China and the West race to the top

By David Sainsbury

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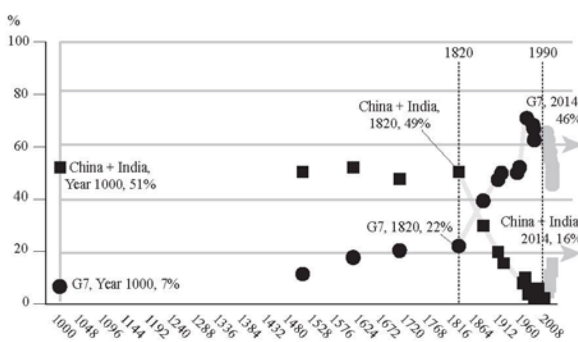
Although macroeconomic stability and efficient markets are essential conditions for economic growth, they do not drive it. If the West wants to compete effectively against China and other fast-growing Asian countries, governments need to make innovation central to their economic policies.

Over the last 25 years, the relative growth rates of the world's major economies have changed dramatically. Six developing countries in particular – China, South Korea, India, Poland, Indonesia, and Thailand – have grown extremely fast during this period. The rich G7 countries, on the other hand, have experienced slowing rates of labor productivity growth, and their combined share of world GDP has fallen from two-thirds to one-half.



Neoclassical growth theory, which has dominated economic thinking over this period, has not been able to explain this reversal of fortunes. For anyone who has watched South Korean and Chinese firms triumph in one world market after another, it is difficult to believe that Western countries will be able to compete more effectively in the future simply by making their own markets more efficient.

If the developed world is to boost its competitiveness, we in the West need to embrace some new economic thinking. That means gaining a better understanding of the growth process, and using this knowledge to develop policies that can help accelerate it. Moreover, we should not think that we can acquire this knowledge by building ever more complex and unrealistic mathematical models.

A good place to start is with the measurement of national wealth, and the fact that a country's GDP *per capita* is simply the sum of the value added *per capita* of all its economic organizations, mainly firms.

We then need to ask how firms increase their value added *per capita*. In the observable world, rather than the world of perfect competition embraced by neoclassical economists, companies can do this in two ways. They can increase their production efficiency, as Henry Ford did when he started using an assembly line to manufacture cars, or increase the competitive advantage of their products, as Steve Jobs did when he developed Apple's iPhone.

Both Ford and Jobs increased the competitiveness of their firms by innovating. Countries like China and Singapore have done the same, helped along by lessons from more advanced economies. Both have declared themselves to be innovation nations, and have put innovation at the heart of government policy.

Western countries therefore need to understand three things in particular. First, they must increase their rates of innovation in order to compete better against fast-growing emerging economies. That will require them to develop policies that strengthen national systems of innovation, education, and training, and improve the governance and financing of their

firms. Municipal- and regional-level policies should support these goals.

Second, the West needs to understand that there is a global ladder of economic development, the rungs of which represent increasing levels of organizational and technological complexity, and value added *per capita*. It is difficult for any firm to gain a competitive advantage in activities such as manufacturing cheap clothes and assembling electronic components, resulting in low value added *per capita*, and thus low wages and salaries. By contrast, companies in industries such as aerospace and pharmaceuticals can build up significant competitive advantages, leading to high value added *per capita* and consequently high wages and salaries.

Developing countries are rapidly moving up the ladder, and are increasingly competing directly with developed economies. The latter therefore must innovate rapidly both to increase the value added of their current industries, and to move into new high-value-added sectors.

Finally, Western firms and policymakers should understand that their countries' competition with China and other rising economic powers is now a "race to the top," not a "race to the bottom" in which cheap labor and a "favorable" exchange rate are seen as the best ways to achieve and maintain competitiveness.

If developed countries can move further up the ladder of economic development by innovating and creating new high-value-added products and services while ceding lower value-added areas of activity to developing countries, then all can increase their national standards of living at the same time. If the pie is larger, everyone can have a larger slice.

To be sure, macroeconomic stability and efficient markets, which lie at the heart of neoclassical economic thinking, remain essential conditions for growth. But they do not drive it. If we in the West want to compete effectively against China and other fast-growing Asian countries, we need to understand that innovation is the engine of growth, and governments need to make it central to their economic policies.

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