

Growing Beyond

Rapid-growthmarkets

Ernst & Young Rapid-Growth Markets Forecast

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Welcome

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For those of us who may have grown weary of economic gloom, this fourth edition of the *Ernst & Young Rapid-Growth Markets Forecast* serves notice of better times ahead. Although recession, stalling growth and high unemployment continue to impact many markets, the data and insights in this quarter's forecast tell us that

the overall prospects for Rapid-Growth Markets (RGMs) remain strong.

Our analysis suggests that RGMs are likely to weather the ongoing Eurozone crisis and remain engines of global growth, though many will see expansion slow this year. Their expansion is expected to accelerate once more in 2013, helping stimulate a wider pick-up. And as uncertainty surrounding the single currency diminishes – for we still believe a Eurozone break-up is unlikely – we expect growth to move forward from 4.9% in 2012 to 5.9% in 2013 and 6.5% in 2014.

What lies behind such positive projections?

First the rapidly growing Asian countries are playing an increasingly powerful role on the global scene. By adjusting their growth patterns toward more reliance, the major Emerging Asian economies would allow greater exchange rate flexibility. Meanwhile, the US and other advanced economies should reduce internal demand relative to overall growth. This shift in relative demand and

prices between surplus and deficit countries will help stabilizing financial markets and economic systems across the world.

Secondly, we believe that soaring domestic demand in the RGMs is poised to change the rules of the world economy. By 2020, the number of middle-class households in emerging countries will more than double, overtaking the US and Eurozone with nearly 150m new consumers.

The speed and scale of the transition is astonishing. For example, in 2011 Emerging Asia accounted for just 14% of global consumer spending in US dollars. By 2020, its share will be 25% and by 2030 that share will be 40% - a near threefold rise in just 20 years. In India, meanwhile, 47% of households had income exceeding US\$5,000 in 2010; by 2020, 80% will.

Emerging market consumers are also on average significantly younger than their rich-world counterparts, and are increasingly concentrated in cities, making them readily accessible. As they become richer they want new homes equipped with modern amenities and filled with consumer durables. Sales in western markets hinge upon replacement cycles and the pace of new household formation; in emerging markets, demand growth is much faster because many households are first-time buyers: that explains why refrigerator sales in China rose by 25% a year from 2005-09.

Businesses need to urgently adapt their strategies to take advantages of these new challenges and opportunities. How should they do so? By optimizing their customer reach firstly, it is vital that businesses decide where to focus their investment. They should expect volatility – and not to lead the market. And in addition, the sheer scale of the opportunities for consumer products companies means it is impossible to tackle them all at once. Instead,

they should choose the most promising group of consumers and focus on how to best target them.

This means that they need to select which products have the most potential for which markets, a decision which depends on them understanding the consumer. To gain an understanding they need to look at their needs and preferences and not just rely on economic data. Within different countries, different groups have different needs and consumer products companies must appreciate how they are evolving as incomes rise.

To this end, price points matter – business needs to offer the right product at the right price for groups of consumers who have different levels of income. To ensure this happens, consumer companies need to work backward from the price point to perfect their products. This means they need to develop a creative supply chain with adequate rewards for vendors, and pay close attention to tax rules to ensure tax- and cost-effective supply.

I hope you find the information and insights in this report useful. Ours remains a global economy that is fraught with uncertainty. By offering timely analyzes of fast-growing markets around the globe, and providing our view on how their development affects business, we aim to contribute to business planning in this rapidly changing business environment.

For more information on rapid-growth markets, the business environment and local contacts, please visit www.ey.com/rapidgrowth

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Highlights

RGMs are likely to take further action to protect themselves against fallout from the Eurozone crisis.

- ▶ Rapid-growth markets (RGMs) are well placed to weather the major risks facing the global economy at the present time given that they have space to ease both fiscal and monetary policy. Indeed, cooling inflation has already allowed short-term interest rates to start to come down in around **a third of the 25 RGMs**, including each of the BRICs.
- ▶ Our central scenario for the RGMs is that growth accelerates in the second half of the year and into 2013 as uncertainty surrounding the Eurozone diminishes. Consequently, we expect growth to pick up from **4.9% in 2012 to 5.9% in 2013 and 6.5% in 2014**.
- ▶ If the Eurozone were to break up, our analysis shows that the Czech Republic and Poland would be pushed into recession, with Hong Kong and Malaysia also hit hard due to their dependence on global trade.
- ▶ Under our central scenario, we expect growth in 2012 to slow by less in the Asian RGMs than it does in either the Latin American or EMEIA RGMs, as falling inflation allows the Asian RGMs to be more aggressive in using monetary policy to support growth.
- ▶ While the slowdown in trade for many RGMs is being cushioned by heavy exposure to other emergers and the US, most countries in Central and Eastern Europe rely overwhelmingly on demand from the Eurozone. Poland, Romania, Hungary and the Czech Republic all recorded falls in industrial output in Q1. In the Czech Republic, this produced a sharp decline in GDP given the weakness of domestic demand, which is under pressure from fiscal austerity.

Growing middle classes make RGMs more resilient to shocks than in the past.

- ▶ Our forecasts for household incomes show that the number of households in emerging markets enjoying higher incomes will grow sharply **over the next ten years**. The number of emerging markets households enjoying an income of over **US\$30,000** will more than double to **149m** by 2020, overtaking the US (120m) and the Eurozone (116m). These households will have discretionary income to spend on leisure pursuits, consumer goods and holidays.

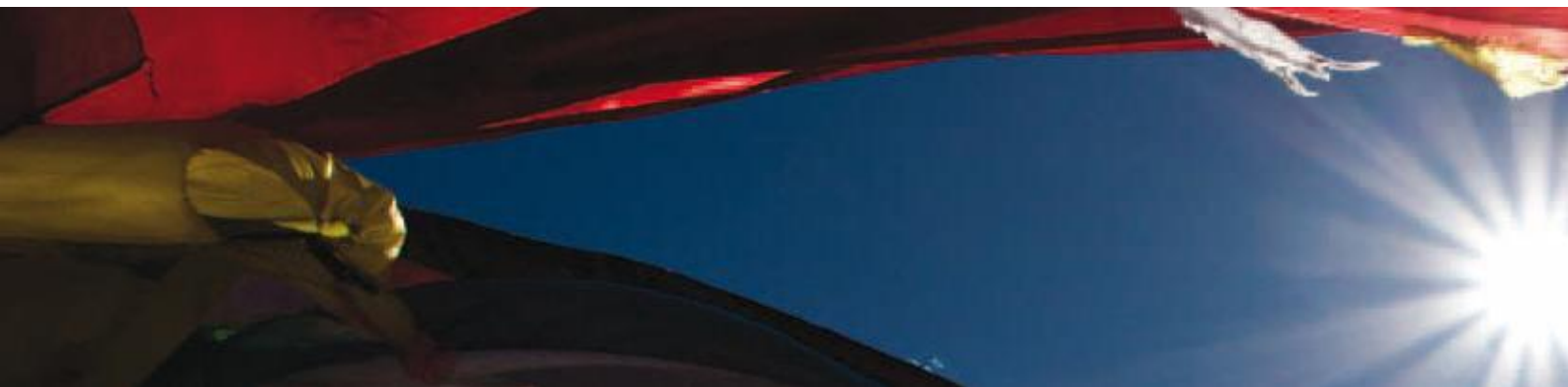
Rebalancing toward services and domestic demand will make high growth more durable

- ▶ The major Emerging Asian countries that have run surpluses in recent years must adjust their growth patterns toward more reliance on domestic demand and should allow greater exchange rate flexibility. Rebalancing Asian RGMs will not only make the world economy more stable but will also help the Asian countries themselves, making high growth rates more durable. By increasing private consumption, investment and infrastructure spending, and realigning price dynamics, large welfare gains can be made across Asia. The services sector will grow strongly in coming years across the RGMs.

Strong rise in FDI flows to emergers in 2011 reflects the long-term attraction of RGMs.

- ▶ The current bout of the Eurozone crisis will have a negative impact on FDI into RGMs during 2012, but longer-term FDI will continue to grow as multinational companies are drawn to the high growth rates of the RGMs at a time when growth is stagnant elsewhere in the world. As the RGM middle-class grows, the focus of the FDI is likely to shift increasingly from building plants for the production of goods to export back to the developed economies, to serving domestic markets. As the growing RGM middle-class starts to consume more services, the focus will also shift increasingly from the manufacturing sector toward the service sector.

The future of growth in the new consumer markets



Business can take heart. Rapid-growth markets (RGMs) are likely to weather the Eurozone crisis and remain engines of global growth, though many will see expansion slow this year. Their growth is expected to accelerate once more in 2013, helping a wider pickup. And soaring domestic demand in economies starved, for some time, of investment and consumption will offer business exciting new markets for goods and services in the years ahead.

Despite signs of quite sharp slowing in leading RGMs during the first half of the year, including heavyweights Brazil, India and China, our central scenario for RGMs is that growth accelerates in the second half. As uncertainty surrounding the Eurozone diminishes – for we still think a Eurozone breakup unlikely – we expect growth to pick up from 4.9% in 2012 to 5.9% in 2013 and 6.5% in 2014.

In Asia, our central forecast predicts 7.3% growth this year for Mainland China and Hong Kong, as policies to bolster growth, including lower interest rates and stimulus measures, kick in. Indonesia too remains resilient, with 238m consumers and an economy keen for foreign investment, sustaining 6.2% growth.

India stumbles, with growth slowing to 5.7% this year before recovering to 7.5% next. A sliding rupee reflects investor concerns about bumpy politics and hesitant reform, though the Reserve Bank of India has cut interest rates.

Big exporters, including China, Korea, Malaysia and Thailand, are inevitably bruised by the Eurozone sovereign debt crisis. But it is high-flying economies in Central and Eastern Europe, which previously prospered as low-cost platforms to supply Western Europe, that feel the effects most. Though cushioned by domestic demand, growth in Poland is expected to moderate to 2.7%, from 4.3% in 2011, while Czech GDP is likely to contract 1.4% in 2012 before growing 1.2% in 2013.

Africa's leaders remain on course though – Ghana tops our league table with forecast growth of 8.5% in 2012. Africa's growth seems relatively immune to the difficulties elsewhere: its 54 countries account for 3% of global GDP, on a par with the contribution of Brazil or Russia.

However, Latin America is less spritely, hobbled by slower growth in Brazil and a less dynamic recovery than might be wished in the US, an important export market.

One striking lesson for companies and firms in such a mixed picture is the extent to which growth is becoming less uniform and more subject to country characteristics. Whether it be inflation in India or a commitment to openness in Mexico executives increasingly need to tune in to the national mood music wherever they are doing business to avoid surprises.

The upsides of a slowdown

As global growth slows, inflationary pressures that had built up in some RGMs, notably China, India and Brazil, are easing. Central banks in these major growth markets acted effectively to contain price inflation and have been aided by softening commodity prices. They have scope to relax policy to boost growth if needed. Yet, in the short term, cooling can benefit business. A slower pace of growth makes it easier for suppliers to expand output in line with rising demand. It also gives infrastructure spending a chance to catch up – a possible boon in countries such as India, where power outages are commonplace.

Slower growth in RGMs can create a positive feedback: a temporary cooling in China helps ease upward pressure on prices of many commodities, especially oil. Cheaper energy reduces production costs across the RGMs, in which it may account for a greater proportion of costs than in developed markets. It also reduces the cost of transport, both within emerging economies and for those shipping products to Europe or North America.

But falling energy prices are less good news for producers, such as Saudi Arabia, other Gulf states, Nigeria and Kazakhstan. And falling Chinese demand for copper led prices to six-month lows in early June – bad news for Chile's big mines.



But the slowdown is likely to prove temporary. The price of oil averaged US\$57 per barrel for 2000-11. In early June this year, Brent was trading at around US\$100 per barrel and prices are expected to average more than US\$120 over the coming decade.

Avoiding a Greek tragedy

Greece is expected to seek some easing of austerity measures required under the €174b fund agreed in March with the troika (International Monetary Fund, European Union and European Central Bank). But New Democracy, the center-right grouping that emerged as the largest party in the Greek Parliament after elections on 17 June, insists on its commitment to doing everything possible to keep Greece within the euro.

If the Eurozone were to break up, the shockwaves would ripple around the world. Our analysis shows that RGMs that border the Eurozone would suffer most, especially the Czech Republic, and Poland. But few would escape the series of aftershocks. One consequence would almost certainly be a liquidity crisis. Supply chains for manufacturers might also suffer disruption triggered by payment delays and unstable currency values. Uncertainty about demand would have a knock-on effect upon RGM exports, not just to European markets but also within regional supply chains involved in producing goods sold to European end users, such as electronics. We believe Hong Kong and Malaysia, which rely heavily upon trade with Europe, would also see growth slow.

A Chinese puzzle

Having contained inflation, in early June, China cut interest rates for the first time since 2008, lowering benchmark lending rates by 25 basis points to 6.31%. After earlier worrying about overheating in the real estate market, it seems the ruling Communist party is now preoccupied with ensuring the pace of growth recovers in a year when power will be transferred to a new generation of leaders. Reports from China say the Government has begun to speed up approval of infrastructure projects, and is increasing investment in public housing.¹ Beijing has said it wants to direct new infrastructure spending into solving bottlenecks and inefficiencies and that priority will go to water and sewage systems, electrical grids, waste management and an environmental cleanup.² The scale of this low-key stimulus effort has not been detailed, but many believe it could be substantial. Policy changes are exceptionally

quick to take effect in China. That is why we expect growth in China to recover to 8.4% in 2013, after dipping to 7.5% this year from 9.2% in 2011.

Foreign investors get into the swing

Foreign direct investment (FDI) in emerging economies accelerated 20.8% to US\$459b in 2011. Global multinationals were drawn by prospects of rapid growth of domestic markets in these countries and opportunities to extract natural resources. Rising inflows benefited Turkey, Columbia and Indonesia as well as the BRIC countries.

We believe that prospects for RGMs overall remain strong, and that multinational corporations should continue investing substantially in emerging economies.

Going forward, investment in mining and oil and gas production is likely to stay high, driven by commodity prices. But three other factors matter: infrastructure imperatives, rising domestic consumption and sector specialization.

In infrastructure, though construction is typically done by domestic companies, foreign direct investors can compete effectively in specialist high-value products and services. These might include the in-country manufacture of railway signaling, traffic management and control systems, or specialist consulting services around sophisticated building systems.

Secondly, RGMs will continue to attract FDI into sectors where they have achieved critical mass and regional or global competitive advantage. Thanks to open trade policies, Mexico, for example, is emerging as a car assembly platform for the Americas. Four carmakers are building new plants there, and component suppliers are joining them. Meanwhile, the world's electronics manufacturing industry is now largely located in East Asia and China, not only because of low costs, but because that is where the global supplier ecosystem and production expertise are now concentrated. Clustering has created a world-class manufacturing industry in Asia.

The third focus will be on identifying the sectors that will benefit from the rise of consumers in RGMs.

1 "Stimulus or not?" *The Economist*, 2 June 2012.

2 "China faces stimulus dilemma," *Financial Times*, 7 June 2012.



Home to the new consumers

An emerging middle class in RGMs is poised to take over as the engine of global demand. We predict that, within 25 years, almost two-thirds of global consumer spending will be in RGMs, from one-third today. The speed and scale of the transition are astonishing, and multinational companies must ensure they ride the trend.

According to our forecasts, within just eight years, by 2020, the number of households in emerging markets with annual incomes exceeding US\$30,000 will more than double to 149m, overtaking the 120m in the US and 116m in the Eurozone.

In 2011, Emerging Asia accounted for just 14% of global consumer spending in US dollars. By 2020, its share will be 25% and by 2030 that share will be 40% – a near threefold rise in just 20 years. In India, meanwhile, 47% of households had income exceeding US\$5,000 in 2010: by 2020, 80% will. In Latin America, income per head last year averaged US\$10,519, with 21% of Brazilian households having income over US\$30,000.

Emerging market consumers are on average markedly younger than their rich-world counterparts, and are increasingly concentrated in cities, making them readily accessible. As they become richer, they want new homes equipped with modern amenities and filled with consumer durables. Sales in Western markets hinge upon replacement cycles and the pace of new household formation: in emerging markets, demand growth is much faster because many households are first-time buyers: that explains why refrigerator sales in China rose by 25% a year between 2005 and 2009.

As income increases, emerging market consumers also eat more prepared food and spend more on personal care, transport, entertainment and services. China has already supplanted the US as the world's largest automotive market: in 2009 vehicle sales there topped 13.6m.

Same needs, different tastes

In the past, multinationals have often prospered in emerging markets by selling goods designed for Western consumers. Today, emulation still appeals: European luxury products remain sought-after by emerging market consumers. Yet as emerging market demand becomes a larger part of the mix, the most successful companies will be those that offer the products or services that are best tailored to the needs of consumers in each national or regional market, whether it be in an emerging or developed economy.

Research and development (R&D) and innovation are becoming more important. International consumer products companies are setting up consumer insight centers and R&D centers in emerging markets where future growth will be fastest. Ethnic diversity has helped make Brazil a global hub for development of hair care products.

Emerging markets have already begun to generate frugal innovation, delivering products or business models that offer goods or services at a lower price – which may appeal to developed market consumers too. And they can nurture new products.

Developing appropriate business models and marketing strategies may make the difference between success and failure in a particular market.

Companies may need to adapt to cultural differences and infrastructure constraints – or opportunities. Some RGMs offer scope for high-tech innovation. In Korea, a popular smartphone app enables consumers to order products from a virtual supermarket projected onto the wall of a subway station, and have them delivered at home.

To keep pace with fast-changing RGM opportunities, companies may need to give additional autonomy to executives in RGMs.

In the coming battle for consumers' cash, multinationals from emerging markets may be best placed to understand what new customers want. As global competition intensifies, companies will need to combine expertise in products and markets to thrive.



The future of growth in the new consumer markets

Recommendations: pleasing consumers in RGMs

- ▶ **Decide** where to focus your investment. RGM opportunities are too numerous for consumer products companies to tackle all at once. Choose the most promising group of consumers and decide how best to please them.
- ▶ **Select** which products have the best chance in which markets.
- ▶ **Understand** the consumer or shopper, looking at their needs, preferences and rituals. Do not rely on RGM data: within countries, different groups have different needs and consumer products companies must understand how they are evolving as incomes rise.
- ▶ **Price points** matter. Ensure you offer the right product at the right price for groups of consumers at different points on the income pyramid.
- ▶ **Work backward** from the price point to perfect the product, develop a creative supply chain with adequate rewards for vendors, and choose the place and methods of manufacture. In-country R&D and manufacturing will flow from this strategy.
- ▶ **Taxation** varies. Pay close attention to tax rules to ensure tax- and cost-effective supply.
- ▶ **Expect volatility**: don't lead the market.

See also: *Disrupt or be disrupted – Creating value in the consumer products brand new order*, Ernst & Young, June 2012

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Emerging Asia leads global rebalancing

The Asian crisis of the late 1990s left Asian countries, companies and consumers cautious. In the wake of financial upheaval, households saved aggressively, companies became wary of re-investing profits and rapidly growing Asian countries built up trade surpluses, providing Western borrowers with cheap money that contributed to the current financial crisis.

In China, consumption as a percentage of GDP fell from 47% to 33% during 2000-11, even as it rose from 69% to 71% in the US.¹

Now rebalancing is under way. Our study shows Asian surpluses are falling fast. RGMs, such as China, Malaysia and Thailand, founded upon export of manufactures, are turning to domestic demand to substitute for slack demand in developed markets.

Domestic consumers want different kinds of goods and services to those that RGMs have specialized in supplying to foreign buyers, though. And, to become true consumers, they must be persuaded to save less and spend more.

That is a challenge, because emerging market consumers continue to save rigorously against old age and misfortune. Provision of health care and pension systems has trailed rising prosperity. Chinese employers used to provide cradle-to-grave care for employees. But this is changing and consumers remain somewhat apprehensive that welfare needs may not be adequately met.

To reduce precautionary saving among households, authorities in Asia need to:

- ▶ Make it easier for individuals to insure against risk through financial liberalization that increases the range of savings instruments
- ▶ Increase government spending on public services, especially in rural areas
- ▶ Increase public provision of pensions, health care and education
- ▶ Improve protection of property rights so that households can use housing and land as collateral
- ▶ Design public spending to support, not crowd out, private spending

Such measures would create opportunities for business. In liberalized financial markets, retail banks and insurers could grow through offering a more diverse range of investments and insurance products. Though banks and financial companies in the US and Europe are preoccupied

* Oxford Economics; the National Bureau of Statistics in China.



with strengthening balance sheets and meeting increased regulatory demands, some multinationals could provide niche expertise and services, perhaps in partnership with local institutions. And strong banks from emerging markets might well use such opportunities to develop a more global footprint.

Increasing public provision of health care and education would improve access, thereby increasing demand for pharmaceuticals, medical and educational equipment and supplies. But it could also spur innovation in the way both health care and education are provided.

Cheaper, better treatments?

Some private hospital groups in India are already innovators in lowering treatment costs through techniques such as remote diagnosis and surgical specialization. In RGMs, authorities can experiment with new economic models of provision, and take advantage of new technologies to develop telemedicine and e-Health systems. They have the potential to leapfrog some elements of high-cost Western health care systems and achieve better outcomes at lower cost. Awareness of this potential is spreading fast. In April this year, the African Development Bank launched an e-Health Award for novel African health care initiatives using information and communication technologies.

Learning more, for less

In education, meanwhile, authorities in RGMs that are expanding or improving underdeveloped education systems can experiment with online learning, electronic textbooks and other non-conventional learning techniques that may not only lower cost, but also improve learning outcomes. Some RGMs are leaders, not laggards. In June 2011, Korea topped a survey by the Organization for Economic Cooperation and Development (OECD) on the way 15-year-olds use computers and the internet to learn.

To stay in the vanguard of medical and educational technology, therefore, multinationals may need to ensure a strong presence in markets where significant innovation is occurring. They will need to monitor such developments closely. Those that do may be rewarded with opportunities to take best practice and apply it elsewhere – including markets in Europe and North America.

A necessary shift to services

As RGMs develop, demand for services will grow sharply. That is especially true where government policies have distorted development by holding back domestic consumption. Today, emerging markets

account for less than a quarter of the service sector worldwide, but within 25 years we expect their share to top 40%.

Financial services need to develop substantially to enable consumers to reduce precautionary saving and simultaneously improve their ability to pay for education, health care and retirement. Improving access to savings products makes it easier for citizens to invest: improving access to credit can help them meet current needs, build businesses or acquire education for themselves and their children, increasing earning power.

But the development of financial services has much wider implications for business. More efficient capital markets make it easier for companies to raise funds as well as aiding better distribution of resources.

Consumer access to efficient payment services is also increasingly critical for the development of a modern economy and many of the business models used by multinationals. Banking services remain underdeveloped in many RGMs. The UK has more than 25 bank branches per 100,000 adults: India has around half that level, Vietnam fewer than 5.

Many banks still see branches as central to opening new accounts and selling other financial services. But transactions are increasingly being carried out online, often by mobile devices. Kenya, China and Brazil have seen especially strong growth in the use of mobile phones to store and transfer money through electronic accounts. Some companies are beginning to offer interest-bearing savings accounts, microloans and insurance by phone too. Technology is substituting for branches. Banking by mobile phone, too, is a critical enabler of economic modernization, including the development of modern retailing.

Let them shop

As incomes surge, the wholesale and retail sector has enormous potential in RGMs. Where governments permit, multinational companies vie with national rivals to develop supermarkets and chain stores, backed by modern procurement systems, supply chains and wholesalers.

Modern retail systems benefit economies by improving quality, efficiency and choice, and by reducing waste. Consumers are keen. Sales in Brazilian shopping malls reached US\$56b in 2011, up 12% on 2010. By 2014, another 113 shopping centers are expected to be built across the country.



The future of growth in the new consumer markets

Some fear consolidation of retailing will lead to job losses. The World Bank estimates that India has around 12m shops employing 40m people, and that 95% are self-employed. The Indian Government recently abandoned plans to allow FDI in multi-brand retailing amid fears of job losses, despite benefits that would have included greater efficiency and better infrastructure.

Yet there is evidence that modernization leads to net job gains. In Indonesia, employment in the wholesale and retail trade rose from almost 18m in 2002, when the economy opened up to FDI in multi-brand retail, to more than 23m in 2011. Retail-related FDI almost doubled from US\$900m in 2005 to US\$1.5b last year, almost a third of Indonesia's FDI total.

Sharing in the shift

The development of modern retailing in RGMs will create vast opportunities for suppliers of all kinds. Retailing is at the heart of the consumer economy. Stores must be built and equipped, products procured in sufficient bulk to stock the shelves and a sophisticated logistics chain created to ensure products arrive in peak condition.

This will create big new markets for manufacturers of retailing equipment, but also for business-to-business services – ranging from extension services for farmers to the development of software for tracking stock, transactions and customer profiles.

Suppliers of consumer products, meanwhile, will see substantial volume growth in emerging markets, making possible scale economies like those they enjoy in developed markets. But it would be reckless to assume retailing in RGMs will mirror that in developed markets today. Online retailing is accelerating in both developed and emerging markets. Multinational retailers are experimenting with home delivery and online ordering backed by drive-in collection. Successful retail models in RGMs may feature some important variations from historic models.

Learning lessons

The vital lesson for business is that, while past patterns will offer clues to seizing future opportunities, intimate knowledge of RGMs and creative thinking will be essential to make the most of them.

This is a time of exceptional uncertainty and rapid change in the global economy. The RGMs will play an increasingly important role. We hope that the information and insight contained in this report provide a useful and authoritative basis for analysis, scenario planning and resource allocation.

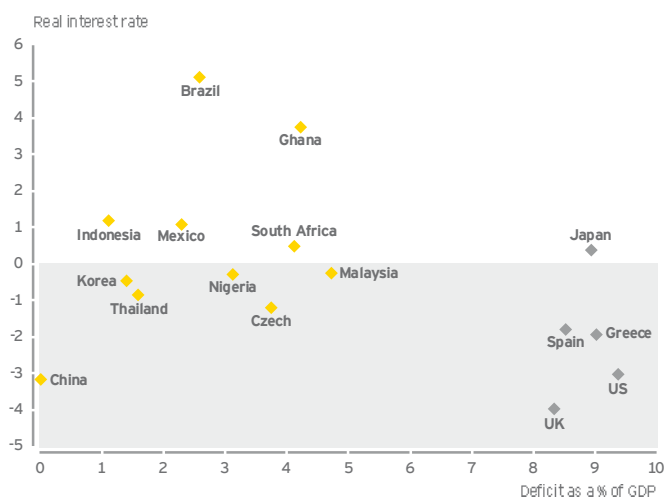


New consumer markets transforming the world's economy

RGMs are taking action to protect themselves ...

The RGMs are well placed to weather the major risks facing the global economy at the present time, given that they have space to ease both fiscal and monetary policy. Indeed, cooling inflation has already allowed short-term interest rates to start to come down in around a third of the RGMs, including each of the BRICs. In China, the lending taps are gradually being opened again to help offset a slowdown in export growth. We expect further easing of monetary policy in the months ahead, particularly if the global economy deteriorates further.

Figure 1
Budget deficits and real interest rates in 2011*



Source: Oxford Economics.

Our central forecast for the RGMs is that they accelerate in the second half of the year and into 2013 as uncertainty surrounding the Eurozone diminishes. Consequently, we expect growth to pick up from 4.9% in 2012 to 5.9% in 2013 and 6.5% in 2014. This represents a significantly better performance than the G7 economies, which we expect to grow by just 1.4% in 2012 and 2.0% in 2013. Growth in these economies will continue to be impaired as they deleverage their banking and consumer sectors and face fiscal headwinds.

* A real interest rate is a nominal interest rate minus the inflation rate.

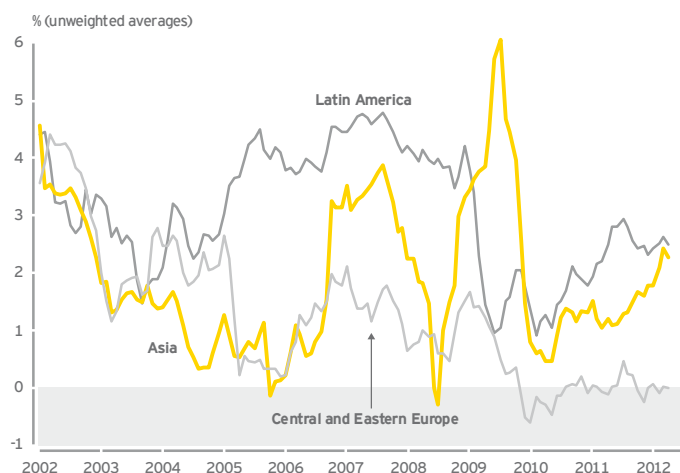
... against fallout from the Eurozone crisis.

Uncertainty over the Eurozone's future has continued to mount since our last forecast, with Greece's ability to remain a member of the single currency in doubt and Spain formally requesting financial aid from the EU to recapitalize its banks. With the second round of Greek elections giving a mandate to pro-bailout parties, albeit with a sizable vote for the opposition, our forecast continues to assume Greece will remain in the Eurozone, and that Spain's government will avoid a formal IMF/EU support package. However, as has been the case for some time, the risks remain skewed toward the downside. The key flashpoint remains whether Greece's new government is able to deliver on its promises to implement the IMF/EU program, or whether the measures become too difficult to implement, especially in the face of a newly energized opposition. Greek exit would place even greater strains on the Eurozone, reducing the credibility of Eurozone policy makers yet further, and push up borrowing costs for Portugal, Spain and Italy - to unprecedented levels.

Falling inflation gives scope to ease policy further

We expect inflation to fall across the RGMs as commodity price inflation cools. We believe average RGM inflation will fall from 5.9% in 2011 to 4.6% in 2012 and then 4.3% in 2013. Against a backdrop of falling inflation, the RGMs have scope to ease monetary policy further if necessary. The slowdown in intra-Asia trade in April adds to the likelihood that policy will be eased further.

Figure 2
Emergers: policy rate – CPI ex food inflation



Source: Haver Analytics, Oxford Economics.



The annual growth in consumer spending remained stable at a healthy 4.9% in Q1 and fixed investment grew by 9.9%, underpinned by impressive FDI inflows. Interest rates were held at 5.75% in May as CPI inflation increased to 4.5% in April. However, inflation is expected to remain below 5.5% during the rest of 2012, which should allow interest rates to stay on hold while doubts about the global economy persist.

Reflecting the resilience of Indonesia's economy, two of the three major ratings agencies, Moody's and Fitch, have upgraded the country to investment grade status in recent months. Standard & Poor's are holding back. In part, this was due to the authorities' last minute back tracking on cutting fuel subsidies, which slightly damaged their credibility.

... but China will continue to set the tone for Asian RGMs

Although Indonesia's resilience is particularly striking, the performance of the Asian RGMs will continue to be heavily influenced by China. Slowing inflation and a cooling of the housing market has allowed China to start to loosen monetary policy again. Consequently, we expect a "soft-landing" in Chinese growth from 9.2% to 7.5% in 2012, before growth accelerates again to 8.5%.

Chinese GDP growth slowed to 8.1% in Q1 and neither the latest survey data nor Korean export figures for April suggest any marked pick-up in early Q2. Consumption accounted for over 75% of growth in Q1. A rebalancing toward higher consumption is welcome and in line with the rhetoric of the latest Five Year Plan, the lower growth target of 7.5% and the emphasis on higher standards of living.

Box 1

The role of Emerging Asia in global rebalancing efforts

Emerging Asia must rebalance ...

The rapidly growing Asian countries are enjoying more prominence in the world economy. This places greater importance on the role these countries must play in efforts to rebalance the global economy. The cheap money that Asian surpluses have provided to advanced economies since the 1990s partly laid the foundations for the global credit crisis in 2008-09. A shift in relative demand and prices between surplus and deficit countries is crucial to stabilizing financial markets and economic systems across the world. The major Emerging Asian countries that have run surpluses in recent years must adjust their growth patterns toward more reliance on domestic demand and should allow greater exchange rate flexibility. The US and other advanced economies which are running large deficits need to play a complementary role by reducing internal demand relative to overall growth. Of course, the fiscal austerity we are currently seeing in the West should help here.

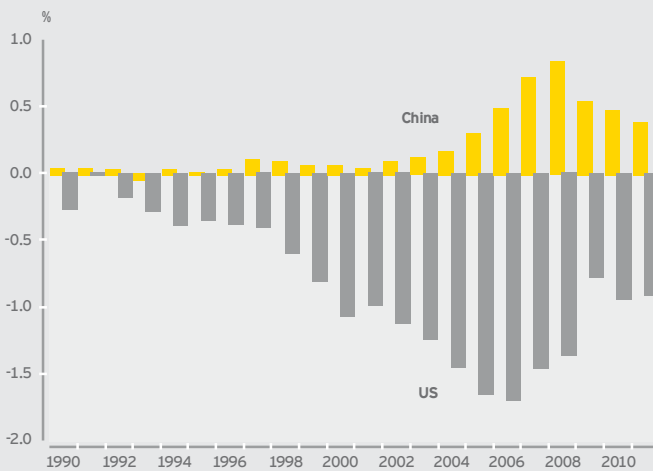
Rebalancing in Emerging Asia will not only make the world economy more stable but will also help the Asian countries themselves, making high growth rates more durable. By increasing private consumption, investment and infrastructure spending, and realigning price dynamics, large welfare gains can be made across Asia.



New consumer markets transforming the world's economy

... in order to reduce global disparity

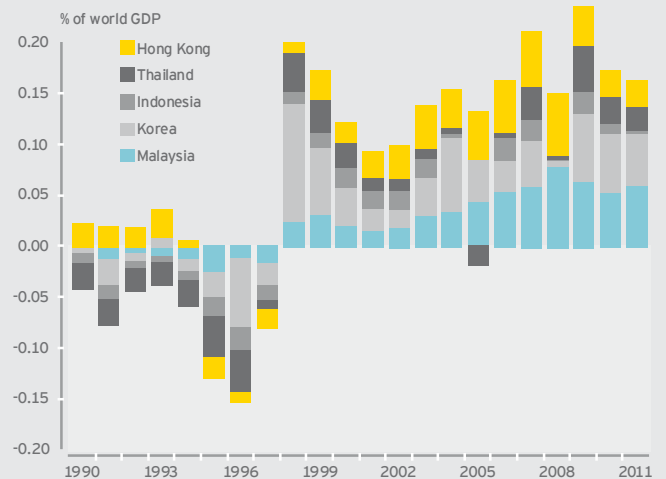
Figure 5
Current account as a % of world GDP



Source: Oxford Economics.

The chart above illustrates how the challenge of the global imbalances developed. In 2006, shortly before the global credit crisis, the current account deficit in the US peaked at 1.6% of global GDP. And in 2008, the current account surplus in China peaked at 0.8% of global GDP. Last year, the Chinese surplus had eased to 0.4% of global GDP while the US deficit narrowed to 0.9% on the same basis. The other surplus economies in Emerging Asia – Korea, Hong Kong, Malaysia, Thailand and Indonesia – together recorded a surplus of 0.16% of global GDP in 2011, down from more than 0.2% in 2007.

Figure 6
Current account balances: Emerging Asia ex China



Source: Oxford Economics, CEIC.

The large surpluses arose from fears following the Asian crisis ...

In the run-up to the Asian Crisis of the late 1990s, the major Emerging Asian economies, excluding China, tended to run sizable current account deficits. But the turmoil dampened the risk profile of the economies who were most affected and these economies acted cautiously in the decade following the crisis. Households increased personal savings and companies shied away from reinvesting profits, enabling these economies to build up large foreign reserves and big external surpluses to ensure that they would never have to seek IMF help again. Businesses became risk averse and, in the economies hit hardest, investment fell as a share of GDP and has never recovered to pre-crisis levels. For example, in Malaysia in 1997 investment contributed more than 40% of GDP. In the 15 years since, investment has never exceeded 25% as a proportion of GDP.



Box 1

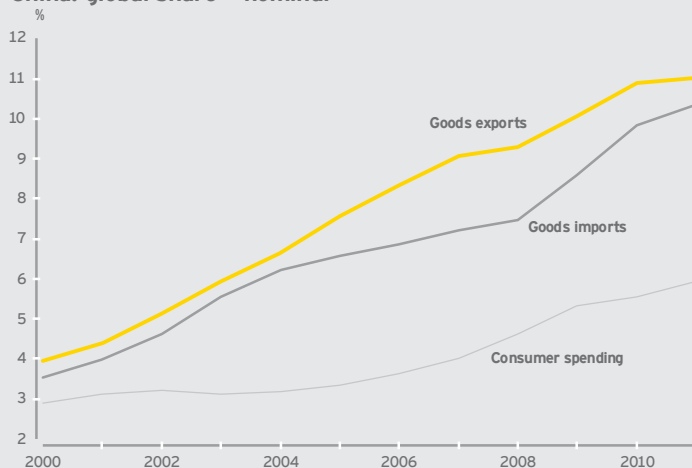
The role of Emerging Asia in global rebalancing efforts (continued)

... and were exacerbated by the pursuit of export led growth

The pursuit of export-led growth has also been a key driver behind the Asian current account surpluses, particularly in Korea, Malaysia and Thailand where exports make up more than half of GDP (or indeed 100% in the case of Malaysia). And China has increased its world market share in goods exports from less than 5% 10 years ago to more than 10% last year. China accounted for around half of the GDP of the rapid-growth markets in Asia in 2010, but almost two thirds of the Emerging Asian current account surplus. The chart below illustrates how China's rapid growth has been export-led, showing how, over the same period, its share in world exports of goods has increased at more than twice the pace of its share of private spending.

Figure 7

China: global share – nominal



Source: Oxford Economics.

Rebalancing already underway, accelerated by the global crisis ...

There is considerable evidence that China is already rebalancing. The current account surplus in China eased to just 2.1% in Q4 2011, having peaked at 9.5% of GDP in Q1 2007 – although it remains subject to considerable volatility. However, this decline has more to do with cyclical factors than underlying structural changes. The massive fiscal package of CNY 4t (around 15% of GDP) that the Chinese authorities implemented in late 2008 to maintain growth above 9% when much of the rest of the world suffered recession, had a huge impact on increasing China's investment and imports. Investment rose as a percentage of GDP from less than 40% in 2007 to near 50% by 2009 and 2010. The chart above shows that the pace at which Chinese imports gained global market share picked up notably in 2009, illustrating that the import recovery outpaced that of exports, dampening the external surplus.

... and terms of trade are deteriorating

In addition, as the chart afterwards shows, China's terms of trade have steadily deteriorated in recent years, excluding the temporary drop in commodity prices in late 2008. Exports have increasingly shifted toward machinery and transport equipment, and the relative price of these goods has declined. In contrast, imports have shifted toward commodities and minerals, and the relative price of commodities has increased. The net effect of this has been a steady deterioration in the terms of trade China faces.



New consumer markets transforming the world's economy

Figure 8
China: terms of trade



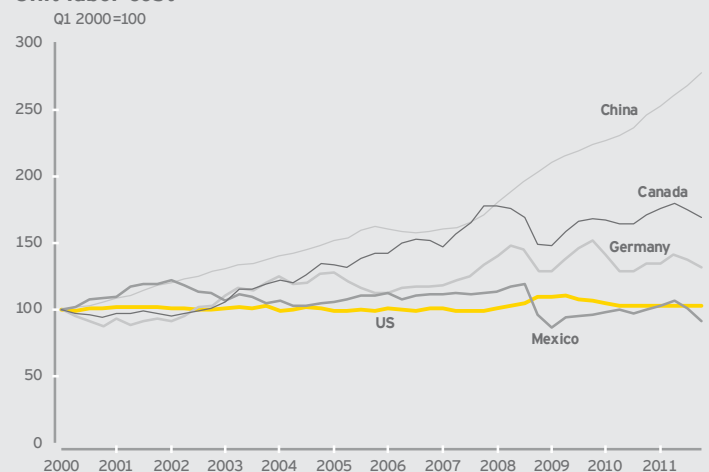
Source: Oxford Economics, Haver Analytics.

Commodity prices and infrastructure needs will keep import bills high

Having averaged US\$57 a barrel from 2000-11, the oil price is expected to average more than \$120 over the next ten years. This will mean that high import bills continue for net commodity importers. The Asian Development Bank estimates that the Emerging Asia region needs to spend around US\$750b per year on infrastructure over the next decade, and both Indonesia and Malaysia have substantial multi-year plans in place to boost investment. This has massive implications for import demand and stronger imports will help narrow current account surpluses in coming years.

China has been exporting deflation for many years, but this trend is expected to reverse within the next five years. Inflationary pressures will help the imbalances unwind, while higher wages will bring huge welfare gains and should encourage higher private spending, assisting the rebalancing of growth patterns.

Figure 9
Unit labor cost



Source: Oxford Economics.

A much bigger shift to greater reliance on consumption is needed

But while higher imports (helped by the higher prices faced by net commodity importers and by substantial infrastructure needs) have helped surpluses narrow in recent years, many Emerging Asian countries, particularly China and India, still tend to have a much smaller reliance on consumer spending as a proportion of GDP than the advanced economies. For example, while consumption as a percentage of GDP rose from 69% to 71% in the US from 2000-11, over the same period in China it fell from 47% to 33%, and in India it fell from 64% to 57%. The chart on the next page shows how low average consumption rates have been in Asia, allowing many of these countries to build large external surpluses and accumulate substantial foreign exchange reserves.

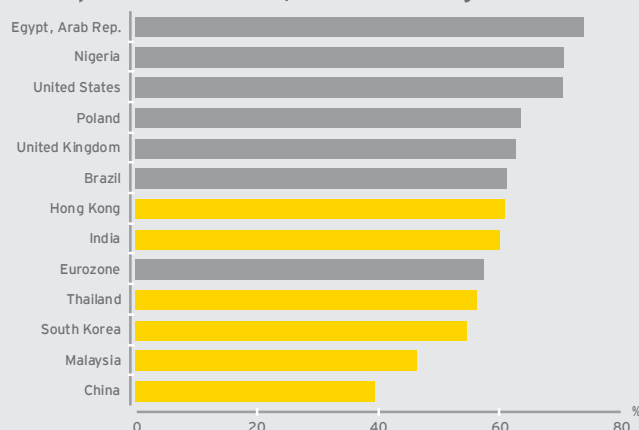


Box 1

The role of Emerging Asia in global rebalancing efforts (continued)

Figure 10

Consumption as a % of GDP, 2001-11 average



Source: Oxford Economics.

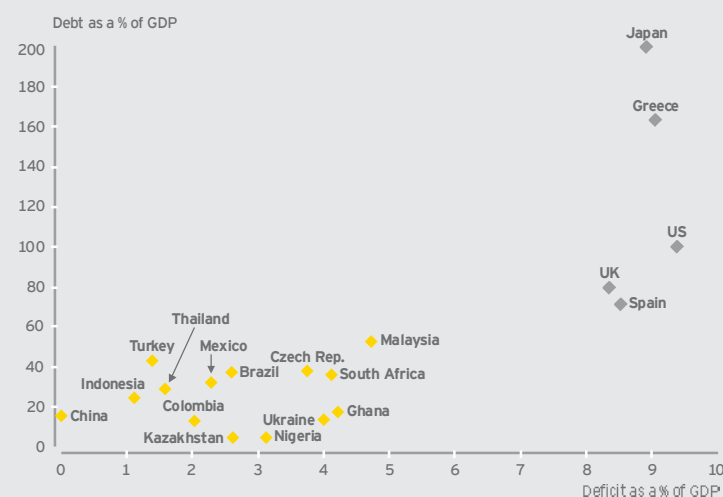
But precautionary saving among households is very high in Asia and, to reduce savings, authorities in Asia will need to:

- ▶ Improve the ability of individuals to insure against risk through financial liberalization, increasing the range of savings instruments
- ▶ Increase government spending on public services, particularly in rural areas
- ▶ Increase public provision of pensions, health care and education services
- ▶ Improve the definition of property rights and rural land reform to allow households to use housing and land as collateral
- ▶ Design public spending plans to support rather than crowd out private spending

The 12th five-year plan for China promises structural reforms to strengthen social safety nets, boost wages and improve access to low income housing, and it is hoped that these measures will stimulate consumer spending. As the chart below illustrates, governments in Emerging Asia are certainly in a much stronger position than the West to increase public spending.

Figure 11

Budget deficits and government debt in 2011



Source: Oxford Economics.

Higher wages and employment will help

The emphasis over the last decade on being very competitive, keeping wages low and maintaining a current account surplus has dampened other aspects of the economy in many Asian countries. Governments must try to facilitate the strong growth of labor-intensive industries and make sure they don't discriminate against imports. Over the last 20 years, employment growth has tended to lag behind both output growth and population growth as governments have sought to maximize productivity. This has dampened consumer spending potential.



New consumer markets transforming the world's economy

Having retained profits to build up substantial foreign reserves and surpluses in the years following the Asian crisis, companies are now beginning to spend more of their profits. As major Emerging Asian countries try to build market share in new industries, investment is increasing. In order to attract more skilled staff, higher wages are being offered. This must continue and indeed accelerate to facilitate the rebalancing of growth patterns toward more sustainable long term growth paths.

Exchange rate flexibility is important

In addition to a shift in demand, gradual rebalancing of the relative prices of goods and services between deficit and surplus countries is required. There is a lot of uncertainty surrounding global financial markets at this time, and so upward pressure on the Yuan is not as great as it has been in previous years. However, given China's state of development and its still large current account surplus, most estimates of China's equilibrium exchange rate suggest that the Yuan is undervalued. Since 2005, China has gradually allowed more exchange rate flexibility, and if China continues to gradually appreciate its currency in real effective terms (both through faster nominal appreciation and through a sustained increase in domestic cost pressures that result in larger inflation differentials relative to China's trading partners), the current account surplus is likely to gradually narrow in coming years, settling at a more sustainable level.

Greater exchange rate flexibility should also substantially improve welfare in China. Despite building up an enormous US\$3t in foreign exchange reserves, the interest rate differentials between the US and China mean that China is receiving interest of around 2% on its holdings of US treasury securities, far less than the interest rates in excess of 5% that foreign investors receive on investments in China.

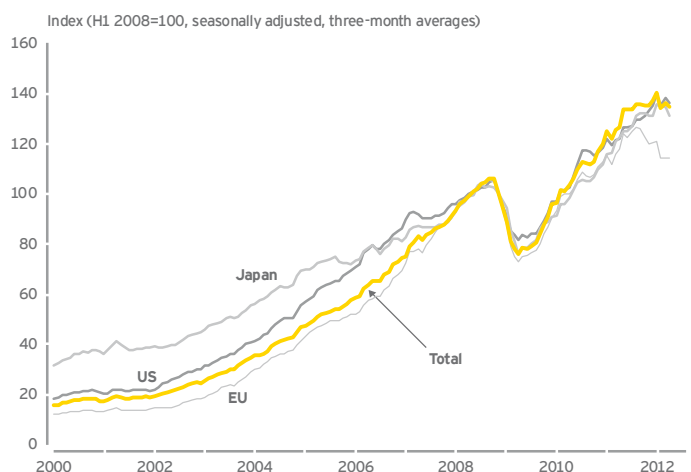
Chinese investment and exports were weak in Q1 ...

Both Chinese exports and investment were weak in Q1, with their growth rates slowing more sharply than expected. Based on our analysis, investment made a relatively small contribution of 2.7pp to growth and net exports were a drag of 0.8pp on growth. According to the China National Bureau of Statistics, growth in investment in March in seasonally adjusted terms was particularly weak within the quarter, rising only 0.6% on the previous month, compared with monthly expansion of 1.9% in February. It could be that the weakness of exports is beginning to take its toll on investment.

Unsurprisingly, exports to the EU have been particularly weak while exports to the US have held up better. With the focus on the Eurozone sovereign debt crisis in recent months, it is easy to forget that the US is almost as important as the EU to China's trade prospects. And so the pick-up in growth in the US over the past six months – particularly of consumption more recently – has provided a partial offset to the weakness of demand in Europe for China's goods.

Figure 12

China: exports by destination



Source: Haver Analytics.



... but the weakness in imports was more of a surprise

The slowdown in China's exports over the last six months has been broadly in line with expectations, reflecting the weakness of the EU, which is the destination for nearly 20% of the country's exports, and fairly subdued demand in many other regions. However, the deceleration in Chinese imports has been more surprising. Indeed, after a broadly flattish trend in late 2011 and in Q1 2012 – though there was considerable monthly volatility – estimated seasonally adjusted imports in US\$ terms fell 7.4% on the month in April. Apart from the collapse in imports that took place in November 2008, this was the sharpest fall outside of the Chinese New Year holiday since the end of 2002. If this import weakness continues during the rest of the second quarter, imports will subtract less from Chinese GDP in Q2 than they did in Q1.

The fall in Chinese imports appears to have been broadly based across countries, though it was somewhat larger in manufactures than in resources. For example, the total of China's imports from countries that predominantly supply manufacturers – Emerging Asia excluding India and Indonesia, Japan, the EU and the US – fell notably.

However, while imports of resources may not have fallen as much in April, anecdotal evidence suggests that they have weakened further in May – reflecting both lower volumes and falling global prices, particularly for oil. Indeed, there have been stories that Chinese purchasers of coal and iron ore have asked traders to defer cargoes, reflecting both their uncertainty about the current strength of demand and concern that they may have over-bought in recent months and built up excessive stocks (for example the volume of iron ore imports in January-April was 6.5% higher than a year earlier).

Chinese authorities will act to limit the slowdown

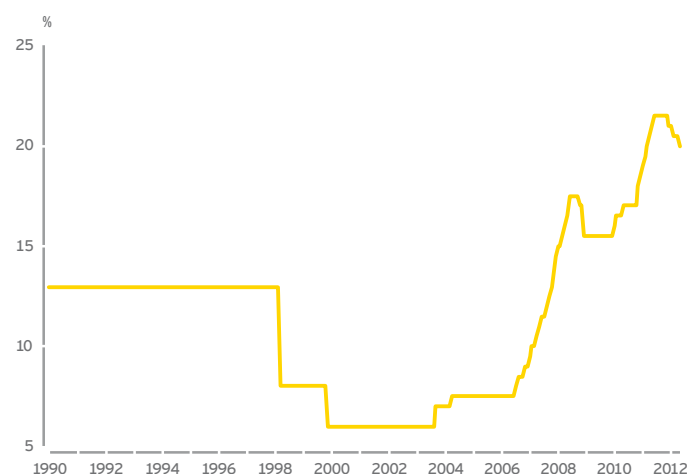
The Chinese government is unlikely to sit back idly and watch the economy slow sharply. Chinese officials have signaled a change of policy direction, saying that the government should now prioritize growth. The new policy direction is expected to include a more proactive fiscal policy, with more loans to big infrastructure projects, lower financing costs, tax cuts and credit for smaller businesses.

Headline CPI inflation has fallen from 4.5% at the start of the year to 3.0% in May, while excluding food and energy, inflation remained subdued at 1.4%. In addition, manufacturing producer price inflation has been negative during the past quarter. With house prices continuing to fall in most cities, the authorities' attention is shifting toward bolstering growth prospects.

The Chinese authorities have already started to ease credit controls. Starting in December, the People's Bank of China has cut the share of deposits that banks must set aside by half a percentage point on three occasions. The policy has already started to have an impact on lending. In the three months to May, net lending increased at its fastest pace since July 2009. In addition, early June saw China's first interest rate cut since 2008. We expect a further easing of policy if growth continues to disappoint.

Figure 13

Reserve requirements for large Chinese banks



Source: Oxford Economics, Haver Analytics.

Weakness of trade now most likely trigger of Chinese hard landing ...

A hard landing for China is still a concern but, with the property sector slowing of its own accord in response to earlier policy initiatives, the weakness of trade is now more likely to be an initial trigger. The interdependency between the property sector, local government finances and the banking sector is one of China's main vulnerabilities, and a significant slowdown in growth could reveal fragility in the banking system. A more "slow-burn" risk lies in the rise in corporate indebtedness.

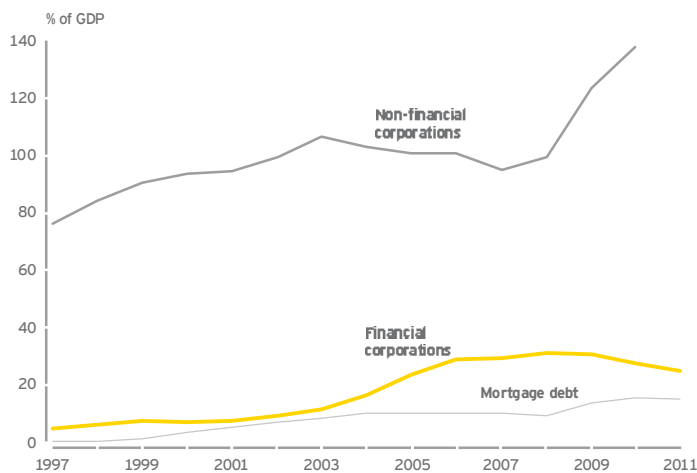


New consumer markets transforming the world's economy

... but capital misallocation adds to vulnerability of China's financial system

Using the flow of funds from the national accounts, we estimate that the level of corporate debt to GDP in China is now above 120%, close to the levels of corporate debt in Japan during the 1990s.

Figure 14
China: sectoral indebtedness

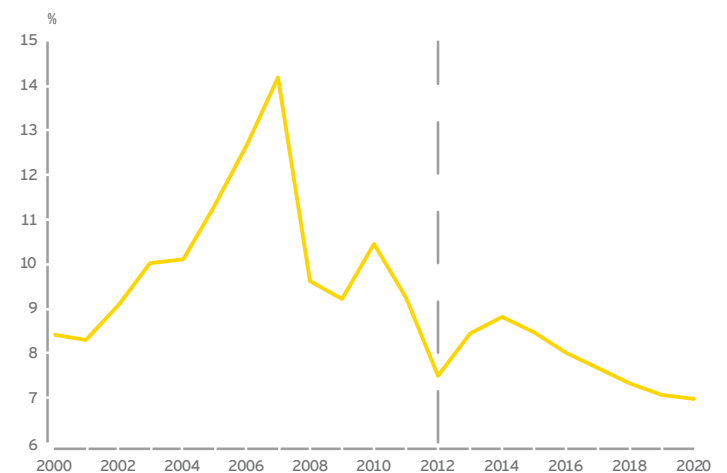


Source: Oxford Economics, CEIC.

With the level of investment so high, not all of this debt can be directed to profitable investments, adding to the misallocation of capital. This could slow China's growth rate and, were profitability to fall, add to the vulnerabilities in the financial system.

China's growth rate to moderate over the next ten years ...

Figure 15
Long-run Chinese GDP growth forecast



Source: Oxford Economics, Haver Analytics.

Although some of China's recent investments may prove to have been unproductive, its growing capital stock will still make a significant contribution to potential growth over the next decade. Nevertheless, more testing times lie ahead for the economy as the implications of the one-child policy starts to lead toward an ageing population. By 2015, the percentage of the population above 65 will start to rise faster than the population of working age, although continued urbanization will help to support the labor supply. But the ageing population, a smaller contribution from the capital stock, and a slowing in technological progress as China catches up with developed countries will contribute to moderate potential output growth over the next ten years.

... but will still remain comparatively rapid

We expect growth to slow from an average pace of 11.2% in 2006-10 to 8.5% in 2011-15, and then to 7.4% in 2016-20. Even at 7.4%, China's growth rate would still rank second among the RGMs, behind India with 7.5% and ahead of Kazakhstan with 6.5% and Vietnam with 6.4%.



India has also cut rates to protect growth ...

At its mid-April policy meeting, the Reserve Bank of India cut the key repo rate for the first time in three years by 50 bps to 8.0%. There were two main factors behind this move. First, that growth was clearly below its pre-crisis trend. Second, that wholesale price inflation had fallen noticeably in recent months, with core manufacturing inflation dropping below 5% in March for the first time in two years, remaining little changed in April. However, at the same time, the Indian central bank indicated that the space for further reduction in rates was limited, as there were upside inflation risks and growth was less fragile than in H2 2011.

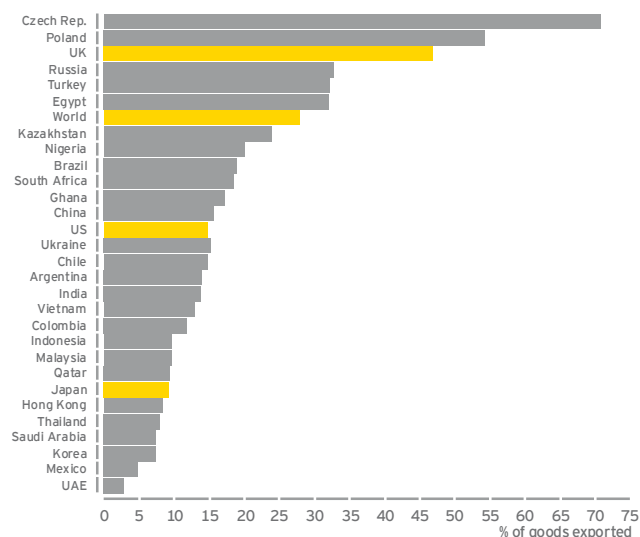
... but has little room for further maneuver

Notwithstanding the modest reduction in global oil prices in April and May, if the Indian government's subsidy bill is to be checked soon, domestic fuel prices need to rise significantly. This could add to inflation expectations, which are already responding to indirect tax hikes levied in March's budget. In addition, the rupee has been slipping since early March, reflecting investors' concerns about the government and, despite the slowdown of the last year, there still appear to be capacity constraints in crucial parts of the economy. In Q1 2012, the annual growth in electricity output was just 4.5%, the slowest pace in six quarters and not fast enough to prevent power outages in certain industries. Given all these factors, the Reserve Bank may have to leave interest rates on hold throughout the remainder of 2012.

EMEIA RGMs expected to slow the most, particularly those linked to the Eurozone ...

While the slowdown in trade for many RGMs is being cushioned by heavy exposure to other emergers and the US, most countries in Central and Eastern Europe rely overwhelmingly on demand from the Eurozone. Poland, Romania, Hungary and the Czech Republic all recorded falls in industrial output in Q1, which in the case of the Czech Republic meant a sharp decline in GDP given the weakness of domestic demand, which was under pressure from fiscal austerity.

Figure 16
RGM exports to the Eurozone, 2011



Source: Oxford Economics.

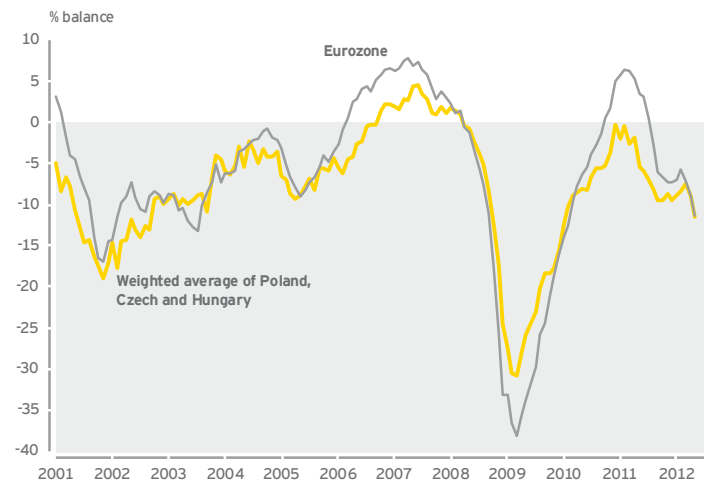
Consequently, the EMEIA RGMs will slow the most in 2012, with growth dropping from 6.0% in 2011 to 4.0%, before reaccelerating to 4.9% in 2013. Much of this slowdown is due to the combination of Eurozone banking sector fragility holding back lending in some of the emerging European RGMs, and the negative impact of a mild recession in the Eurozone on these countries' exports. We believe that growth in Ukraine will slow from 5.1% in 2011 to 2.5% in 2012; in Poland from 4.3% in 2011 to 2.7%; and in the Czech Republic there will be an outright contraction of -1.4% following growth of 1.7% in 2011.



New consumer markets transforming the world's economy

Figure 17

Central Europe: industrial confidence



Source: Eurostat, Oxford Economics.

The outlook could easily worsen if the Eurozone recession persists for longer than expected, or prompts a renewed bout of financial turmoil which would lead to a further tightening of credit conditions.

... but also in the Middle-East and Africa due to temporary factors.

Growth is also expected to slow sharply in Saudi Arabia, Qatar and Ghana due to a variety of one-off special factors rather than more fundamental issues. Saudi Arabia is not expected to repeat the massive government spending boost it saw in 2011, which was partly driven by increases in public sector wages, healthcare and education following the Arab Spring. As a result, we expect growth to slow from 6.8% to 4.5%.

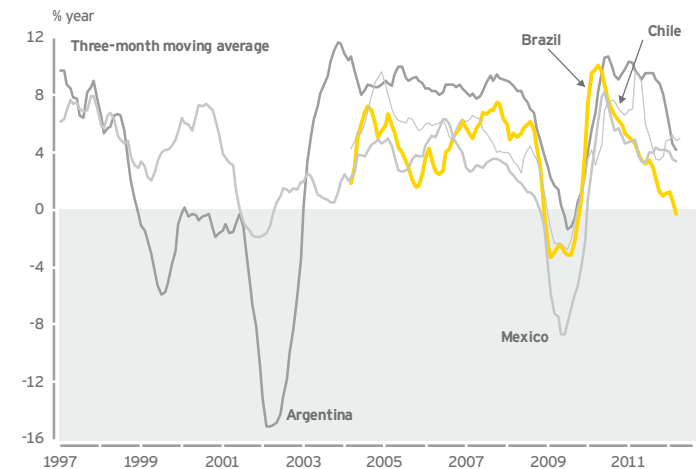
The slowdown in growth in Qatar from 16.7% in 2010 and 14.1% in 2011 to 7.0% in 2012 largely reflects the fact that the earlier rapid expansion in the liquefied natural gas (LNG) sector has come to an end because of a self-imposed moratorium. In Ghana, the oil driven boost to growth is not expected to be repeated and growth is expected to slow from 14.4% to a still rapid 8.5%.

Latin America RGMs will grow more slowly than those in Asia or EMEIA

The Latin America RGMs will be the slowest growth bloc, with growth of 3.2% in 2012 and 4.4% in 2013. The slowdown in 2012 from growth of 4.2% in 2011 reflects a reduction in growth in Argentina from 8.9% to 3.3% and a second year of sub-three-percent growth in Brazil.

Figure 18

Latin America: monthly GDP



Source: Haver Analytics.

Brazil continues to cut rates to help protect growth ...

The Brazilian central bank also cut interest rates in May, by 50bp to 8.5% (making a cumulative reduction of 400bp since the end of August). Brazil no longer occupies the top slot in the global real interest rate league table. Indeed, with a real interest rate of 2.9% – based on discounting projected inflation over the next year – Brazil is placed second to Russia (4.2%) and equal with China (2.9%), with Colombia fourth (1.8%). Markets now expect no further easing, but such an outcome cannot be ruled out in the light of the bank's recent decisive handling of policy, if the news on the economy remains patchy and inflation behaves in line with its somewhat optimistic forecasts.



... but Mexico kept rates on hold.

By contrast, the Mexican central bank left its interest rate unchanged last month, despite considerable speculation that it might cut for the first time in nearly three years. Although taken as a whole the latest monthly indicators were softer than in the previous few months, it still seems quite likely that Mexico can achieve respectable 3.5%-4% GDP growth this year, particularly if US manufacturing continues to pick up.

Sharp slowdown in Argentina due to weaker external environment

In the first two months of 2012, the Argentinean economy grew at its slowest pace in two years, with weaker industrial growth the main factor behind the subdued performance. We expect GDP growth to slow from almost 9% last year to just 3.3% in 2012, reflecting weaker external demand from Brazil and a less favorable global outlook. In addition, growth is likely to be hampered by import restrictions, declining competitiveness and supply constraints.

As a result of continued robust growth, the unemployment rate fell to 6.7% in Q4 from 7.2% in Q3. The last time Argentina had a jobless rate below 7% was in 1992. The trade surplus in 2011 fell to US\$10.3b from US\$11.6.b in 2010 as import growth surged on robust consumer demand and declining competitiveness. We expect this trend to continue in 2012.

Box 2

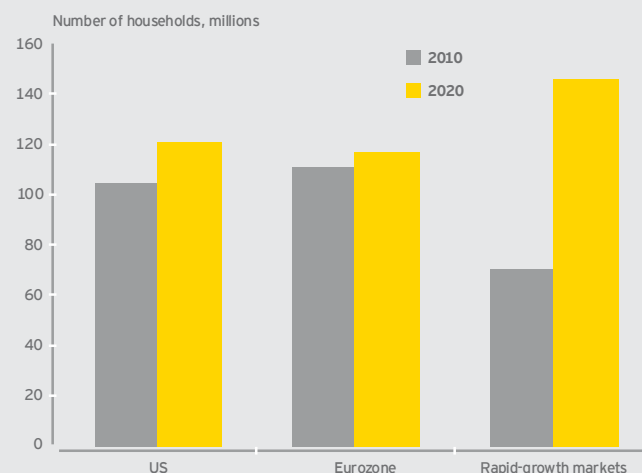
RGM middle classes will increasingly drive global growth

Consumers in the G7 countries have been the primary source of demand in the global economy for the last 25 years, and over the same period the emerging markets have established an increasing share in the supply of goods to the world.

But following the global financial crisis of 2008-09, the Eurozone is struggling under the weight of huge debts and the US is growing only modestly. In these areas, consumer spending is expected to be very subdued. Growth in the emerging markets is forecast to far outpace that in the advanced economies. According to our forecasts for household incomes the number of emerging market households enjoying higher incomes will grow sharply over the next ten years. The number of households in the emerging markets enjoying an income of over US\$30,000 will more than double to 149m by 2020, overtaking the US (120m) and the Eurozone (116m).

Figure 19

Number of households with income greater than US\$30,000



Source: Oxford Economics.



New consumer markets transforming the world's economy

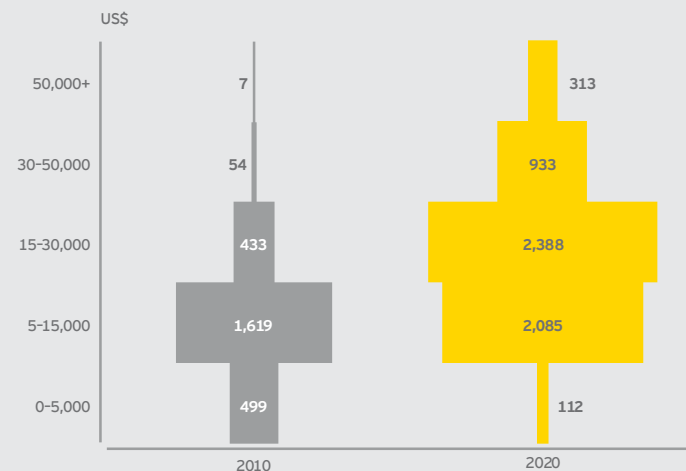
It is assumed that those in the higher income bands will enjoy comfortable housing, healthcare and education opportunities, and have discretionary income to spend on leisure pursuits, consumer goods and holidays. This will have enormous implications for the global economic landscape.

Asia has the largest consumer potential ...

By 2020, almost half of the world's population will live in Emerging Asia and a quarter of global consumer spending in nominal US terms will come from this region, up from 14% last year. By 2030, this proportion will have risen to 40%, with China alone accounting for more than half of this spending. This will reflect the large-scale movement of households into higher income bands. In China, by 2020, households with an income over US\$30,000 will have a total of US\$1.2t to spend, up from less than US\$0.1t in 2010.

Figure 20

China: total income by income band (income in US\$b)

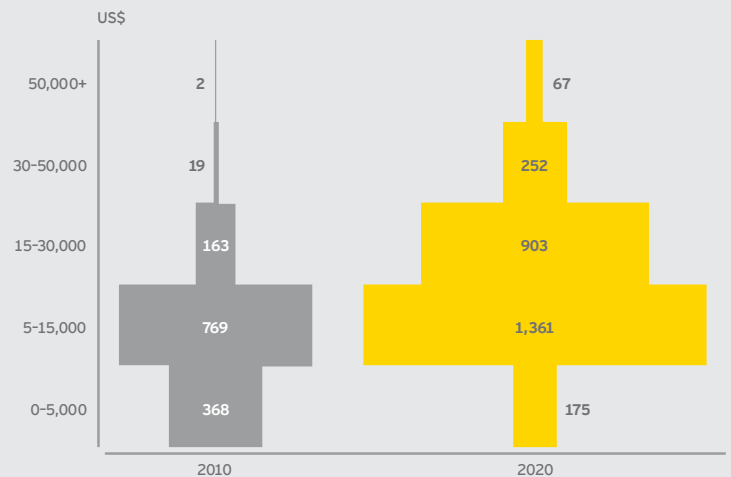


Source: Oxford Economics.

And while in 2010 more than 40% of households had an income below US\$5,000, by 2020 this proportion will have fallen to under 8%. India's share in world consumer spending will double by 2030 and the proportion of households with an income over US\$5,000 will surge from just 47% in 2010 to more than 80% by 2020.

Figure 21

India: total income by income band (income in US\$b)



Source: Oxford Economics.

... but Latam and EMEA will also gain

Last year, Latin America had a per capita income of US\$10,519, almost double that of Emerging Asia's US\$5,983. In Brazil, in 2010, 21% of households had an income of more than \$30,000; a higher proportion than Russia at 13% and China at 0.4%. And in 2010, 80% of the Brazilian population earned over US\$5,000, compared to 60% in China and less than 50% in India. But by 2020, just 5% more Brazilian households will move into the income bands above US\$5,000. China's percentage of households with an income over US\$5,000 will rise to 93%.

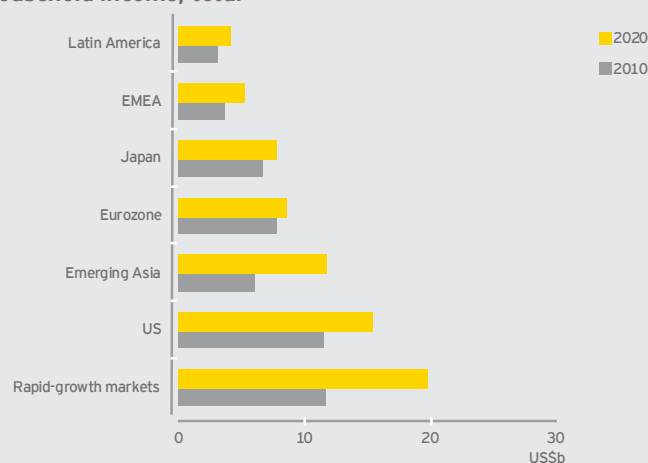


Box 2

RGM middle classes will increasingly drive global growth (continued)

Figure 22

Household income, total



Source: Oxford Economics.

Emerging Europe had a higher per capita income than Latin America last year at \$12,276, and the number of households in the higher income bands is expected to grow notably in the next 10 years. By 2020, almost 40% of households in Poland will be in the income band above \$30,000, up from less than a quarter in 2010; and by 2020, over a quarter of Russian households will enjoy an income of more than \$30,000.

As outlined in Ernst & Young's 2012 Africa Attractiveness survey, Africa's population today totals over one billion people, with combined consumer spending approaching US\$1t. We expect a sizable number of households to move into a higher income band over the next ten years. In Ghana, less than a quarter of households had an income of more than \$5,000 in 2010. By 2020, more than a third of households will enjoy an income above \$5,000. In Nigeria, in 2020 nearly 56% of households will enjoy an income in excess of \$5,000, up from 45% in 2010.

Income growth underpinned by favorable demographic and urbanization trends

Underpinning this growth in household incomes and the movement into the higher income bands is the favorable demographic profile of emerging markets, the trend toward greater urbanization and the development of services – notably wholesale and retail trade; financial markets; insurance and real estate; and education, healthcare and social security. Indeed, in India, the services sector will rise from 58% of GDP last year to almost 70% in 25 years' time.

The emerging markets enjoy a demographic advantage over the advanced economies. The ratio of people of retirement age to those of working age is expected to remain under a quarter into the 2020s in China, Brazil, Russia and India, but in the EU and Japan it already exceeds a third.

And greater urbanization also drives demand. In India, Thailand and Vietnam, a third or less of households currently live in urban areas. This proportion is expected to rise in the coming years. Ten out of 30 of the world's fastest-growing urban areas are estimated to be in India. The ratio of the Chinese population living in urban areas rose from a third. With more of the population living in urban areas and services more established, human capital will also increase across the emerging markets, enabling these countries to build market share in more sophisticated sectors. However, higher wages will very gradually erode the cost advantage many of these countries currently enjoy.

In 25 years' time, almost two thirds of global consumer spending will come from rapid-growth markets

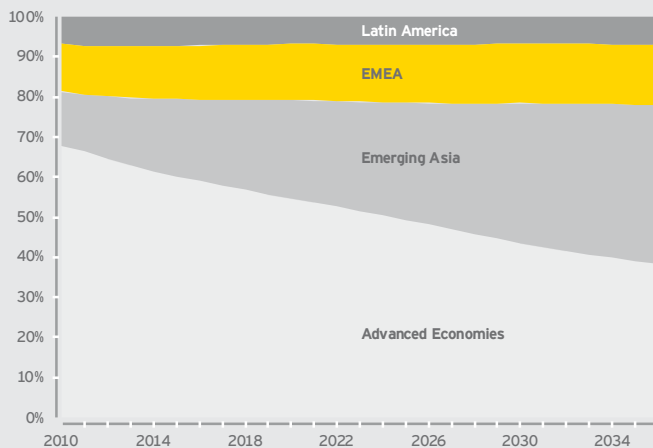
As the chart on the next page shows, last year two-thirds of nominal consumer spending in US\$ terms across the world came from the advanced economies, with the remaining third coming from the emerging markets. Fast forward 25 years and Emerging Asia alone will have overtaken the advanced economies as the key source of consumer spending, responsible for almost 40%, while the advanced share will have fallen to just 38%. This offers support to commentators who speculate that consumer demand from the emerging markets will eventually replace the advanced economies as the key driver of global growth. The shift in import demand should also assist in rebalancing the global economy.



New consumer markets transforming the world's economy

Figure 23

Share of global consumption, nominal US\$*



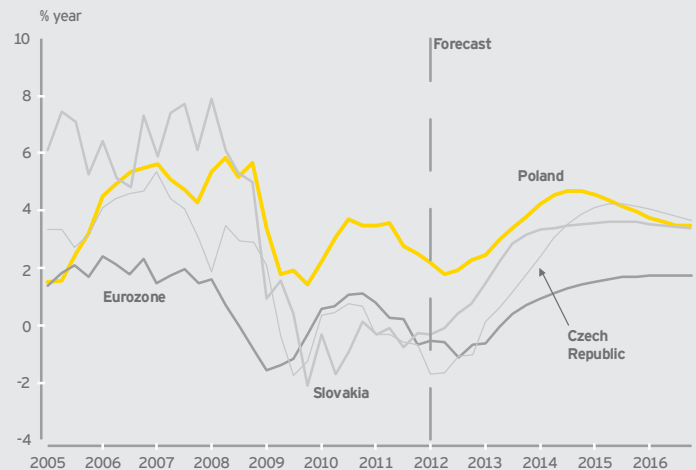
Source: Oxford Economics.

Greater reliance on consumption supports decoupling

Relying on consumer demand as the main engine of growth will also help some emerging markets decouple from the West. Poland is expected to enjoy GDP growth of 2.7% this year, while the Eurozone, Hungary and the Czech Republic are expected to contract. This is because Poland is more domestically driven than its export-led neighbors and as such is less exposed to the Eurozone troubles.

Figure 24

Europe: consumer spending



Source: Oxford Economics, Haver Analytics.

Households in the emerging markets tend to be less indebted than their counterparts in the advanced economies, which should give consumers greater freedom to spend, although savings rates remain high, particularly in Emerging Asia.

Savings rates will fall gradually in coming years. Building a welfare state will require long-term institutional change. Rising inequality has been a feature of the fast growth we have seen over the last decade in many emerging markets, particularly in China and Indonesia, and between rural and urban, and inland and coastal areas. Over the longer term, government spending on education, healthcare and social security needs to increase.

* "EMEA" includes Emerging Europe, the Middle East and Africa.

"Advanced economies" includes the US, Canada, Western Europe, Australia, New Zealand and Japan.



Box 2

RGM middle classes will increasingly drive global growth (continued)

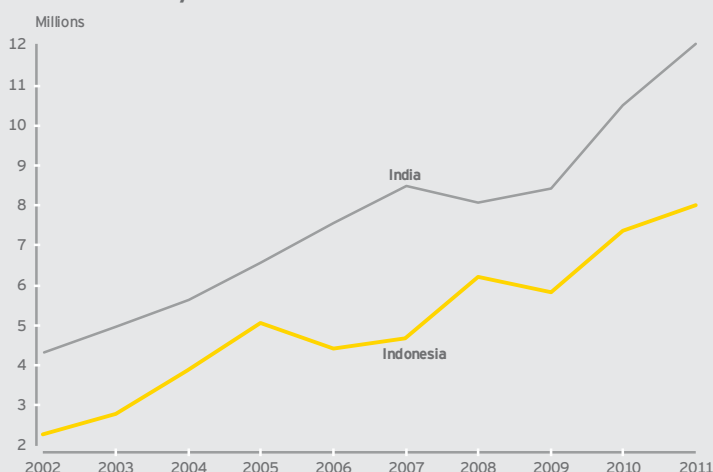
Demand for consumer goods to rise sharply ...

Over the last 50 years, sales of consumer durable goods have been dominated by the advanced economies. These markets are largely saturated, whereas the penetration of such goods is low in many of the emerging markets. According to our studies, once countries reach a certain take-off point in terms of per capita income, the income elasticity for consumer durables rises, until saturation occurs at a much higher income point. Between 2005 and 2009, refrigerator sales in China grew by an annual average of 25%. Our analysis suggests that the take-off point for fridge demand occurs at incomes of US\$5,000-US\$10,000.

Sales of motorcycles and scooters have tripled in India and Indonesia over the last 10 years, illustrating that demand for private transport is growing rapidly in these countries. Penetration of passenger cars is still less than 5% in these two countries, but with both investing heavily in infrastructure and set to see incomes grow rapidly in coming years, we estimate that the number of cars on Indian roads will almost triple by 2020.

Figure 25

Sales of motorcycles and scooters



Source: Oxford Economics, CEIC.

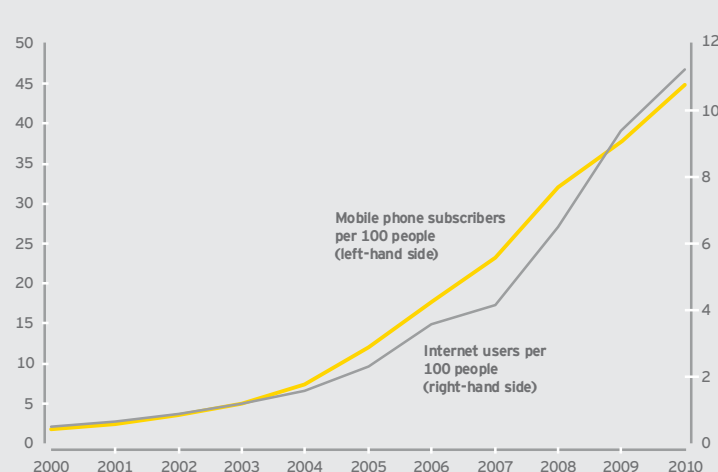
Based on our studies, households in the higher income bands have a preference for product differentiation and are willing to pay extra for quality. And as internet penetration increases and social networking rises, product awareness will grow. As a proportion of internet users, social network usage is higher in emerging markets compared to developed markets.

... particularly in Africa

As outlined in Ernst & Young's 2012 Africa Attractiveness survey, rapid urbanization, population growth and continued socioeconomic development will drive strong consumer growth in coming years. Rising domestic consumption of an ever-broadening range of products and services; growing intra-African trade; and the increasing diversification of many of the African economies will provide a multiplier effect to the emerging potential evident in African consumer markets. The chart below shows that, over the last decade, mobile phone penetration has risen from less than 5% to almost 50%, while internet penetration has risen to more than 10%. The sharp rise in mobile phone penetration has underpinned the development of the mobile banking industry in Africa.

Figure 26

Sub-Saharan Africa: consumer demand



Source: Oxford Economics.

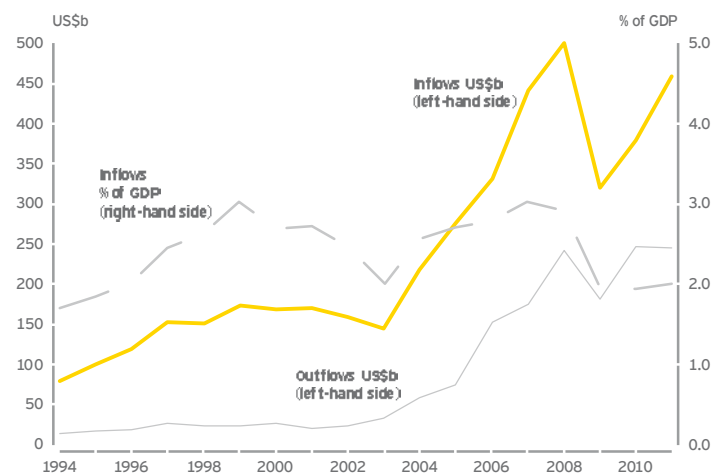


New consumer markets transforming the world's economy

Strong growth drivers such as the growing middle-class will continue to attract FDI to RGMs

Figure 27

Emerging markets: FDI inflows and outflows



Source: Oxford Economics, Haver Analytics.

Annual aggregate FDI inflows to the emergers totaled US\$459b in 2011 compared with US\$380b in 2010. Although 2011 GDP growth in many emergers was not as rapid as in the previous year, it was still fairly robust, in contrast to the subdued performance of most advanced economies. The higher pace of prospective growth in the emergers, particularly those with large domestic markets, remains a key factor behind the pattern of FDI inflows from global multinationals, as does expansion in countries with large natural resources (as long as the investment environment is reasonably stable). But despite the substantial rise in aggregate inflows, the percentage increase was broadly similar to growth of the emergers' GDP in US\$ terms. As a percentage of GDP, FDI inflows to the emergers were about 2% of GDP for the third consecutive year, whereas from 2004-08 it was in the 2.5-3% of GDP range.

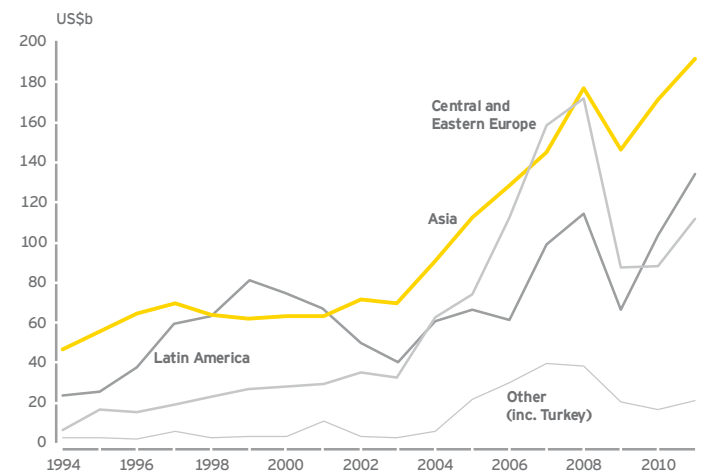
FDI is becoming more broad based

National accounts data shows that, in 2010, most of the overall increase in FDI was generated by just three countries – China, Brazil and Indonesia (US\$47b out of an aggregate US\$59b). But the gain last year was more broad based, with substantial increases recorded by

Turkey and Colombia as well as Indonesia and all of the BRICs. Turkey benefited from its very strong growth performance in both 2010 and 2011, and its links with many of the oil producers in the Middle East and Central Asia, while Colombia's rapidly expanding mining and oil sector continued to attract major inflows. The continued rise in flows to Indonesia probably reflects a combination of factors: strong domestically based growth with considerable scope for expansion; significant natural resources; and a government trying to pass new laws to encourage FDI inflows.

Figure 28

Emerging markets: FDI inflows



Source: Oxford Economics, Haver Analytics.

Short-term FDI into RGMs is likely to weaken ...

The current intensification of the Eurozone crisis hampers business confidence, financial markets and credit conditions. This will have a negative impact on FDI into RGMs during 2012, with a drop in FDI of around 10% possible even if the Eurozone holds together.

... but RGMs will continue to attract longer-term FDI.

Longer-term FDI will continue to grow as multi-national companies are drawn to the high growth rates of the RGMs at a time when growth is stagnant elsewhere in the world. As the RGM middle-class grows, the focus of the FDI is likely to shift increasingly from building plants to manufacture goods for export back to the developed economies, to serving the domestic market. As the new RGM middle-class starts to consume more services, the focus will also shift increasingly from the manufacturing sector toward the service sector.



Short-term weakness will be particularly apparent in the European economies ...

In the short term, FDI inflows to the Central and Eastern European economies are likely to be hit the hardest. Companies will feel that the need to expand capacity in manufacturing operations to produce goods for export back to the richer members of the EU is not pressing, given their poor growth outlook.

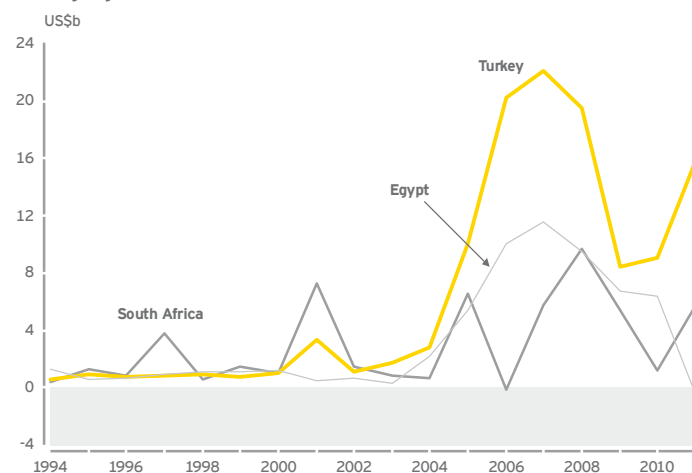
... but FDI into Russia and India could also lose momentum.

Russia and India experienced a rise in FDI inflows in 2011, with growth prospects outweighing the drawbacks of sometimes difficult business environments. However, if growth continues to fall short of expectations, then the interest of the global multi-nationals in these countries will decline. In addition, if these countries are to remain attractive locations for FDI, their governments must not abandon reform efforts or follow a more populist attitude to the business sector.

Political uncertainty to affect FDI into Egypt.

FDI into Egypt plunged from US\$6.4b in 2010 to minus US\$0.5b in 2011, reflecting the fall of the ruling regime and civil unrest. Inflows could easily take years to get back to where they were as companies judge that the uncertainty outweighs the potential benefits.

Figure 29
Emerging "Other": FDI inflows

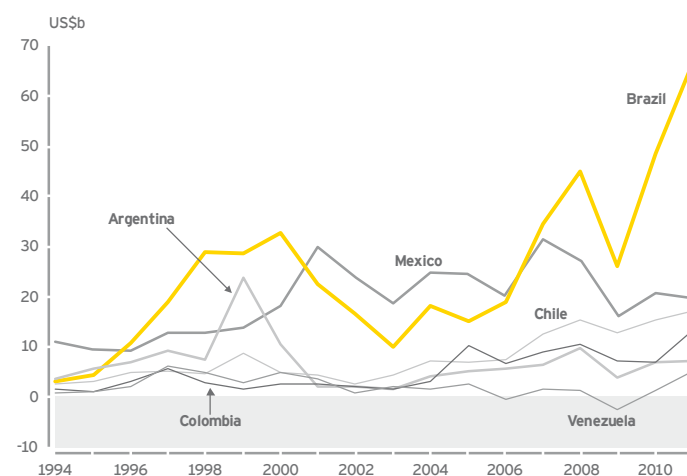


Source: Oxford Economics, Haver Analytics.

Brazil continues to receive the lion's share of FDI into Latin America

Brazil remained by far the largest recipient of FDI in Latin America during 2011. However, there were notable rises in FDI flowing into Venezuela and Colombia. In contrast FDI into Argentina failed to grow. Investments by institutions were probably the key driver behind the noticeable increase in FDI flows to Venezuela last year (up to US\$5b).

Figure 30
Latin America: FDI inflows



Source: Oxford Economics, Haver Analytics.



Box 3

The development of the services sector in rapid-growth markets

Services sectors growing strongly

As the rapid-growth markets develop, demand for services in these countries will increase sharply. Across the world, emerging markets currently account for less than a quarter of the services sector globally. But in 25 years' time, emerging markets will make up more than 40% of the services sector across the world. There are three key segments of the services market: financial, business and insurance; social security; and wholesale.

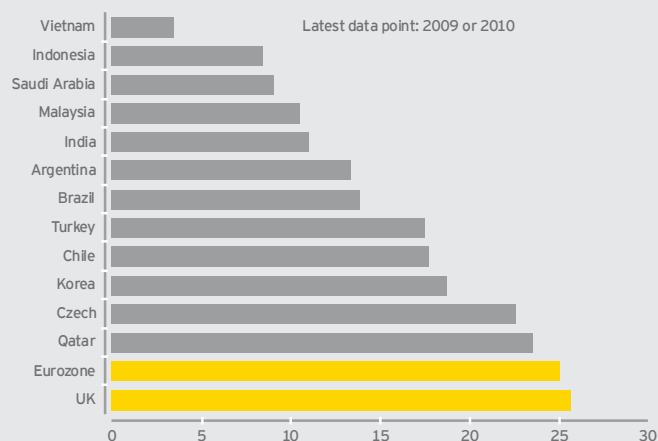
Financial markets drive economic and social development

Financial markets have already grown sharply over the last 20 years in the rapid-growth economies. The market capitalization of the Hong Kong Stock Exchange has risen from just HK\$0.6t in 1990 to more than HK\$20t today.

But Figure 31 illustrates that financial services remain underdeveloped in the rapid-growth markets. And while credit growth has surged in recent years, the breadth of credit available is still much narrower. For example, Korea successfully opened up its bond market following the Asian crisis in the late 1990s and it has increased in size from less than US\$250b in 1997 to over US\$1,000b last year. This has enabled households in Korea to invest more. Over the same period, the personal savings rate in Korea has fallen from an estimated 20%-plus in the 1990s to less than 10% now. To encourage individuals in other rapid-growth countries to save less, authorities must follow the example set by countries such as Korea and increase the range of savings instruments available to households. This should improve the ability of individuals to insure against risk, reducing the need for precautionary saving. The chart below illustrates how, over the last 10 years, the importance of private credit to the economy has grown sharply in many rapid-growth countries, with further growth to come.

Figure 31

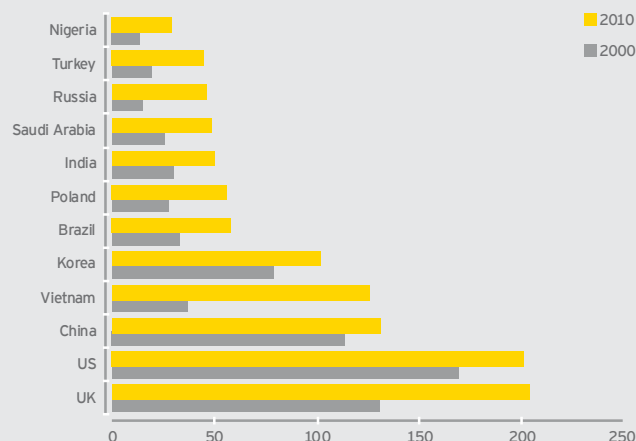
Number of bank branches per 100,000 adults



Source: Oxford Economics, World Bank.

Figure 32

Domestic credit to the private sector as a % of GDP



Source: Oxford Economics, World Bank.



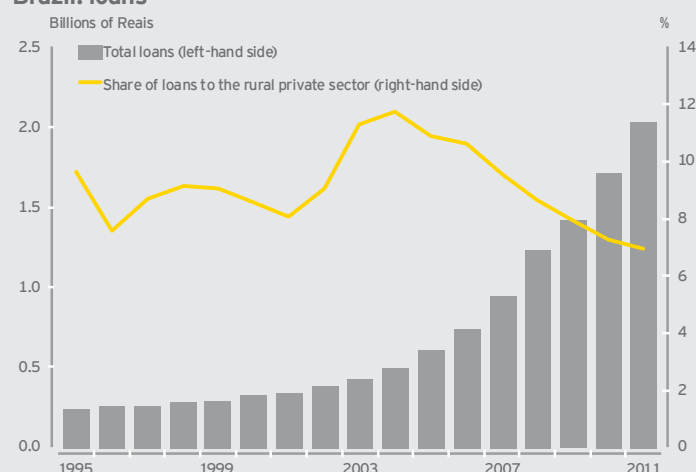
Box 3

The development of the services sector in rapid-growth markets (continued)

But as well as increasing the total availability of credit, accessing it must also be made easier. In Brazil, the financial services sector has surged in recent years, and loans increased from BRL0.3b in 2000 to over BRL2b last year. However, loans to the rural private sector have grown at a much more modest rate, with the share of loans going to this sector falling in recent years.

Figure 33

Brazil: loans



Source: Oxford Economics, Haver Analytics.

Access to financial services is critical to community-driven development projects. Rising inequality has been a feature of the fast growth we have seen over the last decade in many emerging markets. Many low-income families, particularly those in rural areas, do not have sufficient access to financial services to enable them to build enterprises and to meet healthcare and education needs. Supporting privately financed family-owned businesses tends to be a more successful route to sustainable development than one-off grants, so supporting initiatives which enable the poorest communities to generate their own incomes is important.

Microfinance organizations try to lend to households and small enterprises who cannot gain access to conventional credit markets. The market for microfinance has surged in the last decade, with the fastest growth seen in South and East Asia, and the Middle East and North Africa. The market is expected to continue to grow strongly but faces key challenges. Studies by the World Bank show that banks and microfinance reach secondary towns but rarely reach communities more than 30km from the town. In Ghana and Vietnam,

the agricultural sector makes up more than 20% of GDP and, due to the weather, volatility is very high, so more sophisticated ways of mitigating the risks of agricultural lending need to be explored.

The biggest risk that the microfinance market faces is repayment crises and the risk is rising here as market competition increases and borrowers are able to borrow from more than one lender. As the industry grows, regulation must grow with it and lending discipline must tighten. Like the risks surrounding the industry, lending rates, which average in excess of 25%, will remain high. These rates essentially act as a tax on the poorer households in developing countries.

Mobile banking has surged in recent years in many rapidly growing countries, particularly those with limited infrastructure in place. Consultative Group to Assist the Poor (CGAP) and GSM Association (GSMA) estimate that, this year, there will be 1.7b people with a mobile phone but not a bank account across the world, and as many as 364m people without a bank account could be reached by agent-networked banking through mobile phones. In countries such as Kenya, China and Brazil the industry has grown particularly strongly, allowing people in remote and rural areas to store and transfer money through electronic accounts accessed on mobile phones. Some companies are beginning to develop these services, offering interest-bearing savings accounts, microloans and insurance. While this growing market must be monitored very carefully, mobile wallets can bring people without bank accounts into the wider financial world and help drive economic and social development.

Social security needs to develop

Microfinance is not sufficient on its own. The poorest households also need access to savings, insurance and payment services. Although the number of non-life insurance policies in Thailand rose from less than 4m in 1996 to more than 40m last year, it was estimated that less than 1% of households and small businesses had adequate insurance when flooding devastated the manufacturing sector last year. Indeed, industries such as textiles, in which very small businesses play a large part, have yet to fully recover, even though the rains stopped over six months ago.

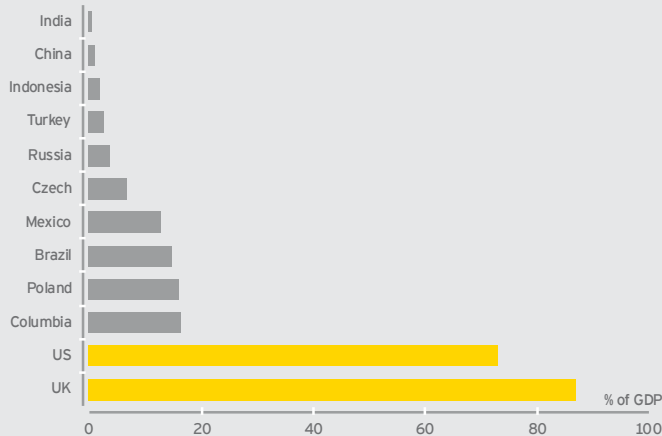
High savings rates in emerging markets are partially driven by the limited provision of social security and the need for households to save for education and healthcare. Exacerbating this issue is the rising dependency ratios. The number of people over 65 as a proportion of the number of people of working age is rising in many rapid-growth markets. In Russia, in ten years' time the dependency ratio will be almost one to four, while in Thailand and China the ratio will be approaching one to five.



New consumer markets transforming the world's economy

Figure 34

Importance of pension funds, 2010

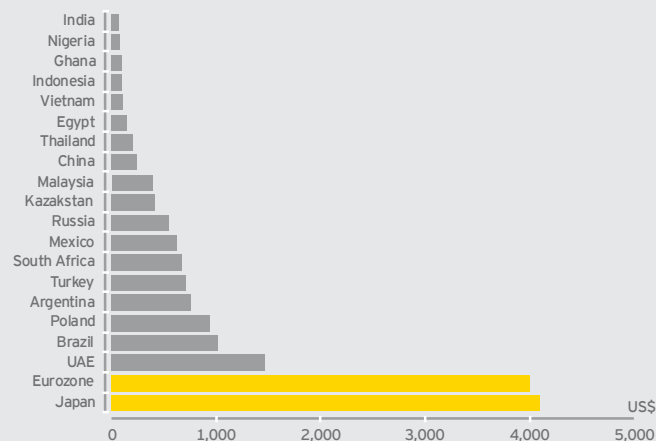


Source: OECD.

The chart above shows the extent of pension provision in the rapid-growth countries compared to the US and the UK. In Turkey, the number of participants in private pension schemes rose from less than 500,000 people in 2004 to more than 2m people today - but this still represents less than 3% of the Turkish population. Public provision of pensions also needs to expand.

Figure 35

Health expenditure per capita, US\$, 2010



Source: World Bank.

There is massive potential for the health care market to increase in the rapid-growth markets. For example, in India the population increased by more than 15% from 1999 to 2008, but the number of registered doctors rose by only 10%.

Wholesale and retail trade potential

With the number of households in the higher income bands rising rapidly and the emerging markets gradually rebalancing toward a greater propensity to spend, the wholesale and retail trade sector has enormous potential in the rapidly growing countries. In Brazil, over the last 10 years almost half of foreign direct investment has gone into the services sector. Wholesale and retail trade is booming, with the Brazilian Association of Shopping Centres estimating that sales across shopping malls in Brazil reached US\$56b in 2011, up 12 per cent from 2010. By 2014, at least another 113 shopping centers are expected to be built across Brazil at the cost of US\$2.83b. While 60% of these are planned for the more industrialized south-east region, 20% will be built in Brazil's more rural northern states.

But some of the rapidly growing markets are more cautious about allowing foreign direct investment into retail. India recently carried out an extensive debate over this issue when the government announced a liberalized regime for foreign investment into multi-brand retail, only to reverse the initiative shortly afterwards. In India, the retail sector accounts for more than 10% of GDP and more than 80% of households will enjoy an income in excess of US\$5,000 by 2020. The World Bank estimates that there are around 12m shops in India employing over 40m people, and that 95% of these are small shops run by self-employed people. The concern is that by opening up the sector to foreign direct investment, many of these outlets and workers would be at risk of being put out of business. But allowing foreign direct investment would mean a greater variety of products would be available at lower prices, helping curb high food inflation in India. And globalizing the sector should bring large supply chain improvements and efficiency savings. In addition, the proposed regime specified that half of the investment into Indian retail must go toward infrastructure development.

In Indonesia, employment in wholesale and retail trade rose from almost 18m in 2002, when the economy opened up to foreign direct investment in multi-brand retail, to more than 23m in 2011. It is estimated that 90% of wholesale and retail business remains with the small traders. Foreign direct investment in wholesale and retail trade almost doubled from US\$0.9b in 2005 to US\$1.5b last year, accounting for nearly a third of total foreign direct investment into Indonesia.

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