



The long unwinding road

Setting the stage

In the decade prior to the current economic crisis, there was strong consumer spending growth in the United States as well as in smaller economies such as the United Kingdom, Spain and Ireland. To simplify what happened, such growth was funded, in part, by borrowing against the increased value of homes, itself the result of a flood of liquidity from surplus countries such as China. This excessive consumer spending growth was not only the principal source of economic growth in these countries, it also fueled export-driven growth in surplus countries such as China, Japan and Germany. In fact, the symbiosis between these “consuming” and “producing” groups of countries was the hallmark of the global economy in the first decade of the twenty-first century.

All that will now change.

The global economic crisis of 2008-09 exposed the fault lines of the imbalanced global economy. When the inflated values of property-based assets peaked and then collapsed, global financial institutions suffered huge losses. The resulting loss of confidence caused a near shutdown in global credit markets as investors fled to the safety of short-term government securities. Moreover, indebted consumers were forced to dramatically shift gears. They increased savings, paid off debts and ceased to spend with abandon. Of course this crisis, like all economic crises, will eventually end, and the global economy will recover – indeed there are significant indications that recovery is now under way. Yet the global pattern of consumer spending of the past decade will not return.

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In the coming decade, the countries that borrowed heavily to finance excessive consumer spending may experience slower consumer spending growth as households struggle to de-leverage, repair tattered balance sheets and accumulate wealth for future retirement and other needs. More of the economic growth of these countries will likely be driven by exports, business investment and government spending. Conversely, those countries whose growth was fueled by exporting to borrowing countries will no longer be able to depend on such markets. The U.S. consumer will not be able to sustain China's export sector as it did in the past. Consequently, countries such as China will shift away from export-oriented growth toward growth driven by consumer spending. The degree to which this adjustment takes place, and takes place smoothly, will depend on the policies put in place by various governments. Nevertheless, an adjustment of some sort will definitely take place.

For those global companies that sell goods and services to consumers (such as those in retailing, consumer products, hospitality and even retail financial services) the next decade will entail a very different business environment than that of the past decade. Not only will the growth of consumer spending shift geographically, the nature of consumer spending will shift as well.

Why can't the pattern of the past continue indefinitely?

The answer is that the strength of consumer spending in debtor nations was based on factors that cannot be sustained. For example, U.S. consumer spending was able to grow faster than consumer income because the personal savings rate continuously declined until it was close to zero. For obvious reasons, it cannot go below zero in perpetuity. Hence, the growth of consumer spending must necessarily slow down, even if consumers don't increase their savings. In addition, the ability of consumers in the United States and the United Kingdom to take on large debts was predicated on the willingness of foreigners to lend to these countries. That flow of capital cannot be taken for granted, especially as those foreigners have suffered sizable capital losses already. China, for example, has expressed serious concern about the declining value of its dollar holdings.

During the past decade, the United States consumed more than it produced and borrowed from the rest of the world to make up the difference. This difference was the U.S. current account deficit. At its peak, it was roughly \$700 billion, or over 6 percent of U.S. GDP. The counterpart to this was a massive surplus in the rest of the world, principally China, Japan and the oil exporting countries of the Middle East. This massive imbalance in the global economy was partly sustained by China's desire to maintain a low-valued currency. Hence, the Chinese central bank purchased dollars in order to hold down the value of the Chinese renminbi. In so doing, it enabled its exports to remain inexpensive and many Chinese workers to remain employed.

When China bought dollars, it represented a flow of capital into the United States. The result was downward pressure on U.S. long-term interest rates. This flow of cheap capital, in turn, probably contributed to the bubble in the U.S. housing market. The rising value of property meant that consumers could achieve wealth without saving, especially as it was easy for them to borrow against the increasing value of their homes.

If this situation were to continue, it would require that

the United States achieve a dangerous and unprecedented level of external debt (it is already unprecedented). This would very likely lead investors to shy away from dollar denominated assets, thereby leading to a collapse in the value of U.S. assets. Something like this actually happened during the past year, but a continuation of global imbalances would probably create an even greater problem.

Rebalancing

The economist Herbert Stein once wrote that “if something cannot go on forever, it will stop.” In some ways, that describes the imbalance in the global economy. It may not stop, but at least for the near future it won’t get bigger and likely will get smaller. What is uncertain, however, is the manner in which the imbalance will be corrected. There are a number of things that could happen.

Reducing the imbalance means that the United States and other debtor countries like the United Kingdom must save more, import less and export more than would otherwise be the case. The path to this usually includes currency depreciation (already under way), which would change the relative prices of traded goods, thereby stimulating exports and suppressing imports. For China, adjustment means undertaking measures to stimulate consumer spending. This could include liberalizing consumer finance, improving the social safety net so as to discourage saving, and allowing the currency to appreciate in value.

There are indications that China intends to move in this direction, but there are obstacles as well. First, China’s government appears to be of two minds on the currency. On the one hand, it wants to encourage domestic demand so that it need not accumulate more foreign currency reserves. On the other hand, it complains about the potential capital loss on its existing reserves should the dollar fall further. During the economic crisis, China stopped allowing the currency to appreciate lest it harm its export competitiveness. However, once global recovery is fully extant, China is likely to allow further revaluation. The question is how much.

Second, China’s response to the crisis was to massively stimulate investment in infrastructure and state-owned companies. The result is an economy distorted by excessive investment and insufficient consumer demand. If the consumer is to play a bigger role in the economy going forward, China will have to adjust policy accordingly. The degree to which this will take place remains uncertain.

If China and the United States do all the right things, then adjustment in the global economy should go smoothly. The growth of global consumer spending will shift away from the United States and toward China. If policymakers fail to act, however, then the road to adjustment could be bumpy. It could, for example, entail volatility in financial markets especially currency markets that could have onerous consequences for economic growth.

How will U.S. adjustment take place?

It is not sufficient to predict that American consumers will simply decide to spend less in the future. Something will compel them to do this, and there are several factors that will likely contribute to a significant shift in U.S. consumer behavior. First, the destruction of wealth that has transpired over the past two years (roughly \$14 trillion) will not be reversed quickly unless both the equity and property markets experience unusually rapid price increases. Thus, consumers will feel the necessity to rebuild wealth by saving, a process that has already begun.

Second, given the destruction of housing wealth, most consumers will no longer be in a position to borrow against increased property values. Thus, consumer spending will be constrained by income. Third, while financial markets are showing signs of recovery, history suggests that banks will remain cautious in their lending behavior for some time to come. Thus, consumer credit will not be as readily available as in the recent past.

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Moreover, prospective changes to the regulatory environment will likely exacerbate this factor. If banks are forced to hold more capital, and if the market for securitization remains a shadow of its former self, there will be less credit available for consumers.

Fourth, other areas of government policy may play a role in restricting consumer spending. Increased taxes on upper income households will have a negative impact on spending. In addition, efforts to restrict emissions of carbon gases are likely to increase the price of energy, thus shifting consumer spending away from other goods and services. Finally, there is the elusory psychological factor. That is, the length and depth of the recent recession, the worst of the post-war era, may have a lasting impact on the willingness of consumers to engage in risky behavior. This may compel a permanent shift toward more frugal spending (fewer big ticket items purchased, more discount shopping).

Is China big enough to make a difference?

If China does all the right things to boost consumer spending and suppress export growth, will the Chinese consumer alone be sufficient to offset the declining growth of U.S. consumer spending? The answer is that it depends on what happens.

In 2008, for example, China's consumer spending was only 15 percent of U.S. consumer spending when measured at current exchange rates. Now, consider the following plausible scenario for future growth. Suppose that, over the next decade, Chinese GDP grows 9 percent per year and consumer spending grows 12 percent per year. Also, suppose that U.S. GDP grows 3 percent per year and consumer spending grows 2 percent per year. Under this scenario, Chinese consumer spending rises from an unusually low 36 percent of GDP in 2008 to 50 percent of GDP in 2020. This would represent an increase in consumer spending in 2020 of \$1.7 trillion above what it would have been with no change in share of GDP. In the United States, consumer spending drops from 72 percent of GDP to 64 percent of GDP. This would represent a decline in consumer spending of \$1.7 trillion below what it would have been if consumer spending had remained 72 percent of GDP. Thus, the dollar value of the drop in consumer spending as a share of GDP in the United States will ultimately be offset by the dollar value of the increased share in China, but not until 2020. This is a long adjustment.

In other words, even in an optimistic yet plausible scenario, China's boost to consumer spending takes a



long time to offset the decline in the United States. The implication is that, for the global economy to adjust to a relatively quick shift in U.S. consumer spending, several large economies will have to boost consumer spending significantly. Otherwise, global growth could be stymied and currency markets could become excessively volatile. The most likely candidates to play that role are Japan and Germany, both huge economies that have been highly dependent on exports rather than consumer spending.

Yet consider the numbers. In Japan, where consumer spending is roughly 30 percent that of the United States, it is 58 percent of GDP, an historically high number already by Japanese standards. It is unlikely to go significantly higher, and Japan's economy is unlikely to grow significantly faster anytime soon. In Germany, consumer spending is less than 17 percent that of the United States. German consumer spending is 56 percent of GDP, a number that is unlikely to become significantly higher. In other words, it is hard to see how these countries can play a big role in offsetting a U.S. adjustment. Moreover, the degree to which Germany and Japan will undertake policies necessary to achieve a shift is uncertain at best.

That leaves the rest of the world. The reality is that, given what is likely to take place in the United States, sizable shifts in economic structure will be necessary in many countries, including many of the big emerging markets.

What could go wrong?

If U.S. consumer spending resumes growth at a level similar to the past decade, or if other countries (such as China) fail to sufficiently accelerate consumer spending, then the global economy could face problems. Either of these scenarios would entail continued large global imbalances, with the U.S. borrowing massively from overseas and/or China and other countries running huge surpluses with nowhere to invest them. If the U.S. continues to borrow excessively, financial markets will respond by driving down the dollar and driving up U.S. interest rates thereby stifling growth, fuelling inflation and causing instability. If China and other countries run large surpluses then there will also be downward pressure on the dollar, increased inflation in China and potential political instability.

What could bring about such failure? Several things could do it. In the United States, these include large budget deficits, failure to reform U.S. finance and failure to allow the dollar to gradually decline.

In China, problems could come about because of support for the dollar, failure to reform financial services, failure to provide consumers with an adequate safety net, and excessive government support for business investment at the expense of consumer spending. The problem in China is that consumers save an inordinate share of their income. Although there are strong cultural reasons for this, government policy could at least cause consumers to switch to a more historical norm. After all, as recently as 1997, consumer spending in China was roughly 47 percent of GDP compared to about 36 percent today. Financial market liberalization could go a long way toward encouraging consumers to take on more debt rather than massively saving for every large purchase, including homes. Yet previous efforts by the government to discourage saving have not been especially successful.

Finally, problems could also arise from a Japanese and/or German failure to shift toward a more consumer-driven economy. Both giant economies have traditionally been

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dependent on exports rather than the domestic consumer to drive growth. Yet if the markets to which they have exported are less prone to importing, then they will not achieve sufficient growth without adjusting to more consumer spending growth. The degree to which they do this will depend on policy. This remains highly uncertain, although the government in Japan and the current coalition in Germany have both signaled an interest in reforms.

In the future, more innovation will take place in emerging markets and be aimed at the specific needs of consumers in emerging markets. While this is already starting to happen, this trend will accelerate considerably in the next few years.

What will the consumer world look like?

In the next few years, a fundamental change in the structure of the global economy will likely shift the manner in which consumer-oriented companies obtain growth. The U.S. consumer will be financially constrained. As such, spending in the United States and other indebted countries such as the United Kingdom will increase more slowly than in the past. Consumers will be more value conscious, seeking low prices and avoiding some discretionary spending. Thus, companies will obtain growth through market share gains rather than simply latching onto a growing market. Achieving this will entail good brand management, an improved customer experience and differentiation from competitors aimed at avoiding ruinous price competition.

During the economic crisis, there have been several changes in consumer behavior, many of which may persist even when the economy recovers. These include a shift toward discount retail venues, a shift toward discounted private label products, a shift away from eating out and toward eating at home, a decline in the share of income spent on large discretionary items for the home, and greater price sensitivity in general. If these trends endure even partly, they will change the requirements for success on the part of consumer-oriented companies.

Meanwhile in China, retail sales have weathered the economic crisis quite well. The shock to the Chinese economy from the global crisis was concentrated on China's export sector. The drop in exports led to the loss of roughly 20 million jobs at coastal factories. Yet despite this significant rise in joblessness, Chinese consumer spending continued to grow rapidly.

There are several reasons. First, the newly jobless factory workers were low paid and did not contribute significantly to overall retail spending. Rather, middle-class service workers in rich cities like Shanghai play a far larger role in generating retail sales. Moreover, these people have not lost their jobs. Second, China's government provided a massive stimulus to the economy, creating consumer income. This, combined with easier credit conditions, fueled consumer purchases of homes and cars.

When the global economy is fully recovered, it is likely that Chinese consumer spending will remain on a high growth path. As this happens, the number of middle-class consumers will continue to rise rapidly, especially in the big coastal cities. That means rising discretionary spending, increased spending on home-related



products, expanded awareness of global brands yet pride in high quality local brands, and increased willingness to eat outside the home. The latter will be especially important as there will be a sizable increase in the number of two-income, middle-class households who are highly time constrained. Still, China will remain a relatively poor country – as will the other big, fast-growing emerging markets such as India, Russia, Brazil, Indonesia and Turkey. That means relatively small shopping baskets, a high degree of price sensitivity and a big market for discount shopping.

What should companies do?

For global consumer-oriented companies, the new business environment will have several implications:

The shift in global consumer spending growth away from the United States toward big emerging markets means that companies will shift their resources in the same direction. Although rich countries like the United States will remain of critical importance, a disproportionate share of growth could come from the emerging world. As such, companies will invest more heavily in brand management, product development and marketing in such markets. Of course a critical component of success for such companies is innovation. In the future, more innovation will take place in emerging markets and be aimed at the specific needs of consumers in emerging markets. While this is already starting to happen, this trend will accelerate considerably in the next few years.

For the United States and United Kingdom and other rich but constrained markets, there will be a greater focus on offering consumers a sense of value. This means innovation, marketing and brand management aimed at attracting consumers who feel constrained financially but remain interested in high quality experiences. It means shifting resources toward

discount formats, a focus on limiting costs, and a recognition that consumers will purchase fewer big ticket items or experiences and, perhaps, purchase more accessory items.

The rise of China as a consumer market will come in conjunction with a rise in the currency and wages of China. Consequently, China will become a somewhat less attractive location for sourcing low-value-added products, and therefore consumer goods companies will diversify their supply chains. Less sourcing will take place in China's big coastal cities. Instead, there will be an increase in sourcing from China's interior cities (with far lower wages) as well as other low wage countries (India, Vietnam, Central Europe, Central America) that, in some cases, are closer in location to the final market. The latter fact will be important if there is a substantial rise in transport costs associated with high energy prices.

What about the longer term?

The changes taking place in the global economy will render a new economic structure that is likely to be with us until the next business cycle. Although the focus of this article is on the next few years, the trends discussed are likely to be sustained over a much longer time – perhaps as long as the next two decades. Consequently, consumer companies would be wise to keep this in mind when making long-term plans.

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Reprinted from *Deloitte Review*, Issue 6: 2010.