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# The Wide Angle

## Can Asian consumers replace the West?

Periodical

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**Summary**

- There are legitimate fears that developed country households, indebted and aging, may not be a growing and sustained source of consumer demand for the foreseeable future. The conventional view is that emerging markets cannot fill the void since they are producers rather than consumers. We found, however, that consumer demand from emerging markets can no longer be ignored. Adjusted for purchasing power parity, the combined private consumption demand of China, India, Russia and Brazil is already 93% of the US market.
- With a 60% share of consumer demand, Asia dominates the emerging markets. From automobiles to entertainment, Asian emerging markets – especially giants China and India – can now claim global scales. Moreover, rapid growth and changing consumer baskets suggest that these countries will dictate incremental market growth for the world as a whole.
- In our view, the decompression of Chinese private consumption will likely shift its economy from tradable goods to non-tradable services. This could potentially ease some of the global imbalance problem. Of course, real estate valuations are a concern in many parts of Asia. The longer term issue, however, is that a re-orientation of the Chinese and American economies could have a major impact on their physical, human and economic geography. Investors need to take account of this churn in their decisions.


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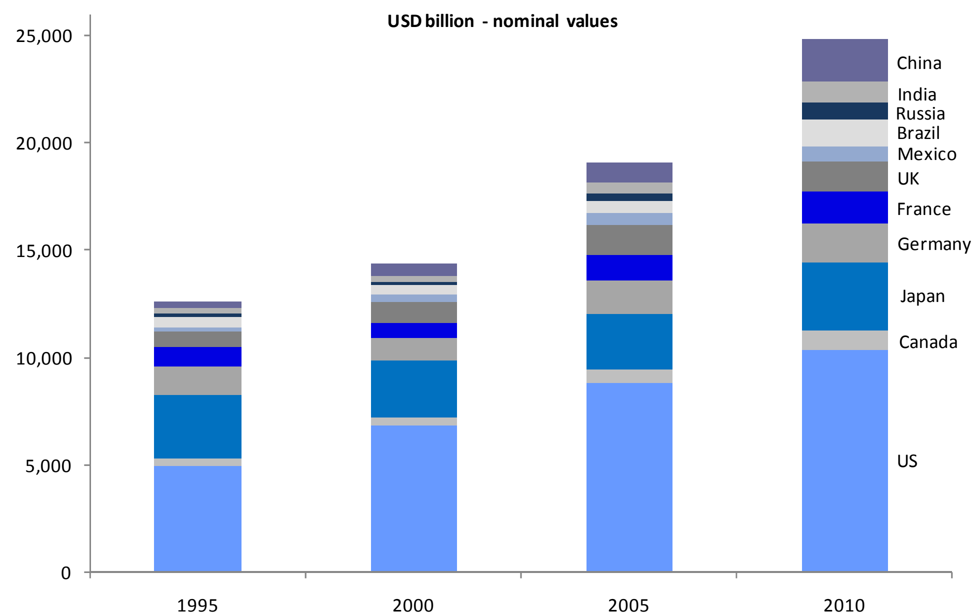
## Background

The modern world is not merely the result of technological progress and the invention of the amazing array of products that we use in daily life. It is equally the result of mass demand for these goods and services. Without this demand, many of these products would never have seen light of day and the intricate production networks that drive the world economy would not have existed. Since the nineteenth century, this consumer demand has emanated disproportionately from the West. As with many other things, Japan was the first Asian country to become a major source of demand in its own right. Many other Asian countries have emulated Japan's economic success in recent decades but till recently none have become major sources of consumption demand. This is partly because most of the newly developed Asian economies were small on a global scale but it is also because many of these economies relied heavily on export demand. Singapore is the most extreme example of this. The city-state may be rich and developed but its economy amounts to only USD 258bn and private domestic consumption is barely 40% of GDP. Its dependence on external demand shows up in a current account surplus that routinely runs at 20% of GDP or more.

**Figure 1: Private consumption demand in nominal terms**




*Source: Haver*

The point is that demand from the West, particularly from the US, has been the fuel that has driven the global economy for decades. The US is the world's largest economy and private consumption accounts for over 70% of its GDP. As shown in the chart above, private consumption demand in the US has so far been an order-of-magnitude larger than that emanating from emerging countries like China, India and Brazil. Even Japan continued to be a bigger market despite years of stagnation. However, household balance-sheets are under severe stress across the developed world. Aging and concerns about the sustainability of public finances will only add to these concerns. This has raised the possibility that consumers in developed countries could remain subdued for a prolonged period of time. This raised several questions. How bad are household balance-sheets in individual countries? Can consumers in emerging countries take over the mantle of supporting demand for goods and services?

Emerging markets are a heterogeneous lot. At USD7tr, China's economy may be the second largest in the world but its growth is driven disproportionately by investment. Private domestic consumption demand accounts for barely 33% of GDP (2010), the lowest of any major economy. India's households consume 57% of GDP but the ratio is now declining as household begin to save more. As recently as the late nineties, private consumption used to account for two-thirds of the economy. In Brazil, the ratio has been fluctuating around the 61% mark. Can this motley lot generate enough consumption to hold up global demand for goods and services at a time that developed economies may be attempting to correct their balance-sheets?

Clearly, they have the clout to generate a lot of demand in specific products. China, for instance, replaced the US as the world's largest automobile market in 2010. The combined strength of the Indian and Chinese movie industries arguably now exceeds that of Hollywood. This experience may widen out to other products as consumption baskets evolve. However, will this new source of demand grow fast enough to counteract stagnation in advanced countries? Moreover, the economic eco-systems of both emerging and advanced countries are not set-up for their new roles in the changed global order. As countries grapple with physical infrastructure, product-mix, human capital and policy frameworks that are mismatched to the new reality, will the transition generate social and economic friction?

## A Brief History of Consumerism

Consumption is the essence of living and people have been consuming goods and services from the earliest of times. However, mass consumerism is a relatively recent phenomenon. In pre-modern societies, the bulk of the population consumed basic necessities and only a tiny elite could afford luxury goods. This began to change very gradually in the richer countries of Europe in the seventeenth century as a proto-middle class began to emerge. Britain was at the forefront of this transformation. Thanks to pioneers such as William Petty (1623-87) and Gregory King (1648-1712) we have a good idea of the consumption basket in England at that time. Note that Britain already had one of the highest per capita incomes in the world – roughly a third higher than in France and Germany, and double of India and China[1]. As shown in the table below, food and beverages were the single biggest item of consumption and accounted for 47% of private consumption expenditure. By pre-modern standards, nonetheless, this was a low proportion and left enough surplus to be spent on other things.

**Table 1: The British Consumption Basket Then and Now**

| As % of total private consumption expenditure | 1688 | 2010 |
|---|---|---|
| Food and beverages | 47% | 13% |
| Clothing and footwear | 23% | 6% |
| Housing & utilities | 8% | 23% |
| Furnishings and durable household equipment | 15% | 5% |
| Healthcare | 1% | 2% |
| Transportation and communications | 1% | 17% |
| Recreation, culture and education | 3% | 13% |
| Restaurants and hotels | 0% | 10% |
| Other goods and services | 2% | 12% |
| | | |
| Private consumption expenditure as % of GDP | 84% | 63% |

*Source: Angus Maddison, The World Economy: Historical Statistics, OECD Development Centre, 2003 and Haver. Note: Data for 1688 relates to England and Wales while that for 2010 relates to the United Kingdom.*

[1] "The World Economy: Historical Statistics", Angus Maddison, OECD 2003

Britain was the first country to experience the Industrial Revolution at the turn of the nineteenth century. The United States and Western Europe went through the same transformation by the middle of the century. Industrialization both produced new products as well as created a middle class – a group that was poorer than the elite on a per capita basis but was collectively a much larger market. Still, the invention of new products and emergence of the middle-class was not enough. Mass consumption required a new cultural mindset and the necessary physical infrastructure. For this we can thank the Americans.

An Irish immigrant named Alexander Stewart opened a business on New York's Broadway in 1846. It was called the Marble Dry-Goods Palace where a large range of products was available under one roof – the first department store. The experiment was a huge success and by 1862, Steward had relocated to an eight story building called the A.T. Stewart's Cast-Iron Palace. Very soon there were dozens of similar department stores across America: Lord & Taylor and R.H. Macy's in New York, John Wanamaker's in Philadelphia, Jordan Marsh in Boston and so on. By the beginning of the twentieth century, some of these enterprises became huge establishments with their own post-offices, hair saloons, roof gardens, restaurants and so on. Wanamaker's in Philadelphia took orders 24-hours a day and its Crystal Tea Room bragged that it could handle 1000 customers at a time!

The retailing revolution was very important because it democratized luxury by exposing the middle-class to products that had earlier been limited to the rich. Harry Selfridges, then working for Marshall Fields, is said to have introduced the idea of bringing goods down from the high shelves to the counters where customers could touch them without being chaperoned. He also introduced the bargain basement, the annual sales and gift certificates. Each of these innovations was an important step towards creating the consumer market as we know it. After retiring at the age of fifty, Selfridges moved to London and founded the department store that bears his name. Of course, the consumer revolution was not just limited to the big cities with large department stores. Founded in 1886, Sears, Roebuck & Company became a huge success as a mail-order service. The bi-annual receipt of its catalogues became a social high-point in the interiors of America[2].

By the end of 1950s, most American households owned cars, telephones, refrigerators and television sets. Each of these products had powerful multiplier effects. The automobile, for instance, led to investment in highways, malls and suburban homes. This fundamentally changed the way people lived their lives and, in turn, generated even more demand for cars. Thus, physical infrastructure, government spending and lifestyle preferences fed on each other to create a particular eco-system for consumerism. The next big shift in the American consumption basket occurred due to the sharp increase in the share of healthcare. Today it amounts to 17% of consumption, the highest in the world. This change only partly reflected new technology and increased demand since countries at a similar level of development spend a lot less on this category. Instead, it can be said to reflect the eco-system of insurance payments and public health provision in that country.

[2] "Made in America", Bill Bryson, Black Swan 1998

**Table 2: Evolution of Consumption Expenditure in the United States**

| As % of total private consumption expenditure | 1930 | 1970 | 2010 |
|---|---|---|---|
| Food and beverages | 21% | 16% | 8% |
| Clothing and footwear | 11% | 7% | 3% |
| Housing & utilities | 23% | 21% | 22% |
| Furnishings and durable household equipment | 4% | 4% | 3% |
| Healthcare | 3% | 7% | 17% |
| Transportation and communications | 6% | 9% | 6% |
| Recreation, culture and education | 4% | 5% | 7% |
| Restaurants and hotels | 5% | 7% | 6% |
| Other goods and services | 21% | 23% | 27% |
| Private consumption expenditure as % of GDP | 77% | 62% | 71% |

*Source: Haver*

Today's consumers no longer need to visit a department store or read through a mail-order catalogue in order to know about new products. We are constantly bombarded by advertisements and information from a bewildering array of sources ranging from the television to the internet. Still, it remains the case that consumer demand is not just about rising incomes and the supply of products but about a whole eco-system that includes physical infrastructure, business innovation, financing options, policy incentives and cultural mind-set. Readers should remember this when thinking about the new consumers of China, India and other emerging markets. This is also true for the aging and indebted societies of the developed world. The existing eco-system of each country exerts a big pull on future trajectories but, once an eco-system is broken, we can get a completely different consumption landscape. Readers will do well to remember the importance of the wider eco-system as we will return to it at the end of this report.

**Table 3: Consumption Baskets of Developed Countries**

| As % of total private consumption expenditure | US | UK | Japan | Germany |
|---|---|---|---|---|
| Food and beverages | 8% | 13% | 18% | 14% |
| Clothing and footwear | 3% | 6% | 3% | 5% |
| Housing & utilities | 22% | 23% | 25% | 24% |
| Furnishings and durable household equipment | 3% | 5% | 4% | 7% |
| Healthcare | 17% | 2% | 5% | 5% |
| Transportation and communications | 6% | 17% | 14% | 16% |
| Recreation, culture and education | 7% | 13% | 13% | 10% |
| Restaurants and hotels | 6% | 10% | 8% | 6% |
| Other goods and services | 27% | 12% | 11% | 12% |
| Private consumption expenditure as % of GDP | 71% | 63% | 59% | 55% |

*Source: Haver NOTE: Figures for US, UK and Germany are in 2010, and for Japan it is 2009*

## Of Aging and Household Balance-sheets

As pointed out in numerous scholarly articles and newspaper editorials, the US economy has come over time to rely increasingly on consumption to drive the economy. By the time the Great Recession of 2008 struck, private domestic consumption accounted for 71% of GDP. The share for Britain was somewhat lower at 63%. Contrast this with ratio in other developed economies: France 58%, Germany 55% and Japan 55%. What led to the very different trajectories experienced by these developed economies? A comparison of the American and British experience with the Japanese and German one is instructive.

In the five years leading up to the Great Recession, Japanese household increased consumption expenditure by a mere 5.5% in real terms while the Germans increased it by even more frugal 2.3%[3]. In contrast, the American and British households increased consumption by 12.4% and 10% respectively from what were arguably already elevated levels. As everyone knows, expansion in British and American consumption was driven by debt. Household debt in the US jumped from 110% of GDP in 2002 to 138% of disposable income while in the UK it jumped from 134% to 184%. Real estate mortgages played an important role in both cases. What was responsible for this?

The American willingness to run up debt is not a new thing but the result of a cultural and financial ecosystem that had evolved over several decades. Household debt rose from 62% of disposable income in 1975 to 75% in 1985 and further to 92% in 1995. Yet, in 2002, the average American household would not have looked especially profligate compared to other developed economies. Its liabilities would have amounted to 110% of disposable income compared to 134% in Japan and 112% in Germany. In order to understand the subsequent change, we need to consider what happened to household balance-sheets after 2002.

As shown in the tables below, the Net Wealth (i.e. assets minus liabilities) of US and UK household rose sharply. The Net Wealth of US households jumped from 514% of annual disposable income in 2002 to a peak of 646% in 2006 with bulk of the gain coming from asset price increases and only a small fraction from savings[4]. The ratio for the average British household jumped from 715% of disposable income to over 900% of disposable income in 2007. Simply put, they were feeling rich and "rationally" decided to consume some of their wealth. Indeed, the ratio of liabilities to net wealth had remained roughly constant at 21% throughout those five years preceding the Great Recession. From the individual's perspective, he or she was not being especially profligate. As we know in retrospect, the problem was that the asset prices were a bubble. We are not concerned here about whether or not policy-makers should have recognized the bubble and deflated it. The point being made is that the US already had the cultural and financial eco-system of debt and the period 2002-07 would not have looked like a break from the long-term trajectory from the perspective of the average American household.

[3] OECD National Accounts Statistics. Constant process and PPPs of 2000.

[4] "Will US consumer debt reduction cripple the economy?, McKinsey Global Institute, March 2009

**Table 4: Household Balance Sheets**

**All figures are per cent of nominal disposable income**

**Germany**

| | 2002 | 2007 | 2010e |
|---|---|---|---|
| Net wealth | 533.6 | 627.6 | 644.7 |
| Net financial wealth | 145.9 | 198.2 | 211.7 |
| Non-financial wealth | 387.8 | 429.4 | 433.0 |
| Financial assets | 257.9 | 299.9 | 310.3 |
| Of which: Equities | 57.4 | 72.7 | 67.1 |
| Liabilities | 112.1 | 101.7 | 98.3 |
| Of which: Mortgages | 72.3 | 68.9 | 66.9 |

**Japan**

| | 2002 | 2007 | 2010e |
|---|---|---|---|
| Net wealth | 719.4 | 735.3 | 711.8 |
| Net financial wealth | 340.7 | 386.3 | 374.8 |
| Non-financial wealth | 378.7 | 349.0 | 337.0 |
| Financial assets | 474.4 | 513.7 | 499.0 |
| Of which: Equities | 29.8 | 50.3 | 35.6 |
| Liabilities | 133.6 | 127.4 | 124.2 |
| Of which: Mortgages | 62.8 | 64.9 | 65.3 |

**United Kingdom**

| | 2002 | 2007 | 2010e |
|---|---|---|---|
| Net wealth | 715.6 | 900.8 | 798.8 |
| Net financial wealth | 260.8 | 307.6 | 291.5 |
| Non-financial wealth | 454.9 | 593.2 | 507.3 |
| Financial assets | 394.7 | 491.3 | 460.2 |
| Of which: Equities | 61.4 | 72.9 | 64.6 |
| Liabilities | 134.0 | 183.6 | 168.7 |
| Of which: Mortgages | 97.1 | 138.2 | 129.8 |

**United States**

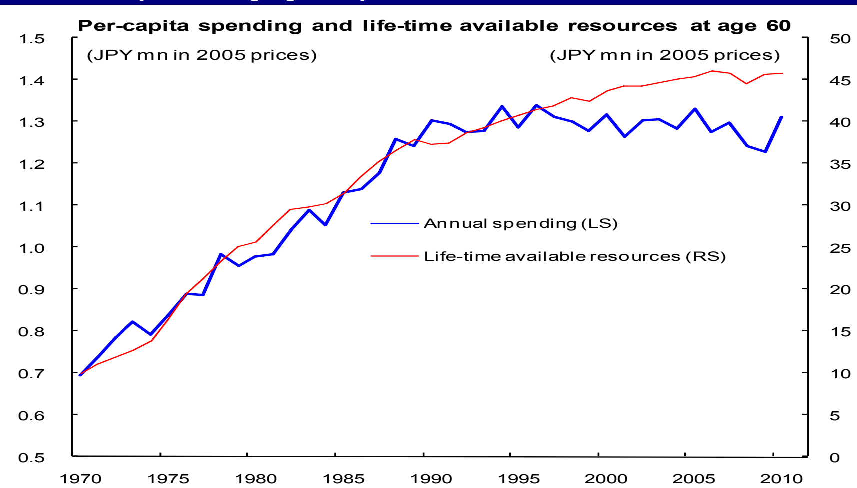
| | 2002 | 2007 | 2010e |
|---|---|---|---|
| Net wealth | 514.3 | 615.7 | 500.5 |
| Net financial wealth | 266.7 | 347.2 | 290.2 |
| Non-financial wealth | 247.6 | 268.5 | 210.3 |
| Financial assets | 376.6 | 485.1 | 410.9 |
| Of which: Equities | 92.2 | 136.5 | 114.4 |
| Liabilities | 109.9 | 137.8 | 120.7 |
| Of which: Mortgages | 77.2 | 103.4 | 91.5 |

*Source: OECD Economic Outlook & Deutsche Bank*
*NOTE: Net Wealth hit its peak in the US in 2006 at 645.9%*

Contrast this with what happened in Japan during the period. Net Wealth rose only marginally from 719% of disposable income in 2002 to 745% at the eve of the crisis. Given the overall stagnation in the economy and household balance-sheets that were not really improving, there was no consumption binge. In Germany, Net Wealth did rise between 2002 and 2007 from 534% to 628% but, in contrast to the Anglo-American experience, much of this gain was due to sustained saving rate of 10-11% of disposable income (compared to the US savings ratio of 2% during that period). Real estate prices in Germany remained subdued throughout the period and were not a source of wealth effect. Equity prices did rise but it remained relatively small in comparison to the overall balance-sheet. In any case, the memory of the dotcom crash of 2000-01 was probably still too fresh in the minds of investors to encourage spending[5]. In short, German households had built up their balance-sheets the hard way through savings and were loath to spend it.

There is yet another powerful long-term factor that may be affecting both German and Japanese households – aging. According to the UN Population Division estimates, the median age in Germany and Japan stand at 44.3 and 44.7 years respectively compared to 36.9 for the US and 39.8 for the UK. A study of Japanese households by Mikihiro Matsuaoka, Deutsche Bank's Chief Economist for Japan, found that consumers temper down their consumption trajectory after they pass the age of 60 years[6]. As illustrated in the chart below, annual per capita spending by those of retirement age has been flat for two decades in real terms! Moreover, as longevity has risen, the amount needed for retirement has grown. Today's average 60-year old will try to ensure that the stock of assets can sustain his/her lifestyle for 30-35 years. This is 8-10 years more than the expected life expectancy at sixty, but is "rational" from the perspective of the individual given uncertainty around the time of death. An equivalent study of German households is not available but it is reasonable to expect that an aging society will be cautious about consuming the stock of wealth as the age-bulge nears retirement.

**Figure 2: Consumption & Aging in Japan**




Source: MIC, DB Global Markets Research (Japan Economics Weekly, 4th March 2011).

Aging is not an immediate concern in the US and the UK but these countries too are growing old. One of the important factors that have kept these countries relatively young is immigration but this may not be reliable factor in future. As we have argued in a previous report in the Wide Angle series, the source countries are themselves becoming older and richer (see "The End of Population Growth", 13th May 2011). Moreover, the flow of pensions is uncertain in many cases. For instance, Robert Novy-Marx and Joshua Ruah have pointed

[5] "German Households: Strong Savers but Weak Investors", Bernhard Graf & Stephan Schneider, Deutsche Bank Research, June 2011.

[6] "Population Aging & the Household Savings Rate", Mikihiro Matsuoka and Seiji Adachi, Japan Economics Weekly, Deutsche Bank, March 2011

out that even assuming an 8% rate of return, local government pension funds in major US cities such as Chicago, Boston and Philadelphia could run out by the end of this decade or early in the next![7] Even if this problem is eventually sorted out, older consumers are likely to remain anxious for an extended period of time. Consumers, both young and old, will also be concerned about what public indebtedness implies for future taxes (this is a large topic in its own right, so we have not elaborated on it here).

What can we say about future consumption demand in developed countries given the above discussion? The most obvious conclusion is that US and UK consumers will first try to repair their balance-sheets before they revert to their pre-crisis enthusiasm for consumption. This is already under way as household liabilities in the US have declined from a peak of 138% of disposable income to 121% in early 2011. It may seem a short way from the pre-boom level of 110% but declines in asset values have severely depleted Net Wealth. We estimate that the Net Wealth of American households is currently at around 500% of disposable income, down from a peak of 646% in 2006 and significantly lower than that of other developed countries. The OECD estimates that the household savings rate in the US has drifted up to 5-6% of income but it will be many years before the damage to balance-sheet is repaired through savings unless asset prices, especially real estate, begin to inflate gain. In the absence of sustained reflation of asset prices, it could take a very long time before the American households recover their pre-Crisis enthusiasm for consumption.

A similar argument can be made for British households although, interestingly, the Net Wealth-to-income ratio is still significantly better than the 2002 level. The British have higher amounts of debt but they also own large stocks of financial and non-financial assets. At almost 800%, the UK ratio for Net Wealth relative to disposable income is the highest of major developed economies (of course, this may change if real estate prices resumed their decline). Meanwhile, the Germans and the Japanese are not likely to step in to replace this lost source demand given their own concerns with aging. Indeed, before the end of this decade, even the US and the UK may also begin to worry about sustaining their lifestyles into old age.

## Will Emerging Market Consumers Step in?

*"As this prudent economy, which people call Saving, is in private families the most certain method to increase an estate, so some imagine that, whether a country be barren or fruitful, the same method if generally pursued will have the same effect upon a whole nation…… This, I think, is an error".*

- From " The Fable of Bees: or Private Vices, Publick Benefits", Bernard Mandeville, philosopher & satirist, 1714

Two centuries after Mandeville wrote the above lines, John Maynard Keynes famously echoed the same thought when he wrote: "Every such attempt to save money by reducing consumption will so affect incomes that the attempt necessarily defeats itself"[8]. As one can see, demand-side economists have long warned against the dangers of excessive savings. One wonders what they would have thought of the save-invest-export strategies used by most Asian countries to grow rapidly. They would probably have viewed China's private consumption rate of 33% of GDP as a scandal. Still, both Mandeville and Keynes have a point. The world as a whole is a closed economy with no recourse to external demand. Burdened with public and private debts as well as facing the prospect of rapid aging, developed country economies are unlikely to be enthusiastic consumers in the near future

[7] "The Crisis in Local Government Pensions", Robert Novy-Marx & Joshua Ruah, in "Growing Old" edited by R. Litan & R. Herring, Brookings, 2011

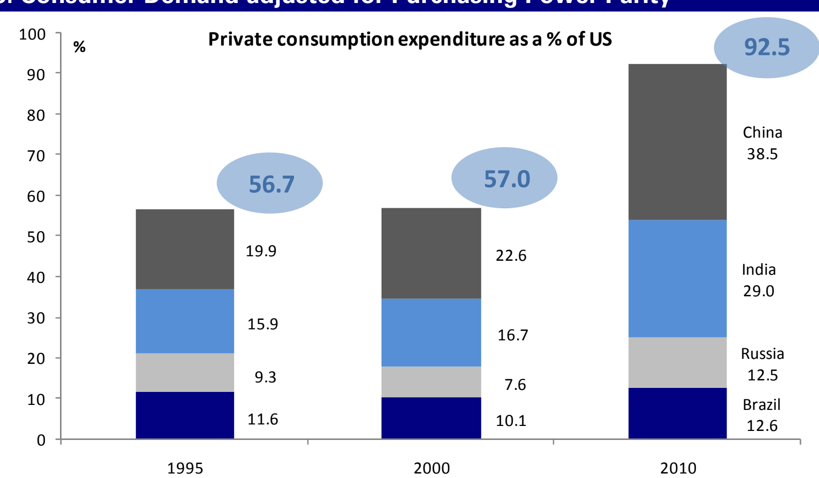
[8] "The General Theory of Employment, Interest and Money", John Maynard Keynes, Palgrave Macmillan, 1936

(unless, of course, we have yet another sharp and sustained increase in asset prices). So, can emerging markets replace the lost the consumer demand?

The conventional wisdom is that consumption in emerging economies is still too small to compensate for a slowdown in consumer demand in advanced countries. As illustrated in Figure 1 at the very beginning of this report, the US is an order of magnitude larger than any other consumer market. Measured in nominal USD terms, private consumption demand in the US in 2010 was five times that in China and double that of Brazil, India, Russia and China combined. Thus, it is argued that when the US consumer sneezes, all emerging markets catch a cold. However, there are reasons to believe that the power-balance may no longer be as one-sided as is widely believed.

First, the measurement of consumer demand in nominal US dollars understates consumption demand in emerging markets since prices tend to be significantly lower in these countries. When adjusted for Purchasing Power Parity (PPP)[9], private consumption demand in China alone amounts to 38.5% of the US. The ratio for India is 29% and that for Brazil and Russia are around 13% each. In other words, the combined consumer demand of China, India, Russia and Brazil is 92.5% of the US and the ratio is rising quickly. As shown in the chart below, China and India have come a long way since the mid-1990s. Looking ahead, both countries are likely to generate high GDP growth rates in the foreseeable future but, at least in China's case, private consumption is likely to grow even faster. As discussed in our previous Wide Angle report, wages are now rising at 15-17% in nominal terms (see "Is Outsourcing History?", 20th June 2011). This is likely to decompress the share of private consumption expenditure to a level much higher than the current 33% of GDP. Indeed, this is a part of official policy objectives.

**Figure 3: Consumer Demand adjusted for Purchasing Power Parity**




*Source: Haver, Penn world tables*
*NOTE: PPP conversion rates have been sourced from Penn World Tables. Such rates were available till 2009. 2010 rates have been assumed to be the same as 2009.*

Second, most commentators tend to underestimate the power of compounding that is implicit in high growth rates sustained over time. Consumer demand in China and India is growing at an order of magnitude faster than anything that Americans generate even during boom years. To put it in perspective, China's private consumption demand rose at 9% in real terms in 2010. This is the PPP equivalent to real consumption demand growing by 3.6% in the US - a rate that would usually draw a great deal of applause. Meanwhile, private consumption grew by 8.4% in real terms in India, 7% in Brazil and 2.7% in Russia during that

[9] We have used PPP conversion factors from the Penn World Tables.

year[10]. Readers who remain suspicious of PPP conversions and real growth rates should note that retail sales in China grew by 18% in nominal CNY terms and almost 15% in nominal USD terms. Thus, even as American demand has stagnated, China has gone from having an automobile market that was significantly smaller than the US in 2008 to one that is significantly larger in 2010 (see table below). In fact, 2010 was the best year ever for global automobile sales despite the fact that US sales remained 30% below peak levels.

**Table 5: Automobile sales in major markets**

| units '000 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| United States | 16,954 | 16,519 | 16,089 | 13,503 | 10,607 | 11,778 |
| Japan | 5,851 | 5,739 | 5,353 | 5,082 | 4,609 | 4,992 |
| Brazil | 1,623 | 1,844 | 2,380 | 2,820 | 3,141 | 3,515 |
| India | 1,205 | 1,455 | 1,710 | 1,971 | 2,257 | 3,016 |
| China | 5,718 | 7,280 | 8,882 | 9,074 | 13,745 | 18,354 |
| **Global** | **64,060** | **66,735** | **70,358** | **67,870** | **64,559** | **73,628** |

*Source: General Motors Corporation annual reports and DB estimates*

Third, consumer demand will also be affected by changing consumer baskets in China and India that, in turn, imply that certain goods and services may see disproportionately high growth rates. For instance, the share of food in the consumption almost always declines as a country becomes wealthier. Food still accounts for 30% of total consumer expenditure in India but the share is likely to decline over time despite persistent food price inflation. In turn, this will free up money for spending on other things. While one needs to be careful when extrapolating international consumption trends onto China and India, the evolution of Korea's consumption basket may provide some indication of how things may evolve (see table below). Notice how Indians already spend a disproportionately large share on transport and communications.

**Table 6: India and the Evolution of Korea's Consumption Basket**

| As % of total private consumption expenditure | Korea | | | India |
|---|---|---|---|---|
| | 1970 | 1990 | 2010 | 2009 |
| Food and beverages | 39% | 28% | 15% | 30% |
| Clothing and footwear | 6% | 5% | 5% | 8% |
| Housing and utilities | 21% | 15% | 17% | 12% |
| Furnishings and durable household equipment | 2% | 4% | 3% | 5% |
| Healthcare | 2% | 4% | 7% | 5% |
| Transportation and communications | 6% | 13% | 17% | 20% |
| Recreation, culture and education | 2% | 5% | 9% | 3% |
| Restaurants and hotels | 12% | 9% | 8% | 2% |
| Other goods and services | 11% | 17% | 20% | 16% |

*Source: CEIC*

An interesting observation made by Jun Ma, Deutsche Bank's Chief Economist for China, is that China's consumption is skewed towards goods. The penetration of most goods now stands above the global average while that of services is sharply lower. In his view, therefore, Chinese consumers will now rebalance their expenditure basket. He points out that when Japan and Korea reached China's current level of per capita income, they experienced a decade where consumption of services systematically exceeded that of goods. In Japan, demand for services grew 14% per annum versus 10% for goods while South Korea's

[10] "Emerging Markets Monthly", Deutsche Bank, June 2011.

consumption of services grew 15.3% per annum compared to 8.7% for goods.[11] Note that from an internal rebalancing perspective, this is a shift from tradables to non-tradables. There are signs that the services boom has already begun. In 2010, box-office revenues jumped 64% in 2010 to over CNY10bn. China produced 540 films during the year, rivaling America[12]. The only country that produces more movies is India, the other Asian giant.

## Implications for Global Consumer Demand

Our analysis of aging and household balance-sheets suggests that it is unlikely that advanced countries will strongly expand consumption in the foreseeable future (except perhaps in the event of a sustained reflation of asset prices). The Net Wealth position of American households is especially weak. The Japanese and Germans have better balance-sheets but are now aging rapidly and consequently will be concerned about creating a buffer for retirement.

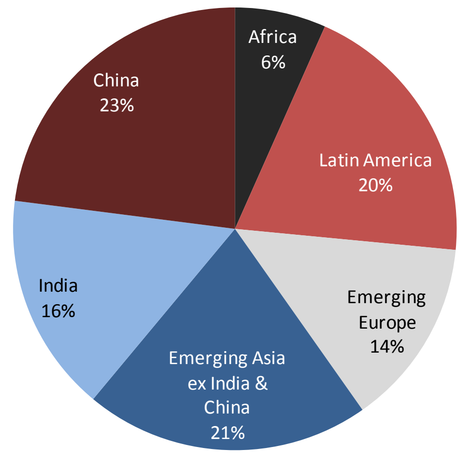
The good news is that the consumer markets of the developing world are no longer insignificant after years of rapid growth. This is especially apparent if one adjusts for Purchasing Power Parity. Furthermore, this demand is growing rapidly. When one looks at the geographical spread of this demand, however, one more factor becomes apparent. It is Asia that dominates the emerging world. As we have seen, consumption demand in China and India is much larger than in Brazil and Russia, but the collective demand from other Asian emerging is also significant. As shown in the charts below, the share of Asia is 60% of emerging market consumer demand compared to 20% for Latin America, 14% for Eastern Europe and 6% for Africa[13]. This should not be surprising because, even excluding the two giants, Asia includes populous countries like Indonesia (population 245mn) as well as rich ones like Singapore and South Korea. Indeed, we estimate the nominal GDP of the four "Newly Industrialized Countries" (i.e. Singapore, South Korea, Hong Kong and Taiwan) will amount to USD 2.2 trillion for 2011. This is as almost as large as the United Kingdom. Their combined consumer market may be still smaller than the British market due to their high savings rates, but we are now dealing with scales that are comparable with major western economies. In short, the global rebalancing of consumption towards emerging markets is disproportionately about Asia. Other regions are not just smaller but are growing more slowly and already have a high propensity to consume. In Mexico, for instance, private consumption already accounts for 65% of GDP and there is little scope for demand decompression.

[11] "From Goods to Services", Jun Ma & Wenjei Lu, China Macro Strategy, Deutsche Bank, December 2010

[12] "Kung Fu Propaganda", The Economist, 16th July 2010

[13] We have obviously not included Japan in emerging Asia but the NICs have been included.

**Figure 4: Shares of Major Emerging Regions in Private Consumption Demand**




*Source: Haver, Penn world tables, Deutsche Bank estimates*
*NOTE: PPP conversion rates have been sourced from Penn World Tables. Such rates were available till 2009. 2010 rates have been assumed to be the same as 2009.*

Of course, non-Asian emerging markets are making their purchasing power felt in specific segments. For instance, Brazil is witnessing a return of many of its soccer stars from Europe as pay has jumped and the exchange rate has appreciated. Spending on new players in Brazil rose 63% in 2010 compared to a 39% drop in Europe[14]. Many talented young players are opting to stay home. Nonetheless, this pales in comparison to what is being experienced by Asian sports. China is well known for its prowess in Olympic sports but it is India that has been home to a sports entertainment revolution. The Indian Premier League is now the second highest paying sports league in the world (second only to the NBA) according to the Global Sports Salaries Survey 2011[15]. What makes this even more remarkable is that the cricket tournament stared as recently as April 2008.

It should be clear from the above discussion, that emerging markets as a whole and Asia in particular have the economic strength to generate consumer demand on a scale that can compensate for stagnation in advanced countries (provided that the developed countries do not collapse). So what are the risks to this prognosis? The most immediate one is that the dynamism of Asia trips on some economic/financial shock. The most obvious potential source of such a shock could be the bursting of a real estate bubble. As most readers will agree, this is notoriously difficult to predict but a survey by *The Economist* magazine suggested that Hong Kong real estate was 63.7% overvalued while Singapore was 17.3% overvalued[16]. Chinese real estate prices were found to be 13.9% above fair value. India was not included in the study but may well have shown similar results. (Note that Britain was found to be 27.8% overvalued despite the declines and the US was reported as 0.5% undervalued). While we do not place great emphasis on the exact numbers generated by the study, they do highlight the risk that Asia may someday suffer its own asset deflation problem.

There is, however, a less appreciated but longer-term problem that will accompany the shift of consumption from the West to Asia. In theory, the shift could be expected to remedy the global imbalance problem as America re-orients its economy from non-tradables to tradables while China does the opposite. In turn, this would cause the CNY to appreciate in real terms

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[14] "Strong Real lures Brazil soccer stars home", Financial Times, 17th July 2011

[15] http://www.sportingintelligence.com/finance-biz/salaries-report/

[16] "Rooms with a view", The Economist, 9th July 2011

even without requiring the nominal exchange rate to rise significantly. Unfortunately, the transition is unlikely to be quite as frictionless.

As highlighted at the beginning of this report, consumption (and production) requires an eco-system of human capital, physical infrastructure, financing, social preferences and government policy. The transition from one ecosystem to another can often be painful to both people and to places. The debris of past transitions is strewn across northern England, America’s Rust Belt and former East Germany. Thus, the shift to the new order can be expected to have a major impact on the human and physical landscape of China, the United States and other countries. In the US, for instance, we could well see a period where skill shortages co-exist with persistent unemployment. Similarly, Chinese cities that witness the construction of new shopping malls and cinemas may not be the same ones experiencing the closure of old smoke-stack factories. All this churn will make investing very difficult for financial investors because the sources of future growth in a particular economy may not yet be publicly listed whereas the listed companies may represent the old economic order. Furthermore, note that this transition will take place in the overall context of aging across the world. China itself will have to deal with the problem of rapid aging and this may entail yet another re-ordering of global consumption in barely a decade’s time. We will return to different aspects of this broad theme in future reports in “The Wide Angle” series as well as in a new companion series that will be launched next month.

# Appendix 1

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