

Emerging market demographic drivers

Good morning ladies and gentlemen

I'd like to thank the IFC for inviting me to kick off your conference.

I'd like to discuss the phenomenon of the rise of the EM, and of China in particular. But rather than recite or celebrate the stunning achievements that have happened, I'd like to ask you to consider the difficulties we have today in making linear extrapolations. I am not making a bullish or bearish case for EM, but just saying that the next several years will be very challenging for them, and that there will be winners and losers.

The term EM was coined by a former World bank official, Antoine van Agtmiel in a book he wrote in 2007 called *The EM century*. In the book, he predicted that the GDP share of EM in the world would surpass that of the rich world by 2035. Measured in what economists call PPP US dollars, he was too cautious.

Chart: EM share of global output

Measured in market prices, he was only a little less cautious, for the cross-over moment may arrive sometime around 2020. From a share of 80% in 1980, developed economies have a share now of 60%, and in a decade, the prediction here is that it will have dropped to less than 50%. As you might expect, Asia shows the biggest gain in GDP shares, from 21% to 29%.

Chart: China is most

As this chart shows, most of Asia's gain is accounted for by China, whose share will rise from 12% to 18%, pretty much the same as the US, and 3 x that of Japan. India and Brazil raise their shares a bit, and European countries lose out, inevitably.

Chart EM story is powerful with sting

As a group, EM account for well over 75% of total population, though that observation is as old as Methuselah. But in the last 10-20 years, apart for GDP, they have already grown to account for more than half of global mobile phone subscriptions, FX reserves, steel and copper consumption, car sales and exports. As things stand their public debt and budget deficits, with one or two notable exceptions like India, are a shadow of what they are in the West.

This powerful story, as I have said, has of course been dominated by China, which is the only country to have raised significantly its share of world GDP and other indicators. Most of the world's next billion consumers - a favourite marketing mantra with respect to EM - will live in Asia, and again, with China

prominent. Rising urbanisation will also be a predominantly Asian, and African journey bearing in mind that Latin America is already 80% urbanised. In fact, according to Le Keqiang, a new wave of urbanisation is shortly to be unleashed. Urbanisation is a powerful demographic and social dynamic that drives income growth, but also standards of healthcare and the demand for social and public services. Especially perhaps where children are concerned, bearing in mind that 1 in 3 EM urban dwellers live in slums, or 6 in 10 in Africa.

According to a recent ILO study on the incomes of employed persons in EM, the proportion earning more than \$4 a day was 23% in 2001, 41.6% in 2011, and predicted to rise to almost 52% by 2017. And a rising proportion of these will be earning more than \$13 a day. Much of this middle class expansion is happening in Asia, and to some degree in Latin America. Some consumer think tanks think that Asia's share of global consumer spending will rise from 23% to 42% over the next decade, mirroring the slide in the shares of the US and Europe.

And we should not overlook more modest but important gains in Africa. Life expectancy is up by 10% over the last 10 years, and the number of countries with average incomes over \$1000 is expected to increase over the next decade or two, from less than half of the 55 countries to about three-quarters.

If you could draw straight lines into the future, then countries like India, Nigeria, Kenya and Ghana could quadruple their income per head to about \$4k-8k by 2050. China and Brazil could raise their income per head to about \$40-50k, and Russia, Turkey and Mexico to about \$50-60k. The US would still be top with about \$90k, but the convergence will have gone significantly further than even today.

We can only wonder what this convergent and increasingly China-centric world might look like, and how international relations may evolve as the distribution of global power and patterns of global governance change. Some people argue that Asia and Latin America, increasingly Africa, will develop their own economic and social models, with the state playing a dominant role both at home, and influencing commercial policies. Global governance institutions such as the IMF and the World Bank, for example, will change significantly to reflect perhaps the substitution of a Beijing, for a Washington, consensus. We shall see.

The Asian commentator and academic Kishore Mahbubani has said, with respect to Asian countries that they have 'understood, absorbed and implemented Western best practices from free market economics to modern science and technology, and from meritocracy and the rule of law'. The implication in this kind of thinking is that a torpedoed Western model has met

its match in a different one, shaped by Asia and other EM. China's model - a market economy with socialist characteristics - says it more colourfully. But while I think Mahbubani is mostly right about understanding Western best practices, I am not convinced about absorption in general, and I am highly dubious about the prospects for implementation. And here's why.

Chart: Governance

This chart maps 6 indicators of global governance down the left side, for some key EM, and the US for comparison, according to percentile. So for example, the US (green) lies in the 75th to 100th percentile on all major indicators. The high incidence of orange indicates that most of these EM governance rankings lie in the 50th-75th percentile, and on the World Bank database, you can track how these have changed over time. But the several grey boxes, which signify the 25th-50th percentile, and a few black ones at the bottom percentile also indicate that in some important respects, there are significant governance weaknesses that run through the EM universe.

Chart: EFW

Here's another chart that's a variant. The information is drawn from the EFW index published annually by the Fraser Institute in Canada, and which ranks 144 countries according to the subcomponents of 5 major scores: size of government, sound money policies, openness to trade and capital, the legal system and property rights, and the quality of regulation in the labour, business and credit markets.

The first thing to notice is that the quartile rankings of these 144 countries in 2010 correspond more or less to their status in terms of per capita income, and incidentally to a couple of other indicators I've shown for reference, life expectancy and growth in per capita GDP from 1990 to 2010.

The 2012 survey throws up some interesting observations. The US has dropped to 18th overall. Italy, not shown here, has fallen to 83rd. Chile is top 10. But larger middle income countries such as Malaysia, Turkey, S Africa and Russia are no better than half way in the league, while Brazil, China and India are nearer the bottom than the top. If you look at the rankings for legal institutions and regulation quality, you get some additional flavour of how good or how bad these countries' institutions are relative to one another.

These two charts illustrate what's wrong with all the blue-sky thinking about the ascendancy of EM and the decline of the West. The problem is that it gets progressively more difficult to raise income per head once you are a middle income country, and that doing so is not about drawing lines from spreadsheets, but about the economic benefits generated by continuously

evolving, inclusive institutions. The economic framework for thinking about this is the so-called middle income trap - a point in economic development where countries are prone to get stuck, at least as measured by income per head. And most do.

According to the World Bank, only 13 of the 101 countries deemed middle income in 1960, succeeded in breaking out of the middle income trap by 2012. These included S Korea, Taiwan, Singapore and HK, of course. In the WB's world of 214 countries, territories and island states, only 35 are classified as high income, and this sort of skewed distribution probably hasn't changed much since 1900.

Basically, the reason EM face big challenges today is because of unrepeatable achievements in their development so far, and unusual global circumstances from the 1990s to 2008. There are a lot of positive things you can do in economic development but only once - for example, building basic infrastructure, joining the WTO, enrolling most kids in primary and secondary schools, or transferring rural workers into higher productivity urban manufacturing. Benign global circumstances, such as those that prevailed from the 1990s thru 2008, were also a tide that lifted all boats. For the time being, I would argue that EM will face a tougher environment externally, and a more challenging one at home, in which the **implementation** of political and economic structural reforms and the building of more robust institutions will define success.

Time constrains the amount of detail I can go into, but here's what I think about the BRICs and Africa and the Middle east, for example.

Chart: Major EM challenges

In China, 20 years of unprecedented change and economic growth have generated large imbalances, which are bringing the country to a sort of tipping point. The biggest imbalance, to which many of the others are related, is the rise in the investment share of GDP to about 50%. The consumption share, by contrast, is a lowly 35-40%. Rebalancing the Chinese economy to avoid an investment bust and lay a path thru the middle income trap is now considered de rigueur, and in doing this, China will have to also rebalance the role of the state and state institutions vis a vis the private sector, strengthen the service sector at the expense of manufacturing, liberalise financial and capital markets, free up the prices of land, capital and energy, and reverse rising income inequality. In short, nothing less than a change in China's economic model, and as you can imagine, this is not so much an economic agenda, as a political one, which may not be compatible with the primacy of the Communist Party. What may happen if the Party's renowned pragmatism lead it to opening up the floodgates of reform even against strong resistance,

as Gorbachev did in the USSR in 1985? And what might happen if they deemed this a bridge too far in the face of rising popular pressure for change? Either way, China's economy looks likely to slow down more than it has already, not least because of the rising clamour over the environment and for higher income, social security and health protection. And the principal losers of a China growing at 5% rather than 8-10% would almost certainly be those that have relied on China's insatiable commodity demand to drive investment, and those that have become embedded in China's long supply chains.

Russia has a pretty good macroeconomic scorecard today. It's an upper middle income country with decent growth, a balanced budget, low debt and a high external surplus. It should do fine for the next couple of years. But it's also an energy and resources giant with a declining and ageing population, and little else of economic significance. Manufacturing is a mere 16% of GDP. Apart from energy dependence, Russia's key weaknesses are its institutional and structural reform deficits, and if Russia is to break out of the trap, the shortcomings in its legal and regulatory framework, corruption and bureaucracy, lack of political competition, and state influence over commerce and enterprise will have to be addressed.

Brazil had just completed its fastest growth decade since the 1960s, but now seems stuck again at around 2-2.5%. The tendency to go through periods of acceleration and deceleration has been evident for the last 40 years. It is of course true that in about a decade Brazil could be an oil superpower, but this might not do anything to help some of Brazil's crucial weaknesses. These include, like Russia, a lacklustre manufacturing sector, and also exceptionally low national savings, a high dependence on credit and growth in bank assets, and weaknesses in infrastructure and in decision-making. Moreover, rapid ageing and still high levels of income inequality are driving a steady increase in the demand for wider welfare and pension arrangements.

India, not long ago, was thought likely to take over China's 10% growth reins, but this prospect has quickly evaporated. Of all the major EM that have high growth, India seems most likely to lapse, even though many of us could come up with a 100 reasons why, sooner or later, India's advantages and potential will win out. The problem in India today is a set of 4 failures, which all drag growth down, and at the heart of which lies what one Indian author has called 'the degradation of our state institutions'.

First, a failure to export the right things, ie prescription drugs, software and machine tools, rather than employment-intensive light manufacturing goods, in which Bangladesh and Vietnam are actually doing better. Second, a failure to control the twin deficits, external and fiscal. Third, a failure to mobilise construction and infrastructure, for example to improve the country's energy,

transportation, and public health and education systems. And fourth, a failure to spur private commerce and foreign direct investment. These failures are not dyed in the wool, but while they fester, India will find the going tough.

And last but not least, SSA and the ME, which have had their fastest growth between 2001-10 since the post colonial 1960s, and which have an array of positives in the form of demographics and internal financial balance. But again I would warn against extrapolation.

SSA export revenues as a share of GDP have jumped from 20 to about 35%, which have driven savings, investment and growth. But virtually all of this gain is due to higher commodity prices, and I'm afraid there is no evidence that commodity price-based economic growth leads to sustainable economic development, or does anything to address the manufacturing, trade or governance weaknesses that I highlighted in the BRICs. Manufacturing is the principal driver of employment and demands modern infrastructure, and in mfg, SSA and the ME lag far behind the countries of Asia and Eastern Europe. Even as China moves up the value chain, traditional mfg is migrating to Cambodia, Vietnam and Bangladesh, not SSA or the ME. As and when commodity prices decline again, especially in real terms, countries that service but are not part of integrated mfg supply chains are going to experience stress. And it's hard to believe this commodity roller coaster will ever change economic prospects for very long, unless or until politicians grasp the nettle of reform, economic diversification, and raising agricultural mechanisation and productivity.

I've talked a little, here and there about demographics - so before I wrap up, I'd like to throw out a few ideas that have a bearing on how to think about EM

As healthcare sector professionals, you won't need any explanations about fertility and longevity trends, or about the principal economic implication, rising old age dependency ratios, which have important effects on economic growth via lower labour force participation rates, lower savings and demands for higher age-related spending. For most EM, but not for China, this point won't arrive for another 25 years, or even longer in the case of South Asia, Sub Sahara Africa and the Middle East, but it's happening with an unprecedented speed.

I'll just show you this chart:

Chart: Working age population:

You can see the changes are dominated by the increases expected in Asia and Sub Sahara Africa

This chart:

Chart: Annual changes in working age population

The annual changes for a group of EM, should draw your eyes to pretty continuous declines in Russia and China. In about 20-25 years, Turkey, Mexico and Brazil will be at that point too.

And this chart:

Chart: Old age dependency,

This shows the cohort of over 64s as a share of the working age population.

On the left side, you can see some bigger EM, paced by S Korea, Russia and increasingly China - and on the right, some of the next tier with Malaysia and South Africa the tortoises among this group.

Chart: China has banked its dividend, can the rest?

But even for the tortoises, harvesting the so-called demographic dividend will not come easily. It has to be exploited by what you might call the 4 Is:

- institutions: better governance, property rights, rule of law, and tackling corruption
- investment climate: macro performance, mfg (N), trade, social and ed policies
- infrastructure
- innovations....especially in agriculture to raise rural productivity, and local technological performance

These 4 i's form a relevant backdrop when we consider the contrasting positions of China and India, one having banked its demographic dividend, the other wondering if it can.

China now faces a triple-whammy in its demographics. By 2050, the number of children and young adults, aged 0-24, is predicted to fall by 133m, the working age population will drop by about 100 million, or from 72% of the population to 61%, and the over 60s will rise by 234 million, or from 12% to 31% of the population. The old age dependency ratio of about 11% today, is expected to rise to 24% by 2030, by which point there will be more over 60s than under 15s, and to 40% by 2050. In other words, the 10 workers that support each older citizen today will have dwindled to 2.5.

These trends are glacial, but nonetheless relentless and cumulative. They are starting to manifest themselves in higher wage growth and in the inadequacy of Chinese public social spending, which is just 7% of GDP, compared with 16-17%, for example, in Brazil and Russia. China is focused on a number of measures to broaden social security and healthcare coverage, but even so, pension payments and coverage, especially for rural workers are weak, and health insurance, which is only partially transferrable between jobs and work locations, is in any case, expensive. More than half of China's over 60s have

to pay their own medical bills, and most of the rest tends to be family-financed.

In addition, China's demographic transition is being complicated by the effects of the 'hukou' system of household residence permits, which divides urban dwellers into officially registered residents, and second class rural migrants, numbering some 200 million, who do not qualify for access to income support, subsidised housing, healthcare or public education. The rising tide of social unrest in China is increasingly being fueled by disadvantaged rural migrants.

By contrast, India, whose population will overtake China by 2025 still has a fertility rate of 2.73, and in the next 15 years, its working age population will grow by more than the entire working age population of Western Europe. Its population of over 60s will double to 15% of the population by 2040, but this is still only where China is today and where the rich world was in 1970.

There's no question about the optimism deriving from India's demographics coupled with its prowess in churning out scientists, engineers and IT and healthcare professionals. India, as you know, produces 60% of the world's vaccines and on course to make about \$4.5 bn from them by 2017. But this could nevertheless turn into a disaster if existing widespread poverty and underemployment are allowed to fester. The main reason is that India lacks employment-intensive manufacturing, its labour laws are complex and burdensome, and the state has failed to supply public goods, including ed and infrastructure, and remove unnecessary regulations and subsidies that suppress employment.

India's rural sector is still home to 70% of the population and provides over 55% of jobs. There is a much weaker tendency for people to leave for an urban life, not least because job opportunities are not that great. Poverty and relatively low educational attainment mean that far too many people are ill equipped for productivity-enhancing work. The recorded unemployment rate of 7% for example, masks a 27% incidence of poverty in persons employed in any capacity, not just full time workers.

Finally, remember that ageing in EM is occurring very quickly. It took France a century for the share of the over 60s to double to about 15% of the population, and in most developed countries it took between 40-80 years. In most EDCs, the process will take about 20 years. In other words, they have far less time to build the financial infrastructure and social security systems needed to deal with the consequences of ageing and rising old age dependency. With a median age of about 29 years and an average 2010 per capita income of about \$4000, they are actually in worse shape than the US which had a comparable median age at the conclusion of the Second World

War, but a per capita income of roughly \$10,000. By the 1970's, when the median age in the US and Europe was a little less than it is in China today, per capita income had risen to around \$12,000-14,000. The low starting point of per capita income and the speed of ageing in EDCs underscore the now common mantra that they will grow old before they get rich. Well designed social safety nets are more urgent for EDC nowadays than they were for advanced economies that have aged more gradually.

Health is capital, which delivers returns via a more productive labour force, and the diffusion of medical science technology into the rest of the economy. But, as you know, here are still very wide gaps between low, middle and high income countries, even allowing for the significant gains made in recent years by countries towards meeting the health-related Millennium Development Goals.

The issue, I think, is while better medical care and support systems are important goals in their own right, so are the economic, social and political circumstances in which people are born and live. Successful health outcomes, in other words, require other successful outcomes, for example from the registration and health-surveillance of hundreds of millions of people, who may not be able to prove their identity, to the provision of better sanitation and clean water, stronger education and employment policies, and lower income and gender inequalities. And above all, as I've tried to suggest here, a willingness on the part of governments to pursue economic and political reforms.