

## A game of catch-up

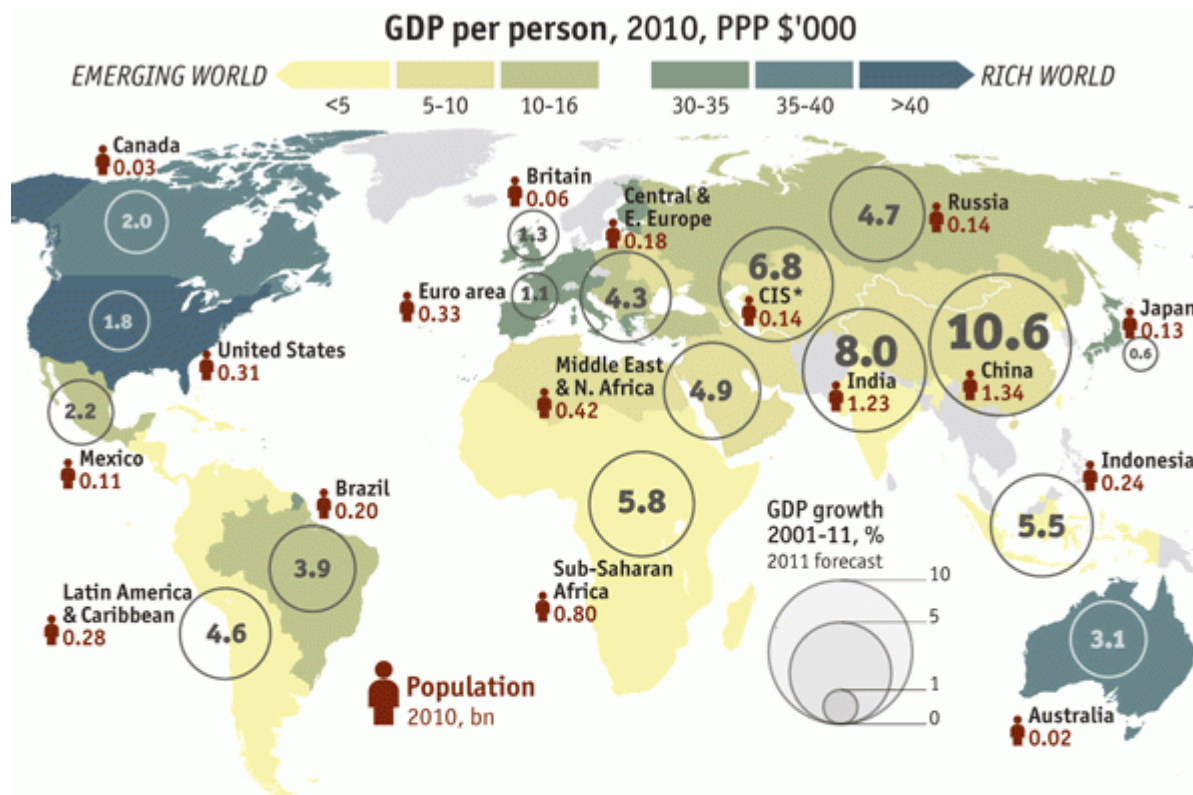
**The shift in economic power from West to East is accelerating, says John O’Sullivan. The rich world will lose some of its privileges**

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QUARRY BANK MILL is a handsome five-storey brick building set in the valley of the river Bollin at Styal, a small English village a few miles south of Manchester. It was built in 1784 by Samuel Greg, a merchant, who found profit in supplying cotton thread to Lancashire’s weavers. The raw cotton shipped from America’s slave plantations was processed on the latest machinery, Richard Arkwright’s water frame. Later Greg extended the factory and installed coal-fired steam engines to add to the water power from the Bollin. All this gave a huge boost to productivity. In 1700 a spinster with a pedal-driven spinning wheel might take 200 hours to produce a pound of yarn. By the 1820s it would take her around an hour.

Greg’s mill was part of a revolution in industry that would profoundly alter the world’s pecking order. The new technologies—labour-saving inventions, factory production, engines powered by fossil fuels—spread to other parts of western Europe and later to America. The early industrialisers (along with a few late developers, such as Japan) were able to lock in and build on their lead in technology and living standards.

The “great divergence” between the West and the rest lasted for two centuries. The mill at Styal, once one of the world’s largest, has become a museum. A few looms, powered by the mill’s water wheel, still produce tea towels for the gift shop, but cotton production has long since moved abroad in search of low wages. Now another historic change is shaking up the global hierarchy. A “great convergence” in living standards is under way as poorer countries speedily adopt the technology, know-how and policies that made the West rich. China and India are the biggest and fastest-growing of the catch-up countries, but the emerging-market boom has spread to embrace Latin America and Africa, too.



Sources: IMF; UN; *The Economist*

\*Commonwealth of Independent States

And the pace of convergence is increasing. Debt-ridden rich countries such as America have seen scant growth since the financial crisis. The emerging economies, having escaped the carnage with only a few cuts and grazes, have spent much of the past year trying to check their economic booms. The IMF forecasts that emerging economies as a whole will grow by around four percentage points more than the rich world both this year and next. If the fund is proved right, by 2013 emerging markets (on the IMF's definition) will produce more than half of global output, measured at purchasing-power parity (PPP).

One sign of a shift in economic power is that investors expect trouble in rich countries but seem confident that crises in emerging markets will not recur. Many see the rich world as old, debt-ridden and out of ideas compared with the young, zestful and high-saving emerging markets. The truth is more complex. One reason

why emerging-market companies are keen for a foothold in rich countries is that the business climate there is far friendlier than at home. But the recent succession of financial blow-ups in the rich world makes it seem more crisis-prone.

The American subprime mess that turned into a financial disaster had the hallmarks of a developing-world crisis: large capital inflows channelled by poorly regulated banks to marginal borrowers to finance a property boom. The speed at which bond investors turned on Greece, Ireland and then Portugal was reminiscent of a run on an overborrowed emerging economy.

Because there is as yet no reliable and liquid bond market in the emerging world to flee to, scared investors put their money into US Treasury bonds and a few other rich-country havens instead. So few are the options that even a ratings downgrade of American government debt in August spurred buying of the derided Treasuries. Indeed the thirst in emerging markets for such safe and liquid securities is one of the deeper causes of the series of crises that has afflicted the rich world. Developing countries bought rich-world government bonds (stored as currency reserves) as insurance against future crises. Those purchases pushed down long-term interest rates, helping to stoke a boom in private and public credit.

Today's faltering GDP growth is a hangover from that boom and adds to the sense of malaise in the rich world. Many households in America, Britain and elsewhere have taken to saving hard to reduce their debts. Those with spare cash, including companies, are clinging on to it as a hedge against an uncertain future. A new breed of emerging-market multinational firms, used to a tough business climate at home, seem keener to invest in the rich world than most Western firms, which have lost their mojo.

### **Grandeur and decline**

People who grew up in America and western Europe have become used to the idea that the West dominates the world economy. In fact it is anomalous that a group of 30-odd countries with a small fraction of the world's population should be calling the shots. For most of human history economic power has been determined by demography. In 1700 the world's biggest economy (and leading cotton producer) was India, with a population of 165m, followed by China, with 138m. Britain's 8.6m people produced less than 3% of the world's output. Even in 1820, as the industrial revolution in Britain was gathering pace, the two Asian giants still accounted for half the world's GDP.

The spread of purpose-built manufactories like Quarry Bank Mill separated economic power and population, increasingly so as the West got richer. Being able to make a lot more stuff with fewer workers meant that even a small country could be a giant economic power. By 1870 the average income in Britain was six times

larger than in India or China. But by the eve of the first world war Britain's income per head had been overtaken by that of America, the 20th century's great power.

America remains the world's biggest economy, but that status is under threat from a resurgent China. With hindsight, its change in fortune can be traced to 1976, the year of America's bicentennial and the death of Mao Zedong. By then income per person in China had shrunk to just 5% of that in America, in part because of Mao's extreme industrial and social policies.

The average Indian was scarcely richer than the average Chinese. Both China and India had turned inward, cutting themselves off from the flow of ideas and goods that had made Japan and other less populous Asian economies richer. India's economy, like China's, was largely closed. Huge swathes of industry were protected from foreign competition by high import tariffs, leaving them moribund.

China was first to reverse course. In 1978 Deng Xiaoping won approval for a set of economic reforms that opened China to foreign trade, technology and investment. India's big liberalisation came a little later, in 1991. The GDP of China and India is many times bigger now than it was in the mid-1970s. In both economies annual growth of 8% or more is considered normal. Average living standards in China are still only a sixth and in India a fourteenth of those in America at PPP exchange rates, but the gap is already much smaller than it was and is closing fast.

Moreover, the great convergence has spread beyond India and China. Three-quarters of biggish non-oil-producing poor countries enjoyed faster growth in income per person than America in 2000-07, says Arvind Subramanian, of the Peterson Institute for International Economics, in his new book, "Eclipse: Living in the Shadow of China's Economic Dominance". This compares with 29% of such countries in 1960-2000. And those economies are catching up at a faster rate: average growth in GDP per person was 3.3 percentage points faster than America's growth rate in 2000-07, more than twice the difference in the previous four decades.

If emerging markets keep on growing three percentage points a year faster than America (a conservative estimate), they will account for two-thirds of the world's output by 2030, reckons Mr Subramanian. Today's four most populous emerging markets—China, India, Indonesia and Brazil—will make up two-fifths of global GDP, measured at PPP. The combined weight in the world economy of America and the European Union will shrink from more than a third to less than a quarter.

Economic catch-up is accelerating. Britain's economy doubled in size in the 32 years from 1830 to 1862 as increased productivity spread from cotton to other industries. America's GDP doubled in only 17 years as it overtook Britain in the 1870s. The economies of China and India have doubled within a decade.

This is cause for optimism. An Indian with a basic college education has access to world-class goods that his parents (who might have saved for decades for a sputtering scooter) could only have dreamed of buying. The recent leap in incomes is visible in Chinese cities, where the cars are new but the bicycles look ancient, and in the futuristic skyline of Shanghai's financial district.

China is still a fairly poor country but, by dint of its large population, it is already the world's second-largest economy measured in current dollars. It may overtake America as the world's leading economy within a decade (see [box](#)), a prospect that has given rise to many concerns in that country. More generally, there are worries about what the ascendancy of emerging markets would mean for jobs, pay and borrowing costs in the rich world.

The first worry is about direct competition for things that are in more or less fixed supply: geopolitical supremacy, the world's oil and raw materials, the status and perks that come with being the issuer of a trusted international currency. For most people, most of the time, their country's ranking in terms of military power is not a big issue. The emerging world's hunger for natural resources, on the other hand, has made rich-world consumers palpably worse off by pushing up the prices of oil and other commodities. The yuan's increased use beyond China's borders is a (still distant) threat to the dollar's central role in trade and international finance, but if the dollar were eventually shoved aside, it would make Americans poorer and raise the cost of their borrowing.

A second set of anxieties relates to job security and pay. Ever stronger trade links between rich and would-be rich countries will mean a reshuffle in the division of labour around the world, creating new jobs and destroying or displacing existing ones. Low-skilled manufacturing and middle-skilled service jobs that can be delivered electronically have been outsourced to cheaper suppliers in China, India and elsewhere (indeed, China is now rich enough to be vulnerable to losing jobs to Vietnam and Indonesia). The threat of outsourcing puts downward pressure on pay, though most American studies suggest that trade accounts for only a small part of the increase in wage inequality.

A third concern, which is at odds with the first two, is that the emerging markets are prone to crises that can cause a still-fragile world economy to stumble. Sluggish GDP growth in the rich world means developing countries have to fall back on internal spending, which in the past they have not managed well. It raises the risks of the overspending, excessive credit and inflation that have spurred past emerging-market crises. Even if crises are avoided, emerging markets are prone to sudden slowdowns as they become richer and the trick of shifting underemployed rural migrants to urban jobs becomes harder to repeat. The rapid growth rates of the recent past are unlikely to be sustained.

## **Status anxiety**

Few forecasters expect America to be a poorer place in ten or 20 years' time than it is now. The present may be grim, but eventually the hangover from the financial crisis will fade and unemployment will fall. What rich Western countries face is a relative economic decline, not an absolute fall in average living standards (though a few of their citizens may become worse off). That matters politically, because most people measure their well-being by how they are doing in relation to others rather than by their absolute level of income.

The effect of the loss of top-dog status on the well-being of the average American is unlikely to be trivial. Britain felt similar angst at the beginning of the 20th century, noting the rise of Germany, a military rival. It seemed stuck with old industries, such as textiles and iron, whereas Germany had advanced into fields such as electricals and chemicals. That Britain was still well off in absolute terms was scant consolation. The national mood contrasted starkly with the triumphalism of the mid-19th century, says Nicholas Crafts of Warwick University. A wave of protectionist sentiment challenged the free-trade consensus that had prevailed since 1846. It was seen off, but not before it had split the Tory party, which lost the 1906 election to the Liberals.

No country, or group of countries, stays on top forever. History and economic theory suggest that sooner or later others will catch up. But this special report will caution against relying on linear extrapolation from recent growth rates. Instead, it will suggest that the transfer of economic power from rich countries to emerging markets is likely to take longer than generally expected. Rich countries will be cursed indeed if they cannot put on an occasional growth spurt. China, for its part, will be lucky to avoid a bad stumble in the next decade or two. Emerging-market crises have been too quickly forgotten, which only makes them more likely to recur.

Education and social security will have to adapt to a world in which jobs continue to be created and displaced at a rapid rate. The cost of oil and other commodities will continue to rise faster than prices in general, shifting the terms of trade in favour of resource-rich countries and away from big consumers such as America. The yuan will eventually become an international currency and rival to the dollar. The longer that takes, the less pressure America will feel to control its public finances and the likelier it is that the dollar's eclipse will be abrupt and messy.

The force of economic convergence depends on the income gap between developing and developed countries. Going from poor to less poor is the easy part. The trickier bit is making the jump from middle-income to reasonably rich. Can China and others manage it?