think piece

Promoting debate and fresh thinking in the financial services industry

A Remarkably Rosy Economic Outlook to 2020?

Vanessa Rossi

Summary

- Expectations for the world economy over the next decade remain upbeat, pointing to growth in the 4-5% range - indeed a new peak of 5½% cannot be ruled out as emerging markets dominate trends.
- The developing world is seen sustaining robust growth of 6-8%, with Asia remaining on top. It can brush off weak growth, even a mild double-dip recession, in the US and Europe. Much of this growth will be down to the phenomenon of increasing middle-class consumerism and the associated growth in trade that this will create in the emerging markets themselves as well as with developed economies.
- On a regional basis, while populous Asia provides a cost effective global manufacturing base that continues to expand, energy and commodity producers are benefiting from firm demand, rising prices and inward investment. And services have seen rapid gains from the opening up of trade, which will continue to benefit India. Trade between China and India looks set to develop rapidly.
- Another factor to watch is the increasing flow of investment coming out of China: Germany and the UK are the major EU recipients of this investment, albeit for different reasons as the UK is seen as the gateway to Europe and a global leader in services while Germany remains the powerhouse of advanced manufacturing.
- Where are the risks? Asia, in particular, seems confident that it can remain immune to the obvious global threats, such as an unsteady US recovery or a crash driven by the Eurozone debt crisis. It is better prepared for financial turbulence should this recur than it was in September 2008.
- Meanwhile, high growth is generating internal pressure in emerging markets. For example, the rise in food price inflation is worrisome, in part because it is symptomatic of supply constraints. And the surge in capital inflows fed by cheap money has already led to a backlash, with some countries imposing capital controls, banking restrictions or taxes to limit the risk of overvalued currencies and markets.

Number 48 (December 2010) **International Series number 13**

CHATHAM HOUSE

CII

CII Introduction: Attention is moving from the 2010 rebound in the global economy and world trade towards the outlook for 2011 and beyond. After the gyrations seen in the last couple of years, it is not surprising to see considerable short-term uncertainty: predictions vary given the risk of double dip recessions in the US and Europe. Yet long-run forecasts are still close to pre-crisis estimates, with world growth expected to remain well above 4%. This optimism derives from the powerful impact of the developing world and its increasing ability to drive global growth solo. Signs of this impact are already visible this year as world trade has picked up sharply, led by booming sales to the leading emerging markets.

After a tough 2009, in which governments fired up fiscal and monetary policies to prevent an even deeper recession, the recovery in 2010 turned out better than expected for most countries (setting aside the debt crisis in the Eurozone's periphery). Gains were chiefly due to the widespread rebound in world trade to pre-crisis levels.

Steering Through the Turbulence as Developing Countries Boost Global Growth

The developing economies appear to be on course for a full recovery from losses caused by the global recession. They will even recover the temporary loss of output thanks to faster-than-normal growth in 2010 and should resume a robust rate of long-term trend growth from 2011/12:

- For Asia, results for 2010 have already validated a repeat of the recovery seen after the 1997/98 crisis, with a number of countries reporting growth of 10% or more.
- Brazil has also shown the hallmarks of a strong V-shaped recovery, surprising analysts with GDP growth of over 8% in early 2010, based on domestic demand as well as a revival in exports.
- And many other developing economies have achieved marked rebounds as low global interest rates have helped stimulate both consumer demand and investment.
- However, a rise in food price inflation remains a possible flash point, raising concern in China as well as feeding existing worries about inflation in India.
- Pressure on asset prices has generally increased in response to domestic growth but also influenced by capital inflows caused by the surge in cheap money flooding out of the developed economies and into the Emergers.
- This liquidity needs to be put to work on building up the recovery in the US and Europe but, unfortunately, this benign process will only get underway once uncertainty and threat levels in the these economies have been reduced and prospects look more assured.

The key debate in both the US and Europe is over precisely how and when budget cuts will be implemented and the economic impacts of such tightening. This is especially difficult as the banking sector may require yet more bailouts.

Most of the worries about the growth outlook concern the sustainability of the recovery in the developed world, especially in view of the rapidly approaching switch in policy to fiscal tightening. This change is inevitable if governments are to maintain confidence in public sector finances and avoid the risk of a Greek or Irish-style sovereign debt crisis. The key debate in both the US and Europe is over precisely how and when budget cuts will be implemented and the economic impacts of such tightening. For the Eurozone, this is especially difficult as the banking sector may require yet more bail outs. Can policy change be accomplished with relatively light damage or will it cast a dark shadow over growth prospects for some years to come, possibly provoking a double dip into recession? Over the next decade, success or failure in achieving the right scale of fiscal adjustment could mean the difference between growth averaging just 1% in the US and Europe (similar to Japan in its "lost decade") or returning to rates of 2-3% in the case of a "Goldilocks" adjustment, neither too harsh nor too lax. This success or failure also depends on the background boost from trade with emerging markets – with some countries likely to fare much better than others, as 2010 has already revealed.

However, does it make much difference to global growth if the developed half of the world grows at 1% or 3%? It is the fast developing half that will provide 70-80% of the projected growth. For the world economy, the question is whether a relapse in the advanced economies might impose sufficient damage to limit prospects for developing countries. Fortunately, emerging markets look better prepared to take a weak or turbulent performance in the developed economies in their stride than in 2008. Strong domestic demand growth and the increasing importance of trade across developing countries are the key factors.

Recent trends support the view that developed countries are now far less dependent on export growth to the US and Europe. Specifically, the share of Emergers trade going to these countries will drop to below half of their total exports over the coming decade, down from around three quarters a decade ago. Although global currency wars might obscure the fact, China has already shifted towards internal demand driven growth. Indeed, many developing countries – especially those in Asia – are poised to enter a period of rapid growth in private consumption. Typically demand for consumer goods and financial services rises only slowly at low income levels, but once the middle income threshold has been passed, demand increases at a far faster pace than income growth. The take-off point typically occurs at income levels of $10,000 to $15,000 per capita.

The weight of the developing economies is growing. Global growth particularly prospects for developing economies, will be less vulnerable to cycles in the advanced economies and their demand for imports.

With China set to pass the middle income threshold point, India likely to follow over the coming decade and a number of other large emerging markets on the verge of similar breakthroughs, then growth in developing countries will gather momentum based on internal demand drivers. With this will come more diversified trade patterns.

In addition, the weight of the developing economies in the world is still growing. For example, China's share of global GDP (in purchasing power parity terms) shot up from just 3% in 1990 to 13% in 2009. By 2020, China could account for a fifth of global GDP. The developing world as a whole represents just under half of global GDP but this is set to increase to as much as 60% in ten years time. As a consequence, global growth, and particularly prospects for developing economies, will be less vulnerable to cycles in advanced economies and their demand for imports – on the other hand, growth will become more interconnected within the developing world itself.

The benefits for the developed world would be more visible if it were not for persistent fears over rising sovereign debt, the impact of tighter fiscal policy and the risk of double dip recessions. For example, the outlook for the German economy has been reinvigorated by the success of its exporters in China and other emerging markets, with these export sales surging by 50-60% – and the UK's growth performance in 2010 has also been stronger than many feared.

Reinforcing optimism regarding global trends, the ultimate drivers of long-run growth - technology, organisational and financial efficiency, urbanization and other productivity boosting factors - are largely unchanged from pre-crisis assessments. Certainly catch-up productivity and consumer growth in emerging markets has ample scope to drive rapid economic expansion over 30-40 years at least – the recession did not end this process.

In spite of the uncertainty about short-term prospects, there appears to be a broad consensus about the general features of long-run projections to 2020:

- Global growth is seen averaging 4-4.5%, with a slight uptrend due to the rising weight of emerging market economies. Advanced countries should grow at slightly below their previous trend, probably at around 2%, while the developing world continues to expand at an average rate of 6-7%. Global growth may even be higher, in the 5-6% range, if all economies fire up strongly at the same time.
- The factors that support this picture of the developing world are well rehearsed: a relatively strong financial background and stable governance in the major emerging markets, sharply rising domestic demand as more consumers reach take-off on the S curve[1] and surging cross-country trade and investment that reduces reliance on exports to developed countries.
- Confidence is high, as illustrated by generally low risk premia across financial markets in spite of the debt crisis on the European periphery and other risks emanating from the developed countries. The main worries in emerging markets reflect the impact of fast growth: how to cope with food price inflation, rising asset prices and currency pressure.
- Buoyant emerging markets are also pulling in imports and reviving capital flows, boosting the advanced economies as well as the developing world. Notably, growth has picked up sharply in Germany, creating the greatest change in forecasts for the major economies. This improvement highlights the scale of the rebound in trade after the disaster in 2009 as well as Germany's exceptional ability to gain more than other countries from this burgeoning outlet for its exports.

In terms of the global hierarchy (see Figure 1 on p.6), China has overtaken Japan as the world's second largest economy in 2010 and will be ever closer to overtaking the US as the world's largest economy by 2020. By this time, the other three BRICs will be reaching the $4.5 trillion GDP range, catching up with the large European economies. However, it should not be forgotten that there is also an important second tier of economies that will be above the $1 trillion mark before 2020, which include Indonesia, Korea, Mexico and Turkey as well as Australia and Canada.

[1] Particularly in Asia.

The Threat from within Emerging Markets: A "China Risk Scenario"?

A critical factor behind the rapid return of confidence and growth in the global economy during 2009 was the leadership provided by China and the resilience of its economy. To offset the impact of the global recession, which cut China's exports by around 25% in early 2009, the Chinese government moved rapidly and decisively to provide substantial support for the economy via monetary easing and fiscal stimulus. One of the largest fiscal stimulus packages among the major economies was announced in late 2008 (quoted as 13% of GDP, almost $600 billion), although subsequent net spending seems to have been somewhat lower.

Turbulence in the Chinese economy, now the main destination for most Asian exports, would badly affect the regional economy. Asia could see a sharp drop in growth to well below the typical rates seen since the early 1990s. However, some regions of the world may be more resilient than others.

Proof that China could withstand the shock and avoid recession boosted sentiment and, more concretely, rising demand from China also fed into trade across Asia and emerging markets in general, helping offset losses in exports to the US and Europe. For example, South American economies with strong trade links to China (including Brazil) saw a marked acceleration in growth that was absent in countries with stronger ties to the US (in particular, Mexico and Central America). China is unique among the developing countries in this respect - the trade ties of India, or Brazil or Russia, are simply not powerful enough to have such a marked impact on the global economy.[2]

However, increasing influence in the world can be a risk as well as a benefit. What might happen if these trends were to reverse due to a serious setback in the Chinese economy? China has become a major swing factor for the developing world – and the global economy. In spite of an exceptional track record for economic management, if Chinese policymakers fail to keep control of their burgeoning economy and financial developments, this could cause serious disruption to global prospects at some point in the future.

The risks emanate from several directions:

- The government is likely to find it increasingly difficult to manage the economy as tightly it did in the past - an inevitable consequence of China becoming a larger and more complex economy. New mechanisms will be needed to address cycle management and external risks – perhaps making more use of the tax system and interest rates in the future.
- Export growth over the coming decade may drop into line with average growth in world trade, in part because recent growth sectors for China (e.g. office machinery and equipment) are maturing and exporters already have high market shares. China is also starting to see migration of basic-skill industries (such as textiles) to even lower cost countries and investment in the export sector will ease off.
- Investment rates will be impacted by higher wage settlements squeezing operating profits. This could severely curtail the scope for self-financed investment, which has been the main source of investment funds in the past (accounting for more than 70% of investment spending).
- In theory, consumer spending will be able to take up the slack as export and investment growth ease off, helping push up the share of consumption in GDP to more typical rates of 60%. However, in practice, this adjustment process may be neither rapid nor smooth: downside risks may emerge more quickly than upside adjustments, creating at least some temporary turbulence in overall GDP growth.

Turbulence in the Chinese economy, now the main destination for most Asian exports, would badly affect the regional economy. Asia could see a sharp drop in growth to well below the typical rates seen since the early 1990s. However, some regions of the world may be more resilient than others. For example, the US and European economies, and their suppliers such as Mexico, India, Turkey and Eastern Europe, would probably remain fairly stable (as they did during the Asian crisis of 1997-98). In addition, South America may be able to switch target markets and its domestic growth might therefore be less effected by a China shock than Asia.

The worst case scenario would be a synchronised cycle with the US and Europe weakening along with China. The risk in this case is that the scale of the global business cycle could be dangerously enlarged.

This suggests that the positive and negative impacts of China might not be symmetric – much of the developing world could act like swing voters, prepared to switch allegiance from one party to another depending on the opportunities on offer. While the US and Europe were in crisis, China provided a significant boost but if China

[2] More technical details on the calculations for China's growth outlook are provided in the recent Chatham House discussion paper "Decoupling revisited" by Vanessa Rossi and William Jackson (September 2010, available on request).

itself were to stumble, attention might refocus on the mature economies.

The worst case scenario, however, would be a synchronised cycle with the US and Europe weakening along with China. The risk in this case is that the scale of the global business cycle could be dangerously enlarged, perhaps threatening a repeat of 2009.

In addition to risks linked to business cycles and the transition to a consumer driven economy, there are important issues to address regarding China's financial sector and currency:

- Financial markets need to be appropriately developed so that they reduce rather than exacerbate concern over potential instability. In particular, the massive household savings base, still largely held in liquid bank deposits, would pose less of a threat to financial stability if it were to be anchored across a range of markets (including property and bonds) and long-term savings instruments such as insurance and pension products.
- There must be a sufficiently attractive range of financial products (including bonds) to ensure a stable spread of investment in the economy is maintained once the capital account fully opens up: this will offer balanced opportunities to both local and foreign investors.
- Without sufficiently mature markets, the risks attached to a premature move to fully open the capital account and float the Renminbi would be considerable, as China itself has highlighted. These risks must be taken seriously in a global as well as local context.

Regarding currency wars and the pressure to revalue the Renminbi, there are important moves taking place that will address some of these issues. In the short term, the government has indicated its intent to step up the rate of appreciation of the currency over the coming year – in part as a means of curbing the impact of world food price inflation – and measures to limit the effect of speculative capital inflows are also being seen, for example in the property market. However, the most important sign of change is the increased backing being given for the development of the offshort Renminbi market, with Hong Kong the main focus of this business.

Further expansion of the offshore Renminbi bond market will also encourage faster growth in direct investment from and into China.

While the offshore market is still in its infancy, it could grow very rapidly given the scope for direct trade settlement in Renminbi based on China's sizeable trade flows around the region and the attraction of the appreciating currency[3]. Further expansion of the offshore Renminbi bond market will also encourage faster growth in direct investment from and into China (ODI and FDI respectively). This will enable more Chinese companies to 'go global' and foreign companies to invest in operations in China using finance raised in local currency terms. In addition, this development effectively provides a form of trial run for the Renminbi to 'go global' ahead of becoming fully convertible.

The Take Aways...

Surprising though it may seem after a shocking global recession, world growth has recovered well, reflecting the reality that the crisis in finance was largely a North Atlantic affair rather than a truly global phenomenon. Although recent debates have continued to focus on the risks to recovery, in fact the evident robustness of the global economy should be boosting business confidence and real investment. Arguably, relatively buoyant stock markets anticipate that the upturn in investment will strengthen in 2011.

There are four key points that emerge from our analysis of economic prospects, indicating global growth opportunities but also to new risks:

- In contrast to fears of a prolonged recession, global growth may actually reach a new peak of 5-6% if all regions fire up simultaneously.
- Rapidly rising demand in populous emerging markets such as China and Brazil is already boosting world trade this year. The advanced economies have benefited from soaring exports of high-end consumer goods, such as high performance cars and fashion products, as well as sales of investment equipment and expansion of consumer services such as media, travel and leisure. Germany has been a key beneficiary of the emerging market surge but results from leading luxury goods producers across Europe point to widespread and substantial gains in this sector.
- Global investment flows as well as trade are being encouraged by the surge in emerging market growth. Such flows will benefit advanced economies such as Germany and the UK, the leading destinations for FDI into Europe. Furthermore, capital flows point to a next generation of trade with emerging markets in financial and professional services, which will also benefit the UK. Demand for retail financial services is poised to take off across the major economies including China

[3] The development of the offshore market is the topic of a forthcoming briefing paper by Vanessa Rossi based on meetings held in Hong Kong and China in November.

and India as more consumers reach important income thresholds.

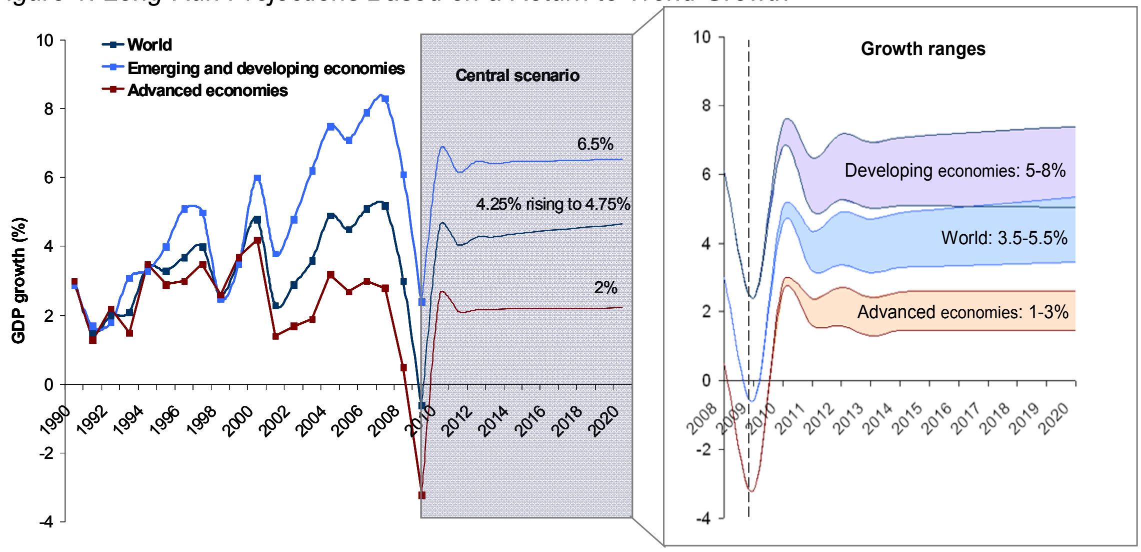
- At the other end of the spectrum, one of the new threats to global economic growth is the potential for instability in China itself. While this is a low probability scenario, as China's economy grows in importance then it inevitably becomes a real source of risk, with significant implications for growth prospects in other emerging markets especially in Asia.

Of course, the importance of such analysis is not just to provide a range of estimates for economic growth but to highlight the need to diversify business strategies in ways that take account of the potential challenges and changes that may appear over the next decade.

Asia has been a consistently strong performer in the world economy and business – it has become the third pillar of the global economy and this cannot be ignored, especially in trade and in financial services. It now has to become a third pillar in currency terms, with the development of the Renminbi a critical part of this picture. However, Asia also has new vulnerabilities that add both to the global challenge and to the arguments in favour of examining global business opportunities on a wider basis.

If you have any questions or comments about this thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact: Laurence Baxter, CII Head of Policy & Research*: [thinkpiece @cii.co.uk](mailto:thinkpiece@cii.co.uk) *or by telephone: +44 (0)20 7417 4783.

Figure 1: Long-Run Projections Based on a Return to Trend Growth



Source: Central scenario and growth ranges are own projections for 2010-2020. The reason for world growth trending upwards is due to the rising weight of the emerging markets

Vanessa Rossi is Senior Research Fellow in International Economics at Chatham House. She has extensive experience in international economics and financial market analysis gained from a career that has included work for The City, the European Commission and consultancy for the World Bank. This includes the 2010 report for the CII on India and South East Asia (see below).

As the leading professional body for the insurance and financial services sector with over 95,000 members in more than 150 countries, the **Chartered Insurance Institute** is committed to protecting the public interest by guiding practitioners in the sector towards higher technical and ethical standards. We do this by offering them a broad portfolio of services and support to achieve this, including membership, qualifications, continuing professional development, thought-leadership, lobbying and the maintenance of a benchmark Code of Ethics. *For more on the CII and the **think**piece series, please visit www.cii.co.uk/thinkpiece*

CII International Activity: with over 16% of our membership based outside the UK, we are increasingly active in supporting our members globally. We have offices in the Asia Pacific region as well as in India, and the Middle East/Gulf region. For more information, see: [http://www.cii.co.uk/pages/localandglobal/globalnetwork.aspx.](http://www.cii.co.uk/pages/localandglobal/globalnetwork.aspx)

Chatham House has been the home of the **Royal Institute of International Affairs** for over eight decades. Its mission is to be a world-leading source of independent analysis, informed debate and influential ideas on how to build a prosperous and secure world for all. *For more information, please visit www.chathamhouse.org.uk*

Recent articles in the series:

No.47: Insurance Contract Law Reform: Bringing the Underpinning Law into the Twenty-First Century by Peter Tyldesley (17 November 2010)

The author examines the problems with English Law regarding the treatment of insurance contracts. He shows that much of the problem stems from trying to underpin a twenty-first century insurance market with law written in Georgian times. He summarises recent steps taken by the Law Commission of England & Wales and discusses some of the implications.

No.46: What Happens Once the Ink is Dry? Claims and the Parties' Post-Contract Duties by David Hertzell, Law Commissioner of England & Wales (8 November)

Law Commissioner David Hertzell examines his team's latest review of insurance contract law. He sets out some of the problems with the existing law underpinning insurance contracts, and discusses some solutions to clarify the insurer and policyholder responsibilities especially after the contract is signed.

No.45: The View from Singapore - Cautious Optimism about Asian Economic Recovery by Mui Pong Goh, Research Fellow, Chatham House, **International Series no.12** (19 October)

Due to its unique vantage point at the heart of Southeast Asia, Singapore is well placed to provide an informed view of global economic developments and their implications for this influential part of the world. This paper discusses the tremendous growth surge underway this year, and reflects on the current wave of cautious optimism regarding the region's economic future.

No 44: A Passage to India: Towards Robust Economic Growth? by Donald Hepburn, Associate Fellow in International Economics at Chatham House, **International Series no.11** (29 September)

Published in the backdrop of the Commonwealth Games, it unpicks some of the underlying economic trends with India's developing economy. The paper begins by identifying the reasons for India's relative success during the financial crisis, before outlining the future prospects for growth and the infrastructural and political barriers to prosperity.

No.43: Time for collective action? Redressing the damaging effects of cartels on small businesses by Ingrid Gubbay and Antony Maton of Hausfeld & Co LLP (10 September)

This paper, by the authors examine some of the harmful effects of cartels on small businesses and discusses reasons why firms remain reluctant to claim for damages. The paper then moves on to highlight the affordable options open to SMEs for redress, and the opportunities for insurance firms to become the underwriters of collective action.

No.42: Speedy Recovery or Lingering Crisis in the Gulf Economies? by Vanessa Rossi and William Jackson, Chatham House, **International Series no.10** (30 July)

Over a year after covering this region in an earlier thinkpiece, the author returns to examine how the Gulf economies have fared especially following the Dubai property crisis last autumn. Despite the setback, Chatham House's forecasts nevertheless show much promise for significant growth in insurance and financial services over the next 5 to 10 years.

No.40: The Future of International Financial Regulation. by Eric Pan, Associate Fellow in International Economics, Chatham House, **International Series no.9** (8 June)

This thinkpiece summarises the challenges confronting attempts to strengthen the global financial regulatory architecture. Prepared by a prominent regulatory law professor based in New York, the paper helps readers make sense of the various interlocking institutions such as the G20, IMF and European Union, and sets out the key issues and challenges facing them as they deal with the effects of the financial crisis.

No.38: Successes, trials and tribulations in regional economic recoveries, by Rodrigo Delgado Aguilera, **International Series no.8** (22 April)

The developing world is seeing the same sort of multi-speed recovery as elsewhere. While the Asian economies have responded well following lessons learned from earlier crises, Latin America and the Middle East seem to have for the most part escaped the turmoil's major effects, but emerging Europe's recovery is still far from over.

All our Thinkpieces are freely available on our website: **www.cii.co.uk/thinkpiece**

If you would like to receive new Thinkpieces by email, please contact us on: **thinkpiece@cii.co.uk**

For more information on the views of the Chartered Insurance Institute and Personal Finance Society, including policy research, briefings, *Our View On* papers, *Papers in Professionalism*, and other publications, please visit www.cii.co.uk/insight

CII