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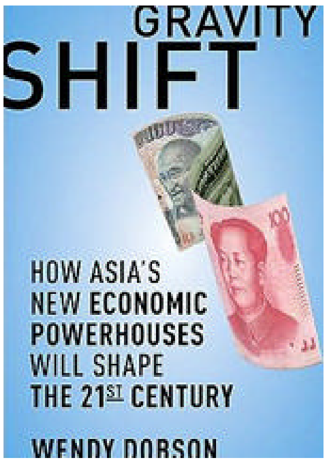

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Why the Shift of Economic Gravity to Asia Is Not a Power Shift

By Wendy Dobson | Wednesday, October 21, 2009

While China's and India's sheer size and ability to maintain economic momentum seem to only strengthen predictions of the United States' decline, such zero-sum thinking is not credible, argues Wendy Dobson. Analyzing the significant domestic challenges the Asian giants must confront, she explains why the gravity shift to Asia is about economics — not power.

China and India are the world's only large economies with positive growth in 2009. Future projections show China catching up with the U.S. economy by 2020 and India doing so by 2035 or 2040.

In contrast, the United States, digging out from the financial crisis, faces slower growth, a less leveraged financial sector and rising taxes and savings rates. The Asians' size and ability to maintain economic momentum seem to only strengthen predictions of the United States' decline.

The gravity shift to Asia is about economics — it is not a power shift.

Yet this kind of zero-sum thinking is not credible.

Both China and India face large challenges at home. China has embarked on a second transformation as it seeks to rebalance its lopsided economy more towards consumption and domestic demand. To accomplish this shift, the Communist Party faces numerous sensitive political and structural issues.

India, despite the successes of its IT services and techno-manufacturing industries, has to transform the economy to create alternatives for the 60% of its

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population still confined to rural agriculture.

China aims to shift its growth strategy from the heavy reliance on investment more towards consumption, relying on services and less energy- and capital-intensive production to do so. With a less capital-intensive industrial structure, growth will rely more on productivity than capital investment.

Looking at how all of this can be done emphasizes the magnitude of the task. Promoting consumption requires the government to take over from households the costs of health, education and pensions which rural households have to finance on their own.

It requires better returns on their savings by deregulating deposit interest rates, creating more jobs closer to home by channeling finance to smaller enterprises with little collateral and few government connections — as well as reducing the cost of imported goods.

While Chinese government spending on social programs tripled between 2002 and 2008, and small-and-medium-enterprise (SME) lending units are being added at state banks, there is no action on deposit rates.

For its part, reducing capital- and energy-intensive production requires deregulating service industries that are dominated by state monopolies, raising the cost of capital by deregulating interest rates, reducing subsidies for energy and enforcing environmental regulations, requiring state enterprises to pay dividends and allowing the under-valued exchange rate to appreciate.

China's and India's leaders will remain deeply preoccupied with domestic challenges for the foreseeable future.

While there is no sign yet of reform of the monetary and financial system to allow exchange rate flexibility, energy prices have increased, state-owned-enterprises (SOEs) are beginning to pay dividends and China aims to source 15-20% of its energy from renewable by 2020.

The complexity of these changes makes U.S. health care reform look like child's play. Sensitive issues of government and Party reforms are involved because strong interests have vested at local levels in China's investment-driven growth. The Communist Party has moved to curb abuses of power by creating structures like the Bureau of Corruption Prevention and giving investigative powers to the State Audit Administration.

But these are party organs that continue to hold members outside the law and are inadequate substitutes for an independent judiciary and a free press. How long will this approach be acceptable to a growing middle class in an increasingly complex economy which puts a heavier premium on independent thinking and risk taking?

Meanwhile, India's Achilles heel is its labor market institutions. The United Nations estimates that in 2020 India's potential labor force will be 900 million people. About 250 million will be in the 15-24 age group, looking for jobs that will have to come from labor-intensive manufacturing, as they have in other successful developing economies.

Yet, lack of modern infrastructure and restrictive labor laws deny entrepreneurs economies of scale and the opportunity to participate in Asia's dynamic cross-border production networks.

By choice, and by default, the United States will continue to be first — among equals — and more multilateral and consultative out of necessity.

While infrastructure investment is moving along, labor laws prevent employers with more than ten workers from adjusting the labor force without government permission and pile on employment costs as the number of workers grows. The net effect on entrepreneurs is to encourage investment in capital-intensive production. Or to stay small, as employers accounting for 90% of the labor force have done.

India's telecom revolution shows reform is possible when the central government has a mandate to govern and the prime minister is willing to push from the top. Government's role was pruned back and service provision opened to the private sector. Intense competition followed in the mobile phone market, adding over 200 million mobile phone users in 2007 and 2008.

Each country's leaders will remain deeply preoccupied with these domestic challenges for the foreseeable future. Their growing economic prominence will play out mainly in Asia, where their East Asian neighbors seek to engage them in regional cooperation.

They are also key players in the G-20, but as the Pittsburgh meeting in September 2009 showed, each seems content to play a counter-balancing rather than a global leadership role.

China gets high marks for stabilizing the U.S. recovery by continuing to invest its foreign exchange reserves in U.S. government securities. However, both nations still feel sufficiently vulnerable to external economic shocks that they have retained controls on capital flows.

By choice, and by default, the United States will continue to be first — among equals — and more multilateral and consultative out of necessity. The gravity shift to Asia is about economics — it is not a power shift.

Editor's Note: This feature is adapted from "Gravity Shift: How Asia's New Economic Powerhouses Will Shape the Twenty-first Century" by Wendy Dobson. Published by University of Toronto Press. Reprinted with permission of the author.

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