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Have emerging markets already emerged?

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ABSTRACT

This Viewpoint article, based on a lecture to the 2012 Oxford Farming Conference, examines the rise in economic power of the so-called 'emerging markets' (EM) and its implications for agricultural markets in the so-called 'developed world'. In particular, the favourable demographic trends in EM are highlighted and contrasted to those in Western countries, creating a potential powerhouse of productive power. While it is easy to see the current impact on global markets, it is less easy to predict future effects of rapid growth either in the emerging markets themselves or on the economies of the rest of the world.

KEYWORDS: Emerging markets; financial crisis; economic outlook; demographic change; China; India; Brazil.

I'd like to begin by thanking the Oxford Farming Conference for inviting me here to give the Frank Parkinson Lecture². But I do so with some anxiety. My experience of farming amounts to having a bolt-hole in rural Wiltshire and downing decent ale with some neighbourly farmers. With those credentials, I have hopefully deflated any expectations about my ability to enlighten this audience about the specific risks and opportunities presented by the rise of emerging markets (EM).

But the question posed for this session - whether EM have already emerged - is one where I can hopefully illuminate some key issues with important implications for global agriculture. EM will spawn the world's next billion consumers, continuing to underpin global demand for food and energy. But they will also be the focus for supply, because of the constraints that arise both from economic development and rapid urbanisation, and from climate change and new weather patterns, to which EM are especially vulnerable.

Some economists argue that the larger EM, such as China and Brazil, have already emerged, and visitor impressions of Shanghai, Mumbai or Dubai may be quite persuasive. At the very least, if 'emerged' simply means that EM have 'arrived on the global scene with the capacity to alter and influence life beyond their immediate borders', then some probably have already emerged. But this is a rather limited, and misleading, way to consider EM. The term 'emerging', itself, implies a process, and from this standpoint, there's a very long way to go, and it may be punctuated by as much by successes as by slip-ups, or worse.

To help illuminate the opportunities and pitfalls in this process, we could choose from a seemingly endless list of topics, but space restricts me to a choice of three. I will look at the phenomenon of the rise of the EM; then I will outline the favourable demographics and population characteristics of EM - in stark contrast to our own; and finally, I will argue that although EM are every bit

as significant as we think they are, we cannot draw straight lines into the future.

First though, a little perspective to put things into context. There is no question that we are living through an extraordinary epoch-changing phenomenon, in which EM are not just catching up with the West, but challenging its dominance for the first time in over 200 years.

Once upon a time, China really did rule the world. And India was no bystander. A kind of global system, with China at its hub, mapped the world from before the birth of Christ and until roughly the 17th century, when China's relative position, compared with Europe, started to weaken. How the world might have evolved, had China allowed its mariners and navigators, with superior ships, free rein to discover the Americas, we'll never know. But Europeans did, and in so doing, they helped to turn the world's centre of gravity to the West. There were many other factors that determined the rise of the West, and the steady and then precipitous decline in China - but from about 1800 onwards, human development in the West advanced faster than ever before, despite revolutions and wars. By the end of World War 2 and until the 1970s, China, the USSR, India and the bulk of what we now call EM were of no consequence economically, except to the extent that they were outlets for Western exports and or key producers of oil or other key commodities.

Although the so called Asian Tigers - South Korea, Taiwan, Singapore and Hong Kong - arrived on the scene in the 1970s, two significant developments really explain the rise of EM.

In 1978, under its leader Deng Xiaoping, China began a period of intense reform that set it on a path that has made the country what it is today. Deng had famously said in a party conference discussion on the economy that 'I don't care if it's a black cat or a white cat, so long as it's a cat that catches mice'. What he meant, of course, was that capitalism could work in China too, albeit under the strict and exclusive direction of the

¹ UBS Investment Bank

² This paper was originally presented at the 2012 Oxford Farming Conference, and is reproduced here by kind permission of the Conference Secretariat.

Chinese Communist Party. And so it is today for the most part.

About 10 years later, in 1989, of course, the USSR collapsed, and the Berlin Wall was dismantled, opening the way to the most intense period of globalisation that we have seen since the end of the 19th century. A billion workers joined the global labour force as developed markets and EM became ever more closely intertwined in trade, international investment, and global finance.

China has become the hub of long and complex global manufacturing supply chains, initially based on toys and textiles, but now including higher value goods, technology, and alternative and clean energy products. Russia has emerged from its communist past as a major oil and raw materials producer. Brazil went through a huge reform programme in the 1990s that brought first economic stability and then added energy exploration, and aircraft and high end manufacturing to its natural resource bow. And India also introduced extensive economic reforms at the time, allowing its services and limited manufacturing sectors to emerge from the shadows, especially in information communications and technology, steel and automobile engineering. Different routes and different strengths, but all with the same objectives: to develop, to become richer, and to stake a claim to power.

Much of this was well understood before the financial crisis struck in 2008, ending a 25 year long period of unfettered financial globalisation and credit expansion. We tend to call it the Global Financial Crisis, but in China, they call it the Western financial crisis - which indeed it was, and is. The consequences of this crisis are fattening the wedge between EM and developed markets, and accelerating divergent trends in economic development.

EM now account for about 40% of world GDP, and perhaps four fifths of global GDP growth. China's GDP will surpass America's in the next decade, while India, and Brazil will be bigger than any European country by the 2030s. Global trade is being boosted by rising transactions between EM themselves, an interesting anecdote being the Singapore Port Authority's current programme to double capacity in what is already the world's largest trans-shipment port. Over 20% of the Fortune 500 global companies are now headquartered in EM, many of them in China, Korea and Brazil. Of the \$10 trillion³ of global foreign exchange reserves, EM account for about 77%, with China's alone standing at over \$3 trillion, and a further \$2.5 trillion owned by Russia, Saudi Arabia, Taiwan, Korea, Brazil and India. Increasing economic weight has inevitably lead to greater EM representation and influence in international bodies, such as the G20, the International Monetary Fund, World Bank and World Trade Organisation. And it has spawned new rivalries both with the West and among EM themselves over secure access to raw materials, export markets, shipping routes, food and in some cases, water.

The power that is accruing to EM is of course the same power that is draining away from the US and Europe. And there's no doubt that the financial crisis has weakened us severely and is obliging us to reduce

bloated levels of public and private debt, prepare for the financial consequences of rapid population ageing, and explore new growth drivers and technologies. The current sovereign debt crisis in Europe which threatens the very existence of the Eurosystem, is bound to keep Europeans engaged for a considerable period of time.

But it is the threat to America's capacity to set and implement agendas in everything from global monetary governance to international security, from the rules of trade and commerce to climate change, and from global food security to the application of science and productivity in agriculture that is the most worrying. The failure of the Doha Round of trade negotiations, for example, after 10 years of trying to reach a deal, of course reflects conflicts of interest, in which China, Brazil and India have understandably become more vocal and demanding, but I think you still need a leader, someone trusted and willing to broker compromises and solutions, to make global negotiations work.

It just seems unrealistic to expect Americans or Europeans to waver from their preoccupations with home-grown political and economic issues. Mind you, you could say the same about EM too.

I don't want to dwell here on the short term outlook, which actually doesn't bode that well for EM. But many EM are still experiencing relatively high rates of inflation, partly commodity price-related, to which they have responded by tightening interest rate and credit policies. Growth in Brazil has stalled, proved disappointing in India, and seems to be slowing significantly in China, where there are growing signs of disquiet in the export industries, and in the real estate sector, which accounts for about 10% GDP and which is arguably the most important sector on the planet because of its copious consumption of iron ore, steel, cement, copper, lumber, energy and an array of other construction materials. If China experiences a property and credit bust in 2012 or perhaps a bit later, there would be dramatic consequences for global industrial commodity prices and for the principal producers.

These issues will continue to command a lot of attention in China and in EM during the next 1-2 years. But my second topic is about the longer-term, in which the single biggest economic advantage - or Malthusian problem, depending on your point of view - that many EM have is their populations and demographics. In the next 40 years, world population will increase by 2.4bn to 9.3bn, of which all but 100m will be born in EM and less developed countries. Population size in China, Russia and Eastern Europe will decline, but there will be an additional 1bn in both the rest of Asia (half of which will be in India and Indonesia alone) and Sub Sahara Africa. A lot more mouths to feed, you may say, quite correctly. But the age structure of EM is the really important issue here, and this has the potential to be a magic bullet.

Most EM are in a phase which demographers call the demographic dividend. This is when fertility rates decline and the working age population expands from previous higher fertility, rising faster than the population of older citizens. In other words as the productive 15-64 year olds increase, the dependency of children and older citizens on them declines. This phase is generally associated with rising levels of incomes and savings, jobs and output, and prosperity generally - as Western

³ In early June 2012, \$US1 was approximately equivalent to £0.64 and €0.80.

countries themselves experienced with the baby boomers in the 1980s and 1990s.

Now there are some exceptions to this in EM, China and Russia among them. China in fact is the fastest ageing country on Earth, today with 10 workers per citizen aged over 60, but by 2050 there will only be 2.5 per citizen. And China will be considerably older than the US by that time. Weak fertility is an almost universal phenomenon that is about economics, child-care, contraception and literacy, and is therefore not unique to China.

But the critical issue for China is really the speed of ageing, set against low income levels and weaknesses in social insurance and pension systems. And it's this that has given rise to the now common mantra of 'getting old before getting rich'. In fact, the speed of ageing in China is such that it will take 20 years for the share of the over 60s to reach levels that took between 70-100 years in the UK, France and other Western nations. And again China isn't unique. Except for the very poorest nations, the same rapid speed of ageing is occurring throughout the emerging world though the full impact won't start to be felt until roughly the 2030s and later.

If China is a demographic hare, the most significant tortoise is surely India. Here a third of the population is aged less than 14, and the working age population is going to grow by more in the next 20 years than the entire working age population of Europe today. This really is a sweet spot to be in. More labour means more incomes, consumption, and tax revenues, higher standards of living, and presumably better human capital as education systems and attainment levels improve.

But to succeed in harvesting your demographic dividend, you have to educate people, give them work, and equip them with capital. Take India again. For all its output of scientists, doctors and IT specialists, India's illiteracy rate is 40%. School enrolment and drop-out rates are low and high, respectively. The official unemployment rate is 7% but there's a 25% incidence of poverty among anyone that has any type of work, suggesting that the real unemployment rate is much more Asian, that is, around 25-30%. So, India and its peers can only look forward to rising wealth, prosperity and productivity if they are able to put their growing numbers of young people to work, allowing them to aspire to economic and political opportunities. Without this - well you only need to think about the blanket coverage of the Arab Spring, to see, in extremis, the consequences.

But given adequate job creation, we can say that from the standpoint of EM demographics, emerging countries still have a lot of emerging still to do, with profound implications, including for their agriculture. As incomes per head rise, of course, so will per capita demand for food, animal protein consumption, agricultural commodities, and of course, energy.

But this is bringing problems too. According to the World Bank, only about 11% of the world's land surface is used for crop production at a time when arable land acreage is under pressure from soil erosion, flooding or desertification and urbanisation. China's urbanisation rate of 47% is expected to reach 70% by 2050, India's 55%, and Brazil's 90%. Water scarcity is becoming a significant issue, partly because of intensive absorption by agriculture and partly because of climate change

effects. Small wonder that the expected 70% increase in food demand by 2050, or over 100% in EM and less developed nations, is making food security and access a leading global issue. Unresolved, this could even brake the emergence of EM.

My final point is about drawing straight lines into future - which is something we all do, and my profession in particular. But there's something really important that you can't plug into an economic model or forecast, or classify under breaking news - and that is the quality of institutions. What I mean by this is the economic and commercial, social and political, and importantly legal, institutions that embody the successful pursuit of initiative, ingenuity, enterprise and creativity.

Institutions matter to human development, for the same reasons they do to a small business or farmer. First, they matter because there's only so much you can do with physical labour and capital. Ultimately, you get more bang for your buck if you combine and organise them efficiently, and improve the quality of both. In my nerdy world, this bang for the buck is called total factor productivity - it is the part of economic growth that can't be accounted for by physical inputs. This is about things such as education and training, organisational methods, incentives, the rule of law and independent enforcement of contracts, the regulatory environment, levels of corruption and so on.

Second, they matter because the need for countries to adapt and refresh their institutions is directly related to the level of development and economic complexity.

Perhaps you can see where this is going. Countries such as Brazil, Argentina, Venezuela, Chile, Poland and Turkey are middle income. But Argentina, Venezuela and to a degree, Brazil have been middle income for a very long time, and haven't been able to jump out of what we call a middle income trap. Brazil may have a fresh chance now, along with others that are trying for the first time. We shall see. The former USSR got to this stage too in 1982 before stumbling - and that was three years before Gorbachev came to power. Russia today has an income per head roughly the same as the USSR's peak - and so here too institutional change will be key, as you may have gathered from the recent public protests over rigged elections. Good institutions, commanding the faith and respect of citizens, matter.

India has phenomenal potential. But if it can be a nuclear power, why can't it improve the lot of its hundreds of millions of rural inhabitants and address urban poverty? If it can become a world leader grains, ICT, and medical services, why can't the whole economy be lifted more rapidly? Again, I refer you to the weighty institutional obstacles that retard or hinder development, including corruption, and note in passing that the Indian upper house recently failed to agree important anti-corruption legislation, which the lower house had already passed.

And finally, of course, China, which has trebled its income per head over the last 25 years to about \$4,500, and is on course to treble it again by 2020. We know China will soon have the largest GDP in the world, but it will take many decades, if ever, to close the gap on the West in terms of per capita income.

I don't think this is going to happen without extensive political changes - and it's a moot point whether the Chinese Communist Party is willing to cede power to the

point where it undermines its own *raison d'être*. Rapid economic development is already generating strains in China which are raising the demand for change and flexibility.

Incidents of social unrest, for example, numbering about 120,000 in the last year, are no longer confined to disco brawls and small local disturbances, but characterised by large protests over job losses, and wages and conditions, and well-supported campaigns against political corruption, the suppression of political rights, land expropriation and environmental degradation.

The major economic issue for the next several years is rebalancing China's chronically unbalanced economy away from an excessive reliance on savings and investment, and especially in property. A more consumer and private sector-oriented economy is going to be key to China's future success but rebalancing requires contentious economic, financial, legal and social reforms, which will draw political power away from vested interests that have been major financial beneficiaries in the last 20 years, and redistribute it to those that have been left behind. In other words, a power shift from state owned companies and banks, local and provincial governments, and coastal regions - sure to be resisted - to private enterprise, consumers, rural migrants and the countryside, and the 6-7 million new college graduates each year, whose aspirations to good jobs and houses are already under some pressure.

Summing up, we can look in the rear-view mirror and out of the side windows and appreciate how far and impressively EM have emerged to date. The effects of the rise of EM are clear for all to see locally, in world markets, and through their interactions with us.

Out of the front window though, things are more blurred than they sometimes appear. On the one hand, modernity, rising incomes, and rapid population growth create major opportunities for EM, and for global

companies: Nestle and Danone, for example, get 40-50% of their sales from EM already. On the other hand, successful human development needs change that is often disruptive to economies and societies.

Think of your own sector. Strong demand and structural and water supply problems in agriculture are already compromising the ability of EM to follow stable fiscal and monetary policies because of the food price inflation risks, for which these policies are poorly designed anyway. Over time, EM will need to ensure that the declining agricultural weight in GDP is also a much more productive weight with new initiatives to improve yields, and resource and water allocation efficiencies. Otherwise, agriculture, itself, could brake economic development, and along with other pitfalls, keep many EM firmly behind what we could call a BRIC Wall.

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