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Converging Economic Destinies

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OP-ED
JANUARY 1, 2014 *CURRENT HISTORY*

SUMMARY The economic convergence of large parts of the developing world with the advanced nations is the great story of the modern era.

The economic convergence of large parts of the developing world with the advanced nations is the great story of our time. Sixty years ago, Singapore was an impoverished, malaria-infested island whose future absolute ruler, Lee Kuan Yew, admired the prosperity and civilization of the United Kingdom, where he had been educated. Singapore's per capita income has since surpassed that of the UK and the rest of Europe by a wide margin and, more recently, that of the United States. Today, one in six households in Singapore has more than $1 million in disposable assets. And as its extraordinarily rapid economic development progressed, Singapore converged with the advanced nations in other ways: by rooting out endemic corruption, adopting strict environmental standards, and making progress toward a more pluralistic and democratic society.

Singapore and its fellow "Asian Tigers" (Hong Kong, Taiwan, and South Korea) are emblematic of rapid development, but they represent just a speck in the world's economic ocean. In a momentous turn, around the mid-1980s, income acceleration took hold in the giant nations of China and India and several of their Asian neighbors, which together account for about half the world's population.

Convergence today is no longer confined to Asia. The phenomenon spread to Central and Eastern Europe with the collapse of communism. It has also reached large parts of Latin America, the Middle East, and most recently, Africa. These regions have benefited from the surge of commodity prices induced by the acceleration of world growth.

DEEP ROOTS

The roots of the convergence phenomenon are buried deep in the economic history of the past 500 years. It can be understood as "payback" for more than two and a half centuries during which developing countries fell behind, while European nations and some of their sparsely populated Western offshoots—such as today's United States— adopted the techniques and market institutions known as the Industrial Revolution. Although colonization of distant lands by Europeans had spread since at least the sixteenth century, the Industrial Revolution enabled imperial rule across territories that were home to most of the world's people.

Japan, which was not colonized, became the first non-Western nation to systematically adopt techniques from the Europeans and Americans in the second half of the nineteenth century, and subsequently saw unprecedented growth rates. Whether or not the relationship is strictly causal, it likely is not an accident that the acceleration of growth in the developing world began shortly after decolonization in the wake of World War II was largely complete. (control and extraction of wealth by foreigners are obviously not conducive to the promotion of a market-driven globally competitive economy.)

Although some of the forces that have propelled growth in poor countries in recent years may prove temporary or sporadic—notably surging commodity prices—the increasing weight of developing nations in global economic activity results from deep economic trends that will not easily be diverted. According to the United Nations Population Division, over the next 40 years the world's labor force will grow by more than one third, with most of the growth occur - ring in developing countries still early in their transition from high birth and death rates to low birth and death rates (China is a notable exception). Another factor is investment in infrastructure, machines, and housing, which is much larger in proportion to the initial stock of capital in the latecomers than in advanced countries.

CATCHING UP

But the most important driver of growth, almost synonymous with convergence, is catch- up with the technologies and market-friendly institutions of the advanced countries. Per capita incomes in the most dynamic and largest developing economies, China and i ndia, are still a fraction of that of the United States. While current rates of growth are bound to slow as these countries approach the technology frontier, the convergence phenomenon may persist over at least the next two or three generations. Simple growth accounting techniques suggest that by combining the effects of demographics, investment, and technology, the aggregate GDP of developing countries could (barring major "traffic accidents" such as wars and prolonged recessions) potentially grow some 2.5 percent to 3.5 percent faster than advanced countries for decades to come.

This differential would be in line with recent experience, but could not last indefinitely. For example, several of today's higher middle-income economies, such as Malaysia, and relative newcomers to the high-income club, such as South Korea, have seen a sharp deceleration of growth compared with their take-off period.

Globalization has enabled countries that are stable and open, and that invest in education, to learn rapidly from those in the vanguard of economic performance. However, in the giant developing economies and in many smaller ones, globalization is only one aspect of the convergence story. A large part of the process is no longer about opening up and adopting the technologies and institutions of advanced countries for the first time. It is about spreading these methods, already familiar in the advanced regions of developing countries, to the backward areas: from Shanghai to rural Luzhai, from Mumbai to Calcutta, and from São Paulo to the favelas of Rio. It also means facilitating migration from the countryside to the cities.

Techniques familiar to world-class firms such as Tata Industries, Huawai, and Ali Baba must spread to myriad low-performing medium-sized enterprises. Thus, convergence is largely about moving large numbers of workers from low- to high-productivity activities within the same nation. This process involves investments in infrastructure and education, and the development of market institutions suited to local or regional needs. India, for example, has world-class high-tech firms, and any number of scientists, economists, and executives, yet half the country's population lacks sanitation and reliable electricity.

MISSED OPPORTUNITIES

Although the forces driving convergence are fundamental and persistent, the process is not likely to be linear. It may well be punctuated by crises and temporary lulls in growth due to domestic or external shocks, including miscalculations and misguided policies. Sharp slowdowns of growth in India, Indonesia, Turkey, and Brazil, and many countries' nervousness about the prospect of the US Federal Reserve beginning to withdraw its monetary stimulus, are recent examples of the volatility to which developing countries are especially susceptible.

Convergence could have coincided with an acceleration of growth in the advanced countries, creating a golden era in which they took advantage of the enormous export and investment opportunities created by the rise of a new middle class of hundreds of millions of consumers in the developing world. But so far this has not happened. Over the past 20 years, growth in the advanced economies has been disappointingly slow. The success of emerging economies has stood in stark contrast to massive crises that hit Japan with the bursting of its housing and banking bubble at the end of the 1980s, the United States with the onset of the Great Recession in 2008, and Europe, where the US debacle triggered a euro zone sovereign-debt crisis that had been long in the making.

It is tempting, as some are prone to do, to draw a causal link between the stagnation of the rich and the rise of the rest, a zero-sum or Darwinian view of world markets where only the fittest survive and where Japan and China, or the United States and China, cannot prosper together. But given the diversity and rapid expansion of global markets (world merchandise and services trade volume is 5.5 times larger than in 1985) and the many opportunities for specialization, the correct interpretation is that the crises in advanced economies occurred despite the opportunities offered them by globalization and convergence.

The crisis of the rich is essentially the result of errors in macroeconomic policy and regulation and a failure to manage credit cycles, as well as a reluctance to undertake structural reforms to address deep-seated distortions. Yet in the era of convergence, advanced countries are not doomed to fail. While Italy, Japan, and Greece have struggled, several high-income economies such as Australia, Singapore, Hong Kong, and Israel have done well, boasting annual per capita income growth rates above 2 percent over 20 years.

BONES OF CONTENTION

The market opportunities presented by convergence are clear for everyone to see, but so, increasingly, are the policy challenges. From the vantage point of global economic governance, as conducted through the Bretton Woods institutions or periodic gatherings of the Group of 7 or Group of 20 industrialized nations, convergence brings with it a shift not just in the balance of power, but more fundamentally in the nature of the actors that wield greater influence.

We have already moved into a world where the largest economies are no longer uniformly rich, as was the case a generation ago. Today, three of the seven largest economies—China, India, and Russia—are the poor cousins of the four others: the United States, Japan, Germany, and the UK. Conservative projections suggest that within a generation, six of the seven largest economies may be relatively poor countries, as Indonesia, Mexico, and Brazil join the group, while among the wealthy only the United States—second in size to China, but still much richer—will remain in this new and entirely transformed G-7. It may not be long until the great powers of Europe that once shaped the world's destiny no longer rank among its main economic actors.

It is an inevitable feature of the era of convergence that worldviews and priorities among the largest economic powers will differ much more starkly than before, when they were uniformly rich. Take the crucial issue of intellectual property rights, the main comparative advantage of the most advanced and innovative economies. Developing countries are primarily avid adapters or, to say it plainly, copiers of new technologies rather than the prime innovators. So, in contrast to the advanced countries, their interest is in short patent lives and weak forms of intellectual property protection. This is one of the great bones of contention in all trade negotiations involving developing and advanced countries.

More broadly, as we have seen in the floundering Doha round of trade negotiations, it is impossible to reach agreement on the pressing issues of trade facilitation—liberalization of services trade and foreign investment rules, and removal of nontariff barriers in the form of subsidies and specious regulation—without co-opting countries that will soon account for the majority of world trade but are also the largest source of these distortions.

Even when there is agreement on basic objectives, such as promoting open markets, countries at widely divergent levels of development will perceive trade-offs differently and will want to proceed at vastly different speeds. When a large part of a nation's population is living on fewer than 2,000 calories a day and social safety nets are largely absent, the trade-off between bread today and cake tomorrow looks rather different.

CRUCIAL COMPROMISES

Just as it has become harder to strike compromises, convergence means that doing so has become even more important, particularly regarding the environment. Projections of the effect of economic growth on carbon emissions and climate imply that large parts of the globe—including regions with huge populations in South Asia— will become unlivable. Unless mores change and the intensity of fossil fuel use declines, ultimate convergence, which implies Chinese and Indians owning multiple cars and air conditioners, is impossible.

Macroeconomic coordination and financial regulations are other arenas where the participation of the large developing countries—whose policy frameworks and capital market institutions are even more fragile than those of advanced countries— has become crucial. The emerging markets already attract a large share of global foreign direct investment and a significant share of bank loans, and their bonds and equities represent a rapidly rising share of global portfolios. Moreover, they are increasingly investing in each other. As they become larger and more integrated into global financial markets, the likelihood of a systemic crisis originating in one of the large developing economies increases steadily.

Yet even when the likes of Russia, Brazil, China, and India agree on the need for more systematic regulation and on the broad direction of reform, their capacity to execute can lag, and the rate at which they can progress will remain heavily conditioned by their own development processes. A case in point is China's very gradual opening up of its capital account and its slow adoption of a more flexible exchange rate regime, which remains a source of tension.

SHARING THE FRUITS

A companion of convergence has been the entry into the global labor force of a large cohort of unskilled workers. There is little doubt that this epochal development has combined with aspects of globalization, including increased mobility of capital and rapid technological change that favors skilled workers, to contribute to a wave of rising inequality in many countries across the world, including most of the largest developing economies. Regressive changes in tax policy have accentuated the inequality trend in many nations. So we have the paradox of convergence reducing poverty and inequality at the global level, but contributing to increased inequality at the level of individual countries. This encourages antiglobalization, isolationist, and protectionist movements of various kinds and contributes to more polarized politics, as in the United States today.

Convergence presents great global challenges, but it also means escape from poverty for hundreds of millions and the creation of a vast new global middle class. This middle class aspires for more representative and accountable government, and also wants to consume the goods that firms and workers in advanced countries know how to produce. In the not too distant future, the inventions of scientists and engineers in Bangalore or Shenzhen, not only those in Cambridge or Menlo Park, may enrich all of humanity.

Capturing these and other prizes of convergence will require policies that promote the sharing of its fruits at home, as well as reforms of the global institutions that have underpinned postwar prosperity—in part to give the rising powers more weight in decision making. Failure to carry out such changes would usher in a new era of sharp divisions and conflicts, repeating on an even larger scale the upheavals that have accompanied rapid economic change in the past.

This article was originally published in *Current History.*

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Source http://carnegieendowment.org/2014/01/01/converging-economic-destinies/gxjl