TD Bank Financial Group

Observation

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HIGHLIGHTS

- The 'myopia of the mature economies' has set in – surely the global economy must see slower growth since the epicenter of the global economy as it is currently constituted will slow as mature, advanced markets age?
- But this change will coincide with the ongoing coming of age in emerging markets.
- Two decades ago, emerging markets accounted for only one-third of the global economy.
- Because of their rapid rate of economic growth and an interdependent virtuous cycle, emerging markets are likely to constitute two-thirds of the global economy within two decades.
- This is likely to cause the global economy to actually speed up during this time, not slow down.
- But transitions of this ilk are rarely seamless, so be prepared for EMs to increasingly test their economic muscle, for EM policymakers to test the boundaries of orthodox economic management, and for more mistakes like the Dubai debt standstill to happen along the way.

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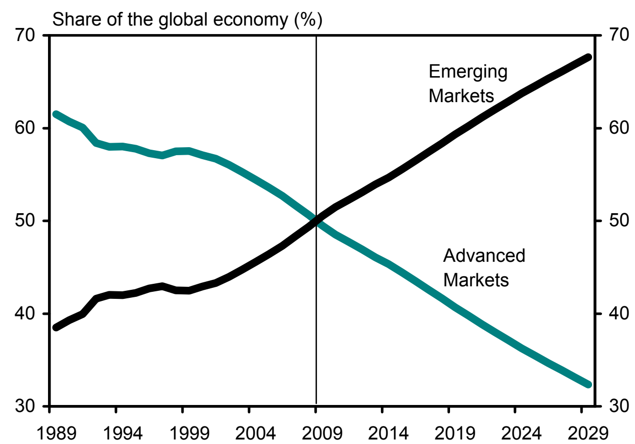
THE GLOBAL ECONOMY OF TOMORROW: BETTER, STRONGER, FASTER

As we emerge from the doldrums of recession, it is easy to remain fixated on all the near-term challenges facing the global economy such as balance sheet repair and fiscal stabilization. The enormity of these hurdles has left many with a rather dour view for economic potential. This 'myopia of the mature economies' takes what will clearly be slower economic growth among advanced nations that are aging and deleveraging and blindly proclaims that the global economy as a whole will see slower growth.

This is a biased view that fails to recognize that the world is rapidly evolving and we are sitting on the pivot point of a new economic era. Twenty years ago, advanced nations made up two-thirds of the global economy. Today, they comprise only one-half and within twenty years, these advanced nations will account for only one-third of global output, with emerging markets (EMs) accounting for the lion's share of the global economy. As a result of this increased market share, in spite of slower expansions in the mature advanced economies, the global economy is likely to see a higher average pace of growth in the future. The growing pains of emerging markets over the last twenty years have sown the seeds for a seismic shift in power, influence and dynamism that will mark the next twenty years of economic history.

A TURNING POINT IN ECONOMIC HISTORY*



*Forecast by TD Economics as of December 2010; Source: IMF

The Age of Aging in the Advanced World

In delineating the last couple centuries, historian Eric Hobsbawm saw the world moving from the Age of Capital, to the Age of Empire and most recently the Age of Extremes. Looking ahead, the tag line for the coming generation could very well be the Age of Aging. Advanced economies seem destined to see their average pace of GDP growth slow as a large share of the population shifts from the labor force to retirement.

Our detailed analysis of the Canadian economy suggests annual average GDP growth is likely to average 2% in the coming two decades (see A New Normal: http://www.td.com/economics/special/gb1109_potential.pdf). This would be slightly slower than in the U.S., where we expect GDP growth to average 2.25% over the same period. With demographic pressures even more acute in Western Europe and Japan, these economies will likely see even more sluggish growth, decelerating to just 1.2% and 0.9%, respectively.

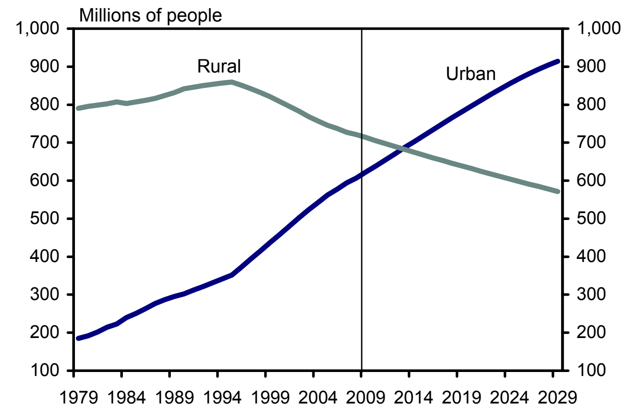
In many regards, there are numerous similarities in the cycle of life, whether we are talking about people, companies, or economies. It is easy to grow rapidly in the early stages of development when growth depends largely on copying those that went before you and accumulating resources. For an economy, new factories, new machines, and new people mean more growth now. But over time, it becomes harder and harder to grow market share, and we reach a mature phase where workers can't effectively use any more physical or human capital, and economic growth becomes a function largely of productivity. Advanced economies reached this phase many years ago, but over the next few decades, productivity growth is going to be offset by slowdowns in employment growth in the U.S. and Canada, and outright contractions in Japan and Western Europe. And even productivity has its limits. It's cheaper and easier to catch up than it is to blaze a new trail so over time, productivity growth tends to converge, as well.

The Coming of Age in Emerging Markets

So the epicenter of the global economy as it is now constituted will slow, but that story has been well told at this point. That change will mean that this source of growth for EMs will wane and weigh on their export-led plans, but that implication seems rather obvious. What is not fully appreciated are the various positive synergies that can fuel catch-up growth in EMs, and not since the industrial revolution has such a large share of the global economy undergone this process at the same time.

For most EMs, the capital accumulation phase of economic growth still has a ways to go until capital per worker is ideal to fuel optimal productivity, meaning above average growth throughout that time. Moreover, there tends to be a positive causation from wages to productivity, especially at lower income levels, another big positive for EMs. Rising spending will fuel rising productivity, while rising incomes will allow for improving educational standards. There is also evidence that productivity growth potential can be constrained by the least productive in society, so by alleviating poverty, this can further fuel productivity. And lastly, EMs that have remained open to trade and FDI flows have tended to sustain better productivity performances, as well (although short-term capital flows are another matter as the domestic financial system must be ready to absorb these safely).

CHINESE POPULATION*



*Forecast by TD Economics as of December 2009;
Source: China National Bureau of Statistics.

So as Yogi Berra said, while it's true that forecasting is hard, especially about the future – and especially when that future is the next two decades – there are four major trends that, in spite of a slowdown in mature markets, should cause the global economy to actually speed up to an average pace of around 4.5% over the next two decades, not slow down.

The urbanization process will be the most important driver for Chinese economic growth

China's population control policies mean that overall population growth is likely to average just 0.0%-0.5% per year over the next two decades. But it is not population growth but urbanization of the existing population that defines Chinese potential. As in many advanced nations, population growth in China is going to contribute next to nothing to overall economic growth, and potential could even be a drag, but this will be far outweighed by the rapid growth in the actual labor pool. Since 1995, China's urban population has grown by 4.2% per year while its rural population has contracted by 1.3% each year. In spite of this wide growth gap, China will still see the rural population outnumber the urban population until around 2013. And even allowing this transformation to continue at a decelerating pace through 2029, China's urbanization ratio would sit at just 62%, well below the average for advanced nations.

This is crucial because the urban Chinese consumer spends three times as much as a rural consumer and has seen consumer spending grow two and a half percentage points faster each year over the last decade. And while Chinese consumer spending accounts for only 35% of nominal GDP

– about one-half the ratio for most advanced nations – much of the reason lies in the declining share of the rural consumer. In 1980, rural consumer spending accounted for over 30% of GDP and now, it accounts for less than 10% as the urban share has grown.

And the fall in the consumer share since then was not because of a slowdown in consumer spending – its contribution to GDP growth was relatively unchanged – it was the fact that it couldn't keep up with the rapid acceleration in spending on capital formation and exports. But China's export penetration is reaching a mature phase that will make it difficult to replicate the same 20-40% annual growth in exports going forward. And capital investment is being increasingly directed into the poorer Western areas of China so that workers need not just move to urban areas. The existing rural areas are themselves becoming urban.

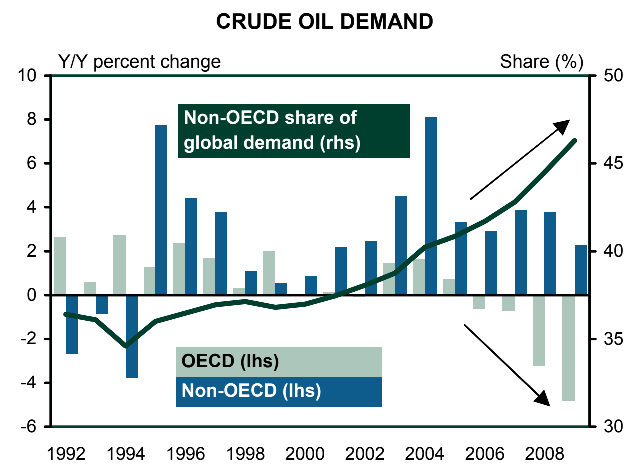
Commodity and credit multipliers will work to reinforce the growth cycle for EM consumers and the broader economy

There are also two very important multiplier effects that will help spread economic growth, both across markets and within EM consumers. The first is the commodity cycle. The urbanization of China remains heavily dependent on natural resources in creating the infrastructure and meeting the demands of those emerging from subsistence and/or poverty. China accounts for around half of the world's demand for iron ore and coal, one-third of the world's demand for steel, zinc, aluminum, and copper, and a growing 10% share of the world's oil. As China demands commodities, and these commodities are largely found in emerging markets, it is these commodity-rich EMs who will continue to disproportionately benefit. Among these countries, Iran, Nigeria, and Saudi Arabia seem best placed to increase their GDP growth rate over the next two decades, while Sudan and some of the smaller Gulf nations will likely see it harder to improve on their past performance. And not only that, this industrialization in EMs has itself become the dominant driver of global oil demand. Oil consumption among OECD nations has fallen every year since 2006 while it has continued to grow strongly in emerging markets right up until the effects of the global recession interrupted demand in 2009.

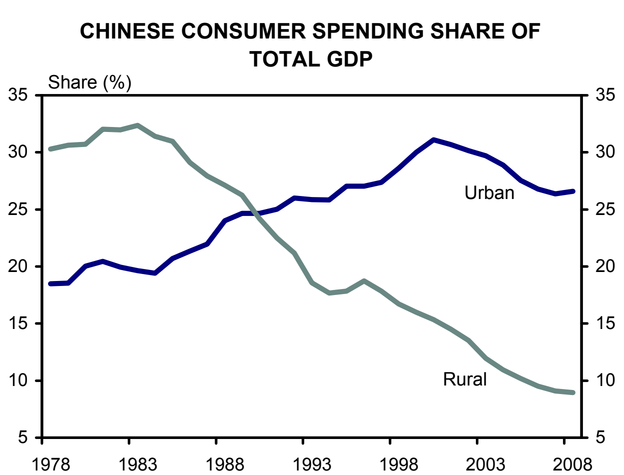
The second multiplier is credit. Credit is the answer to the realization that time is money. If you want it now, you can have it, as long as credit is available and you are willing to pay the interest costs. For most EMs, the evolution of credit markets remains at a very early stage. This means the credit multiplier process will help to juice up the spending power of EM consumers, even while many consumers in advanced nations look to deleverage. The potential here is obvious when we note that while EMs now account for half of global output, they account for only a quarter of global consumer spending.

Institutional factors will remain key for ensuring these impulses reach their full potential.

For economists, institutions are things like the rule of law, the existence of private property rights and the ability to access the judicial system to defend those property rights when they are violated. These are factors we take for granted in advanced economies, but for developing countries, history can be difficult to overcome. While we tend to think of things like employment growth, capital accumulation, and productivity as the primary sources of economic growth, evolving research over the last decade has shown that the lack of effective institutions has been the defining feature separating EMs that have succeeded and fallen behind.



*2009 YTD: Oct data
Source: Energy Intelligence Group



Source: China National Bureau of Statistics.

Without the right to use property as collateral, the capital in capitalism is worthless. Not only that, there has been further evidence that even things like high inflation and large budget deficits are themselves symptoms of bad institutions, rather than the root cause of economic stagnation.[1]

While it becomes much harder to measure these sorts of intangibles, we can take increasing expatriate investment in emerging markets – both in factories and residential investment – as a sign that foreigners feel more secure in their holdings. Moreover, as these investments grow in importance for EMs, the governments have growing incentives to ensure that these essential initial conditions are sustained. Moreover, the growth of sovereign wealth funds (SWF) and the integration of EM capital into the global financial system also increasingly allows the market to penalize those who attempt to renege on these rights – a lesson Dubai World is learning all too well. And with the $3.2 trillion in reported assets under management (AUM) in EM SWFs as of the third quarter of 2009 already one-third the size of the market cap of the S&P 500, EMs are likely to be just as concerned about the security of their own holdings in advanced nations. In fact, if the S&P 500 averages the 8% long-run return we expect, AUM of EM SWFs would need to grow by only 14% in combined annual returns and new cash injections to surpass the market cap of the S&P 500 over these next two decades.[2]

The simple math of EMs growing faster than advanced economies and building their market share means they drive the headline global GDP growth figure.

The last trend is simply the arithmetic that results from the previous three trends. Over the last twenty years, emerging markets averaged a 5.3% GDP growth rate per year while advanced economies averaged 2.2%. As a result, the global economy averaged a 3.2% growth rate. Advanced economies were a larger share of the world economy so the global growth rate gravitated closer to their figure. But with EMs now accounting for a larger and growing share of global output, it is their growth rate which will dominate. So while advanced economies look likely to grow by less than 2% per year over the next two decades, EMs seem capable of sustaining an average growth rate just north of 6% per year. With those growth rates, EMs will come to account for two-thirds of the global economy within two decades and a two-thirds/one-thirds split would imply a growth rate for the global economy of around 4.5%.

In many regards, this kind of performance wouldn't even be that spectacular. In the current decade, the U.S. economy averaged 2.0% GDP growth per year while EMs averaged 6.1%. So obviously a new normal where the U.S. grows by 2.0-2.25% per year has sustained EMs in the past. One factor dragging on the global economy in the past was the large one-time cost in transitioning the Russian and other former communist and socialist economies into capitalist economies, which biased past growth rates of the global economy lower. While some of the oil exporting economies cited above may see slower economic growth moving ahead,

AVERAGE REAL GDP GROWTH

			Forecast*	
	1990-99	2000-09	2010-19	2020-29
WORLD	2.9	3.5	4.2	4.5
ADVANCED	2.5	2.0	2.2	1.8
United States	3.2	1.9	2.7	2.3
Canada	2.4	2.1	2.4	2.0
Japan	1.5	0.8	1.7	0.9
Western Europe	2.1	1.5	1.6	1.2
EMs	4.3	6.1	6.5	6.3
BRICs	5.1	7.7	7.7	7.1
Brazil	1.7	3.3	3.9	3.7
Russia	-3.8	6.1	4.3	5.3
India	5.6	7.1	7.5	6.9
China	10.0	9.8	9.2	7.9
OIL EXPORTERS	3.9	5.4	4.8	5.3
Iran	5.2	5.1	4.8	5.8
Kuwait	3.2	5.9	4.6	4.7
Nigeria	2.6	8.3	6.0	6.0
Qatar	4.7	11.2	5.9	3.3
Saudi Arabia	3.1	3.4	5.1	5.3
Sudan	3.1	7.1	4.6	4.4
UAE	5.6	6.9	4.4	4.7
Venezuela	2.5	4.1	2.7	4.2
CENTRAL AND E. EUROPEAN	1.4	3.8	4.0	4.2
OTHER HIGH-POTENTIAL EMs	4.6	4.0	5.0	4.8
Bangladesh	4.8	5.8	6.3	6.1
Egypt	4.1	5.0	5.7	5.6
Indonesia	4.3	5.1	5.7	5.6
Korea	6.3	4.3	4.7	4.5
Malaysia	7.2	4.6	5.4	5.6
Mexico	3.4	1.9	4.5	3.7
Pakistan	4.0	4.5	4.7	4.7
Peru	3.2	5.2	5.5	5.1
Philippines	2.8	4.6	4.3	4.2
Singapore	7.6	4.6	5.1	5.3
Thailand	5.3	4.0	5.5	5.6
Turkey	4.0	3.6	3.6	3.3
Vietnam	7.4	7.2	6.7	6.5

*Forecast by TD Economics as of December 2009
Source: IMF and TD Economics

national growth rates will still likely remain above the global growth rate for six of the eight (Qatar and Venezuela are the likely outliers), meaning the group will be supportive of a faster rate of global expansion.

Nor is this forecast contingent on a Chinese economy still growing gangbusters. China will not be able to sustain the 10% GDP growth rate it has seen the last two decades and will instead decelerate to something closer to a 7.5% annual rate of growth. But this is still three percentage points faster than the 4.5% pace of growth we expect for the global economy as a whole. As a result, the Chinese economy will continue to build up its share of global output, as well.

Think Big

Now, will this process be a straight line as portrayed in the chart on the front page? Absolutely not. There will be recessions along the way. Will EMs avoid future crises just because they have accumulated vast foreign exchange reserves to defend against the crises of the past? Nope. These can defend against past crises, but an evolving structure for the global economy and global finance implies an evolving structure for crises. History suggests that economies have frequently seen some kind of hiccup when trying to make the transition from the accumulation phase of economic growth to one driven by productivity. The state planners, who proved so successful in directing investments to drive the early takeoff, tend to be slow to remove their hands from the pot when the complexity of the economy surpasses their ability to control. Imbalances tend to build and the financial system tends to remain underdeveloped.

Perhaps the hardest part for the world will be coming to grips with the fact that the world has changed and economists and investors will increasingly need to differentiate between different markets. We will have to come to know the nuances of China, Peru, Indonesia, Vietnam, and Dubai just as we do now with the U.S., Canada, or Germany. And the list of the good, the bad, and the ugly will not stay static. The Polish economy significantly outperformed Hungary during the global recession but the decision of the Polish government to dip into pension funds to alleviate fiscal pressures raises more concerns for the future. The Brazilian decision to impose capital taxes and the consideration by other EMs to do the same raises the risk that some might take these to extreme and starve the economy of the foreign investment needed to fuel growth. And there will be other innovations and other mistakes along the way such as the overzealous decision of Dubai to use too much leverage to fuel the economic transformation. Even for advanced economies, perhaps we may find we have underestimated how much a stronger crop of EMs could support GDP growth in commodity economies, like Canada and Australia, or exports from all advanced economies.

So somewhere between the discovery of costless cold fusion and the exhaustion of crude oil lies the more likely path for the global economy. That path appears to be a higher speed limit and the rising importance of emerging markets. It may be hard to believe having seen the global economy barely alive, but we can rebuild it. We have the technology. Better, stronger, faster.

END NOTES

[1] For more on property rights and EM growth, see Hernando de Soto's *The Mystery of Capital*. For research on the connection between institutions and macroeconomic policies, see "Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth" by Daren Acemoglu, Simon Johnson, James Robinson, and Yunyong Thaicharoen.

[2] In 2008, State Street research estimated SWF's assets could reach $20 trillion by 2020, implying an average annual growth rate of 17-20%. While these funds have been hit along with all investors in the current downturn and have had to pull back on investment plans, a rate of growth exceeding U.S. equities is certainly feasible.