think piece

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Emerging Markets: Upwardly Mobile Economies and New Consumerism

Vanessa Rossi

Summary

- The global background is becoming more encouraging. In spite of continued concern for the health of the major developed economies, their steep recession is beginning to bottom out and it may, technically, have come to an end over the summer. However, a true recovery can only be announced when business confidence and investment return along with consumer spending.
- In the wake of the 2008 crisis, emerging markets saw growth slow dramatically. While some are still performing very poorly, much of developing Asia, especially China and India, has continued to grow relatively robustly. These economies could not avoid severe contagion, but they have certainly prevented global growth from plunging into as deep a recession as the developed world.
- China, India and the rest of Asia will quickly benefit from any upturn in the US and Europe, restarting exports to run alongside the internal demand motor. On a sectoral level, while the ICT sector may be the key to encouraging a fairly speedy recovery in Asia's exports, internal demand growth will boost urbanization as well as ownership rates for homes and durables such as cars and household appliances.
- This development boom in the next layer of global consumers was already predicted before the current crisis, and despite the recession, this boom is still on its way. Growth in financial services will be stimulated by products linked to the fast rising ownership of consumer durables and property as well as coming directly from demand for services such as bank accounts, credit and personal insurance.

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CII Introduction: Looking beyond the current recession, the recovery is widely expected to produce a substantial rebound across emerging market economies even if growth in the developed world remains relatively weak. In this sixth in the series of thinkpieces by Chatham House, Vanessa Rossi looks at the prospects of the emerging markets.

In the early stages, this rebound will probably focus on Asia, indeed figures from key parts of Asia are already looking better than expected, with growth in India and Indonesia, for example, fairly robust and China leading the way, even gaining an upgrade in the World Bank's and IMF's summer forecasts. Latin America, the Middle East and Africa will also reap benefits from former commodity demand and prices in the future, encouraging local demand to revive. However, large parts of emerging Europe look likely to take longer to recover given poor prospects for demand and trade in key European markets, heavy competition in those markets, the end of the property boom and the overhang of debt and financial problems, which will all hold back both regional consumption and investment. The most nimble and financially robust of the new EU members may do well but others could find that tough competition in the same markets and products (the result of too much copy-cat development) and tougher credit conditions make it hard to succeed.

Although at least modest signs of an improvement in consumer spending in the US and Europe will be essential if the current revival in confidence and hopes of recovery are to be maintained, the key driver of the world's next decade of growth will be the developing world, inevitably led by role model China, the only developing country in the top tier of the world's largest economies. What happens next to China is therefore critical. If growth remains steady and strong, this will boost confidence in the potential for a recovery led by emerging markets. But if China starts to show signs of instability as a result of the extraordinary efforts made to support economic growth through the turmoil of the last year, this could be taken as a sign that emerging markets are not yet able to take on the leadership role. Prospects for world growth may be marked down.

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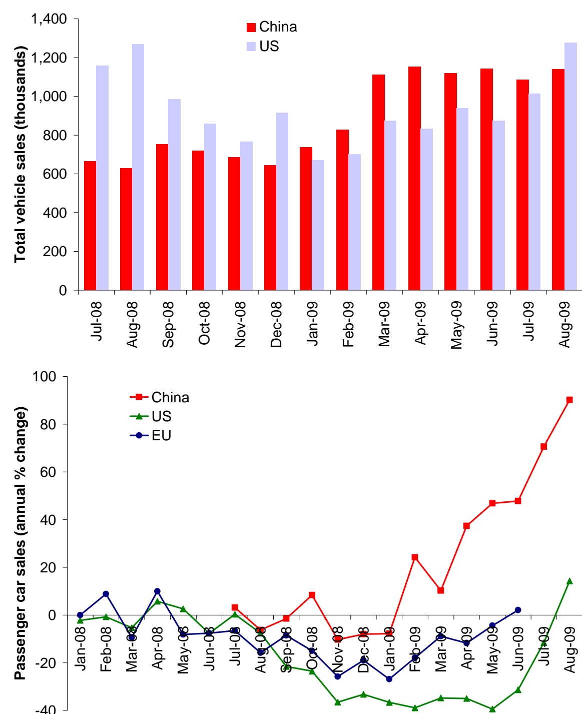
So far, the news is fairly positive. In spite of its growth rate almost halving compared with the 2007-2008 peak to just 6.1% in the first quarter of 2009, buoyant domestic demand growth helped offset a large loss of 20-25% in exports. China's economy has continued to expand, accelerating to 7.9% in the second quarter, supported by easy monetary policy, including a massive surge in credit, and a big fiscal boost, which may be worth as much as 15% of GDP over two years. It has been able to maintain much of its vibrancy in terms of local consumer spending (retail sales up by around 15%) and investment (rising by more than 30%).

This strength is epitomised by the continued growth in car production and sales, in contrast to virtually every other major market, excluding the one-off impacts of the car scrapping schemes in some countries (especially visible in Germany and France and now followed by the UK and US). Monthly unit sales in China reached over 1.1 million vehicles per month at their peak this year, temporarily overtaking the US. However, sales have been helped by massive tax cuts (up to 50%) on small cars, which have had an even more dramatic effect than scrappage schemes in Europe, turning the Chinese motor industry's end-of-2008 decline into rapid double-digit growth. Since February, sales have been 46% higher on average than the previous year and the total stock of cars registered is also rising at a double digit rate given the still low ownership rate in China.

China/US/Europe car sales



Sources: CAAM, BEA, ACEA

Notwithstanding the boost from tax breaks, the car market is an important signal of the resilience of domestic demand in China. There has also been a boom in household appliance sales, in part thanks to promotion schemes in the poorer rural areas (where ownership rates for such goods remained very low).

Purchases of high ticket durables also point to the growing need for related products and complementary services. These include not just energy inputs but insurance and other financial services, such as consumer credit. This is also true for other emerging economies besides China.

In this article, we will examine prospects for future growth and development not just in China but across the emerging market world, drawing important implications for consumer markets and also financial services development.

1. From boom to recession – and now hopes of recovery?

As we highlighted in the opening article in this series, published at the start of 2009, the extraordinary recession that kicked off last autumn quickly spread to all regions.[1] The slump in demand from the leading developed economies, along with the global credit crunch, inevitably hit trade and investment around the world. Indeed, estimates of the depth of the plunge in GDP in 2009 point to a drop of 4-5% for the OECD and as much as 2-3% at the global level. The developing world has seen growth fall to near zero, possibly less, considerably weaker than consensus forecasts initially predicted, with Asia almost the only source of growth.

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In the midst of this massive global downturn – as total world trade fell by around 20-30% in early 2009 - even China struggled to support its manufacturing growth. In spite of enormous fiscal and monetary packages being promoted by the government at the end of 2008 (much of this coming from the cash-rich banking sector), policy easing came too late to prevent a sharp slide in GDP growth to just 6.1% by the first quarter of 2009 – just half the recent peak in growth of more than 12%. In the same period, and representing a shocking measure of the scale of devastation across the global economy and world trade, GDP in Singapore, a key hub for Asia, actually contracted by more than 10%. Taiwan was similar to Singapore, hit by the heavy losses in ICT trade, and Hong Kong was only slightly better, with GDP down nearly 8%. While Brazil's recession is expected to be shallow, Latin America's second largest economy, Mexico, may also be heading for an 8% drop in GDP this year, although, in this case, the impact of the flu outbreak has been a significant contributing factor. But some of the worst figures have come from Eastern Europe, with the Ukraine and the Baltic states seeing GDP fall by as much as 20% in early 2009 and the largest economy, Russia, possibly heading for a loss of 10% this year.

In spite of the worse than expected results for early 2009, sentiment was given a boost by the G20 agreement (finalised on 2 April) regarding new financing for the IMF to provide aid to badly hit developing countries – this deal served to allay immediate concerns about the recession taking another lurch down on the back of a possible deepening of the financial crisis in those emergers with large external debts. A key beneficiary from the expansion in IMF resources was Eastern Europe, where financial problems were feeding back into the EU banking system, adding to the risk of a new round of turmoil. Thus the outcome from G20 was fairly positive for EU banks as well.

The boost to financial market confidence and liquidity has helped support the rally in global stock markets and encourage expectations of recovery in the OECD economies. Nevertheless, current indicators are only pointing to the downturn stabilizing in the US and Europe and a true recovery will be some way off. Even central banks keen to get policy back to a more normal footing are restraining themselves and warning that there could be a bumpy and long drawn out recovery for the major economies and also much of emerging Europe. Apart from the need to resolve issues involving the financial and property sectors, the recession-induced rise in unemployment and government deficits will take time simply to stabilise over the next year before the unwinding process can get underway. Governments are already talking about the need for "exit strategies" from the bail outs and fiscal spending increases implemented during the crisis, implying their actions will also curb domestic demand growth in the post-crisis period.

"In spite of a still weak second quarter, there are more signs of a genuine pick up in the US, with a modest pick up in imports over the summer backing up evidence of some revival in consumer demand."

However, on a very short term view, some economies have indeed seen a bounce back from the depths of early 2009. In particular, Singapore but also China and other Asian economies have reported a rebound in the second quarter, although others remain weak, for example Russia and much of Europe. Most surprisingly, there has been a pick up in GDP in Germany and France,

[1] Vanessa Rossi, "Coming up for air after the recession: which countries and sectors would lead a recovery?," *CII Thinkpiece*, no.10, January 2009
http://www.cii.co.uk/downloaddata/Chatham_House_1-Coming_up_for_Air_vF6_Jan09.pdf

allowing the duo to be the first developed economies to declare an end to recession - less fortunately, the key reason for this reported rebound in GDP is a drop in imports, which has negatively impacted on trade partners. In spite of a still weak second quarter, there are more signs of a genuine pick up in the US, with a modest pick up in imports over the summer backing up evidence of some revival in consumer demand. In addition, a rebound could be encouraged by restocking following the large fall in inventories during the crisis – some of which was linked to cut backs in orders by retailers and wholesalers as a precautionary move in the midst of the credit crunch of last autumn and fear over the depth of the recession. News of workers being recalled to restart production in some sectors (e.g. in Japanese car plants) during the second quarter has been a mildly positive sign versus the general picture of rising unemployment.

The mild recovery in the developed countries over the summer is tentative and largely due to one-off adjustments (like Germany's net trade) and the effects of fiscal packages, easy monetary policy and the drop in inflation caused by weaker commodity prices versus a year ago, which is benefiting consumers. But any pick up is good news and will help turn the recessionary tide, lifting global production and trade from the lows reached in early 2009.

The key point for the developing world is that even a weak recovery in US and European demand, for example to the levels seen in 2007, would enable key global industries to at least get back to work rather than face lengthy or permanent closure. This is especially important for Asia, the world's workshop, but it is also crucial for Europe's largest economy, Germany, where exports also represent nearly 50% of GDP and for emerging Europe, where many new EU member states have Asian-style export/GDP ratios well above 50%. Global demand is critical for key industries such as the car producers and ICT, two of the worst hit manufacturing sectors. Securing some increases in sales and production will be the important first step to getting the world economy working again.

After this first step is secured, stronger growth in domestic demand across the developing world will be able to resume quite quickly, enabling it to generate its own growth dynamic and sustain a robust expansion. Conditions may not be quite as buoyant as when the world was firing on all cylinders in 2004-2006, with GDP rising at 4-5% rates, but global growth could still recover to around 2-3% as long as the developing countries can average rates of 4-6%, with the OECD block rising by 0-2%. In this case, the concept of "decoupling", that fell out of favour as the world tumbled into recession, will re-emerge stronger than ever. In contrast to the feeble potential of the developing world during previous global recessions, now this half of the world economy should be large enough and sufficiently strong financially to be able to generate high growth rates from internal demand, leading the world economy ahead, even if the developed world remains sluggish for some years to come.

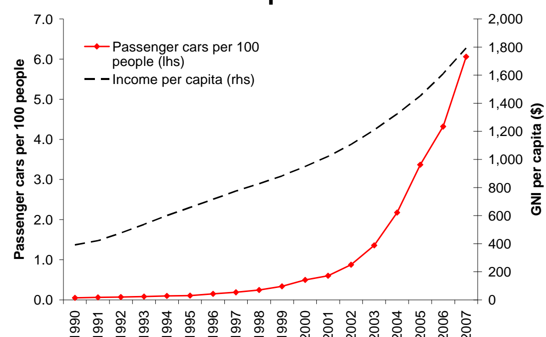
"Lagging behind in the development process are other household durables […] and access to services such as health, education and also finance. These will benefit most from the next phase of growth."

Virtually all forecasts – whether they suggest a rapid rebound in the OECD economies or a slow, weak recovery – point to the re-emergence of robust growth in the developing world by 2010-2011. And most agree that it will be Asia that takes the leadership role for global growth.

2. Consumer growth in the developing world to take the lead

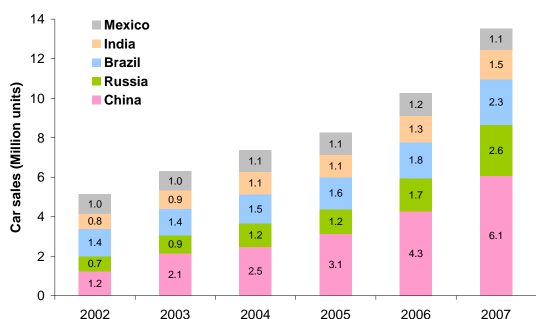
Apart from pushing up GDP and incomes, development is also rapidly raising urbanization rates and increasing consumer demand across a broader spectrum of goods and services. Ownership rates for TVs and mobile phones are already relatively high in most developing countries, even the poorest, plus there is widespread access to communications and, in most cases, transport services. But lagging behind in the development process are other household durables (e.g. washing machines, air conditioners and refrigerators as well as private cars) and access to services such as health, education and also finance. These will benefit most from the next phase of growth.

Chinese Car Ownership and Income



Sources: World Bank, China Statistical Yearbook

Car sales in emerging markets



Source: Fenabrave

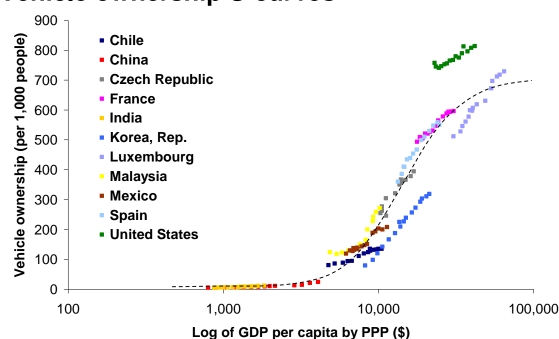
"Countries moving up the income and development curve usually see a rapid increase in use of the formal financial services sector, most clearly signalled by the start up of bank accounts and use of credit cards but also including access to insurance and other products."

The transition process from a simple cash economy to adoption of the full range of banking and financial services may be held back by educational standards and informal employment practices. However, countries moving up the income and development curve usually see a rapid increase in use of the formal financial services sector, most clearly signalled by the start up of bank accounts and use of credit cards but also including access to insurance and other products. To illustrate this, in China there were 2.2 billion bank accounts registered in 2008, a 10% increase from the previous year, and 1.8 billion bank cards in circulation, over 20% more than in 2007 (although credit card access is much lower, under 10% of the number of bank cards in circulation).

These trends are typically illustrated by cross-country comparisons in the form of "S curves", showing the income threshold at which there is a very strong surge in demand for certain products (e.g. private cars), which bring with them demand for linked financial products and insurance. Demand growth eventually tapers off at higher income levels, in line with mature markets. For cars, for example, sharp increases in ownership rates are evident from around the $5-6,000 threshold of GDP per capita (measured in PPP terms, probably equating to income levels of about $3-4000 at market rates). The peak for the income elasticity of demand is around $10,000 and demand then starts to level off at about $20,000. However, it is important to note that factors such as culture and geography also play a role. In China, for example, car ownership only began to grow at faster rates than income from the mid 1990s, from a very low base, and it will grow even faster as the middle-class population swells. For upper middle-income countries, which already have a relatively higher standard of living compared to other developing economies, periods of sustained growth also tend to have a pronounced effect on access to finance (particularly credit and insurance) even if the growth in ownership of consumer products has already begun to slow.

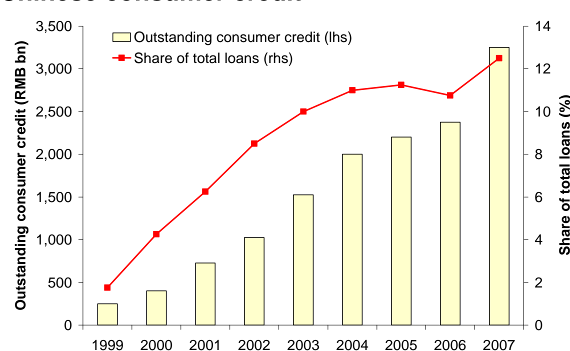
Governments may also take an active part in expanding the role of financial services among the general population and boosting consumption through incentive schemes. The China Banking Regulatory Commission has recently proposed the creation of consumer finance companies in four major cities (including Shanghai and Beijing) providing personal loans for consumer durables (and government incentives for car and other durables sales were already mentioned above). The stated intention of such plans is to 'transfer China's growth model from export led to consumption oriented' but this will also serve to broaden the scope of financial activities for local and foreign firms. In Africa, Nigeria has lifted the ban on foreign participation in its banking sector, thus opening up the continent's potentially largest market for financial services.

Vehicle ownership S-curves



Source: World Bank

Chinese consumer credit



Source: BIS (PBC)

Although the recession experience has dented confidence in the growth process and in the financial system in particular, a return to growth will improve sentiment once more. As households move up the income ladder, and the financial system gradually restores its credibility, there should be a simultaneous return to fast growth in the numbers of people using banks and financial

products for the first time. This trend may not be too pronounced in the early stages of recovery but should gather pace in the next couple of years. Indeed, for products linked to purchases of durables such as cars, the recovery may be even swifter as many governments (not just China) are trying to encourage local demand to pick up as a way of boosting GDP growth during the recession. In addition, the current weakness in the global car market has meant heavy discounts in consumer prices to further encourage new buyers.

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Overall, post crisis, it will become increasingly evident that emerging markets have moved into the driving seat of the world economy and this will be all the more important if recovery in the advanced economies is sluggish. A significant part of this emerging market growth will be due to rising consumer spending from an expanding and more productive middle class. In addition, there will be benefits from a broadening of financial services among the general population. These trends will facilitate faster consumption growth both through access to consumer credit and through use of insurance products (such as life and accident policies), which reduce the need for very high levels of precautionary savings in liquid assets (chiefly cash and bank accounts). For example, in China this could easily imply a fall of one percentage point per annum in the household savings rate over the next decade, taking it from an official estimate of about 25% of disposable income to just 15%.

Savings rates have risen sharply in the US, as many predicted would be necessary to correct previous excesses, but, for the world to sustain a recovery, savings rates need to fall in the developing world, especially China. Roughly estimated, a rise from zero to 5% in the US savings rate could be offset by an equivalent fall of five percentage points in the developing world's average savings rate. While GDP for the developing world is almost 50% of the world total (using the PPP measure), consumer spending is still underperforming, representing only around a third of the global total. This illustrates the ample scope for catch up in this sector, potentially assisted by the financial services sector. Change is now underway and will progress even more rapidly in the post crisis years, bringing significant business opportunities with it.

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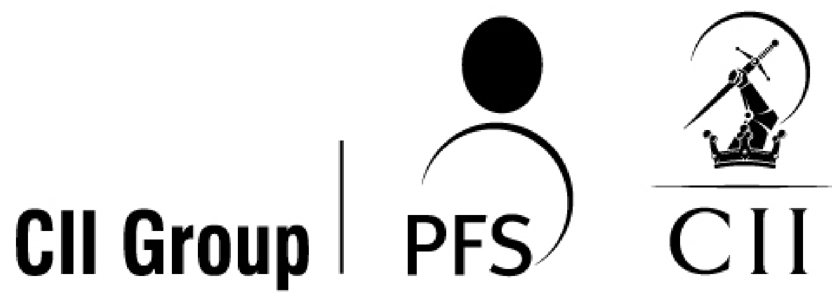
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