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Domestic Demand in a Multi-Speed Global Economy 1Q, 2015

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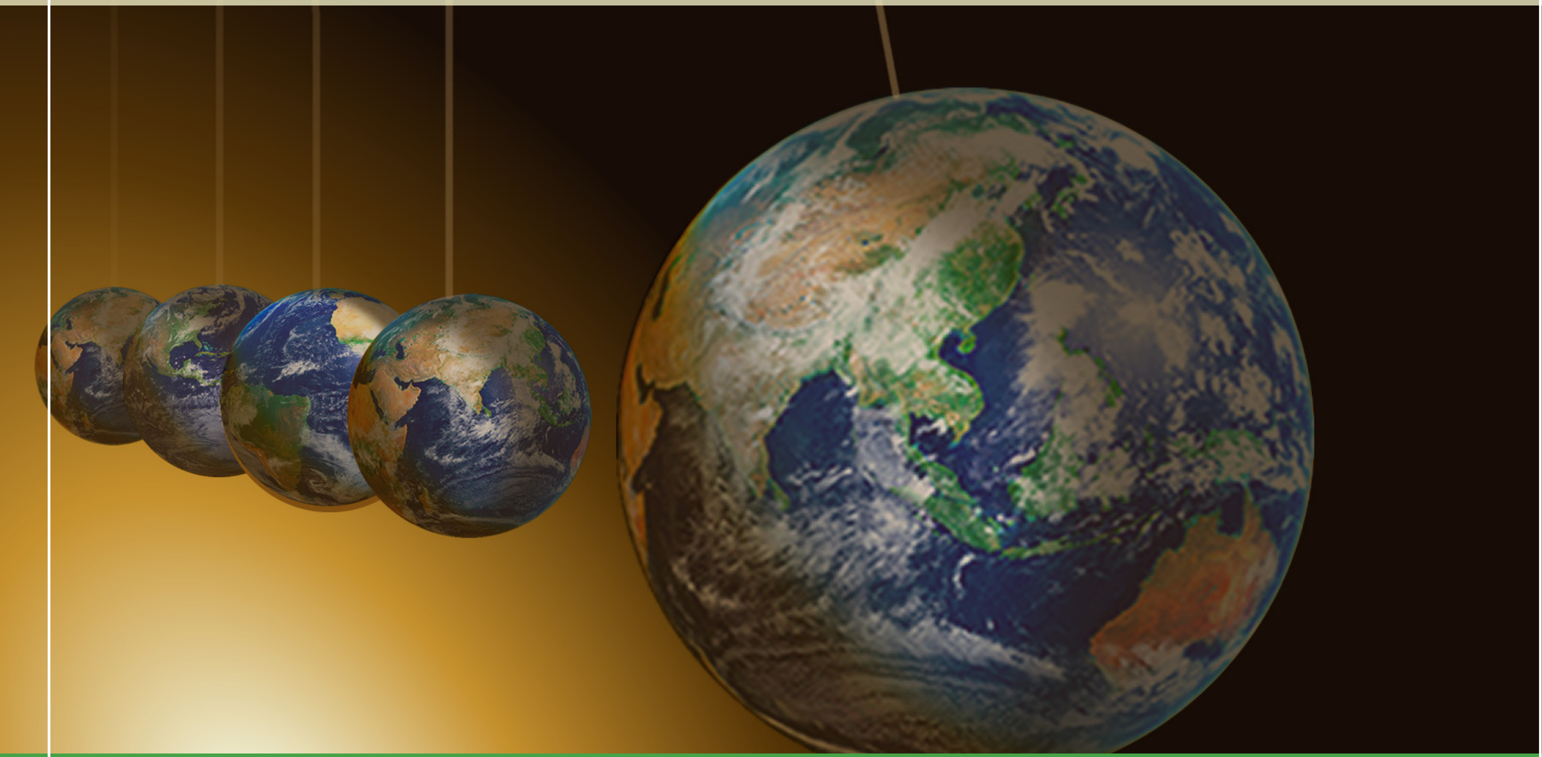

In this Report:

- A Multi-Speed Global Economic Future
- The Critical Importance of Domestic Demand
- The Developed World
- The Developing World
- Domestic Demand and Economic Dynamism

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A Multi-Speed Global Economic Future

The recovery cycle is now over five years old. Even though it has been longer than the post-war average of 4.8 years, the global economy remains fragile with uncertain outlook. Many have voiced concerns that the major economies of the world have yet to close the so-called output gap, meaning their economies are expanding at a rate below their capacity. In a more typical business cycle, the usual challenge would have been overheating at this stage, not under-performance.

We don't even need to believe in the concept of the output gap, or that it can be precisely measured, to see that there is no dynamism in the global economy. Global economic growth in the past five years has been uneven, intermittent and generally weak; with different parts of the world diverging rapidly in prospects. This is in sharp contrast to the decade prior to the 2008/09 global financial crisis when a super abundance of liquidity and credit created the classic rising tide lifting all boats phenomenon, when any Tom, Dick and Harry could have half decent economic growth by doing the minimal or nothing at all. But that rising tide has vanished, and the bubble has burst. Now every country has to chart its own way forward. And the economic fundamentals governing their prospects turn out to be very different between them, and that is why the global economy is facing a multi-speed future in the coming decade, with all the complexity that it entails.

Firstly, there is a major difference today between the advanced economies and emerging markets in terms of debts (and we are talking about the sum total of government, corporate, and household debts). In the past, problems of high and unsustainable debts were exclusive to poor and developing countries. It was seen basically as a poor country problem. But in a very dramatic departure from historical experiences, today we are confronted with high and increasingly unsustainable debt levels in advanced economies. Emerging markets, in contrast, are doing much better. For example, total debt load is an astonishing 460% of GDP in Japan, close to 400% in Spain, over 300% in Greece, Portugal, Italy, and France. The US debt level, on the other hand, is a more manageable 250% GDP. In contrast, total debt in China is just over 200% of GDP, and it is only 125% in India, 105% in Turkey and around 75% in Mexico.

Such high debt loads in the advanced economies means that low inflation is a problem and deflation positively dangerous. This is because the best way for a country to get out of debt is through strong economic growth coupled with moderate inflation. Deflation creates the worst possible situation whereby the debt load automatically increases as time goes on. Even if a highly indebted country manages some economic growth and avoids deflation, its fiscal policy remains necessarily constrained, reducing its ability to invest in physical and social infrastructure that is critical to raising productivity and long term growth, as well as narrowing its policy options for responding to external shocks or domestic social needs.

For many emerging markets, even with relatively low and manageable debt loads, they now have to cope with stagnant demand for their exports in the advanced economies, which are their traditional markets. In the decades before the 2008/09 global financial crisis, world trade grew twice as fast as world GDP. However, in the last five years, alarmingly, world trade grew slower than world GDP. It is now much more difficult for any country to export its way out of economic difficulties. The slowdown in China has also seriously affected global demand for commodities and related resources, hurting commodity exporters. The dramatic collapse of the world price of oil last year further undermines the balance of payment position of many oil exporters, especially those with higher costs of production like Russia and Iran.

The Critical Importance of Domestic Demand

Against such a global economic environment, strengthening domestic demand is the most promising way forward in generating robust economic growth. Domestic demand has two components: domestic investment and domestic consumption, which could come from either the private or the public sector, or both. For domestic demand to be sustainable, especially when external demand is weak, domestic investment and domestic consumption have to become mutually reinforcing. When domestic investment is generating high social and private returns, economic efficiency improves, business profits rise and employment and income grow. The middle class then expands, and its higher spending drives developments of the consumer market. An expanding consumer market in turn creates exciting new opportunities for further investment. Thus, under the right conditions, a virtuous circle linking domestic investment and domestic consumption can be set in motion, leading to a sustainable increase in domestic demand that can support robust economic growth. In the multi-speed global economic future, strong domestic demand will be the new criterion of success. The varying abilities of different countries in generating sufficient domestic demand are the primary reason that they will move at different speeds.

The Russian novelist Tolstoy famously said that happy families are happy mostly for the same reasons, while unhappy families tend to have their own specific reasons for being unhappy. I think we can say the same for economies; successful economies tend to be successful for more or less the same reasons, whereas unsuccessful economies tend to have their own specific reasons for failure. Here is a closer look at both the developed and developing worlds to highlight some of the common features among those succeeding in generating sufficient domestic demand, and specific reasons among those who fail.

The Developed World

The US has been the best performer among all the advanced economies in the post-crisis years. This is in spite of its near dysfunctional politics, which speaks volumes about its non-financial private sector's resilience and abiding capacity for self-regeneration. But domestic investment remains low by historical standards, which is a key reason why unemployment has taken an inordinately long time to come down. For instance, there has been far too little upgrading of its aged infrastructure which is crying out for more investment.

Ironically, what is holding back domestic investment in the US today is its close-to-zero interest rates. Don't get me wrong, the very decisive and aggressive actions by central banks, led by the Federal Reserve, in pumping liquidity into the financial system clearly held back the global economy from falling off the cliff in 2009. But a prolonged period of keeping interest rates close to zero is now undermining the creative-destruction dynamics that is the wellspring of innovations and renewal in any market economy, and in the US especially. Quantitative easing and close-to-zero interest rates together reduce the cost of holding onto bad investment. They allow bad companies to survive and poison the operating environment for good companies, thereby shutting off opportunities for new and innovative business entries and start-ups. As a consequence, business investment is weak and economic dynamism suppressed. Worse still, the longer interest rates are kept low, the more the business cycle becomes dependent on central bank's printing press, and the more likely domestic investment is suppressed. It also kicks the can down the road in terms of re-financing bad loans and rollovers, storing up problems for the future. Today, much depends on how soon and how quickly the Federal Reserve would normalize interest rates. The sooner and quicker it happens, the more likely that domestic demand would rebound to rejuvenate the US economy.

"Strengthening domestic demand is the most promising way forward in generating robust economic growth"

In the Euro zone, the crisis is by no means over. As Churchill said after the Battle of Britain, "This is not the end, this is not even the beginning of the end; this is perhaps the end of the beginning." The current stability in the Euro zone came about as a result of the European Central Bank's (ECB) policy of "outright monetary transaction", its announced intention of buying any amount of distressed Euro zone sovereign debts for as long as necessary to prevent an outright collapse. That calmed the market, but in terms of economic fundamentals, nothing much has changed since the eruption of the crisis. A huge amount of structural reforms will be needed to end the crisis.

When the crisis first erupted, the Eurocrats who run the Euro zone were caught in a dilemma; they knew the debt crisis has to be tackled convincingly to avoid a collapse of the euro, but they were paralyzed by fear. On the one hand, they feared contagion if they moved toward debt restructuring aggressively, which may have made financial instability worse (investors could have abandoned all Euro zone government bonds altogether). On the other hand, they feared moral hazard if they sought debt socialization as a solution, and that would have further aggravated the acrimonious North-South divide within the Euro zone. So they compromised with half-way measures: they lent to the crisis countries at penalty rates while rejecting debt-restructuring, which is economically incoherent and strategically ineffective. A state of temporary stability has been purchased at a horrific price of massive unemployment and economic contraction in the crisis countries and alienation of the German bloc countries in the north. And they have dangerously raised the risk of long term stagnation.

Today, domestic demand is even weaker than before and the threat of deflation looms ever larger. To say that the market stability today is more apparent than real is an understatement; it is likely to be very transitory. The ECB is gearing up to operate large scale quantitative easing to shore up the markets for sovereign debts. Such a move is set to stroke further the tension of the North-South divide. The ECB's position is that wholesale purchase of government bonds is not the same as providing support to any particular Euro zone country, which would violate the separation between monetary and fiscal policy, and is explicitly forbidden by Euro zone rules. Instead, ECB argues that the objective of quantitative easing is the policy instrument that a central bank must rely on when its policy interest rate has hit zero; it has nothing to do with supporting sovereign solvency. Unsurprisingly the Bundesbank does not agree.

"Today, domestic demand is even weaker than before and the threat of deflation looms even larger "

The deeper fear of the Bundesbank is that large scale quantitative easing would lead the Euro zone into a trap, it would make the ECB hostage to government behaviour in the crisis countries. Ultimately quantitative easing by the ECB can be justified only if the governments in the crisis countries can effectively implement structural reforms, however painful, with the window of opportunity afforded by the ECB action. The German electorate in general and the Bundesbank in particular have very little faith that governments in the crisis countries would behave with sufficient discipline and determination to justify ECB's quantitative easing. Furthermore, German anxiety has also grown regarding Italy and France. Although not part of the original crisis countries, both are showing increasing signs of fiscal indiscipline with rising debts and saddled with structural rigidities similar to the crisis countries.

Financial markets appear to have priced in ECB's quantitative easing, which is expected in 2015. There is therefore a real risk that should the ECB disappoint, bond and foreign exchange markets may see abrupt and chaotic unwinding of positions, leading to rising long term rates, tanking stock markets and renewed eruptions of the crisis.

Ultimately, in order to rejuvenate domestic demand, the Euro zone has to drastically reduce structural rigidities in its labour and service markets in crisis countries as well as in Italy and France. In these countries, labour and capital need to be redeployed flexibly and quickly to the more productive (and usually the tradable) sector if they are to become more competitive. Successful deep structural reforms would also ease German anxiety and re-open the flow of capital from the German bloc countries (net savers) to the rest of the Euro zone (net debtors). This is, however, a prospect that is at least several years away. In the mean time, domestic demand suffers and will remain insufficient to lift economic growth in the Euro zone in the foreseeable future..

The trap of quantitative easing in the Euro zone that the Bundesbank fears has been fully sprung in Japan. The Bank of Japan already holds massive amounts of government debts at around 40% of the total, and it is committed to new purchases amounting to 16% of GDP more each year going forward. Increasingly it is not possible to speak of a market for Japanese government debts given the size of Bank of Japan's holding. Effectively it is the Bank of Japan that sets the price of government debts.

Under these conditions, it is not an exaggeration to say that the Bank of Japan is now being held hostage to the Japanese government. The Bank of Japan's actions are justifiable only if the Abe government is successful in repairing public finance and making it sustainable, rolling back deflation, and reigniting economic growth. Should the Abe government fail, then the Bank of Japan would find itself in a deep dilemma: if it stops buying government debts, or even if it buys new debts at a slower pace, it could unleash a sovereign debt crisis, and reduce the value of its portfolio; if it continues to buy government debts when it is clear that structural reforms are unsuccessful, then it is abetting irresponsible government behavior that could eventually lead to a total meltdown of the financial sector.

There is so far scant evidence that more than two decades of debt-funded public investment in Japan has led to rising domestic consumption, hence the virtuous circle linking domestic investment and domestic consumption is nowhere to be seen. Under conditions of a seriously old population, a shrinking labour force, and a female labour force participation rate firmly stuck below 50%, the Abe government has its hands full trying to maintain current domestic consumption, let alone boosting it.

In the developed world over the coming decade, the US has the best chance to see its domestic demand to rebound through rising investment and business innovations, sustaining robust economic growth. The Euro zone may muddle through if new institutions can be built in time to turn the currency union into a fully-fledged transfer union (with all the socio-political consequences that it implies); while the risks of a re-eruption of the crisis cannot be ruled out. If there is a dim light at the end of the (very long) tunnel for the Euro zone. By comparison all Japan is likely to have is just the tunnel! Domestic demand in Japan is set to shrink, and the only uncertainty is the rate at which it will do so.

The Developing World

China is the single most important economy in the emerging markets universe today, and how it performs in the multi-speed global economic future will have far-reaching impacts on emerging markets and developed economies alike. Not surprisingly China's recent economic slow-down has set alarm bells ringing in many quarters.

Contrary to what you may have read in the media, the slowdown in growth in China is actually the good news. It is a sign that the rebalancing of the Chinese economy is finally happening. Export has slowed from an average of 29% annual growth in the 2001 to 2008 period to below 10% in the last few years, making foreign demand a less critical economic driver. More significantly, manufacturing employment and output as a share of total began to decline in 2013 for the first time in almost 30 years, while services for the first time accounted for more than half of total economic growth. Labour's share of national income actually started to rise in the last two years, and as a result the gini coefficient that measures income inequality dropped from 0.52 in 2010 to just below 0.50 in 2013 (the lower the gini the better the income distribution).

We need to recognize that a lower Chinese GDP growth rate implies a quantity/quality tradeoff. Lower growth rates now come with better growth quality. China will be importing more for domestic end use consumption on a per unit GDP basis compared with the past. Domestic services, which are closely geared toward meeting everyday lifestyle needs, will become the primary economic engine. And China is also contributing more to rebalancing the global economy; its current account surplus has shrunk from its peak of 10% GDP in 2007 to below 2% today. So the current slowdown in China's growth is not a sign of trouble, in fact quite the opposite. China is transiting to a lower and more sustainable growth trajectory in the coming decade as its economy becomes increasingly domestic demand driven, even though it will continue to be a powerful export machine. Annual growth in real GDP in the range of 5-7% will be the norm, which is also much more appropriate for China's level of per capita GDP with a more service-driven economy.

> "Strengthening domestic demand is the most promising way forward in generating robust economic growth "

In India, a cyclical upturn is baked into the cake, as it were, after Modi's election victory. The open question is whether difficult reforms can be implemented in the next few years to generate a structural lift of real GDP growth to the 7%-9% per year trajectory. As is well known, the two key bottlenecks that have been choking off growth in the economy are poor infrastructure and labour market rigidity. India's infrastructure deficits stem in part from problem of land acquisition. A small minority who own a crucial piece of real estate can hold developers, and sometimes even the government, to ransom; blocking project development for years and even decades. China's extraordinarily rapid infrastructure development has come at a cost to protection of small landholders' rights, while India's inability to fast-track its infrastructure is because of the disproportionate power of the small landholders who are capable of holding back progress of the whole society. A more efficient land acquisition process is desperately needed in India to drive growth higher.

The second bottleneck, labour market rigidity, is blocking the expansion of India's labour intensive manufacturing. With China exiting low-end manufacturing due to rising wages, there is a window of opportunity for India to expand in this sector. The potential is massive; manufacturing value-add amounts to a mere 13% of GDP in 2013, compared with 30% in China. But labour market liberalization and better infrastructure and logistics are the prerequisites for India to realize its potential in labour intensive manufacturing.

Meeting these prerequisites are equally important for expanding another industry that can also create tens of millions of better paid jobs for India's vast army of low skilled workers – tourism. According to World Tourism Organization, tourism contributed only 7.7 million jobs in India in 2013, lower than 8.3 million in Indonesia and 15.3 million in Thailand (both with much smaller populations than India). Together, labour intensive manufacturing and tourism hold the key for creating jobs for about ten millions of young Indians that are entering the workforce each year. These jobs are crucially important for turning India's current demographic burden into demographic dividends.

Should the Modi government succeed in opening up the two bottlenecks of infrastructure and labour market rigidity in the next few years, then the virtuous circle linking domestic investment and domestic consumption could be set in motion in the coming decade, easily lifting real GDP growth to the 7%-9% range, transforming India into an economic power house.

Besides China and India, the Association of Southeast Asian Nations (ASEAN) is shaping up to be a third important economic player in the developing world. By the end of this year, the ASEAN Economic Community will come into being, with its ten members forming a free trade zone.[1] Collectively, ASEAN is a close to US$3 trillion economy, bigger than India, and would make it the seventh largest in the world if it is counted as a single country. Over the 2000 and 2013 period, ASEAN's collective GDP grew by 5.1% a year in real terms, ranking it third in the world just behind China and India. ASEAN governments also have generally maintained their fiscal house in good order, with their collective debt to GDP ratio estimated at a very healthy 46.7% in 2013.

Precisely because the member countries are so diverse in terms of income level, resource endowment, infrastructure, developmental conditions and population size, their respective comparative advantages can be leveraged much better once trade barriers between them start to come down. Even if the pace of integration is slower than planned (highly likely), the virtuous circle connecting domestic investment

1 They are: Indonesia, Philippines, Vietnam, Thailand, Cambodia, Laos, Myanmar, Malaysia, Singapore, and Brunei.

and domestic consumption will take off in ASEAN in the coming decade. Domestic demand will become a steady driver of growth regardless of the ups and downs of the global economy.

Beyond Asia, the prospects of stronger domestic demand supporting economic growth in the developing world vary dramatically from one region to the next and between countries. Through the lens of domestic demand, they can be seen as belonging to two groups: net exporters and net importers of commodities and resource.

Net exporters of commodities and resources are clearly affected by weak global demand, and oil exporters are further shaken by the collapse of the world price of oil. Prospects of their economic growth are now fully contingent on how effectively they can substitute external demand for their resource exports with domestic demand. In this regard, countries like Australia and Indonesia are much better positioned because of their strong domestic demand; private domestic consumption is very robust in both countries and Indonesia is also benefiting from a rising investment cycle. At the other end of the spectrum are Russia and Sub-Sahara African countries, such as Nigeria and Angola, which are highly dependent on oil exports. Once their shares of GDP based on oil exports are stripped away, their economies look emancipated with very poor domestic demand. Declining exports in these countries could easily lead to a downward spiral of currency depreciation, deteriorating balance of payment, rising interest rates, and financial sector turmoil; which then further erodes domestic demand. Russia is Exhibit A in this regard.

Through the lens of domestic demand, countries in Latin America can also be separated into two groups. The first are countries that are more market oriented, with floating exchange rates and low cost of capital, and where domestic demand is more resilient. Mexico, Colombia and Chile belong to this group. The second are countries where governments are wedded to populist policies with subsidies, high taxes, and income transfers, leading to chronically weak fiscal accounts. They also have multiple exchange rates, high deficits, and large country risks. Brazil, Venezuela, Peru, and Argentina belong to this group where it is a lot more difficult to increase domestic demand.

Overall, the economic outlook of the developing world is just as mixed and complex as in the developed world, which is characteristic of the multi-speed global economy.

Domestic Demand and Economic Dynamism

In an earlier GEMS report, I described an economic growth engine for emerging markets as having four cylinders: innovations, investment, market, governance.[2] They apply equally well in describing domestic demand. The only adjustment needed is to narrow the definition of the "market" cylinder to the domestic market, excluding exports. Where domestic demand is strong and expanding, these four cylinders

2 "The Future of Emerging Markets: Prospects for Global Economic Convergence", GEMS, 1Q, 2014.

are firing in concert – which is the common feature of Tolstoy's "happy families". Weak and insufficient domestic demand, on the other hand, could stem from a wide range of causes that stop some or all of the cylinders from firing, consider the differences between Euro zone, Japan, Russia, Brazil and Angola; *a la* Tolstoy's "unhappy families".

And the emphasis on domestic demand is not to be confused with a closed economy and autarkic policies of "self-sufficiency". In fact, strong domestic demand can come about only if there is an open economy for transfer of ideas and knowhow (the innovations cylinder), capital flow (the investment cylinder), transmission of consumer lifestyle and consumption trends (the market cylinder), and a level playing field for business operations, entry and exit regardless of whether they are local or foreign (the governance cylinder).

An economy characterized by strong domestic demand, driven by the virtuous circle of domestic investment and domestic consumption, is also a society that exhibits dynamism. It is a society that is optimistic about the future, thrives on entrepreneurship, embraces innovations, relishes and welcomes change and creative-destruction. Furthermore, such a society is likely to be more at peace with itself and with its neighbours, surely a very desirable characteristic in the world today.

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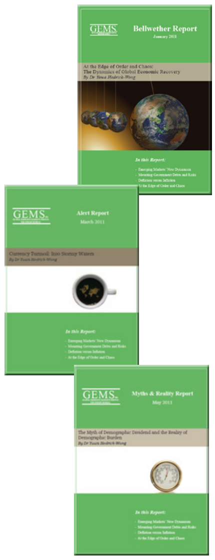

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