

## Aaron Mehrotra: For Europe, Asian growth brings challenges

The growth of eastern Asian economies, from the perspective of economic theory, is an example of the well-known catch-up process, in which countries with lower levels of income grow faster on average than richer countries. This is largely due to productivity growth, as poorer countries upgrade their production processes by adopting the technologies of developed countries. In principle, the integration of Asian countries into the world economy should raise the level of economic welfare at the global level via expansion of markets and more efficient international division of labour.

The integration of China, India and other highly populated countries into the world economy has significantly increased the total labour input in the competitive international markets. This has put downward pressure on real wages and on the relative prices of labour-intensive products. The transfer of production to Asian countries may in the short term reduce the welfare of developed countries, at least in the labour-intensive sectors. The concern over China's economic growth among Europeans can be viewed in light of this shock arriving through the labour markets. As regards China, the huge supply of labour and the rapid growth of production capacity pose a special challenge.

### The difficulties of structural change

Developed economies, in principle, can meet the challenge of low production costs in Asian countries by making the appropriate structural changes. Economic output should focus increasingly on high-tech products that are competitive despite their relatively high labour costs. However, structural change and reallocation of labour to new sectors are generally time-consuming processes. Moreover, the high level of incomes in Europe tends to dampen the zeal for fundamental reform.

The true short-term risk to the world economy is thereby increasing protectionism in the form of various trade barriers aimed at shielding those sectors of the rich economies that are the most vulnerable. This could constrain Asian countries' export-driven growth and thus slow the convergence of poorer countries' living standards to those of the developed countries. One mitigator of protectionism's appeal is the dependency of multinational companies on trade

with the Asian countries. Moreover, rising living standards translate into higher levels of domestic demand in the Asian countries, which can partially offset the impact of slowing export growth due to protectionism.

### Competition spreads to the service sectors

Asia is not limited to competing in industrial products. The decline in communication costs and developments in information technology now for the first time enable extensive world trade in services. Trade in services presents a challenge especially for the English-speaking developed countries, since eg many Indian companies provide services and offer a high level of fluency in English. Global trade in services benefits consumers in developed countries because of low-cost final products, just as in the case of goods. At the same time, low labour costs in developing countries raise concerns about protecting jobs in the service sectors of the wealthy countries.

The possibilities for boosting economic growth rates of developing countries solely via service exports are however limited. Economic growth that could create jobs for the masses of Indians living in the countryside could hardly take place without a huge expansion of industrial production. Moreover, notable economic development seldom occurs without high rates of investment. It has been argued that, in spite of the recent growth of service exports (incl. information technology), India's comparative advantage actually lies in labour-intensive production – not least because of its huge population – and the growth of service exports could be due mainly to the relative paucity of state regulation of the service sector.

If India is successful in developing its infrastructure, the challenge that the growth of its economy will pose to western countries is more likely to reside in low-production-cost sectors (à la China) rather than high-tech sectors. For this to happen, however, workers will have to move in significant numbers from agriculture into higher-productivity industrial production.

The importance of institutions and the risk factors Asian economic growth does not come without risks. In China, the environmental problems are well known among central government officials. In India, implementation of economic reform has proven to be extremely difficult, partly because of the broad political base of the Government as well as the present high rate of economic growth, which reduces interest in effecting the necessary structural changes.

As globalization progresses, countries learn about each others' institutional and policy choices. At the same time, the benefits of globalization depend on those policy choices. Key here is the creation of institutions that promote the international division of labour and beneficial use of new market areas. Protectionism and trade disputes can significantly reduce the benefits of globalization, which can in turn have political repercussions.

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