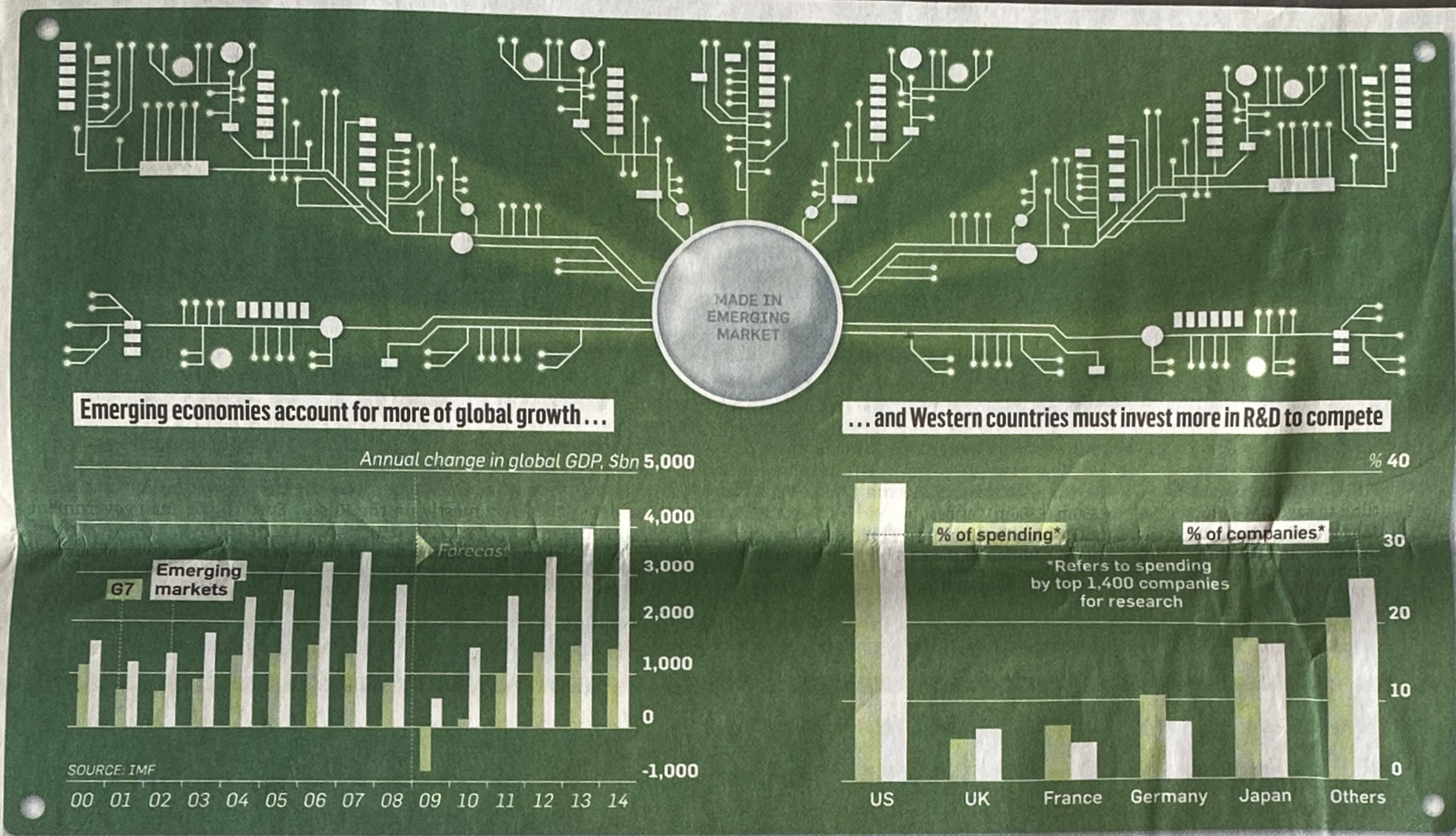

Britain must look to the east to grow strongly

We need to reinvent ourselves and invest in innovation to compete in the emerging markets, writes **Gerard Lyons**

A profound change is under way in the world economy. The balance of economic and financial power is shifting from the West to the East. This could lead to sustained growth for the economies that are best positioned to exploit it. The successful countries will be those with financial clout, natural resources or the ability to change with the times. Britain's biggest challenge will be to position itself in this category.

The recent financial crisis is a sign of this global shift. Many factors triggered the crisis, including a systemic failure of the financial system in the West and an imbalanced world economy. Savings flowed "uphill" from the regions running current-account surpluses, such as the Middle East and Asia, to deficit countries such as America, Britain and Spain.

Some blame the savers, not just the borrowers. This is harsh. The Chinese premier, Wen Jiabao, made clear his view on this earlier this year at Davos. Drawing attention to practices in parts of the financial sector, he asked why the West talked only about Adam Smith's invisible hand and never referred to his visible hand? The invisible hand is the role of the markets. The visible hand is the importance of morals and ethics. It shows how times are changing when it requires the Chinese premier to ask this question.

The countries that provided the savings to fuel the global boom were not the problem but they are part of the solution. The 1944 Bretton Woods agreement that has driven thinking since, placed no obligations on savers to correct global imbalances. The emphasis was put on countries with deficits to take action. This has to change. There is a need for a balanced global economy. It sounds simple. The West should spend less and save more while the Middle East and Asia do the reverse.

Achieving this will take years, and the implications are huge. The West will become relatively poorer. Money and savings will flow east as multinationals and pension funds invest in markets with higher growth and rising incomes. Asia will need to change its growth model and boost domestic demand.

At the recent annual Asian Development Bank meeting in Bali there was a determination to take steps to achieve this, with a focus on social safety nets to discourage saving for a rainy day. Asia also needs to deepen and broaden its capital markets so that firms can raise funds, invest and generate jobs. Over the next decade Asia needs 750m extra jobs for its growing young population. If it achieves this, and I think it will get close, this will create a huge market for the West to sell into, but at the price of greater global competition.

In recent years, the pace and scale of change in economies as diverse as Brazil, Vietnam and China has been profound. Despite the economic downturn, the infrastructure boom in the Middle East is continuing, particularly in Saudi Arabia and Qatar. One really has to visit these countries to appreciate the speed at which things are changing. It is remarkable. Expectations and ambitions are rising too. More of the increase in global growth is being accounted for by the emerging economies.

China and India are the two countries that attract most attention.

China is still a poor country in terms of income per person, yet over the past three decades its rise has been phenomenal. Now it is heading into another development phase, where it is building its infrastructure to compete at every level. China's policy stimulus of $586 billion over this year and next is being supplemented by two profound measures, one aimed at building a social safety net, the other at helping farmers to buy consumer goods. As a result, this year alone the rise in Chinese consumer spending may make up for more than half the shortfall in American consumption.

China's growth is forcing other countries to step up a gear too. In India the recent election of a strong government could usher in a period of reform, boosting investment and innovation. With 600m people under 25, the potential for India is huge if it gets this right.

There are serious implications for commodities, trade and financial flows. Already China accounts for one-third of global demand for metals and the proportion is rising. India could follow suit, and it will be not just metals, but food as well. The outcome will be higher commodity prices, increased investment in countries rich in resources, and the need for technological solutions. Regional trade flows are already shifting, with rising intra-Asian trade and greater flows of commodities, goods and investment between Asia and the Middle East, Africa and Latin America. This will continue and, as it does, it will spell problems for the dollar.

There is a slow-burning fuse underneath the dollar. A decade ago, Asian central banks held one-third of global currency reserves; now they hold two-thirds and the bulk of these are in dollars. This has been called the "dollar trap", but the reality is that countries do not want to sell the dollar. Instead, passive diversification is under way. As reserves build, fewer are put into the dollar. Brazil and China recently discussed paying for trade in their own currencies, not in dollars as is the norm. Expect more countries to manage their exchange rate against a basket of the currencies with which they trade.

In this changing global environment, Britain needs to make a profound shift if it is to succeed. The recession has shown that Britain cannot sustain strong growth by relying on debt and rising asset prices. Not all is broke. Parts of the City are still world class, we have many dynamic firms, such as in the creative industries, and the world's sixth-biggest manufacturing sector, though it is shrinking. The top end of our education system is great. Warwick University, for instance, has the world's only digital lab.

Across Asia there is a view of America as a country that reinvents itself. We need to be like that because our growth will be lower unless we create the environment for innovation and investment.

Britain needs to think global and sell into the future growth markets. We can't compete on price, so it has to be on quality. Other countries are trying to create knowledge-based economies, so to succeed we need the right hard and soft infrastructure. By soft I mean the right skills and education. Yet Britain compares poorly with our competitors on skills. We also perform badly on key measures such as research and development and patents, with the 2007 Sainsbury review of science and innovation identifying many problems. On infrastructure, the World Competitiveness Report showed that we ranked 24th, in part because it takes too long to make painful decisions, such as on Crossrail or an airport in the Thames estuary.

There is a need for leadership and clear strategic thinking on many of these issues. Recovering from recession will be painful but, as we do, it is vital to reposition the British economy to cope with the challenges and global opportunities ahead.

PS: **This week's meeting of the Monetary Policy Committee ought to be uneventful. The shadow monetary policy committee at the Institute of Economic Affairs voted unanimously for rates to stay on hold and expects no change in the scale of quantitative easing.**

However, there were differences of view on the future bias. Peter Warburton wanted to hike before the end of the year, Tim Congdon and Patrick Minford to hold and John Greenwood was keen to extend the scale of quantitative easing. I am with Greenwood on this. The economy looks set to hit bottom this autumn, but unemployment will go on rising, it will take some time to get balance sheets back into shape, and inflation is not a problem.

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