Rich Man, Poor Man

The emerging codependence between today's developed and developing worlds.

BY MILTON EZRATI

The comparisons are stark and will continue to have profound economic and investment implications for some time. China, India, and many other developing economies, though still desperately poor, grow at fantastic paces, while the rich economies of Europe, Japan, and America seem to plod. The developing economies possess youthful, eager workforces. The rich developed economies carry ever-aging populations. Clearly, global prosperity as well as investment opportunity lies as never before with the world's developing economies. But as always in economics, matters seldom fall to simple distinctions between winners and losers. On the contrary, marked growth, wealth, and demographic differences speak loudly to reciprocal needs between developed and developing economies, needs that should yield gains from trade and globalization and consequently create economic and investment opportunities in both the developed and the developing economies.

DEMOGRAPHIC IMPERATIVES AND RECIPROCAL NEEDS

Seen in one light, all the advantages would seem to lie with the developing economies. Rapid real growth at near-double-digit rates in China and India already fosters speculation about when they might "catch up" with or even "surpass" the major developed economies. Other developing economies may not report growth at such a

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breakneck pace, but they nonetheless are growing much faster than the United States, which has exhibited a real growth rate in the low single digits, or Japan or the European Union, either of which has hardly grown at all. Even more telling for the future are the demographic differences. Lengthening life expectancies and declining birth rates may be raising the average age of populations the world over, but for a long time to come the developing world will retain the younger, relatively more plentiful workforce that it needs to sustain its rapid growth path, especially relative to the developed West and Japan.

The accompanying exhibit reviews the key indicator in these sorts of comparisons, what demographers call "dependency ratio." By calculating the number of workers available to support each dependent retiree, it highlights the relative burden on each economy's workforce. America, for example, presently has five workers on average to support each retiree. By 2020, even considering impressive, ongoing immigration flows, the country will have less than four workers per retiree, and by 2030, it will have less than three. Europe is even more extreme. Germany, for instance, has only three workers per retiree even now and by 2030 will have barely two. Japan is in still more difficult straits with less than three workers for each retiree today and less than two projected for 2030. By contrast, China, India, Brazil, and other developing economies (not included in this exhibit) face a much less burdened future. China, for instance, even with the tendency for Beijing's long-standing one-child policy to slow the growth rate of that country's labor force, will still have over five workers available for each dependent retiree in 2020 and by 2030 just under four. Workers in Brazil and India will carry even lighter relative burdens, with almost five and almost six workers available for each dependent retiree respectively even by 2030.

For all these clear advantages, matters are not entirely one-sided. For one, labor in the developed world is more productive than in the developing world. Years of investment in education, modern plant, equipment, and technology have given their relatively smaller workforces the tools with which to support a greater burden of retirees than they otherwise could. This greater productivity has also enabled labor in the developed economies to remain internationally competitive, despite their higher wage scales.

Dependency Ratios* for Selected Countries

	1997	2007	2020†	2030†
United States	5.0	4.8	3.6	2.9
Japan	4.3	2.9	2.0	1.9
Germany	4.0	3.0	2.6	2.0
France	4.0	3.6	2.8	2.3
United Kingdom	3.7	3.8	3.1	2.5
Brazil	11.1	9.1	6.7	4.8
China	9.1	7.7	5.3	3.7
India	12.5	11.1	7.7	5.9

*Working-aged population per dependent retiree population.

†Official U.S. Bureau of the Census Projections.

Source: U.S. Bureau of the Census

Of course, Japan and the West eventually will lose much of this competitive edge. They already are in some industries, such as textiles, a pattern that will expand as the developing economies continue to invest in education and modern facilities and continue to increase their own labor productivity. The West and Japan will need to innovate continually just to keep a portion of their productive edge. No doubt they will make such efforts. But this comparative story also goes beyond simple workforce and productivity measures. The trade advantages implicit in these differences should give further advantages to each sort of economy. Indeed, the huge wealth, knowledge, and demographic gaps seem to demand economic integration between the developed and the developing worlds.

On one side of the exchange, the developing economies clearly offer the rich economies of Japan and the West a much-needed supply of labor, a need that clearly will grow over time. To be sure, America, Europe, and even Japan can rely on immigration to meet some of their relative labor needs. But even in the case of the United States, with its great immigration heritage, the future labor shortfall will become so great that immigration sufficient to meet it would risk social unrest. The only way, then, these developed economies can satisfy the consumption needs of their large, retired populations without straining their meager workforces beyond endurance will be to tap the developing world's youthful and ample workforce, either through imports from the developing economies or through outsourcing or offshoring arrangements.

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Meanwhile, on the other side of the equation, India, China, and these other developing economies desperately need the rich consumer markets of the developed world. Though these developing economies have grown fast, they remain desperately poor. They have such low levels of wealth and such low wage scales that their domestic markets simply cannot absorb the full output of their workforce and will likely remain inadequate in this respect for some time to come. Without the rich consumer markets of the West and Japan, these economies would have no place to sell their growing production. Their pace of growth would slow to that of their still meager domestic consumer markets. They would take decades to accomplish the development they enjoy yearly in the present environment. Clearly, the developing economies, however impressive their growth and their demographic fundamentals, depend on their overseas customers in the developed world about as much as the rich, aging economies depend on the output from the developing world's youthful workforce.

There is another crucial point of reciprocal exchange between the world's developed and developing economies. The aging populations of Japan and the West increasingly will need high-returning investments to support themselves in their retirement. Many of these better, more productive investments exist in the world's fast-growing developing economies and will continue to do so in coming years, provided, of course, they can continue to grow rapidly through access to rich consumer markets. That investment opportunity is something these developing economies offer the developed economies of the West and Japan. At the same time, the West and Japan have something to offer in exchange for these needed investment returns, something that the developing economies desperately need to realize their potential: a flow of financial capital to finance development and bring other necessary skills, such as management expertise, technological innovation, and of course, financial acumen.

ECONOMIC ADJUSTMENTS AND INVESTMENT STRATEGIES

As trade and investment patterns respond to these reciprocal needs, the economic landscapes of these various economies will adjust in ways that surely will provide signals for long-term investing. Opportunities will appear in both developed and developing economies according to their comparative advantages.

Matters are more straightforward in the developing economies. Their growth and the investment opportunities surrounding it will center one way or another on applying their labor resources to meet the demands of the developed world's rich consumer markets, as indicated through either exports, outsourcing, or offshoring. Since their comparative advantages lie with their abundant, relatively inexpensive workforce, those opportunities will center primarily on the more labor-intensive activities. And because these developing economies as yet also lack the sophisticated capital infrastructure that exists in the developed world or the general educational base, their economic effort will also tend to concentrate on less complex processes, what economists refer to as low-value-added activities. Of course, not all developing economies are alike. China, for instance, has acquired a dominance in manufacturing, India in services and technologies of a sort, and Brazil, for a third example, in materials and a range of manufacturing, too. But for all these differences, all the developing economies have in common the push toward low-value-added, labor-intensive activities.

The developed economies will need to relinquish direct competition in these areas, where increasingly their high-cost, relatively scarce labor supply will put them at a disadvantage. To sustain their position, they will have to cultivate the greater sophistication of their workforce and rely on the more advanced capital and technological infrastructure available to them. That effort should lead them toward processes that are capital-intensive instead of labor-intensive and that focus on more complex economic activities, what economists refer to as high-value-added. These might include precision machine tools, other specialized machinery, metallurgy, sophisticated services, and, of course, technology, not so much the manufacture of equipment as innovation and development. The world's economic portfolio, as a consequence, and accordingly an investor's equity portfolio would do best, then, to draw on such activities from the developed economies in a mix with the labor-intensive, low-value-added investments from the developing economies.

But this shift alone would not complete the necessary adjustment in the developed world. The West and Japan increasingly will also need to find ways to leverage their comparative advantages even from the operations they place in the developing economies themselves. When an American, European, or Japanese firm establishes an offshore operation in China or some other developing economy, the wages it pays there to the local workers naturally will accrue to the developing economy, as will the rent, tax, and several other aspects of the venture. But there still remain ways for these developed economies to gain advantage beyond simply profits. There are, of course, the exports of equipment for the initial start-up and subsequent upgrades. Further, the developed economy can reap returns from licensing the technology,

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engineering, and design used in the venture and from marketing as well as transporting that venture's product anywhere on the globe. What is more, the management skills used in running the operation and getting its product effectively to market also should provide a return to the home operation therefore to many in the developed Western or Japanese economy.

In a similar way, old established economies will also gain from a focus on their clear comparative advantage in finance. Intuitively, the returns to finance and foreign investing might seem small when compared with the material parts of the economy, but in fact finance can yield huge advantages and returns in international exchanges. The interaction between the United States and China should offer a useful illustration (and incidentally answer any concerns of those whose obsession with national accounting might prompt them to question how the United States and other developed countries can run trade deficits and still gain from foreign investing.)

The financial process starts with China's huge trade surplus with the United States and the huge dollar flow it generates. Because Beijing's export strategy aims to keep China's products attractively cheap by holding down the value of its currency, the yuan, the People's Bank of China dares not sell this dollar surplus, for fear that such an action will drive down the dollar's foreign exchange value next to the yuan. Instead, China invests those surplus dollars in the United States, mostly in U.S. Treasury bonds. America's sophisticated financial markets, however, will not let these funds just sit. Rather, it filters them through various financial intermediaries in search of better investments, many in developing economies, including China. These recycled investments earn Americans a huge premium on their financial expertise. According to research at the National Bureau of Economic Research, Americans generally between 1994 and 2005 (the last year for which

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complete data are available) earned almost five full percentage points more on their investments abroad than foreigners earned on their investments in the United States. On just recycling the $2.3 trillion in U.S. Treasury bonds owned by foreigners in the United States, a small part of the $16-plus trillion assets owned by foreigners, that return differential should generate some $115 billion a year in flows to American-based investors, a significant amount equal to almost one-fifth the country's annual overall trade deficit.

Of course, China, India, and other developing economies have demonstrated an active ability to absorb sophisticated technological, management, and even financial skills from the West and Japan. Developed economies will have to innovate continually to hold their own, to improve their facilities and upgrade their educational base both. The most successful economic ventures and therefore investment holdings from the developed economies would then seem to lie with those capital-intensive, high-value-added firms that can also stay ahead of the innovation curve. The gains in these areas should more than make up for the losses in some of the traditional industries, such as textiles, that Japan and the West will have to abandon.

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RISKS

Faced with these demographic and wealth imperatives, trade and economic adjustments would seem to stand as the best way to protect Western and Japanese living standards, even as they facilitate development in the poorer spots on the globe. Though adjustment will cause pockets of hardship, which the nations involved will have an obligation to alleviate, the real threats to prosperity will come not from the economic fundamentals but rather from any effort to thwart them. Subsidies, for example, to support traditional industries in the rich West or Japan can at best only postpone the inevitable, while they burden the rest of the economy in the process, making other necessary adjustments that much more difficult. Rather than fight such a losing, burdensome battle, it would be better to help those affected retool their skills and shift their focus. Even worse threats to prosperity would emerge from efforts to interrupt trade and the progress of economic integration—the anti-globalization effort, for one, and more recently, the growth of protectionist sentiment in the U.S. Congress.

Should either of these unfortunate efforts succeed, both the developing and the developed economies of the world would miss what each needs from the other. Without access to the rich developed markets, development in China, India, and other poorer nations would proceed much more slowly and maybe even stop altogether or even reverse, with adverse effects world wide. If the anti-globalization effort effectively denies the developed West and Japan access to the much-needed labor resources of the world's developing economies, the developed economies would have to cope with their aging populations on their own. Their economies would struggle to meet the obligations to the elderly and slow or even decline. Standards of living would inevitably fall in both the developed and the developing world.

If, however, these destructive forces can be held in check, there is every reason to expect trade and investment flows to proceed to the benefit of both the developed and the developing economies of the world. In the fullness of time, no doubt, as the developing economies catch up to the rich economies of the West and Japan, these reciprocal needs will disappear. Patterns of trade as well as investment flows will shift again. By then, of course, demographic imperatives may also change, perhaps even reverse. In the case of China, in fact, as the earlier data showed, that is a likelihood. But all these subsequent changes, however they eventually play out, are a long way into the future, decades in fact. In the meantime, the patterns outlined here should prevail and set the tone for global economic and investment strategies. ◆