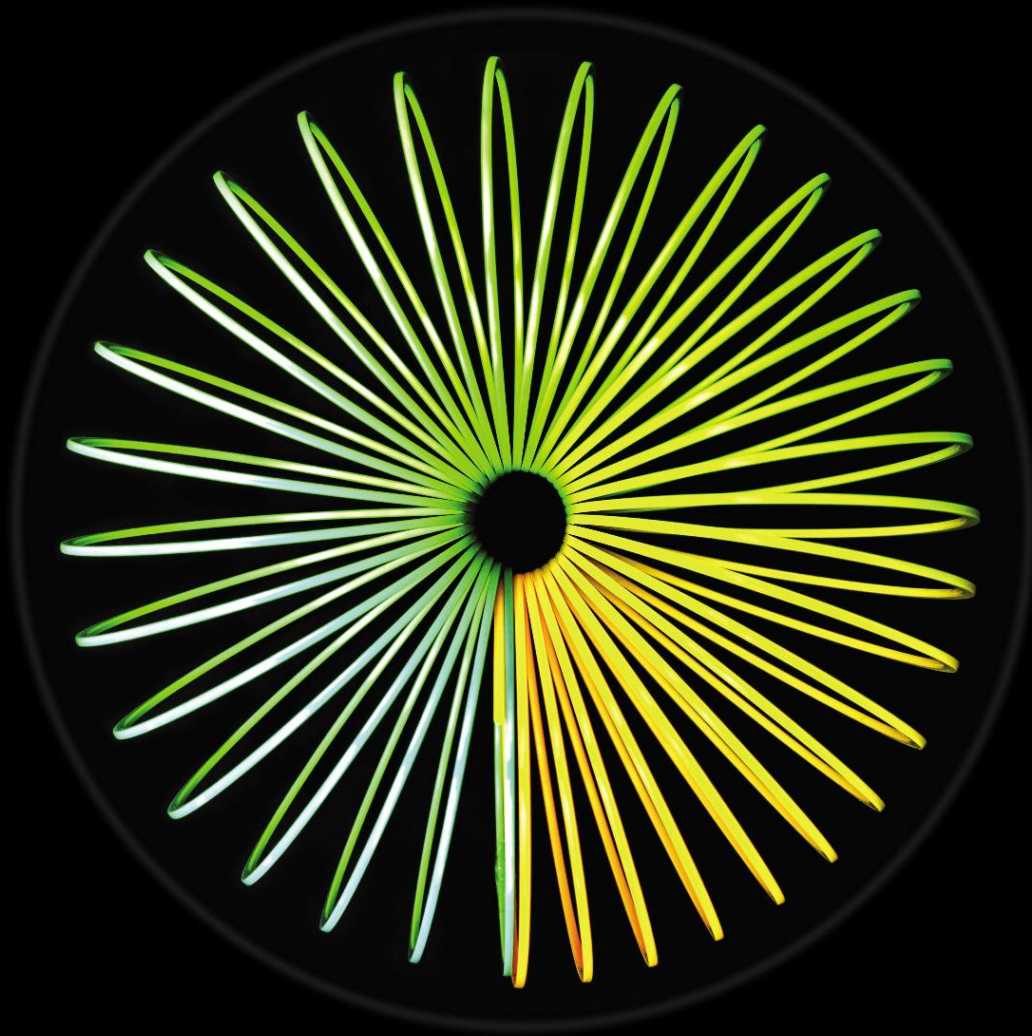


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## **Emerging market insights**

The coming emerging market  
demand shock

September 2017

## The coming emerging market demand shock

It may not feel like it in South Africa, but a fundamental economic shift is taking place in the wider emerging market (EM) world. We need to take ourselves out of the local negativity so as to see what is really taking place in EMs.

Since the beginning of 2017, EMs have become the engine of global growth and the new opportunity presenting itself is that this growth can be more inclusive in nature.

For almost a decade and a half from the turn of the century EMs enjoyed strong and synchronised growth. This was driven by their market opening, excess liquidity, rising foreign direct investment (FDI), booming trade, robust and rising commodity prices; not to mention confidence.

Such was the amplified nature of the growth that in 2007 – the year prior to the financial shock of the Lehman Brothers collapse – over 100 developing economies were growing at over 5%.

Today, this growth rate is almost unimaginable. In the two decades leading up to 2007, only 50 countries had managed to achieve an average growth rate of more than 5%.

This supercharged and clearly abnormal growth trajectory was disrupted in 2008 and came to a rapid end in 2013 when the United States (US) Federal Reserve began rolling back its QE-stimulus and when China's own resource-intensive infrastructure spend stimulus in response to the "Great Recession" was largely exhausted. The golden growth decade from around the turn of the millennium for EMs came to an abrupt end.

The past three years have been tough on two categories of EMs, namely those that are price-taking exporters of commodities, and those that suffer the economic cost of poor political governance. But the cycle is now turning.

Since the beginning of 2017 there has been a U-turn in the overall performance of EMs, although not all EMs are created equal. Considering the self-inflicted economic wreckage in Brazil and Russia – not to mention lesser (frontier) EMs such as Angola, Egypt, Nigeria and Venezuela – this may seem an overly positive view.

Beyond the negative news in recent years, there is now a real boom in middle-class consumption in key EMs that is creating new opportunities for employment, corporate profit and economic growth in the global economy.

Over the course of the next decade, a sizeable increase in middle class spending power emanating from EMs will become visible. This will equate to one-and-a-half times the size of the entire existing population of the US.

**Figure 1. Projected additions to the global middle class**

**510 million**

projected new additions to the global middle class between 2015 and 2025



Source: Mastercard, 2016

And, while some might think this projection to be overoptimistic, it is in fact based on conservative projections for GDP growth, for example, 4% per year in the coming decade in China, which is a figure that is most likely understated.

This is calculated to lead to an increase in middle-class spend of US\$9.1 trillion between now and the end of 2026 in eight of the biggest emerging markets namely Brazil, China, Egypt, India, Indonesia, Mexico, Nigeria and South Africa.

Of course this assumes reasonable recovery from recession in Brazil, Egypt, Nigeria and South Africa. But the vast bulk of this expanding spend in emerging markets, 90%, in fact, will be concentrated in just three countries: China, India and Indonesia – all in Asia.

**Figure 2. New additions to the global middle class, 2026f**



Source: Mastercard, 2016

The year 2016 was beset with negative news around global economic growth forecasts and the rising trend of inequality in the developed world. Persistent negativity has eclipsed the reality of the coming EM “demand shock”. Unlike recent shocks in the global political-economy, this is one to be welcomed for its potential to contribute to global inclusive growth and new economic opportunity.

### The shift from manufacturing to services

What’s driving this demand shock? In essence, we have reached a turning point in the industrialisation of a number of leading EMs. This is the point at which GDP has risen enough in these markets that mass, labour-intensive manufacturing is going to deliver fewer and fewer benefits – simply because

there is less low-wage labour that makes such manufacturing economical. This is true of China and many other emerging markets, with the possible exception of South Asia and Africa.

The shifting value chain of production in China and its neighbours holds out potential for low-cost manufacturers elsewhere. The rising cost pressures on China’s light industrial manufacturing sector is leading to manufacturing capacity to relocate to lower-cost destinations.

Justin Lin, former Chief Economist of the World Bank, calculates that China could lose up to 85 million jobs within the next decade or so due to rising production costs. Chinese “hollowing out” of low-end manufacturing and its offshoring is fast becoming a reality.

As this shift in production out of China’s south-eastern provinces takes place, there is a prospect for forward-looking developing countries to emerge as “new Vietnams” – lesser cost destinations for manufacturing investment.

Ethiopia is emerging as the best candidate to assume this role in Africa. The country is now able to compete with China and Southeast Asia to attract low-end labour intensive manufacturing.

This is incredibly important as there is no sector like manufacturing that expands value and supply chains, creates secure jobs and diffuses wealth throughout a society. All developed world countries’ wealth was created from a manufacturing base.

So there are two key drivers of the coming demand shock that emerge in this process. The first is rising wages in China which drives faster growth in household income and spending.

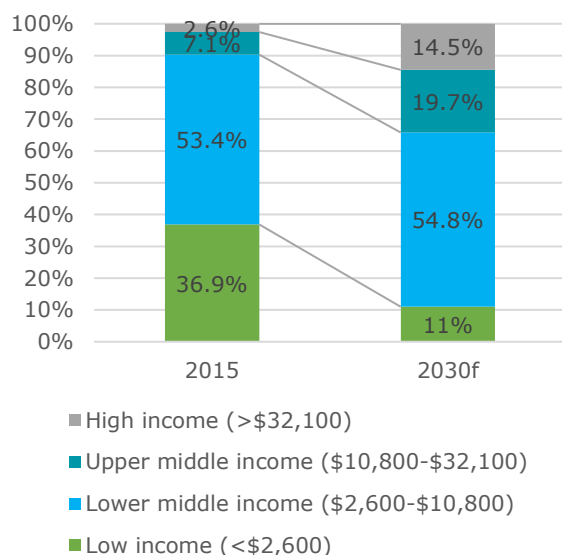
The second is rising employment in labour-intensive manufacturing in countries to where China’s low-end manufacturing is being relocated. These two drivers are mutually reinforcing, and together they are creating a new wave of consumer demand in these emerging markets.

### The shifting centre of gravity of growth

Post the “Great Recession”, the centre of gravity of growth has clearly shifted to Asia as the region now leads global growth. China’s growth model is rapidly shifting from state stimulus to services and consumption.

It is forecast that by 2030, 19.7% of the population will be in the upper middle-income bracket (\$10,800-\$32,100) and high-income individuals (above \$32,100) will comprise 14.5% of the population. This will result in significant increases in domestic consumption spend.

**Figure 3. Share of Chinese population by income bracket, 2015 vs 2030f**



Source: EIU, 2016  
 Note: In 2015 dollars

The outlook for the rest of Asia is also strong. Growth across Southeast Asia is forecast to top 5% through 2030. The bookend economies of Southeast Asia – Indonesia and Philippines – are both finally realising their growth potential, with the former likely to surpass the US\$1 trillion GDP figure this year.

India’s growth remains robust with the OECD, IMF and World Bank all predicting growth to be approximately 7.5% in 2018. Growth is likely to accelerate in most economies in Asia which will be supported by

strong domestic demand as disposable income levels increase. The rise of this emerging new Asian middle class will have huge implications for economic activity in both developing and developed economies.

### The rising EM tide

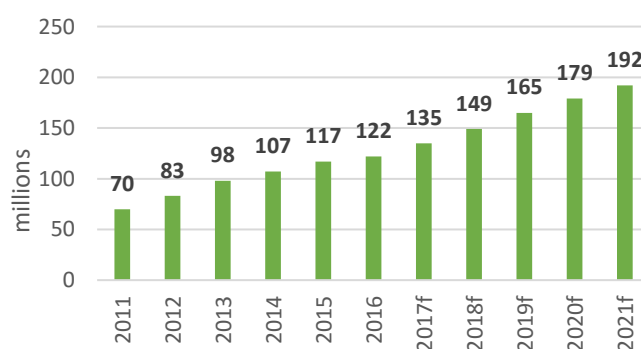
Investor sentiment toward EMs is now positive. This contrasts with the subdued growth prospects of developed markets. This year the IMF forecasts EMs to grow by 4.5% compared to 2% in developed markets.

Quoted in the Financial Times in July, Pictet Asset Management’s index measuring EM consumer confidence indicates that it has risen to its highest level since 1993. The index includes data from 25 countries.

Robust or broader economic growth across most EMs – South Africa being an exception – is resulting in rising consumption. It may be argued that EM fundamentals have not made the dramatic reforms required to justify the positive investment flows but the rally has been driven by the fall in the US dollar in recent months.

While developing states can – with the right enabling policy framework – take advantage of this macro trend by creating domestic conditions favourable to attract FDI into their manufacturing sectors and benefit from this demand shock, the global economy will undoubtedly benefit from increased tourist flows and spend as well as the rapidly increasing demand for services from Asia.

**Figure 4. Chinese outbound tourism numbers, 2011-21f**



Source: China Statistical Yearbook/China National Tourism Administration/FGRT  
 Note: includes non-tourists such as business travellers

Outbound tourism spend by the new emerging middle class will create massive employment opportunities in hospitality, transportation and retail sectors. The staggering increase in Chinese tourists travelling and spending abroad is arguably among the mega economic trends of our times.

Last year, 135 million Chinese travelled abroad spending US\$261 billion, the highest source market globally since 2012. It is forecast that this figure will reach US\$429 billion in 2021. This coming demand shock will benefit economic activity in countries that are able to attract these tourists.

### New growth models

The services economy is incredibly complex and more difficult for public policy to cater for considering the traditional focus and reliance on physical resources and manufactured goods. Perhaps the significantly rising EM middle class will enable a new services-driven route for economic growth for developing states. Services no longer play just a supportive function but have become an export in their own right.

What this means for business is probably obvious but what implications does this have for governments seeking to unlock growth potential in their own economies?

As the above calculations are based on conservative estimates of what the demand shock will be as opposed to what it could be, there could be an even more significant expansion of this global EM middle class if citizens are enabled to start their own businesses, especially if these are in the formal sector offering better-paying jobs that contribute to middle class demand.

One way to start is by looking at measures that improve the ease of doing business and offering better recognition and protection of property rights for micro-entrepreneurs. This would allow them to create bankable assets they can use. Ultimately a more formalised developing economy is a more inclusive economy.

The irony is that the opportunities presented by the EM-powered world are massive but the operational and policy obstacles often make them so difficult to realise. The long-term successful economies will be those that adopt pro-growth reforms that are implemented in a pragmatic and inclusive manner.

*This article was first published in the Sunday Times in September 2017, and was originally authored by Dr Martyn Davies, Managing Director of Emerging Markets & Africa at Deloitte, and Dr Yuwa Hedrick-Wong, Chief Economist, Mastercard Center for Inclusive Growth.*

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