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The Future of Growth: The New Global Economic Dynamics of Prosperity
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By Dr Yuwa Hedrick-Wong

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Where Will Future Economic Growth Come From?

According to the IMF, world trade contracted in June this year - the first contraction since October 2009, when world trade was hard hit by an abrupt drying up of trade finance and a sharp decline in demand as a result of the 2008/09 global financial crisis. This is just one of the many signs of the fragility of the global economy, more than three years into the recovery phase of the current cycle. Clearly global economic outlook is still affected by persistent and corrosive uncertainty, an issue explored in depth in an earlier GEMS report.[1] This current contraction has also highlighted a new anxiety about the future of growth. Is the global economy merely facing some stiff but temporary head wind or is it being re-routed to a lower growth trajectory that is weaker and less dynamic than the pre-crisis period?

Today's global economic conditions contrast sharply with the pre-crisis days when growth was seen as part of the natural order; so prevalent was strong growth in emerging markets that it appeared as if it simply came with the membership – emerging markets were supposed to emerge and show strong growth. At the apex of emerging markets stood BRIC, the acronym representing Brazil, Russia, India and China - supposedly the most powerful emerging markets poised to overtake the developed world. No wonder South Africa wanted to be included as part of BRIC, adding an "S" to create BRICS; and similarly Indonesia aspired to add an "I" to turn BRIC in BRIIC. Indeed, in the decade ending with the 2008/09 crisis, economic growth was so widespread and the general level of growth so robust, that by 2007, according to IMF data, only three countries in the world were experiencing economic contraction. It felt as if recession had been banished from the global economy.

To state the obvious, this extraordinary period of widespread growth is now history. Future historians may well refer to the decade before the of 2008/09 crisis as a one-off "decade of emerging markets" - a brilliant flash in the pan. With hindsight, the unique convergence of factors which made that decade possible is sorely absent today; a global flood of easy money and cheap credit, subdued inflation which was due in part to China's supply shock, and rising global risk appetite. In those pre-crisis days, there were many straight-line extrapolations that projected scenarios of China taking over the US in the near future and emerging markets dominating the global economy. They were lauded as bold and visionary at the time, but now seem silly and foolhardy. Indeed, they now look uncomfortably similar to the confident predictions commonly heard in the 1980s that Japan was on track to becoming the world's number one in virtually everything – superior in growth, technology, business models, and competitiveness. What we are seeing now is the end of an era indeed. Where, then, will growth come from in the future?

To be able to answer this question, we need to debunk two myths. The first is the decline of the US,

1 See Prospects of Global Recovery: Uncertainty, the Animal Spirits, and Global Economic Outlook. GEMS. September 2012.

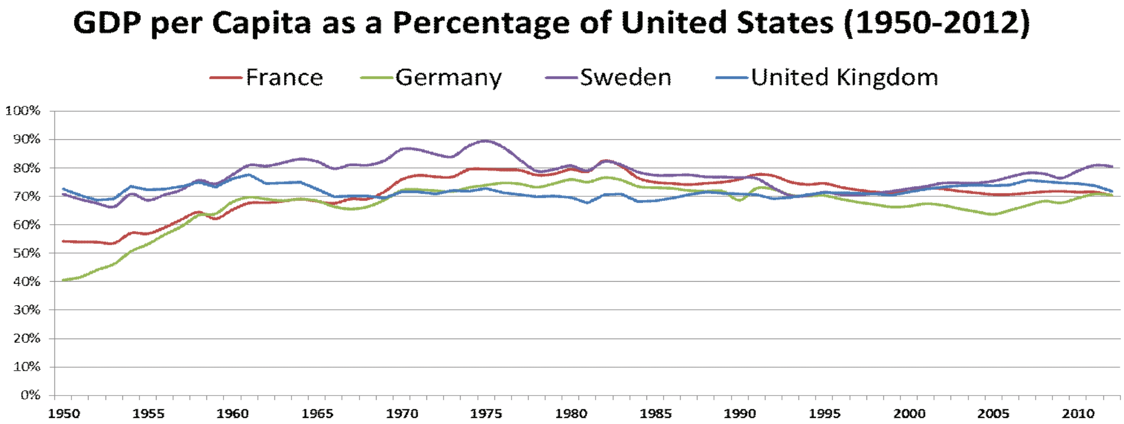
commonly portrayed as a spent force in so many of the "emerging markets rising" projections. The second is to debunk the BRIC myth, which has seriously misled our thinking about emerging markets themselves. Clearing up the misunderstanding perpetrated by these myths is equivalent to polishing the lens of our glasses, wiping away the smudges and dust, so that we can again see better what the future holds for global economic growth. In so doing, this GEMS report argues that, in the coming decade and beyond, the US will continue to be the centre of gravity of the global economy in terms of its consumer market, investment financing, technological advances, and business innovations. In other words, the US economy will be the single most important source of global growth in the future. Debunking the BRIC myth, on the other hand, will allow us to examine more realistically how emerging markets will "emerge" in the future. The short answer is through a lot of hard work. By working hard, many emerging markets will continue to rise, but there will be no more "rising water lifting all boats" type of growth as in the previous decade. The most intriguing aspect of this global economic future is that the continuing dominance of the US and the continuing rise of many emerging markets will be synergistically connected and mutually reinforcing.

From the perspective of economic fundamentals, the core ingredients for achieving strong growth will be the same as before: shifting productive resources from low to high productivity sectors, improving logistics and infrastructure efficiency, and enhancing market competition while making growth as inclusive as possible. However, for emerging markets, China included, the bar has been raised, and they will have to meet more exacting standards in the future in devising policies and strategies that are effective as well as appropriate in their specific context to ensure that these vital ingredients are working well. Thus, emerging markets will not emerge equally; some will succeed and many, no doubt, will fail. Future growth will therefore come from a diversity of sources. An economic renaissance in the US will see it securely positioned as the anchor economy of the world for the foreseeable future. Accompanying the central role of the US will be a churn of emerging markets - some rising and others falling - interconnected in an evolving ecosystem that will continue to generate new and exciting business opportunities, provided one knows where to look.

US as Number One

The phenomenon of emerging markets catching up with the developed markets is nothing new. In fact, the first markets to "emerge" after the Second World War were the war-devastated European countries when they began to close the gap with the US in terms of per capita GDP. These were Western European countries that were already highly industrialized before the Second World War. Their experience in catching up with the US is highly instructive in gaining a better understanding of the uniqueness of the American economy, while shedding light on the future of the emerging markets. Chart 1 shows the change of per capita GDP of Germany, France, Sweden and the UK as a percentage of the US from 1950 to 2010[2]. All of them started to close their gap with the US quickly after the war ended and Germany rose especially fast as a result of post-war reconstruction, powerfully supported by the Marshall Plan. However, something strange happened as the gap between them and the US narrowed; they got stuck and never managed to close the gap. Sweden, the least war-affected among them, converged with the US more quickly than others to reach 90% in the 1970s, only to fall back to 80% later and stay there. Germany rose from the post-war low of 40% of the US in 1950 to 75% of the US in mid-1980s, then it also fell back and only managed to recover to around 70% of the US in recent years. A similar pattern can be observed for France and the UK as well. In other words, there appears to be something uniquely American that renders the attempt to close the last 20% difference in per capita GDP extremely difficult, if not impossible, even for highly developed and industrialized Western European countries.[3] What happened to these Western European countries is mirrored in other industrialized and developed

Chart 1 GDP per Capita as a Percentage of the United States



Based on GDP per capita in Khamis-Geary International Dollars

Source: Angus-Maddison Database, IMF WEO

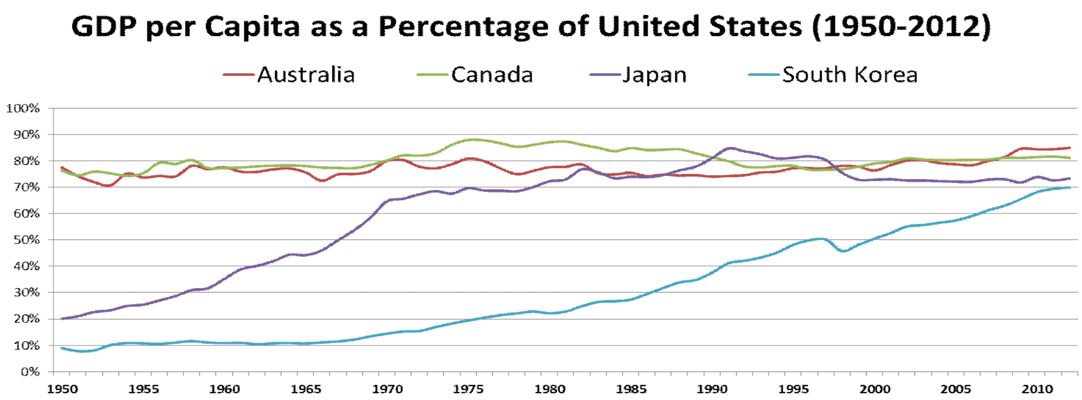
2 The common monetary unit for making the comparison is the so-called Khamis-Geary International Dollars formulated by the OECD. It is an aggregation method in which category "international prices" (reflecting relative category values) and country purchasing power parities (PPPs); (depicting relative country price levels) are estimated simultaneously from a system of linear equations. It has the property of base-country invariance, matrix consistency and transitivity. See Handbook of the International Comparison Program, Studies in Methods, Series F, No. 62, UN Department of Social and Economic Development, Statistics Division, New York, 1992.

3 The only exceptions found are a few oil exporting countries with small population and massive oil revenue.

countries. Chart 2 shows the experience of Australia and Canada, two highly industrialized and resource rich countries, and Japan and South Korea, two of the most successful East Asian countries over the same time period. Both Australia and Canada had the great fortune of not having their territories directly affected by the war [4], and began the post-war period with their per capita GDP tracking the US at around 70-80%. Canada's per capita GDP got as close to the US as 90% in the 1970s, and then it fell back and stabilized at around 80%. Australia's per capita GDP as a % of the US basically hovered around the 70-80% range throughout this period, slightly rising to around 85% in recent years. Japan's per capita GDP rose steadily as a percentage of the US from 1950 to the early 1990s, peaking at around 85%, reflecting its sustained and strong growth in the period before the bursting of its bubble economy, then falling back to just over 70% today. South Korea's economic takeoff came two decades after Japan's, and after three decades of growth it has now also reached 70% of the US. If the experience of the other countries is a guide, then South Korea is unlikely to get much closer to the US's level of per capita GDP any time soon.

Finally, we can also look at the experience of the RIC countries,

Chart 2 GDP per Capita as a Percentage of United States



Based on GDP per capita in Khamis-Geary International Dollars

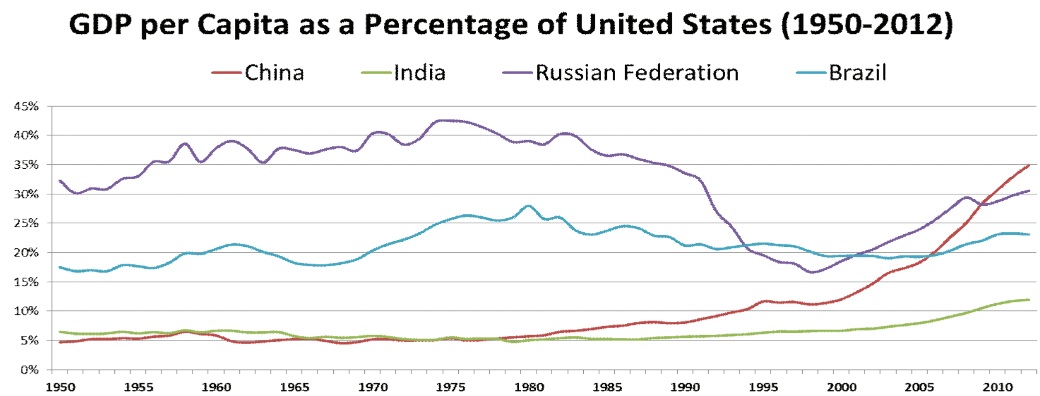
Source: Angus-Maddison Database, IMF WEO

4 Apart from a few Japanese bombs that fell on Darwin in 1942.

as shown in Chart 3. Russia's per capita GDP rose to a peak of 43% of the US in the mid-1970s, then it plunged to as low as 16% in the late 1990s, recovering to 30% today. Brazil, on the other hand, peaked in 1980 at 27%, then fell back in the 1990s, and climbed slowly through the 2000s to about 23% in the last few years. From 5% of the US in 1980, China's economic takeoff in the next three decades raised China's per capita GDP today to 35% of that of the US, making it the highest among the BRIC countries. India's per capita GDP started to close with the US in the 1990s and went from 5% then to about 12% today. In the range of 12-35%, the BRIC countries' per capita GDPs are still very low compared with the US, far below the 70-80% range where other industrialized and high income countries get stuck. Unless the BRIC countries know something that these highly developed countries don't, when they get to the 70-80% range of that of the US (if indeed they get there), then the chances are that they too will get stuck.

So what is it that makes the US so special? In one word: innovation. The process of catching up to the

Chart 3 GDP per Capita as a Percentage of United States



Based on GDP per capita in Khamis-Geary International Dollars

Source: Angus-Maddison Database, IMF WEO

US, climbing from 20-30% to 70-80% of US's per capita GDP, is typically facilitated by copying the best practices from abroad (and frequently from the US) and by technology transfer. By the time a country has reached a per capita GDP level of around 80% of that of the US, there is not much left to copy and increasingly has to blaze new trails on its own. And that means innovations. This is the last mile that has hampered the rest of the high-income, developed countries from converging completely with the US. The unique American combination of a mobile labour market, a strong entrepreneurial culture (constantly rejuvenated by new immigrants), strong private property rights and a critical mass of leading post-graduate academic institutions -- which are the most business-oriented in the world -- has made the American economy the world's leading innovation machine. This is what sets the US economy apart from the rest.

Contrary to a lot of the doom and gloom commentaries, I believe that there is an economic renaissance in the making in the US, led by the non-financial corporate sector. In the aftermath of the 2008/09 crisis, corporate America responded with a wide-ranging process of technology and knowledge-intensive innovations. Today, the non-financial corporate sector in the US does not have any debt and collectively holds a cash reserve of some US$1.2 trillion. In spite of anaemic growth, corporate profit is at its highest for over a decade. American productivity is booming, its exports are increasing and its competitiveness rising. More importantly, America is leading the rest of the world in the profound process of redefining and reinventing manufacturing.

Virtually all the negative commentaries on American manufacturing make the basic mistake of confusing the decline of the manufacturing labour force with the manufacturing sector itself. While America's manufacturing labour force has indeed been shrinking, from over 21 million strong two decades ago to around eleven million today, its output has more than doubled over the same period. To put it in perspective, the nine million American manufacturing workers are currently out-producing 170 million Chinese manufacturing workers in terms of total output value. It is all about rising productivity. For example, the average American auto worker produced seven cars a year in the 1960s. This rose to 13 cars per worker per year in the 1990s. In 2011, it was 28 cars per worker per year. And these are far more complicated cars to make. The average American manufacturing worker today produces US$180,000 worth of goods a year, more than three times what he produced in 1978[5] . American manufacturing is not declining. On the contrary, it is getting more productive, more innovative and more competitive.

Over the medium term, the US economy will also benefit from a strong tail wind from the shale gas energy revolution. The price of natural gas in the US is set to drop to one-third of that in Europe and Asia. This will prompt substitution of oil by natural gas, deploying a wide array of innovative technologies. Downstream operations like the chemical and pharmaceutical industries will benefit from cheaper input prices. America's balance of payments will also be strengthened as a result of becoming more energy self-sufficient; at present about half of the current account deficit is due to the cost of importing oil. But the most encouraging aspect of this economic renaissance is the fact that it is happening not because of the government, but in spite of it. It is a case of American businesses and entrepreneurs doing what they are best at: reinventing themselves. And this is why the US will remain the world's number one economy in the foreseeable future.

5 Cited in Moretti, E. 2012. The New Geography of Jobs. Boston: Houghton Mifflin Harcourt.

Debunking the Myth of BRIC

Getting rich is incredibly hard. Of all the 180 countries covered by the IMF, only 35 are considered developed. For half a century from 1950 to 2000, apart from a few small oil exporting states, the gap in per capita GDP between the less developed countries (before they were re-branded as "emerging markets"), and the developed world steadily widened. Only a handful of countries, notably the East Asian Tigers of South Korea, Taiwan, Hong Kong and Singapore (joined by Malaysia and Thailand later) and a few Southern European countries, managed to close the gap with the developed world. They managed to maintain growth rates exceeding 5% for three to four decades, however they are the exceptions that prove the rule. The vast majority simply failed to grow beyond 5%. For the two dozen or so countries which managed to grow at 5% or more, none managed to sustain it beyond a few years.

There is nothing magical about BRIC, apart from its catchy acronym. These four countries have nothing intrinsically in common except having big populations. China and India having the biggest and the second biggest populations in the world, Brazil has the biggest population in Latin America, and Russia the biggest in Europe. And, coincidentally, they all grew strongly in the decade before the 2008/09 crisis (so did most of the emerging markets). It is on the basis of this decade long experience, nothing more, that the BRIC myth was created. It propagated the belief that somehow a new era had dawned and it was now easier for countries to get rich.

The fact is that the economic fundamentals that drove the growth of BRIC in the last decade differed significantly. China's growth was very much investment-led, both in the expansion of its industrial production capacity and in infrastructure, which allowed the economy to shift tens of millions of underemployed rural workers to more productive employment in urban construction and manufacturing. Surging exports ensued and foreign investment flooded in. In this regard, it resembles most closely the experience of the East Asian Tigers. India's growth was first lifted by the unleashing of a massive pent-up demand from its consumers with market liberalization when suddenly businesses could offer an ever-widening range of products and services. The surge in consumer spending in turn stimulated rising business investment. But in India there was neither a surge in exports nor a massive expansion in labour-intensive manufacturing.

Both Brazil and Russia are highly dependent on exports of oil and commodities. They benefited hugely from the so-called commodity super cycle in the past decade, which was actually a stiff head wind for China and India, since both were big importers of oil and commodities. Brazil's own track record of growth is very unstable and the historical evidence is actually against Brazil being able to sustain strong growth for more than half a decade at a time. For example, Brazil's per capita income grew by 3.5% a year for a while in the 1970s, but it quickly fell back to 0.5% a year in the 1980s and 1990s. Its growth picked up again in the last decade only with the upswing of commodity prices, assisted by cheap credit that fueled consumer spending.

Russia's growth record is even more suspect and it is never clear why it was chosen to be part of BRIC, except for the addition of "R" makes the acronym sound a lot better. Its economic performance has been the worst among emerging markets in recent years, in spite of high oil prices. There is no evidence that the economy outside of the oil and gas sector has become more efficient or competitive in Russia, nor are there any signs that the wealth generated by oil and gas exports has been equitably distributed to benefit businesses unrelated to oil and gas, let alone the society at large. In fact, the opposite appears to be true.[6]

In 2012, all BRIC countries experienced sharp slowing of their growth. In the third quarter of 2012, China's real GDP growth slowed to an annualized 7.4%. In India, year-on-year growth in the third quarter of 2012 was down to 5.3%, with the expectation that real GDP growth for fiscal year 2012/2013 would be only 5.5%. Brazil's growth in the third quarter of 2012 plunged to a dismal 0.6%, and the expectation is that growth for 2012 as a whole will come in at 1% or less. Russia's third quarter year-on-year real GDP growth also fell to 2.9%, down from 4% in the second quarter [7]. Just as the strong growth of the BRIC countries in the previous decade had been driven by different factors, their current slowdown is also due mostly to developments and conditions specific to each, with the overall weakness in the global economy playing only a peripheral role.

There is no conceivable reason why BRIC would grow in unison in the future. Each is on its own, and getting domestic policies right will be far more important than being named a member of BRIC or BRICS. What is happening to BRIC is also happening to all emerging markets, with varying degrees of resonance. All emerging markets in the future will face closer scrutiny by international investors who have replaced their herd behaviour of the past with new scepticism and anxiety. With generally weaker global demand, the days of double-digit growth in exports year after year are also long gone. Emerging markets will have to work hard for every single percentage point increase in exports – by raising competitiveness, improving product quality and streamlining logistics efficiency to meet more exacting delivery deadlines. In other words, they will have to compete more intensely than before in the global market and their growth will be highly differentiated. While some will manage to sustain relatively high growth rates, others will fail.

The Future of Growth

Debunking the myth of the decline of America and the myth of BRIC allows us to reexamine the global economy more clearly to identify where future growth will come from. The broad global outline is

6 Russia is famous for its super rich, dominated by a class of oil-fueled billionaires whose assets are estimated to top 20% of GDP.

7 IMF data.

that the US will continue to be the anchor economy in the world, rejuvenated by the economic renaissance that is currently underway, and America's consumer market will continue to be the largest and the most dynamic. The euro zone, on the other hand, is going to be shackled by its ongoing crisis, which will keep Europe idling in neutral gear, even as Eastern Europe is becoming more integrated with Northwestern Europe. Then there are the emerging markets, which will be sharply differentiated between those which are forging their way ahead and those who are falling behind. Within this broad global outline are two primary engines of growth: consumer spending in the US and domestic investment in emerging markets.

Today, American households are paying down their debts and rebuilding their savings. This is setting the foundation for a revival of consumer spending in the US in the next few years, which will also be supported by a stabilized housing market, with a slow but steady increase in prices. And the declining manufacturing employment discussed above is no impediment to rising consumer spending in the US. The trend of the declining manufacturing labour force is a natural consequence of the evolution of a developed economy becoming more knowledge intensive and hence more service sector driven[8]. Services will be the dominant sector of any high income, knowledge based economy of the future. This evolution basically repeats the pattern that was seen in agriculture; today, less than 4% of the labour force in the US is engaged in agriculture whereas the sector's output is many times more than that of a century ago, when agriculture employed over one-third of the labour force. Shrinking agricultural employment was a very good thing; American households' spending power increased as agriculture employment shrank. In the same way, manufacturing employment will continue to shrink in the future, and this will be a good thing too.

Critics who complain about the "decline" of manufacturing are prone to denigrate service employment as low tech and low pay, the proverbial job of "flipping hamburgers". The reality, however, is very different and far more nuanced than this simple caricature. Service employment can be very well paid in both the high tech and low tech spectrum. According to company reports by Microsoft, the average pay of their Seattle-based employees in 2011 was US$170,000, which included all their secretaries and janitors. These are very well paid workers and are typical among high tech firms. On the other hand, a great number of the new service jobs created are relatively low tech but not necessarily low pay. For example, one of the fastest growing job categories in the US in the last ten years is of yoga instructor. Yoga instructors' earnings are close to the average service sector employment, but the job clearly offers more in terms of personal fulfillment and interests than flipping hamburgers in a fast food outlet.

8 Manufacturing itself is becoming more service-intensive in developed countries. In the US, over one-third of manufacturing employment today is service-oriented, and higher in the innovative technology sector.

High tech and well-paid service workers are, however, the sharp end of the evolution of the economy. Their high earning power in turn creates a lot of new jobs in the locations where they live, especially in personal services such as legal, health and medical, educational, and, yes, yoga instructors. For instance, for the "average" Microsoft employee in Seattle with an income of US$170,000 per year, after subtracting expenditures on housing, basic food, transportation, taxes and savings has some US$80,000 left for discretionary spending. This is enough to pay for two full time average non-professional jobs at prevailing wages in Seattle. So having a dynamic, expanding and innovative high tech service sector is important in generating higher household income, directly and indirectly.

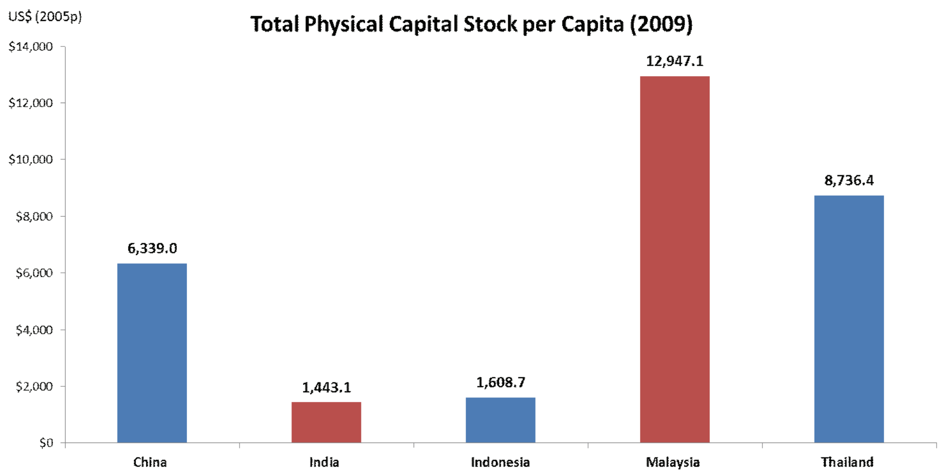
While many service jobs are in the non-tradable sector - services that are produced and delivered locally --think of getting a hair cut or a foot massage-- high tech services typically benefit from rising overseas demand, especially from emerging markets. Demand for software, scientific instruments, medical devices and machineries, transportation and aerospace products has been rising fast in all emerging markets with a sizable and expanding middle class -- China is the best example of this. Thus, it should come as no surprise that US exports to China have increased by 500% in the past ten years, ten times faster than the increase to the rest of the world, chiefly driven by exports of knowledge intensive capital goods, which in turn require extensive inputs domestically from the high tech and innovative service sector. The future of a high tech and service-intensive American economy is therefore entirely compatible with emerging markets in spite of weaker growth and more intense competition in the global economy. Indeed, they form parts of an evolving ecosystem characterized by mutual dependence. This is the economic dynamics through which America's consumer market, anchored by expanding high tech innovative services that will serve as an engine of global demand.

The second future engine of growth in the global economy will come from domestic investment in emerging markets. For emerging markets themselves, domestic investment is going to be the single most important factor that separates those which will succeed from those that which will fail in the new global economic environment. While investment is the prime mover of economic growth anywhere, for emerging markets the ability to raise investment level can have an especially dramatic impact, due to their generally much lower level of capital stock per capita. The capital stock is defined as the sum total of all productive assets in the economy, adjusted each year by accounting for new investment in the stock and subtracting the depreciated capital. And capital stock per capita is a key indicator of an economy's capacity for growth, as well as being highly correlated with per capita income and quality of life generally. Chart 4 shows the estimated capital stock per capita in China, India, Indonesia, Malaysia and Thailand in 2009. Respectively, their capital stock per capita are US$6,339 in China, US$1,443 in India, US$1,609 in Indonesia, US$12,947 in Malaysia and US$8,734 in Thailand. At these levels of capital stock per capita, investment tends to have a very high rate of marginal return, especially in public infrastructure that can quickly improve the country's logistics efficiency, benefiting businesses and consumer alike. Investment in infrastructure and residential construction in most emerging markets is also very labour-intensive, which is good for employment generation, especially for low skilled workers. In addition, large infrastructure and construction projects drive up demand for commodities, industrial machineries and capital goods -- very often imported -- thus benefiting countries that export such supplies.

Driving up growth with strong investment is what China has been doing for close to three decades, which saw investment's share of GDP rise to almost 50% in recent years. In the early 1980s, China's capital stock per capita was estimated to be less than US$500, lower than India's. It is through sustaining a very high level of investment for close to three decades that it reached US$6,339 in 2009. It is astonishing how low it still is. And that in turn means China can continue to keep investment at the relatively high level of 35% to 40% for at least a decade or more before the marginal returns on investment would begin to fall.[9]

To illustrate how much further

Chart 4 Total Physical Capital Stock per Capita



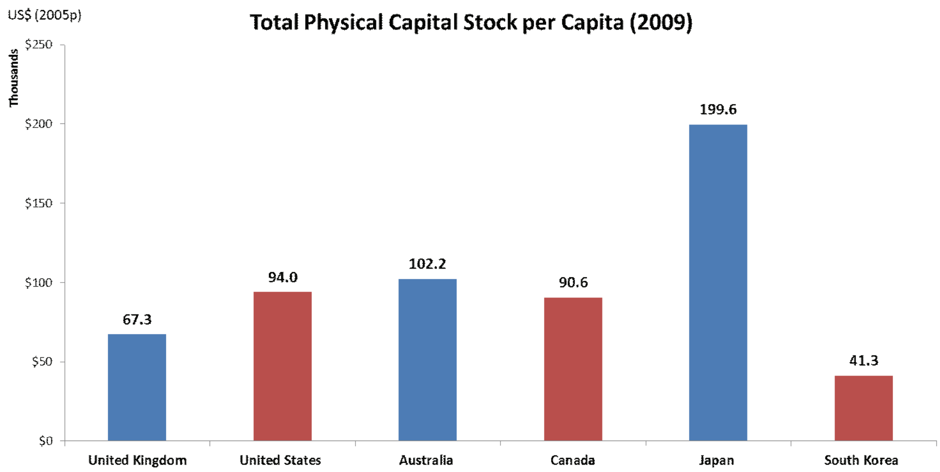
(World Bank and analyst estimates)

9 Popular commentaries on China's "over investment" typically confuse the cyclical with the structural. China has had several major bouts of cyclical over investment in recent decades, but from a structural perspective, China will continue to need a lot more investment before reaching a level of capital stock per capita that is comparable with those of the developed markets.

emerging markets can go with domestic investment as a growth engine, Chart 5 shows the capital stock per capita of six developed countries from different global regions as a comparison. In 2009, the capital stock per capita, is estimated at US$94,000 for the US, US$67,300 for the UK, US$102,200 for Australia and US$90,600 for Canada. South Korea, the last country in this group to join the developed country club, is estimated to have a capital stock per capita of "only" US$41,300. At the other end of the spectrum, Japan has the highest capital stock per capita estimated at US$199,600. This explains why Japan failed repeatedly over the last two decades to use public investment projects, financed by fiscal deficits, to reignite economic growth in the aftermath of the bursting of the bubble economy. At this level of capital per capita, it is not surprising that the marginal returns on investment have been extremely low, if not negative.

For many emerging markets, both fiscal and monetary conditions

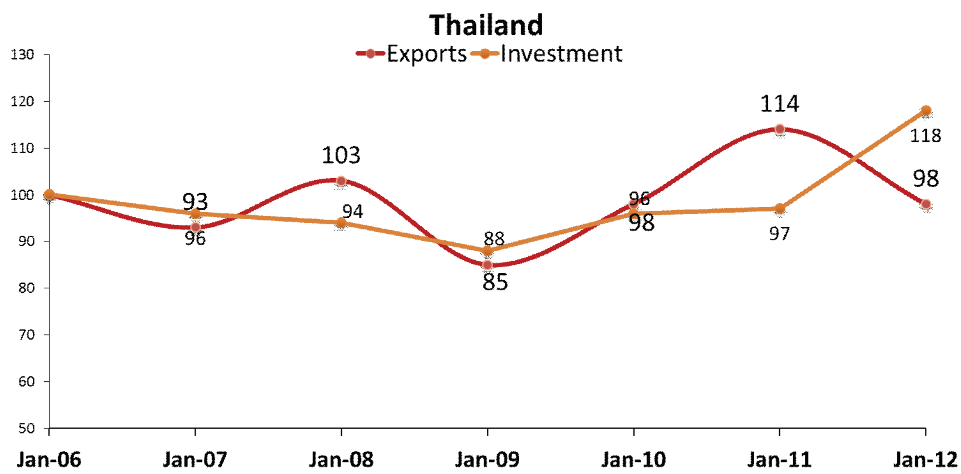
Chart 5 Total Physical Capital Stock per Capita



(World Bank data and estimates by GEMS)

are very conducive to increasing domestic investment in both public infrastructure (especially when associated with urbanization) and industrial capacity building. High savings countries can do so with little foreign borrowing. For these countries, foreign direct investment functions more as a conduit of transfer of technologies and management knowhow, as opposed to being a source of investment financing. For example, as sizable as foreign direct investment has been in China at around US$50 billion a year for almost two decades, it actually played a relatively marginal role in financing China's domestic investment. Between 1995 and 2011, foreign direct investment accounted for just 9.25% of gross

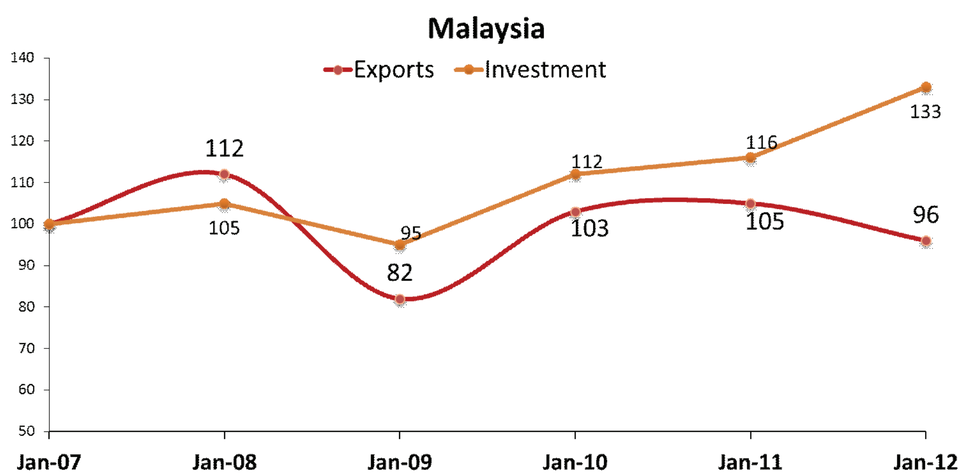
Chart 6 Investment in Thailand: January 2006 = 100



fixed capital formation in China[10]. The vast majority of China's investment has been funded from domestic sources.

Weaker global demand for exports is therefore not an insurmountable impediment to increasing investment, if there is sufficient domestic demand supported by rising private consumption. For instance, Thailand, in spite of having an export-oriented economy, has recently managed to delink domestic investment from exports. In the third quarter of 2012, for instance, investment grew by 5.3% quarter-on-quarter (annualized to over 20%), which is completely

Chart 7 Investment in Malaysia: January 2007 = 100



10 Estimated with data from CEIC.

out of sync with exports, which are falling as illustrated in Chart 6[11]. It appears that the increase in investment has been focused on domestic services for meeting rising demand in consumer markets in the provinces outside of Bangkok. Coupled with growth of private consumption estimated at 2.2% in the third quarter (quarter-on-quarter growth), this investment upswing could be instrumental in keeping real GDP growth in 2012 at close to 6%.

In Malaysia, another country usually considered as export-oriented, a similar phenomenon can be observed, starting back in mid-2010. As shown in Chart 7, while exports have been a drag on overall growth, investment has been rising, sustained largely by public infrastructure spending. Thus, even as the outputs of manufacturing and mining contracted in the third quarter 2012, construction and services kept on growing.

However, to ensure that emerging markets' investment-led growth is sustainable, such growth has to be made as inclusive as possible. This requires an equitable distribution of the fruits of economic growth, both in terms of reducing regional disparity as well as closing the gap between the high and low income households. The best outcome is an expanding and increasingly prosperous middle class, the presence of which could ignite a virtuous circle of strong investment growth leading to rising private consumption because of increased household income, which in turn stimulates more investment to meet the rising consumption demand. Conversely, failure to make growth inclusive risks creating a vicious circle: initially strong investment leading to unchanged or even weaker domestic consumption demand, causing poor or even negative returns on investment, eventually resulting in a collapse of investment altogether. Trying to ignite the virtuous circle (or at minimum avoiding the vicious one) by making growth more inclusive is precisely the challenge facing China today, made more daunting as it is rapidly approaching a "middle income" level and will have to ensure that it does not get ensnared by the so called middle income trap (a subject addressed by a GEMS report in 2012 [12]).

In a more challenging future global environment, the importance of generating inclusive growth cannot be emphasized strongly enough. As persuasively argued by Acemoglu and Robinson,[13] it is neither resource endowment, nor the size of population and territory, nor geographic location, nor cultural heritage that determines the level of wealth and prosperity of any country. It is the man-made institutions that ultimately determine a country's economic fate. Therefore, all countries hold in their hands the key to prosperity, should they be able to establish the right kind of political and economic institutions that promote, generate and spread inclusive growth. Inclusive growth in turn enables a country to become more resourceful and resilient in navigating the stormy weather of a weaker and more volatile global economy.

What about the mountains of debt in the global economy? Deleveraging is unavoidable, and indeed necessary, if the global economy is to return to a more stable and sustainable growth path. If so, would global deleveraging not pull the rug from underneath the feet of any

11 Estimated with data from CEIC.

12 Reinhart, C. and K. Rogoff. 2010. "Growth in a Time of Debt", American Economic Review. Papers & Proceedings 100, May: 573-578.

13 Acemoglu, D. and J.A. Robinson, 2012. Why Nations Fail: the Origins of Power, Prosperity, and Poverty. New York: Crown Publishers.

hope for growth, investment supported or otherwise? Pessimists the world-over have been harping on precisely this point to suggest that it is not growth that the future holds, but stagnation and decline. But the fact of the matter is that the easiest way to deleverage is to have strong growth. Any serious and pragmatic policy for deleveraging must begin with the priority of keeping growth on track while deleveraging. Indeed, a key difference between the debt situations in the US and in the euro zone, in spite of similar debt to GDP ratio, is that fact that nominal GDP growth in the US has exceeded the cost of debt over the past four years, whereas the GDP of the crisis countries in the euro zone shrank repeatedly, even as the costs of debt jumped.

We should not be unduly fixated by the debt to GDP ratio, which is at the end of the day a completely arbitrary measure. While debt is a stock concept, GDP is the annual flow of output of a country, and there is nothing intrinsically sacrosanct about the debt to GDP ratio. We can easily imagine a debt to quarterly GDP ratio, which would automatically raise the ratio by a factor of four. Or we can consider a debt to generation ratio (a generation is usually defined as 20 years) which suddenly becomes 20 times smaller than the debt to GDP ratio. The debt to generation ratio arguably makes more sense as many historical episodes of debt deleveraging are generation-long affairs.

The point is that there is nothing magical about a debt to GDP ratio of 60% or 100%, even though the former is frequently quoted as the threshold for emerging markets before the debt burden is said to become "unsustainable", and the latter is said to be a similar threshold for developed markets. A few years ago Reinhart and Rogoff published a paper that analyzed 44 countries over a period of 200 years[14]. They showed that growth is affected by government debt at as low as 30% of GDP, though at debt levels exceeding 90% of GDP growth, it is likely to slow a bit more. Clearly there are many other factors at work in determining how any given level of debt may affect growth, and how much growth is affected by a given level of debt. The bottom line is that deleveraging and growth are not incompatible. The best way to deleverage is to ensure that the economy is growing.

The situation in the US today illustrates how deleveraging and growth can be compatible. American households have been very aggressive in paying down their debts. From a peak of around 145% of annual disposable income, debt has been brought down to below 110% today. American households are also saving more now, with a savings rate of about 6% of disposable income, compared with less than 2% before the 2008/09 crisis. In the meantime, the non-financial corporate sector collectively does not have any debt and is sitting on a cash pile estimated to be around US$1.2 trillion. The debt burden has completely shifted to the government sector. And the government is in the best position to manage the deleveraging process to ensure that the economy grows faster than the cost of debt, chiefly by avoiding the imposition of punitive taxes while keeping interest rates low. As long as this is the case, deleveraging and growth are actually mutually reinforcing.

The American economy, with an increasingly competitive private sector and a recovering consumer

14 Reinhart, C. and K. Rogoff. 2010. "Growth in a Time of Debt", American Economic Review. Papers & Proceedings 100, May: 573-578.

market, will remain the key anchor for the global economy and serving as its growth engine in the coming years. It will be supplemented by a second growth engine of domestic demand in emerging markets. Together, they will form the primary source of growth in the global economy in the foreseeable future. The global economy will be shaped by these two growth engines. It will be an ecosystem that exhibits strong codependency, with the American economy as the anchor, interconnected with a range of emerging markets growing at diverse trajectories. Leaving out the BRIC countries for the moment, the most likely candidates for inclusion in high growth trajectories are Thailand, Indonesia and Philippines in Southeast Asia, Ghana and Nigeria in Sub-Sahara Africa, Poland and the Czech Republic in Eastern Europe, and Turkey in the Middle East.

For the four BRIC countries, the growth trajectories of China and India will be critically determined by their respective domestic reform policies. i.e. a transition to inclusive growth in China and further market liberalization in India. Brazil, on the other hand, faces a daunting challenge in making a policy U-turn to jettison its socialist and anti-market development programmes of the past and to engage the private sector to raise desperately needed investment to support economic growth. Russia, however, will likely begin to fall behind, especially if energy prices decline. Getting their policies even half right could sustain real GDP growth in China and India in the 6-8% range in the coming decade, whereas it will be much more difficult for Brazil to do so. With luck, Brazil's real GDP could grow in the 3-5% range in the coming years. Russia, on the other hand, would most likely languish in a low growth trajectory of 3% or less.

There will be no shortage of new and exciting business opportunities in such a global economic future. But there will be a critical difference with the past. In this future global economy there will be no rising water lifting all boats type of growth. The American consumer market will not be credit driven as before, but will grow at a pace that is commensurate with increase in household income. Among emerging markets, there will be a mix of winners that are emerging successfully and losers that are falling behind. And there will be a continuous churn of winners becoming losers and vice versa. In other words, emerging markets will be sharply differentiated, and their performance highly contingent upon having the right policies and getting them implemented effectively. Thus, even though new business opportunities will continue to open up, they will be harder to see in the midst of conflicting trends, distracting noises and misleading signals. Clear market insight will command a hefty premium and visionary leadership a prerequisite for business success.

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Dr Yuwa Hedrick-Wong

Yuwa Hedrick-Wong is a global economist and business strategist, based on Salt Spring Island off the west coast of Canada. He is the HSBC Distinguished Visiting Professor of International Business at the University of British Columbia in Canada, as well as being the global economic advisor to MasterCard, ICICI and Southern Capital Group. Along with other leading economists, journalists and business commentators, Dr Hedrick-Wong belongs to The Insight Bureau's resource network, providing speeches and presentations at business conferences and also delivering confidential, in-house briefings to senior executives and boards.
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