Playing leapfrog

If today's rich world does not watch out, it could become tomorrow's relatively poor world

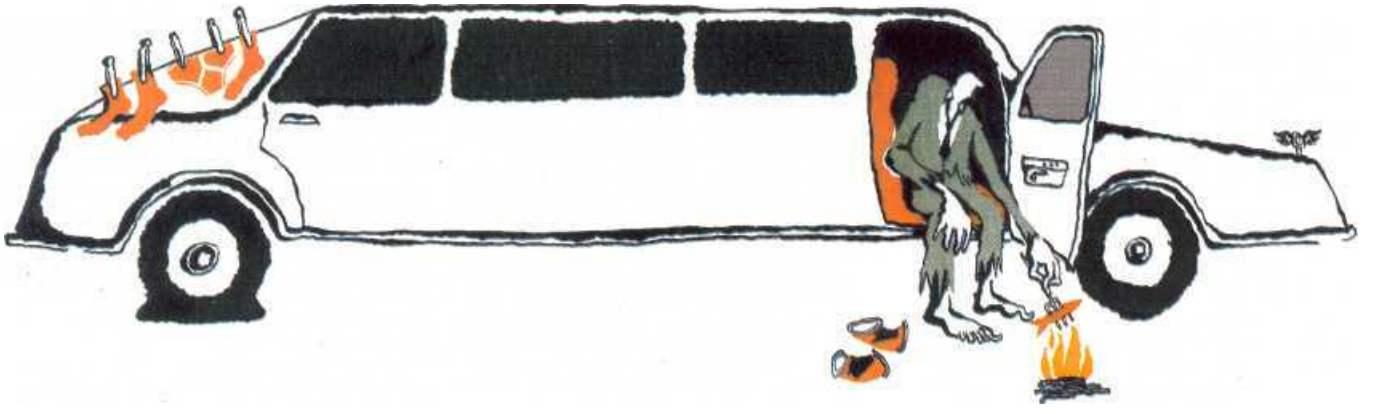
ALEXIS DE TOCQUEVILLE once observed that the French hate anybody who is superior, and the English like to have inferiors to look down upon. These two nations were long ago knocked off their pedestals. Now it is the Americans who fret about losing their economic supremacy. If China continues with its reforms, one day it will become the world's biggest economy. Should America care?

Being the biggest economy has its attractions. It helps to provide military security and gives a country more clout in global economic affairs. Being the main reserve currency is also useful. America's ability to borrow and to settle its imports in dollars has saved it from paying more interest to finance its profligate ways.

However, remaining number one cannot be an end in itself. The goal of economic policy should be to improve living standards, which depend on a country's absolute, not relative, rate of growth. Indeed, an obsession with remaining number one could lead America to adopt policies that are likely to hasten the day China pulls ahead. Trade barriers, subsidies and restrictions on offshoring merely shield inefficient firms that need to become more productive if America is to thrive.

If rich economies raise import barriers in the misguided belief that they will protect Western living standards, they could destroy the main source of wealth-creation in the list century. They could also deny better living standards to hundreds of millions of people in the developing world. It is rich countries' fear of emerging economies' success, not that success itself, that is the real danger to the world economy. It would be ironic if the triumph of free trade and market economics in the emerging economies were to turn the rich world more protectionist and interventionist. If they continued down that path, today's rich countries might even end up as tomorrow's (relatively) poor ones.

That might sound far-fetched, yet



• China, once the world's technological leader, provides a sobering lesson on how economies can slide down the international league table. In the 18th century it was the world's biggest economy, with a GDP seven times as large as Britain's. But it kept its doors closed to foreign goods, so it was left behind by the industrial revolution and the explosion in global trade.

In 1793 Lord George Macartney was sent to Peking by King George III to establish a permanent British presence and open up trade relations with China. But the Chinese emperor Qianlong informed his visitor that "we have not the slightest need of your country's manufactures." China's economic isolation was to last for almost another 200 years, during which real incomes fell. By 1950 China's GDP per person had shrunk by a quarter compared with Lord Macartney's day; Britain's had risen fivefold.

In America today the drumbeat of protectionism is getting louder. As this survey has argued, that is because although globalisation benefits economies as a whole, the gains are unevenly distributed, and the costs-job losses and lower wages—are much more visible than the wider benefits to consumers generally. Workers tend to be better organised and more vocal than consumers.

In recent years, as profits have surged, most workers' real incomes have been flat or even falling; only those near the top of the tree have enjoyed big pay rises. Globalisation has shifted the balance of power against workers and in favour of companies. But unless ordinary folk are seen to share in the gains from globalisation, there will be growing demands for import barriers or much higher taxes on booming company profits.

The trouble is that, in a globalised economy, policies aimed at fleecing companies will fail to spread the rewards more widely. Firms will simply move to a more congenial environment. The best way to boost national economic prosperity is to make labour and product markets work more efficiently, speed up the shift of jobs from old industries to better-paying new ones, and improve education and training to prepare workers for tomorrow's jobs.

But that may not be enough. Governments may need to tackle sluggish wage growth and increased inequality more directly. Rich economies as a whole gain from the new wealth of emerging ones, so governments have ample scope to compensate the losers, but they rarely do. Yet there may be a case for helping out those who lose their jobs or have to manage on lower pay in order to ensure continued political support for free trade. The challenge for governments is to find ways to share out the fruits of globalisation more fairly without undermining the economy's ability to reap the benefits.

Shifts in economic power tend to be associated with disruptions, in the world economy, and are rarely smooth. The globalisation that followed the industrial revolution was brought to an end by two world wars, high protectionist barriers and the Great Depression. Now the rise in emerging economies is once again altering power relations among states and creating new geopolitical risks. This new revolution, too, is bound to bring forth its share of disagreements.

How should the world's policymakers respond to the developing world's growing economic power? Big emerging economies will need to be given a larger stake in the smooth running of the world economy. As the world's fourth-biggest economy in dollar terms (and second-biggest at PPP), China should be a full member of all international economic policy forums, such as the 07 and the OECD. Yet these organisations remain firmly in the hands of the old rich economies. How can governments sensibly talk about pressing issues such as global imbalances or energy prices without China being present? The G? should be pruned to a 04, consisting of America, Japan, the euro area and China; and the status of the 020, which already includes emerging as well as advanced countries, should be elevated.

IMF members meeting in Singapore this month are expected to agree to give more votes on the organisation's board to some of the bigger emerging economies, in recognition of their growing weight in the world. Several developing countries, especially in Asia, are hugely underrepresented, whereas rich'European economies are overrepresented. China currently has only 3% of the total vote, not much more than Belgium (with 2.2%), even though China's economy is seven times larger at market exchange rates and a lot bigger still at purchasing-power parity.

America v Europe

Which developed economies will gain most from the emerging economies' new economic muscle? Conventional wisdom has it that America's economy is coping much better than Europe's with competition from emerging economies, thanks to its flexible labour and product markets. According to this view of the world, Europe is having a tough time dealing with globalisation, burdened by high minimum wages, extensive job protection, high taxes and generous welfare benefits. Many people blame the euro area's sluggish growth in output and jobs in recent years on its loss of global competitiveness.

But conventional wisdom may have got it wrong. Since 1997 employment in the euro area has grown slightly faster than in America. Over the past decade, European firms have been much more successful than America in holding down unit labour costs and thus remaining competitive. And since 2000 the euro area's share of world export markets has risen slightly, to

• 17%, whereas America's share has slumped from 14% to 10%. Thus, by many measures of competitiveness, Europe appears to be coping better with the emerging economies than America.

The main reason why America's economy has been growing faster than Europe's is that sluggish real wages have been offset by large capital gains on homes, massive borrowing and an unsustainable fall in saving, all of which have boosted American household spending. If (when) house prices fall and consumers wake up to the fact that they are not saving enough, consumer spending will weaken perceptibly. Americans need to prepare for a recession or, at best, a prolonged period of below-trend growth.

In a few years' time, the relative economic fortunes..of America and the euro area could be reversed. A report by ixis, a French investment bank, suggests that Germany and Japan are much better placed to benefit from growth in emerging economies than America or Britain. Germany and Japan export 7-9% of their GDP to emerging economies; the equivalent figure for America and Britain is only around 3% (see chart 16). France and Italy are somewhere in-between. The euro area's exports to emerging economies have grown by an annual average of 14% since 2000, twice as fast as America's.

A report by Goldman Sachs also finds that by some measures Europe has benefited more than America from trading with the BRICS. The bank concludes that Germany and France are set to enjoy big gains. Italy, Greece and Portugal are less well placed because the make-up of their exports is closer to that of the BRICS, so they will face head-on competition.

For globalisation to benefit economies, resources must be reallocated towards higher-value-added goods and services. So to reap the full gains, Europe must urgently push ahead with making its markets more flexible and open. A study by the European Commission concludes that, if the European Union were fully to embrace the rise of China and India, its GDP per person by 2050 could be up to 8% higher than it would otherwise have been, implying a boost to average annual growth of 0.2% over the period. If, on the other hand, EU countries lurch towards more protectionist policies, GDP per head could be 5% lower than in the base case.

Japanese firms and workers have even less reason than American and European ones to fear China's economic might. Japan has been a major beneficiary of re-

gional integration in Asia, and China is likely to overtake America as Japan's biggest trade partner by the end of this year. Japanese firms have invested heavily in China, shipping capital-intensive components there to be processed and assembled by cheap labour before being re-exported. Exports to China have played a big part in Japan's export growth in recent years, helping to spur its economic recovery. A survey by the Nihon *Keizai Shimbun* found that most big Japanese firms think a large appreciation of the yuan would not be in their interest because they have moved so much of their production to China.

Coining of age

The fact that people in rich countries are fretting about the emerging economies' success, rather than just their poverty, is itself a remarkable tribute to the progress those economies have made. Poverty in the third world is still rife, but rising incomes there should be welcomed by all. As long as they continue on their path of reform, there is an excellent chance that their rapid expansion can be sustained for several more decades.

China and India offer immense opportunities, but they also bring new risks. If these economies stumble, or even if they simply decide to sell their American Treasury bonds, the world will certainly notice. Because of the emerging economies' increased economic weight, a crisis there would have a much bigger impact on the global economy than formerly.

It is important to keep a sense of perspective. America still remains the world's biggest manufacturer, some way ahead of China. On visiting Beijing and Shanghai, many foreigners conclude that China is already a wealthy economy, yet China and India have more poor people than Africa does. Conversely, sceptics who try to downplay the importance of China and India underestimate the huge adjustments that lie ahead. China's vast labour force and its unusual openness to trade mean that its global impact is bound to increase. One day it will regain its place as the world's largest economy. And China is only one among scores of emerging economies that look set to prosper.

When your correspondent started as a journalist at The Economist is 1985, the world economy she was writing about consisted largely of the G7 economies. Twenty-one years later the emerging economies have come of age. To understand the world economy, it is now necessary to understand and track the new world, especially Asia. That is why this correspondent is about to move herself and her economic toolkit from London to Hong Kong. •

Fonte: The Economist, v.380, n.8495, p.26-28, 16 Sept. 2006.