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From the Desk of...

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Are You Ready for the Post-Recovery World?

Dr. Yuwa Hedrick-Wong, one of Asia's leading minds on global economics and the markets of Asia Pacific, urges companies to grasp the realities of this recovery and not fall into the trap of having survived the recession only to misunderstand the true nature of Asia's recovery.

An industry has been created in debating the shape, timing and nature of the recovery of the global economy. And it is only right that this should be so; after all, there is still a great deal of uncertainty out there and while it is clear that the heart-stopping economic free fall has been arrested, the long climb back to growth has only just started.

However, as much as the recovery debate is useful and needed, the fact that the global economy will recover is no longer in doubt. The risk of a Great Depression style of decade-long slump has receded and now it is a question of whether it is another 9 months, 12 months, or 18 months before the global economy can be considered to be "recovered" -- and no doubt pundits of different stripes will debate what the proper definition of "recovered" should be.

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What needs to be explored more rigorously, however, is what the post-recovery global economy will look like. I believe that profound forces of structural transformation have been unleashed by the global recession and it is critically important that we look beyond the recovery to understand (and be ready for) the post recovery challenges, many of which will be undoubtedly surprising, both positively and negatively. For global businesses the real risk today is that they may survive the global recession only to fail in the post recovery global economy.

Emerging Asia's Powerful Rebound

The most convincing growth rebound today is seen in Asia and within Asia, it is all about China. The shock of the collapse of exports in the second half of 2008 knocked Asia into a tail spin, China included. From their peak in mid-2008 to March 2009, exports from key Asian markets fell by 30% to 50%. Given most Asian markets' well known export-dependency, expert opinions, as recently as a few months ago, were uniformly downbeat on Asia's outlook. With global demand remaining anemic at best, growth prospects in Asia seemed abysmal.

By the second quarter this year, however, China's powerful rebound in growth was the first to surprise, expert opinions notwithstanding. This was followed by stronger growth reported in India and Indonesia. And for other Asian markets that are still expected to end this year with negative growth, their pace of contraction now appears to be much smaller than earlier forecasted. All these happened when Asian exports were still falling (albeit at diminishing rates) and there was no sign of a growth rebound in either the US or in Europe, the biggest and most important export markets for Asia. For 2010, I am expecting China's real GDP growth to exceed 10%, India's to be around 7% (fiscal year 2010/2011), Indonesia's at 5.5% and, in sharp contrast, I see growth in the US to be less than 1% (most likely at 0.75%) and the Eurozone at 0.3%.

Asia's successful growth rebound can be attributed, at least in part, to its relatively strong macroeconomic conditions prior to the global recession. Household indebtedness in Asia was significantly lower compared with households in the US or the UK, hence when interest rates were being cut and governments' fiscal spending increased, households in Asia responded by spending more, instead of using the extra cash to pay-down debts. Most governments

in Asia also had healthy fiscal accounts, which allowed them to ramp up spending quickly, and massively so in some instances, without risking out-of-control government budget deficits. Equally important is the fact that the banking system in Asia was in good functioning order when the global crisis hit and in Asia there has been no "lending strike" by the banks, as seen in the US or Europe. Credit creation has continued to function as it should in Asia. All these helped in mitigating the severe impact of the collapse of exports.

Apart from these macroeconomic conditions that partly explain Asia's resilience in coping with the shock of the global recession, something else has also happened – in China. While the media continues to refer to China's policy response to the global recession as "fiscal spending", the reality is that the centerpiece of the policy response is actually the acceleration of bank lending, mostly to local governments (from the provincial to the town and village level), to fund a wide array of infrastructure investment projects. These include subway systems and airports (in many medium sized cities) to highway and secondary road building projects, to double-tracking railways, to electricity transmission and distribution and water supplies in rural areas. Literally tens of thousands of such projects have been approved by Beijing since the beginning of the year and it is expected that new bank lending could reach a massive US$1.2 trillion for the whole of 2009, dwarfing the central government's fiscal package.

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Infrastructure projects in China are very labour intensive, thus convenient for employing low-skilled workers, leading to significant income and employment multipliers overall. Data also show that many investment projects are happening in the rural sector and in the poorer central and western regions. Investment growth from the first four months of 2009 in rural western and rural central China dwarfs the growth in urban eastern China, which had higher investment levels in the past. From this perspective, it appears that this new round of infrastructure investment is going to places where the needs are the highest.

There are, however, rising concerns that such a massive wave of bank lending could impair China's banking sector, leading to mounting non-performing loans (NPLs), cumulating in a repeat of the situation in the late 1990s, which subsequently took several rounds of capital injection and writing-off of bad loans to repair the damage. But the situation in China's banking sector today is very different; simply put, it is in much healthier shape. Gross NPLs of the banking sector (before provision) as a whole fell to less than 3% of total loans in 2008 -- it was at 18% in 1999. Banks are cashed up and are keen to lend. Even though their ability to properly manage investment risk remains suspect (and in any case lending to local governments is a completely different kettle of fish from lending to private businesses), they do pay attention to the bottom line and market competition today, which was not the case at all in the 1990s. Assuming for the moment that a full quarter of the new loans made in 2009 will turn sour (a very pessimistic assumption), NPLs will rise to about 8% of the total, still a very manageable sum.

The question is whether the central government's fiscal account will be affected. After all, the big banks remain government-owned (their minority foreign shareholders notwithstanding). When the chips are down, Beijing will have to bail them out if NPLs start to skyrocket. Is the government in a position to do so? In this regard, the good news is that the government's debt level overall remains very low. In 2008, estimated from the central bank (PBoC) data, the government's total contingent liability is just over 40% of GDP, a relatively healthy situation. The central government has actually been running budget surpluses in recent years. The central government is in a strong position to absorb a significant increase in NPLs if it does come to pass that a significant portion of the new bank lending this year ended badly.

While the worries over rising NPLs and its impact on the government's fiscal account can be dismissed, at least for now, there is however a real risk that this massive acceleration of bank lending could lead to inflation spiking later. Both the PBoC and the China Banking Regulatory Commission (CBRC) seem to be aware of this potential risk. Indeed, the CBRC recently issued "instructions" to banks to advise them to "smooth" their lending, a code word for "slowdown, comrade!" The pace of the growth of bank lending has indeed slowed since the June-July period. But the central bank is clearly ready to impose lending curbs should inflation start to accelerate.

China's aggressive policy response has certainly benefited regional suppliers that export commodities and raw materials to China such as Indonesia and Australia. While China's overall imports continued to shrink on a year-on-year basis over the January to June period this year, imports from Indonesia and Australia started to grow in March (Australia) and June (Indonesia). Indeed, while China's overall imports were still contracting at 13% year-on-year in June, imports from Australia and Indonesia were growing at 10% and 11% year-on-year respectively.

It is a similar picture for China's imports from Japan and Korea, which supply China with "capital goods", which include industrial machinery and equipment needed for infrastructure developments. On a month-on-month basis, Chinese imports from Japan and

Korea started to grow again in March 2009 and by June imports from Japan and Korea increased by 34% and 11% over the previous month respectively. The growth rebound in Asia is therefore very much a China-centric story.

The Coming Structural Transformation

The combination of China's massive infrastructure roll-out and fiscal spending is changing its domestic consumer markets, both urban and rural, in a deeply profound way. The fiscal package announced by Beijing, about US$600 billion, focuses on boosting spending on health care, education, environmental protection, social housing and subsidies on automotive and home appliance purchases. Better social welfare support, which includes education and health care services and care for the ageing, would significantly reduce Chinese households' precautionary savings, thus increasing their discretionary spending. For example, in one study, 70% of the households in a rural county in Shandong province planned to increase their spending because of social welfare services had improved. It appears that this is precisely what Beijing now aims to do. In the first seven months this year, government investment in health and education increased rapidly by 70% and 40% year-on-year respectively. As high as these growth rates are, the base is nevertheless very low. Total government spending on health and education amounted to less than 3% of GDP in 2008. High rates of investment in health and education will be a standard feature of the government's fiscal budget for many years to come.

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The massive infrastructure roll-out, on the other hand, is accelerating the pace of urbanisation, as well as boosting productivity. One direct impact is on the rural consumer markets. Rural consumer markets in China have been chronically under-developed, which is a result of supply-side constraints – i.e. insufficient choices of consumer goods, being relatively more expensive due to the high cost of logistics, a lack of scale and poor facilities and so on. In the next few years, with rural infrastructure improving at an accelerated pace, rural consumer markets can be expected to expand in scope and scale while becoming more price-competitive. Rural demand will therefore rise relative to income.

But the most powerful trend in raising private consumption in China is a secular one; the expansion of urban consumer spending. China's urban consumer spending has been rising fast in the past decade, estimated at around 12% per year, mostly driven by rising income and expanding urban population. In the coming decade, this fast pace of spending increase will be further supplemented by a large number of urban households reaching an income threshold where their discretionary spending will take off. In the urban and developed coastal regions, I have estimated that by 2013 there will be some 220 million people who belong to households that earn between US$6,000 to US$18,000 a year. Their marginal propensity to spend will be equivalent to that of an American household earning between US$50,000 to US$75,000 a year. This means that the number of people reaching an inflexion point where their discretionary spending will explode will be the equivalent of the populations of the UK and all Western Europe combined! In a clear break from the pattern of the past, private consumption in China will rapidly become a powerful engine of economic growth.

With rising private consumption will come changes in the nature of intra-regional trade in Asia. Intra-regional trade, as fast growing as it has been, has been driven by demand from outside of Asia. It has been primarily a trade of components and parts, with China being the final assembly hub from which the final products are exported to outside markets. This has been the story of how Asia managed to recover from the series of shocks in the last decade. It was the rebound in exports that lifted the region out of the slump caused by the 1997 financial crisis and I have estimated that about 63% of the growth of exports over the 1999–2000 period came from outside of Asia and therefore only 37% originating from within the region. Similarly it was export growth that pulled Asia out of the 2001 recession, with 68% of the growth of exports in the 2002–2003 period coming from outside of Asia. Again, during the boom years of 2004–2007, about 60% of the growth of exports came from demand outside of Asia.

With rising private consumption in the coming years, led by China and with India not far behind, followed by Indonesia and other southeast Asian markets, intra-regional trade will change from components and parts to finished products. Not only will this mean that growth of exports will increasingly originate from within the region, the nature of the demand will change as well. More products and services will be produced to cater to the needs and tastes of consumers in Asia, as opposed to consumers in the US or Europe. The levels of value-add in the production process will also increase, benefiting all the markets involved in intra-regional trade.

Make no mistake; the coming rise of private consumption in Asia does not mean that exports are no longer important. Nor is Asia ceasing to be an export powerhouse. The total monthly value of Asia's exports rose from US$83 billion in 1998 to US$330 billion in 2008, an astonishing record of growth. In the coming decade growth will unavoidably slow down, perhaps by as much as two-thirds in the next few years. As Asia increasingly diversifies its exports to other emerging markets, growth in exports will recover to just under half of the growth rate of the previous decade. This would still mean that the

monthly export value of Asia's exports will rise to about US$600 billion by 2013/2014. The real change is that rising private consumption in Asia will gradually reduce the region's export-dependency while changing the nature of demand for goods and services, both for domestic businesses as well as for global companies. The mix in the growth dynamics in Asia is therefore poised to change, and with it, the business conditions of the region.

Glimpses of the New Global Economy

Private consumption in the US will likely contract by about 0.5% in 2009, followed by virtually no growth in 2010. Over the 2009 to 2013 period, private consumption in the US will probably grow by an average of 0.4% to 0.5% per year. In contrast, Asia (ex. Japan) will see its private consumption grow by about 8% per year over the same time period. In 2008, total private consumption in Asia (ex. Japan) came to 39% of that of the US. The drastically different rates of growth between Asia (ex. Japan) and the US means that Asia's contribution to global demand in the coming five years will be 7.8 times that of the US -- a truly unprecedented phenomenon.

In the post-recovery global economy, Asia's role will shift from just being a supplier to both a supplier and end-user. Global companies will have to deal with the preferences, tastes and eccentricities of Asia's consumers if they are to succeed in getting a piece of this fast expanding pie. Many global companies have known this in the past, but the shape of the new global economy will make this a much more urgent priority, as the developed markets of US and Europe will hardly grow at all for some time.

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Apart from their rising private consumption, Asia will also play a very different role in investing in the global economy in the future. Led by China, outbound direct investment will focus more on other emerging markets, for instance Africa and Latin America. The so called "South-South" trade will begin to play a more significant role in global trade and economic integration. In mid-2009, for example, China's investment in Sub-Saharan Africa reached US$15 billion, counting only the big and widely reported projects. The range of projects covers energy and resources, hard infrastructure, hydroelectricity, banking, telecoms and bio-fuels. Investment from India is no less active, though of much smaller scale and channeled through private businesses operating through the Indian Diaspora network in Africa.

In the Middle East, exports to both Europe and the US, their traditional markets, have been declining year-on-year since the second half of 2008 and this is true for both the oil-exporting and non oil-exporting countries. Their exports to China and India, on the other hand, are rapidly rising today. Kuwait's export to India, for instance, was only 18% of its exports to the Eurozone in 2008 but it is growing at an astonishing 270% per year. Similarly, Oman's export to China was only 50% of its exports to the Eurozone in 2008 but it is now growing at an impressive 51% per year.

The post-recovery global economy will be fundamentally altered by the new role played by Asia, simultaneously through its rising private consumption, transformation of its intra-regional trade, and its outbound investment. The world is unmistakably moving from a unipolar to a multi-polar one, with far-reaching ramifications for global businesses.

Business Implications

Harry Warner, one of the founders of Warner Brothers, a leading movie studio that started life in the silent film era, said in 1927, just as experiments were becoming successful in adding sound to films, "Who the hell wants to hear actors talk?" Before we laugh and dismiss Harry Warner's statement as typical of Hollywood moguls' silly and arrogant remarks, we should appreciate how right he was. In the silent film era, not many actors had good voices -- they were not selected for their voices -- and some leading men actually had high-pitched voices that made them sound, well, less than manly! Some actors could not speak proper English at all, as in the case of the leading heartthrob Valentino. Harry Warner knew this, which is why he thought it was crazy that people would want to hear actors talk. Where he was wrong, of course, was in the fact that a whole generation of new actors would emerge, with the coming of the "talkies", people who had good looks, could act and could talk with the right voices.

We see the counterparts of Harry Warner today whenever we hear business executives justify and defend their current business strategies and practices in the face of evidence of disruptive structural changes. They are always 'right' within the narrow context of the business conditions they have experienced in the recent past. In times of disruptive structural changes, as we are seeing today and as we transition towards a new post-recovery global economy, they become dangerously wrong.

The business implications of the new global economy, as described above, are far-reaching and this article cannot hope to go into all the details. Let me conclude, however, with just a few high level observations:

Firstly, that global businesses need to re-think how they should engage emerging markets, especially in Asia. The typical stance of the past was to look at how the business could enter and capture these markets with their existing products and services. These companies typically had their core business in the developed markets and would look at emerging markets as an extension to the core, and to the extent that they could capture some specific niches, the 'icing on the cake'. And this has not been a bad approach in the past, as many global businesses benefited hugely from being able to sell into these fast growing markets. The situation is very different, however, if in the future a far greater portion of the growth in global demand comes from emerging, instead of the developed, markets. Global companies may have to learn to build their core business in emerging markets, which will require a radically different approach. Instead of trying to work out how to sell products and services into these markets that they currently have, they may need to think instead of how to create new and innovative products and services that these emerging markets will embrace in order to ensure sustainable success.

Take for example the luxury automaker, Porsche. At the April 2009 Shanghai Auto Show, Porsche launched the Panamera, Porsche's fourth model and very much a global product, taking its place along the classic 911, the Boxster and the Cayenne in the luxury automaker's line-up. Tellingly, though, the Panamera unveiled to the world in Shanghai, launched with a lucky "888" license plate and featured on the company's UK web site in front of the Shanghai skyline, is stretched to give backseat passengers extra legroom. Most Porsche drivers revel in the thrill of driving these powerful machines, but affluent Chinese Porsche buyers want room to stretch their legs in the back while their chauffeurs do the driving. Once Porsche determined that the China market would be of central importance to its global sales, it moved quickly to design specifically for this market.

Another high level observation is that the emerging markets, especially China and India, offer exciting opportunities for global companies to pursue radical innovations that are needed in these markets, while benefiting the developed markets at the same time. In China and India, for example, the consumer markets can best be characterised as having "big aggregates but small wallet", – i.e. the overall number of consumers and total spending power is high but made up of individuals with personal budgets which are still relatively small. These markets also face daunting challenges in addressing environmental challenges and in improving quality of life generally. In the future when there are 600 million private vehicles on the road in China and India (compared with 30 million now) these vehicles simply cannot be the same as ones running today, otherwise air pollution alone would render the entire planet unlivable! Radical innovations will be needed. We will have to come up with cheaper products that do not sacrifice quality, with alternative technologies and designs that are vastly more efficient in resource use and dramatically lower in their environmental impact. These are the commanding heights that forward-looking global companies should aim to capture.

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Many global companies are already doing precisely that. They are already working in these emerging markets to come up with innovative solutions for their global operations. The Microsoft Research Center in Beijing, set up in 1998, is the company's biggest research centre outside of its Redmond headquarters. The John F. Welch Technology Center, set up by GE in 2000 in Bangalore, is the biggest of GE's four technology centres in the world, the others being located in upstate New York, in Shanghai and in Munich. For global companies that can get it right, emerging markets of the future offer business potential that is limited only by their imagination.

About Dr Yuwa Hedrick-Wong and The Insight Bureau

Yuwa Hedrick-Wong, based in Singapore and a frequent visitor to the USA, Europe and the Middle East, is a leading economist focused primarily on the Asia Pacific region. He is an advisor to MasterCard Worldwide, Southern Capital Group and ICICI and is also adjunct professor at Funan University, Shanghai and at the University of British Columbia, Canada. His depth of analysis, combined with an ability to communicate his insights and to uncover the implications for businesses has made him a keenly sought-after presenter, who shares his observations and forecasts in business summits and at companies' strategy and planning meetings. He has provided personal briefings to the chairmen and CEOs of many Asian, European and North American organisations. The Insight Bureau offers a global resource network, providing confidential briefings to senior executives, a service that helps achieve a better understanding of the world in which we do business and ultimately strives to enable companies to make better business decisions.

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