APRIL 2014

The flow of value: An interview with Michael Spence

Emerging economies are creating extraordinary shifts in wealth, supply, and demand. Nobel Prize–winning economist Michael Spence explains how the notion of value is changing.

From the forging of the ancient Silk Road to the boom of the spice trade in the 1600s, the global flow of goods and services has never been static. As Michael Spence, the Nobel Prize–winning economist and senior fellow at Stanford University's Hoover Institution, explains, the rise of emerging economies is again upending global trade flows—and altering the very notion of value. This interview was conducted by McKinsey's James Manyika. An edited transcript of Spence's remarks follows.

Why economies grow rapidly

We never have seen countries grow at 7, 8, 9, 10 percent—ever—in the history of the world. Now, the way that happens is because of the enabling effect of the global economy. The global economy provides two things. One is a huge market that you can't really penetrate to an extent that you turn the terms of trade against yourself. It's just too big. That means, basically, that you can grow as fast as you can invest, provided you have some competitive edge.

The second thing—and it's probably even more important—is that the global economy provides knowledge, technology, know-how. All the things that get learned in an economy over decades, and even centuries, is being transferred into developing countries at a very high rate. And the combination of those two things, plus a little bit of inbound investment, which is a kind of transmission channel, enables countries to grow at rates that are simply not possible in any other way.

So the flow of information carried by people—not necessarily migrants but people moving among these countries—and then accelerated and augmented by the fact that you can now access virtually any kind of digitized information in the world instantaneously, means that there's an acceleration in this flow of knowledge, technology, and learning. And that turns into an acceleration in growth and prosperity in the developing world.

Measuring value in a global market

Where does a product like an iPad come from? In the old days, you'd give an answer: "It came from country X." That answer is wildly misleading now. The semiconductors come from three countries; the assembly is done in a different country; the displays come from another set of countries.

And of course, the design, the branding, and so on—which is a huge part of the value creation, more than half by the time a product like that gets to retail—gets done in the place where the company is located. There's an effort now, a big effort, to try to take apart these supply chains and understand where the value is actually created.

When I buy something—go out on the street and buy something—the producer gets whatever I pay for it minus the costs of building it and delivering it to me. And I get a whole lot of benefits over and above what I paid for it. This is sometimes called a consumer surplus, in economics. Now, if the consumer surplus has a constant ratio to the transactions, then that's fine. But if the consumer surplus for certain classes of products and services is enormous, relative to the cost, then measuring the benefits by looking at the transactions turns out to be a wild underestimate.

So, for example, a partial miracle has occurred in the developing world. Ten or 12 years ago, we talked about the digital divide—these countries can't afford to build land lines and all this connectivity and buy the computers and so on. And now we have these little devices, and they're Internet connected. And the regulators forgot to regulate the cell-phone mobile-technology companies, and the private sector kicked in and built the networks. And then somebody kicked some butts and forced the interconnects. And now, for very modest amounts of money, because technology was used to design affordable products, a growing, vast majority of people on the planet have access to this digital technology.

Now, if you added up what everybody's paid for these things in India, China, and Brazil, and so on, and asked yourself the question, "Did we capture the benefits—that their kids can get at books, that schools have access to libraries that were never there before?" The answer's so clearly no.

The future of supply chains

If technology becomes capital intensive, and this really is enabled by digital things—3-D printing, automated systems that remove labor from various processes—then one of the most immediate effects of that is that the supply chain starts moving toward the market. Because it doesn't have to be somewhere else for cost or economic reasons.

The other thing I would mention is that because the developing countries are becoming big—and China has a particularly important role in this, its economy is evolving very rapidly. It is in the process of not being the "low labor cost" assembly place anymore, although the movement of that economic activity out is delayed by the massive efficiency of the logistics systems in China. But that's going to go somewhere else in the developing world.

The bottom line is south–south trade, as it's sometimes called, is becoming an increasingly important part of the story. And if you ask, for most of the developing world, what's the single most important thing that needs to happen for them to thrive, the answer is China succeeds in the middle-income transition and sustains the high growth.

Michael Spence, winner of the 2001 Nobel Memorial Prize in Economic Sciences, is a senior fellow at Stanford University's Hoover Institution. This interview was conducted by **James Manyika,** a director of the McKinsey Global Institute and a director in McKinsey's San Francisco office.