by 2001.

Looking ahead, most projections see China's share of world output continuing to climb. Here for example I show some *very* simplistic projections for 2010 that key off past growth trends and assume no change in performance. These suggest that China's share of world output

[7] Barry Eichengreen, Yeongseop Rhee and Hui Tong, *The impact of China on the exports of other Asian countries*. NBER Working Paper No. 107682004.
[8] Angus Maddison, *The world economy: historical statistics*. Development Centre Studies. Paris, OECD, 2003.

could have risen to more than 17% by the end of the decade, with the prospect of China overtaking the United States some time in the following decade.[9] Note however that in per capita terms, China would still remain a much poorer economy than the United States.

The basic message here then is that on its current trajectory the world economy is set to see a return to a major role for China: what we are currently seeing is not so much China's *emergence* as a major economic power as China's *re-emergence*.

(2) China and world trade

One of the most important ways in which China is exerting an influence on the world economy today is through its participation in international trade. The next table presents data on world trade showing that China last year accounted for around 6% of world merchandise trade flows, making it the world's third largest importer and exporter of goods.

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Comparisons: trade in goods and services

(2004)	**China**	US	India
Merchandise exports	**US$593b**	US$819b	US$73b
% of world total (rank)	**6.5% (#3)**	9.0% (#2)	0.8%
Merchandise imports	**US$561b**	US$1,526b	US$95b
% of world total (rank)	**5.9% (#3)**	16.1% (#1)	1.0%
Comm. services exports	**US$60b**	US$319b	US$32b
% of world total (rank)	**2.8% (#9)**	15.2% (#1)	1.5%
Comm. services imports	**US$70b**	US$259b	US$38b
% of world total (rank)	**3.3% (#8)**	12.4% (#1)	1.8% (#15)

Sources: WTO World Trade Report 2005. Rank reported for top 20 economies only

China's share of world merchandise exports has jumped from less than 1% in 1980 to around 6½% by last year, while its share of merchandise imports has increased from 1% to almost

[9] Projections based on consensus growth forecasts applied to PPP-weighted GDP give a similar result. Forecasts based on MERs would show China taking longer to become the world's largest economy. For example economists at Goldman Sachs have estimated that this would occur sometime after 2040. See Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: the path to 2050*. Goldman Sachs Global Economics Paper No.99, 2003. Most of these sorts of forecasts assume a kind of 'business as usual' outlook, and assume no role for serious economic or political shocks.

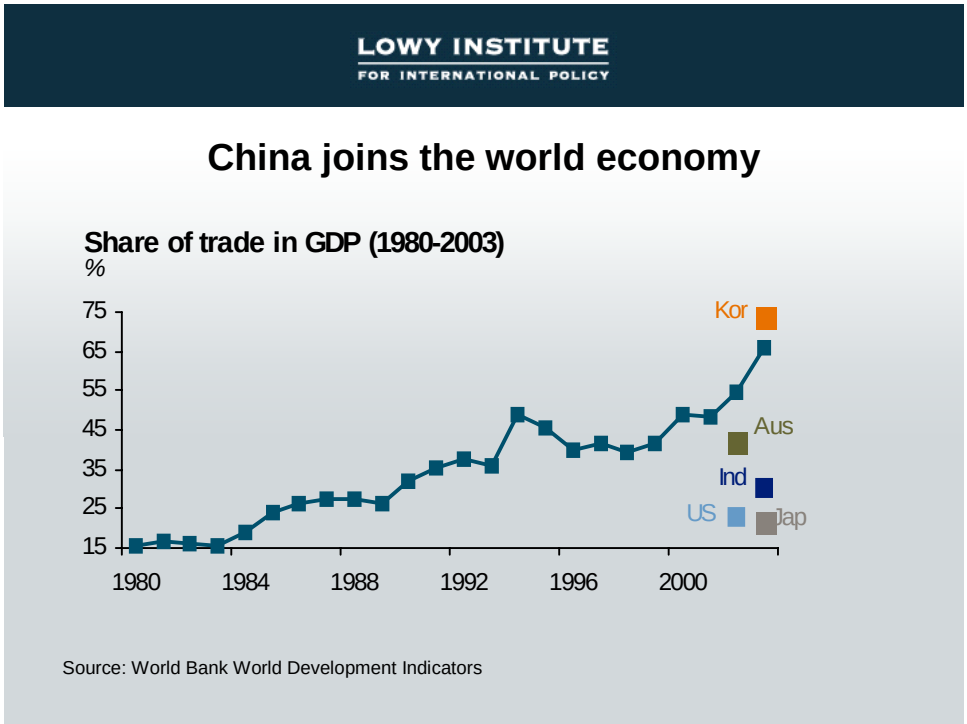
6% over the same period. This rapid growth in market share is in turn a product of strong export and import growth: during most of the second half of the 1990s for example, China's merchandise exports grew at twice the pace of world export growth.

In fact, since 2000 China has been the single most important country contributor to the growth in world trade: in 2003 China accounted for roughly 12% of the growth in world exports by value and for about 11% in 2004 (for the United States the figures are roughly 3% and 6%, respectively).

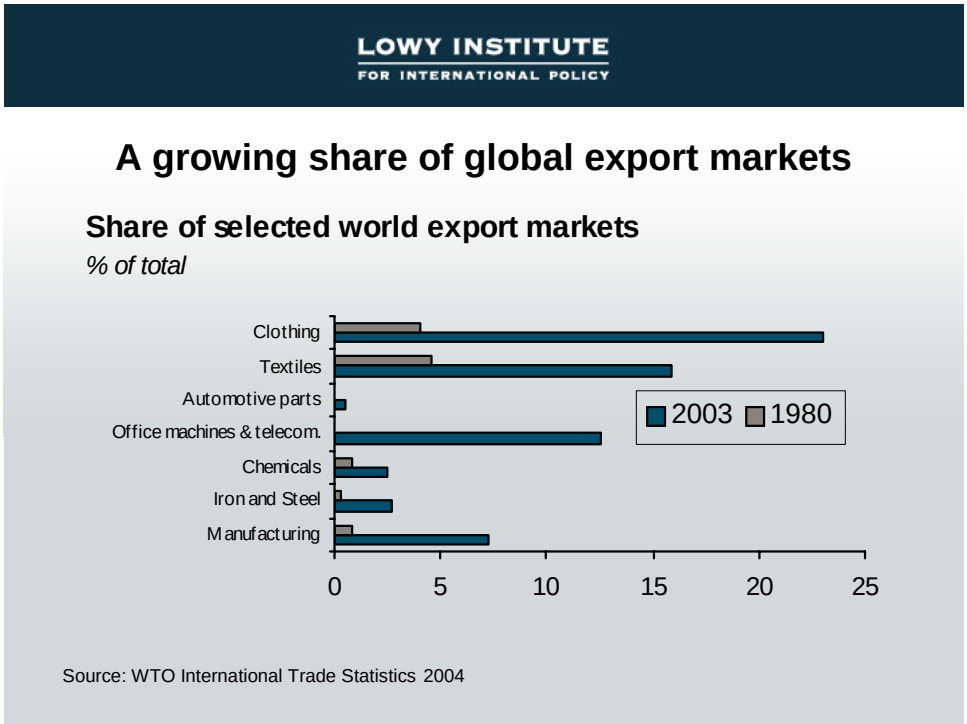
This growing share of world markets is in turn a reflection of steadily rising integration with the world economy. Thus the share of trade (export and imports of goods and services) in Chinese GDP rose from around 15% in 1980 to more than 30% by 1990, and to 66% by 2003. This makes China a much more open economy than (say) the United States (23%), Japan (22%) or India (31% of GDP).

The ratio of trade to GDP is a measure of outcomes, and is influenced by several factors including geography and size. Policy indicators also confirm this story of rising integration: for example, the simple unweighted average tariff for China in 1982 was about 56%; by 1992 this had fallen to 43%, and by 2002 was down to 12%.[10]

[10] Table 2.8 in International Monetary Fund, The global implications of the US fiscal deficit and of China's growth.



China's growing role in international trade has been concentrated in manufacturing: according to WTO statistics, from accounting for less than 1% of world manufactured exports in 1980, China's share had risen to more than 7% by 2003.



In the same year, China accounted for 23% of world clothing exports and 16% of world textile exports. China's competitiveness in this sector has been particularly evident in the surge in textile exports at the start of this year into markets previously protected by ATC quotas.[11] While this dominance of labour-intensive (relatively) low-skill production is not surprising – it reflects the powerful comparative advantage conferred by a large, low-cost supply of labour – China is also an increasingly important player in exports of electronics and machinery, accounting for example for almost 13% of world exports of office machines and telecommunications equipment in 2003. Indeed, last year exports of machinery and electrical equipment were relatively more important to China than exports of textiles, with the former contributing over 40% of total export growth in 2004, as against about 7% for the latter.[12]

China now has a key position in international and regional production chains, where in many cases its role is that of host for the final assembly stage of production. This in turn is visible in the pattern of exports and imports. Thus in 2003 the share of manufactures had risen to more than 92% of merchandise exports, with one category (machinery and transport equipment) comprising about 43% of the total, while on the import side, some 82% of Chinese imports were also manufactures with the largest single component (47% of total merchandise imports) again transport and machinery. Interestingly, recent data show a steady improvement in China's trade balance in the transport and machinery sector, indicating that an increasing number of components are now in fact being sourced from domestic suppliers.[13]

One implication of China's growing market presence is downward pressure on prices / margins in those products in which China has a comparative advantage. This of course is good news for consumers of those products, but bad news for rival producers. Since China's comparative advantage is in labour-intensive manufacturing, this suggests that it will be other emerging markets that will most feel the brunt of this competitive pressure. For example, most empirical studies have suggested that winners from China's greater presence in world markets will be advanced economy consumers of Chinese products, while losers will be those countries that compete in products such as clothing and textiles (particularly in South and South East Asia).[14] The chart showing the different trajectories of US manufactured import

[11] For example, increases in imports from China to the EU reportedly ranged from 51% to 534% in the first months of 2005 across nine categories of textiles. Some categories in the United States reportedly saw four-digit growth rates.

[12] This trend has continued into 2005, with for example exports of Notebook PCs alone rising by 66%pa in the first four months, contributing 6% of total export growth. Data from Ben Simpfendorfer, China: economic consequences of a trade war. *JP Morgan Global Data Watch 3 June* 2005.

[13] World Bank, *China quarterly update April 2005*, World Bank Office, Beijing, 2005.

[14] Thus a series of econometric studies have looked at the implications for the rest of the world of China's accession to the WTO. These have tended to conclude that the result will benefit both China and the world economy overall, but may entail welfare losses for some developing countries (for

prices for industrial (advanced) economies and other economies is consistent with this kind of story.

What about the implications for aggregate prices? Some have argued that by keeping manufactured prices low, China has contributed to worldwide low inflation.[15] There may well be some truth to this. However, the downward pressure on (some) manufacturing prices provided by Chinse exports has to be set against the upward pressure on the prices of energy and other resources generated by Chinese *import* demand.

China is an increasingly important consumer – and importer – of several commodities, having displaced the United States as the world's largest market for copper, iron ore, aluminium, and platinum.[16] For example, in the case of copper (the price of which has recently reached 16-

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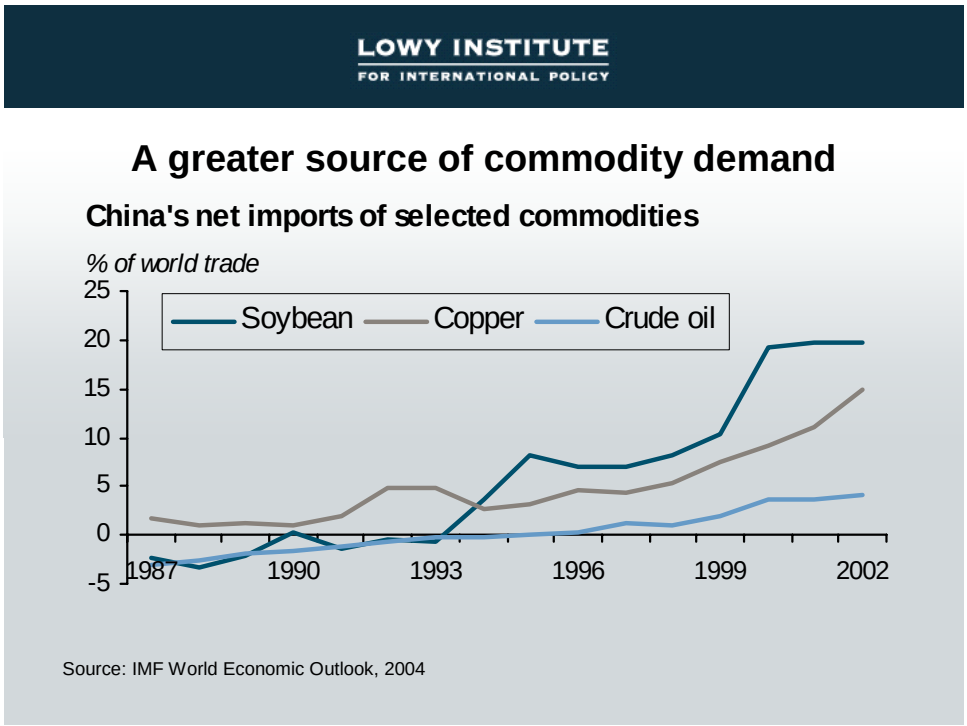
example in South and Southeast Asia) that compete with China in third markets in sectors such as textiles. See for example Elena Ianchovichina and William J Martin, *Economic impacts of China's accession to the WTO*. World Bank Policy Research Working Paper 3053. Washington DC, World Bank, 2003. Also Elena Ianchovichina, Sethaput Suthiwart-Narueput and Min Zao, Regional impact of China's accession to the WTO, in *East Asia integrates: a trade policy agenda for shared growth*. ed. Kathie Krumm and Homi Kharas. Washington DC, World Bank, 2004.

[15] The case that China has contributed to low inflation is made for example in The Economist, From T-shirts to T-bonds: China and the world economy. *The Economist*, 28 July 2005. Some evidence suggests that (at least until recently) any impact has probably been quite modest. See Steven B Kamin, Mario Marazzi and John W Schindler, *Is China "exporting deflation"?* International Finance Discussion Papers Number 791. Washington, DC, Board of Governors of the Federal Reserve System, 2004.

[16] David Hale, China's growing appetites. *The National Interest* Summer 2004.

year highs) China's share of world trade jumped from less than 1% in 1990 to 15% by 2003. And while China's share in world metals demand overall is roughly 19%, its role in generating demand at the margin is much greater: China is estimated to have accounted for almost half of *additional* metals demand in 2004.[17]



This growing presence in international commodity markets has been particularly evident in energy markets, where China is now the world's second largest consumer. In the case of oil, for example, while China's share in world demand is still relatively modest (at around 8% - still enough to make it the world's second largest consumer after the United States (25%)) China contributed to just over one-third of the global growth in oil consumption last year, and has been an important factor in the current run-up in world oil prices.[18]

In other words, the price pressures are not all one way, with China's impact being felt most strongly in terms of shifting *relative* prices, rather than changes to the overall 'world' price level.[19]

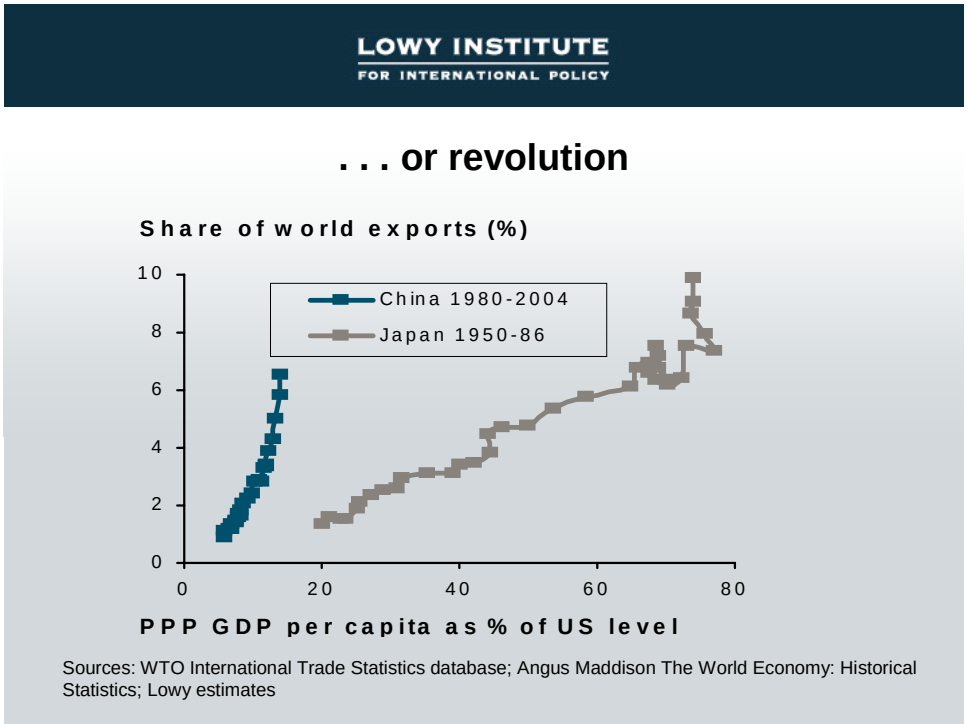
How much further does China's penetration of world markets have to run? Comparisons with the past experience of other East Asian economies such as Japan suggest that the potential for continued expansion of trade remains substantial. For example, for much of the past two

[17] World Bank, *China quarterly update April 2005*.
[18] Calculations based on data from BP, *Statistical Review of World Energy 2005*, BP, 2005.
[19] These shifts in relative prices are visible in China's own terms of trade, which fell 5% last year.

decades China's share of world exports has been below that achieved by Japan during its integration process, and is only now catching up.

But is China's integration experience more likely to be revolutionary than a replay of the Japanese story? One obvious difference between these two integration experiences is the relative income level at which they have taken place. Thus Japan started *its* post-World War Two integration process with a level of GDP per capita roughly 20% that of the United States (measured in PPP terms). Then, by the time Japan's share of world exports had reached the 6-7% range, Japan's GDP per capita had climbed to roughly two-thirds that of the US level. In contrast, China began its integration process with a GDP per capita of around 5% of the US level, and was still at less than 15% (below Japan's starting point) when it reached the same 6-7% range last year. This much bigger gap between leader and follower implies that the scope for further 'catch-up' growth remains substantial.

A second obvious difference is scale. China's share of world population is far higher than Japan's, and the scale of the resulting global supply shock is therefore likely to turn out to be much bigger. For example, China's population is almost four and half times larger than that of the United States, while its labour force is roughly five times bigger: at the comparable stage in Japan's penetration of world export markets, Japan's population and labour force were closer to half US levels.



(3) China and world financial markets

Along with trade, the other major channel through which China's influence is exerted on the global economy is financial flows.

China received net capital inflows of around US$135b last year, making it one of the largest emerging market recipients of private capital. The World Bank estimates that China was the recipient of roughly one-third of all net FDI inflows to developing countries in 2004, and of 90% of such inflows to East Asia and the Pacific. Similarly, China received about 40% of all net portfolio investment inflows to developing countries last year.[20] Still, as a share of GDP China's share of international capital flows has broadly been in line with that enjoyed by other East Asian economies during their integration process.[21]

Until very recently, much of the international focus has been on China as an *importer* of capital in general, and an importer of FDI in particular. Estimates by UNCTAD show China attracting almost 10% of worldwide FDI inflows last year, in second place only to the United States (after having been briefly in pole position in 2003). According to UNCTAD, the stock of inward FDI in China now exceeds US$500b.

[20] World Bank, *Global Development Finance 2005: Mobilizing Finance and Managing Vulnerability.* Washington DC, World Bank, 2005.
[21] International Monetary Fund, The global implications of the US fiscal deficit and of China's growth.

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Comparisons: foreign direct investment

(2003)	**China**	US	India
FDI (inward flow, 2004e)	**US$62b**	US$121b	US$6b
% of world total	**9.6%**	19.8%	1.0%
FDI (inward stock)	**US$501.5b**	US$1,534b	US$30.8b
% of world total	**6.1%**	18.6%	0.4%
FDI (outward flow)	**US$1.8b**	US$151.9b	US$0.9b
% of world total	**0.3%**	24.8%	0.1%
FDI (outward stock)	**US$37b**	US$2,069b	US$5.1b
% of world total	**0.5%**	25.2%	0.1%

Sources: UNCTAD World Investment Report (2004); UNCTAD press release for 2004 inward flow estimate.

This stock of FDI has played a central role in the Chinese export (and import) story. For example, according to the Ministry of Commerce, the share of exports produced by so-called foreign-invested enterprises has risen from 2% in 1986 to 41% in 1996 to 57% in 2004.

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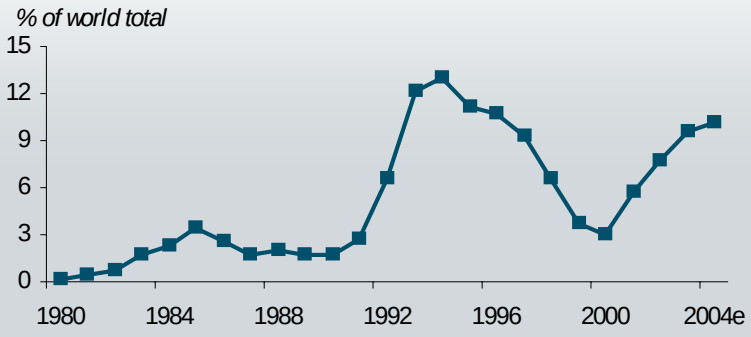
A dragon's share of world FDI

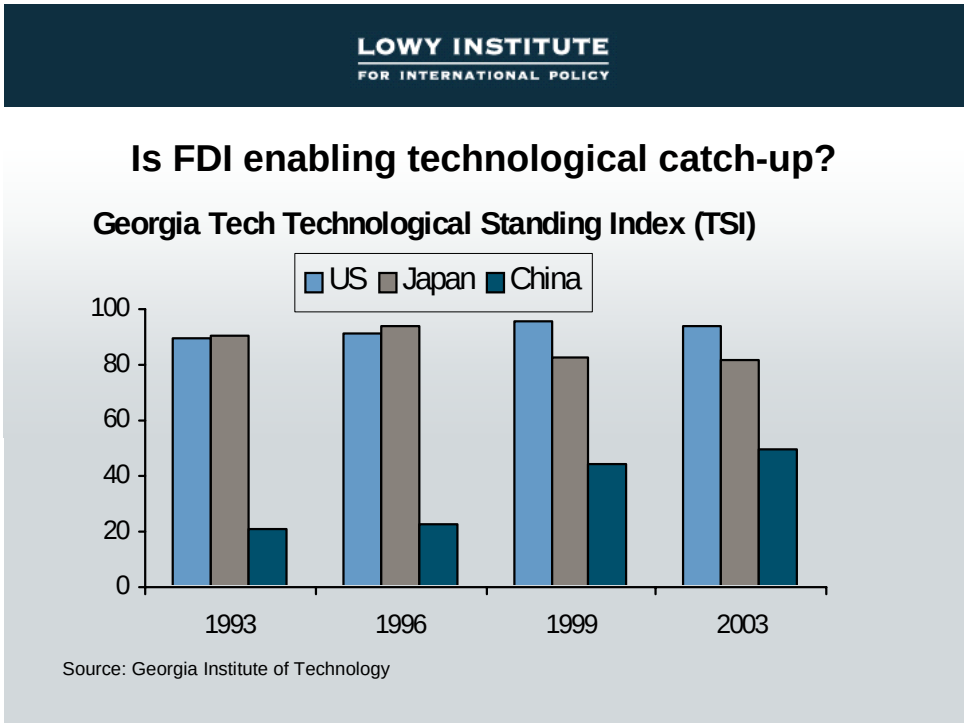
China: foreign direct investment inflows



Source: UNCTAD World Investment Report (2004): UNCTAD press release for 2004e

In contrast to its role as an importer of capital, China's role as a *source* of overseas direct investment remains small, although the amount of attention devoted to the recently aborted CNOOC bid for Unocal, for example, suggests that this is likely to become a more noteworthy issue in the future.[22]

An interesting issue here is the extent to which FDI (along with improvements in communications technology and the spread of globalisation more generally) is reducing the time taken for technology to diffuse across the world economy, and hence for developing economies to 'catch up' with the technological frontier. One attempt to measure relative standings is the Georgia Tech Technological Standing Index (TSI) which combines statistical data (the value of high tech exports and electronics exports) with survey evidence. This particular indicator suggests that over the past decade China has been able to close the gap with the industrialised countries, but also that the gap remains quite substantial.



Some China-watchers however have suggested that talk of Chinese technological catchup with the rest of the world is overdone. George Gilboy for example has argued that China still remains technologically dependent on the advanced economies, and that there is little

[22] China is of course already a significant portfolio investor in the United States in the form of purchases of US government paper.

evidence that the skills and technology used by foreign ventures is having major spillover effects into the rest of the economy. [23]

A second FDI-related issue is the extent to which China's success in attracting inward FDI may have crowded out flows to other emerging markets. For example, it has been argued that a proportion of the FDI inflows formerly heading into the Mexican *maquiladora* sector have been diverted to China.[24] Similarly, there have been suggestions that the flow of Japanese FDI has shifted from ASEAN economies to China. Alternatively, however, there is also the possibility that some FDI in China is *complementary* with investment in other regional economies, reflecting the expansion of regional supply chains.[25]

Finally, the *other* capital account development that has received a lot of attention is China's accumulation of foreign exchange reserves, which have risen from just US$2½b (or less than 1% of the world total) in 1980 to US$614½b (about 16% of the world total) by the end of last year, after increasing by more than US$200b over the course of 2004 alone. As of June this

[23] George J Gilboy, The myth behind China's miracle. *Foreign Affairs* (July/August) 2004.
[24] United Nations Conference on Trade and Development, *World investment report 2004: The shift towards services*. New York, United Nations, 2004.
[25] Eichengreen and Tong find that Chinese FDI is complementary (in aggregate) with FDI in other regional economies, but also that there is some evidence of FDI diversion from advanced economy recipients. Barry Eichengreen and Hui Tong, *Is China's FDI coming at the expense of other countries?* NBER Working Paper No. 11335, May 2005.

year China's reserves stood at well over US$700b, making it the second largest holder of reserves in the world, after Japan.

This reserve accumulation reflects the fact that for most of its process of economic integration with the rest of the world, China has been running current account surpluses, including a series of consecutive trade surpluses since 1994.[26] It is also a product of recent large scale capital inflows, including speculative bets on China's exchange rate policy. And of course rapid reserve accumulation has been a result of Beijing's increasingly controversial fixed exchange rate policy – a policy whose recent change has already generated a huge amount of analysis.

Indeed the sheer scale of the attention that has been focused on the future path of Beijing's RMB policy, whether it be by international policymakers such as the G7 and the IMF, by national politicians in other countries (for example the Schumer bill in Washington[27]) or by financial markets, represents a clear indicator of the importance which the rest of the world economy now attaches to China. As such, it is perhaps an appropriate point on which to conclude this brief survey of China's influence on output, trade and financial flows.

Conclusion

So what do all these trends mean for the world economy?

China's rising share of world output – and of global markets – is part of a general shift in the geographic distribution of economic weight in the world economy back to Asia (from whence it departed in the nineteenth century). This in turn will have consequences for the structure of the international economic architecture. Some of these will be felt at the international and multilateral level, where China in particular, and Asia in general, will expect to have a greater presence and a bigger say in the various committees and institutions that seek to manage and regulate the global economy. Others will be felt at the regional level: both the United States and the EU for example have surrounded themselves with a network of interlocking trade and political treaties that both reinforce and encourage economic ties. The same should be expected from China, a development that is already visible in the East Asian Summit and in the spread of regional preferential trade agreements involving Beijing.

[26] This is in contrast to the deficits that were run by many other East Asian economies during their integration processes. IMF (2004).
[27] US Senators Charles Schumer and Lindsey Graham co-sponsored a bill that would impose a 27½% tariff on Chinese imports if Beijing did not revalue the RMB.

China's success in world markets will also have implications for the economic strategies pursued by other developing economies. Thus, all else being equal, by boosting the supply of unskilled labour in the world economy, China is likely to have lowered relative returns to such labour. Low-skill workers in low and middle income developing countries look to be the most vulnerable to these trends, which may also call into question the development models pursued by some of these economies.[28] The debates over whether Chinese trade flows and investment demand 'crowds out' or 'crowds in' other economies is clearly central here.

Finally, there will also be implications for developed economies. One interesting question here is whether China's effect on global relative returns to labour is limited to unskilled labour, or whether there is a broader effect at work; that is, whether by boosting the overall supply of world labour (skilled *and* unskilled) China has contributed to a general shift in favour of capital over labour (boosting profits relative to wages) with implications for income distribution at a worldwide level.[29] If such an effect is in operation, then it may have important implications for richer countries' commitment to international economic integration in general, and to liberal trading regimes in particular.

[28] See for example *Competition and the fallacy of composition* Chapter IV in United Nations Conference on Trade and Development, *Trade and development report, 2002*. Geneva, United Nations, 2002.

[29] See Richard B Freeman. *Doubling the global work force: the challenge of integrating China, India and the Former Soviet Bloc into the world economy*. Institute for International Economics 2004.

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About the Author

Mark Thirlwell is Program Director, International Economy at the Lowy Institute for International Policy. Mark is a graduate of Cambridge University and has an MPhil degree in economics from Oxford University. Before joining the Institute, Mark worked as an economist for the Bank of England, JP Morgan and the Australian Export Finance and Insurance Corporation.

He is the author of the Lowy Institute Paper ***India: the next economic giant.***

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