Tomorrow's World

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What does the world look like today? Since August, it has become clear that the problems in the West are deep and long term in nature, and the challenges are serious: demographic disadvantage, a fiscal crisis and a clear lack of leadership.

The award-winning book "This time is different: Eight centuries of financial folly," by Carmen Reinhart and Kenneth Rogoff, makes the point that crises are almost never different. When sovereign debt gets over 90% of GDP, growth is at best sluggish and the economy is increasingly prone to crashes. If you add to this the current household and corporate debt, then the total debt levels in the West are over 200% of GDP, making the outlook less encouraging.

The only way out of this mess is through default, inflation or a Japanese-style de-leveraging, none of which is appealing and all of which will make the political problems faced by governments around the world worse.

Japan's lost decade has become the yardstick for the West's prospects and it is sobering to realize that over the last decade, Japan's annual per-capita GDP growth of 0.9% has actually outpaced that of the US, Canada, France, the UK and the Eurozone. Of the major Western economies, only Germany has fared better than Japan since 2000.

To make matters worse, this sort of environment generally produces weak political leaders. US presidents like Gerald Ford and Jimmy Carter in the 1970s were weak, while Germany, France and Britain also produced a series of barely memorable names. Politicians only thrive when they have money to spend and today the coffers are empty. The upshot is political paralysis in the US and the Eurozone.

However, this time does appear a little different to past crises, but only in that it looks worse than nearly any previous downturn since the Great Depression. The demographic decline in the West is a new phenomenon. So too is the increased extent of government involvement in the major western economies, as measured by government expenditure to GDP, welfare dependency and the extent of government regulation. For those, including myself, who regard these factors as a drain on economic growth and dynamism, these problems outweigh the unsustainable levels of sovereign debt.

Still, there are a few bright spots. At least the US has a proactive central bank that has slashed interest rates to nothing, and although the economy is constrained by the national debt, investors can see some potential for growth helped by migration and a young population.

Europe is in a much tougher position. After Germany successfully restructured its labour market over the last 10 years, it has probably the best model in the Eurozone and would like to see Spain, Greece, Italy and Portugal take some pages out of its game book – but so far only Ireland has made the effort. Leaders in the other members of the Eurozone fear years of economic depression if they impose further austerity and the alternative of leaving the Eurozone altogether looks increasingly appealing to them. Default and devaluation can provide a way out of the dead end that most Western countries find themselves in, but as Russia, Indonesia and Argentina found out at the turn of the century, the process can be deeply destabilising.

The intense media coverage of the problems in developed economies (better called "stagnant economies" now) continues to mask the potential of the rest of the world. The irony is that 90% of the media's 24/7 coverage is concerned with the West, whereas 90% of the opportunity is in emerging markets.

Behind the bad news coming out of Europe and the US, there is a more significant story that is being ignored. This crisis has accelerated a change that was already well advanced: emerging markets have become leaders in the new economic world order and their importance will only grow, as they can also play the role of saviours either by helping to bail out the indebted countries of the West or providing dynamic markets for their companies to expand into.

The latest International Monetary Fund's economic outlook predicts the global economy will grow at 4.0% a year in both 2011 and 2012, but the advanced economies will expand by only 1.6-1.9%, while emerging and developing economies will grow by 6.1-6.4%.

Why is the difference so great? The short answer is that crises in the emerging world look worse, but do less lasting damage. Typically, most of the emerging markets had better fiscal and financial positions going into the meltdown in 2008. Since then, high underlying growth and sound macroeconomic policies are making fiscal adjustment to the new realities much easier.

Exports have largely recovered, and whatever shortfall in external demand they experienced has largely been made up by increases in domestic demand. Capital outflows have turned to inflows, due to both better growth prospects and higher interest rates than in the advanced economies. More fundamentally, the emerging markets continue to put in profoundly superior productivity growth and, in most cases, benefit from vastly superior demographics.

The shift from east to west has been widely anticipated, but it's clear from looking at nearly any indicator you care to mention that it's moving a lot faster than anyone had predicted. China's GDP has grown from 12% of the US' in 2000 to 47% now, and will overtake the US completely by 2016, according to the IMF. At the same time, advanced economies' share of global GDP has fallen from 74% five years ago to 64% now, and it will fall to 59% in another five years.

The same thing is happening in trade, equity issuances, the bond market and other sectors as international capital flows into the growth markets; global investors are seeking exposure to growth, not to stagnation.

This is not to say that emerging markets are immune to the problems in the West. Fears of a global recession, which clearly would affect emerging markets, led to downgrades in July, but their relative growth performance has actually improved. As an ever increasing number of developed markets are likely to repeat Portugal and Italy's 1% growth over the last decade, investors will turn to the emerging markets, which are expected to grow three- to five-times faster (and in Africa's case 10-times faster) over the next decade. And this growth will come without any significant increase in leverage.

With the boot now firmly on the other foot, Europe and the US will have to cede some voting control over the IMF if they want to tap the huge currency reserves now held in countries like China and Russia, and it will not be long before emerging market countries not only provide the funds, but also lead these international financial institutions.

In conclusion, after 20 years of participating in this extraordinary change, I am still astounded at how many commentators analyse long-term opportunities through the prism of short-term events and circumstances. The changes that have occurred over the last two decades have been monumental. Russia's GDP has expanded tenfold from $200bn to $2 trillion since 1999. Chinese neighbours like Kazakhstan and Mongolia have experienced similar rises. In the coming years, the transformation in the dynamic large population centres like Poland and Turkey will be as dramatic. And the greatest opportunity of all is in Africa itself, which already rivals India by population and GDP. By 2050, some estimates suggest Nigeria alone will have the third-largest population in the world. All of these countries remain resource-rich, low-debt economies, whether we count sovereign, household or corporate debt, and irrespective of how the crisis in the West plays out, they are already moving to cooperate more closely in terms of trade, investment and politics.

But this transformation will not be smooth. The imbalances caused by the problems of the "stagnant economies" will distort the capital flows and lead to new problems. There will be asset bubbles and fresh dislocations that may be even bigger than the current crisis. The corollary to accelerating the rebalancing of the global economy is more frequent, and probably larger, shocks.

The outlook for the global economy has rarely been more uncertain, but this crisis is different in one dramatic way to previous boom-busts; the outcome should result in a radically different global economic order. The short-term reporting on the ins and outs of government attempts to contain the trouble glosses over the long-term redistribution of economic activity; the West is facing at least five years of pain, but many of the fast moving economies have already recovered to their pre-crisis levels of growth or, in some cases, grew right through the rest of the world's turmoil. While every country in the world has been impacted, thanks to the success of globalization, the crisis is also catalyzing the shift of capital from west to east that was already well underway before 2008. The emerging markets – long associated with relatively high risk – will become an investment destination most identified with stability. ■

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