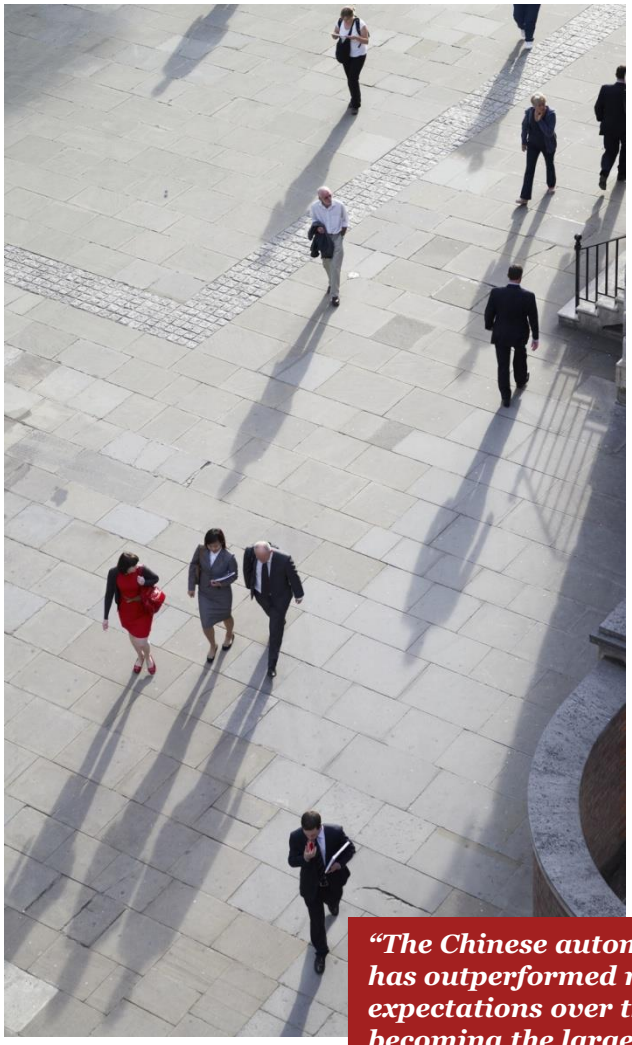
Are developed economies reaching 'escape velocity'?



At a glance

After five years of crisis, recession and disappointing growth we think that developed economies may now be approaching the 'escape velocity' needed for a sustainable recovery. Here are three reasons to be cautiously optimistic:

- First, the Eurozone grew by 0.3% in Q2, emerging from an 18 month recession. The French and German 'core' fared particularly well.
- Second, other major developed economies are also posting positive GDP figures: the US, UK and Japan all recorded growth of around half a per cent in Q2.
- Finally, consumer sentiment is looking up. Our Global Consumer Index (see page 4) posted annual growth of 3% in August, above its long-run average rate.

But there are still risks to this outlook: debt sustainability remains a concern in some Eurozone economies and there are on-going issues of budget deficit reduction in the US and unrest in the Middle East.

In contrast to the story for developed economies, some major emerging markets have slowed over the past year, including India, Brazil and most notably China.

How important is Chinese growth for developed economies? Certainly its importance is increasing: China already the world's second largest importer of goods after the US and contributed almost 40% of global growth in 2012. The automotive industry illustrates this: China is now the world's largest car market by new vehicles. So what are the prospects for China's economic performance?

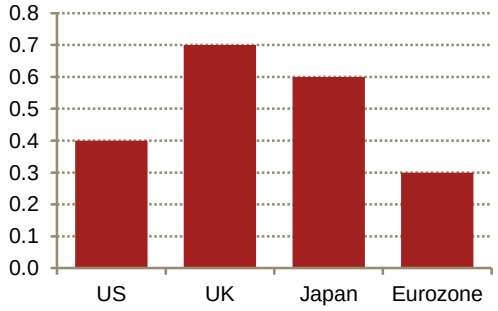
Despite recent wobbles, we still expect China to achieve its 7.5% growth target for 2013. Looking ahead, the Chinese economy (in common with many other emerging markets) is set to transition towards a 'mass affluent' middle class that will shape global consumption over the next growth cycle. To indicate the scale of this opportunity, bringing China's consumption share of GDP into line with its G7 peers would add over US$ 2 trillion to global consumer spending. That's a huge prize for international companies to aim for.

"The Chinese automotive market has outperformed most initial expectations over the past decade, becoming the largest market in the world in volume terms in 2009" – *Michael Gartside, Senior Automotive analyst, PwC Autofacts*

China share of German car export market value

Source: OECD, Eurostat, PwC analysis

Fig 1: Q2 GDP growth rates of key economies



Source: Eurostat, Datastream

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Economic update

Recovery at last in the Eurozone?

Latest figures show that Eurozone GDP grew by 0.3% in the second quarter, the first quarter of positive growth in 18 months. The core countries of France and Germany led the rebound, growing at 0.5% and 0.7%o respectively, well above market expectations. We have upgraded our 2013 Eurozone growth forecast slightly to – 0.5%.

This doesn't mean that the Eurozone's problems are finally over. Economic fundamentals are still weak in peripheral economies. Persistendy high unemployment and debt sustainability remain a concern. It is likely that Greece will need to engage with creditors over an expected €4bn funding gap in its financing package.

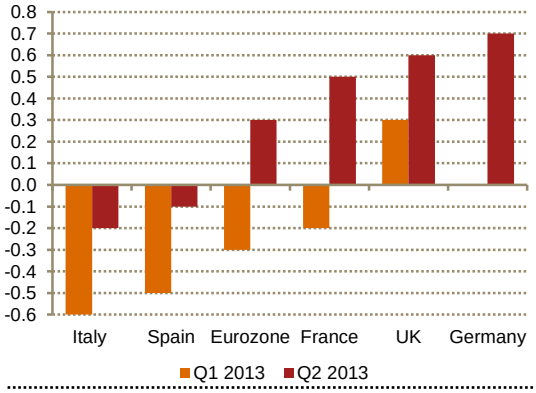
The upcoming German elections are unlikely to lead to a change of government, with Angela Merkel generally expected to remain Chancellor. However, a refreshed mandate for her government could improve the chances of driving reforms needed in Europe (such as a banking union) and developing a clear line on debt sustainability issues.

Across the Channel, Mark Carney has shaken up UK monetary policy. Anchoring the base rate at 0.5% as long as unemployment remains above 7% (unless inflation or financial stability risks override this), marks a notable shift away from pure inflation targeting.

This 'forward guidance' did not come as a surprise to us, but the market reaction did: yields on benchmark UK gilts have increased by around 20 basis points since the announcement-not what Mr Carney might have hoped for.

Another developing story has been brewing uncertainty in emerging markets. Currencies continue to tumble as liquidity draws back to developed markets, triggered by expectations of QE tapering in the US. For example, despite intervention in the bond market, the Indian rupee has hit an all-time low of 64Rup/$.

Fig 2: Eurozone GDP growth



Source: Eurostat

A focus on China

The twin investment and export growth engines are losing horsepower

Chinese economic growth has slowed over two consecutive quarters, with Q2 coming in at 7.5% year on year. However, despite this slight loss of momentum, we still expect China to achieve its 7.5% growth target for 2013. Latest Purchasing Manufacturing Index data for August were positive in this respect.

Nonetheless, China's historic growth strategy, which has relied on the twin engines of investment and exports, will need to evolve.

The government has recognized this. While investment in manufacturing and construction has created millions of jobs and kept the economy busy over the last decade, ghost towns have emerged across the nation in which few can afford to live. The National Audit Office's latest audit on 36 local governments found debt had ballooned by 12.9% between 2010 and 2012. We expect this rapid accumulation of debt will take time to unwind.

China's strategy of maintaining a relatively weak Renminbi and relying on low-cost exports is also under pressure due to rising wages and tensions with major trading partners. Monthly export growth has hovered around 0.2% since the start of 2013 compared to 2.0% over the same period in 2012.

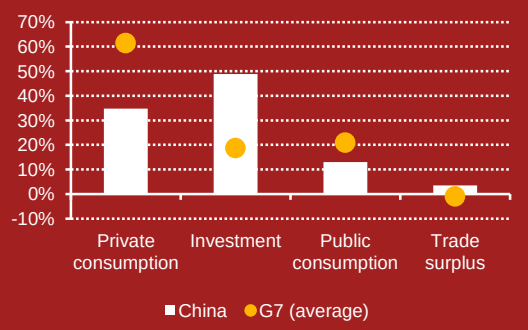
Rebalancing to consumption

As China evolves, households will need to take on a bigger role in the economy (see Figure 3, right). Consumption accounts for only 35% of GDP, well below the G7 average. The scale of this consumption potential is formidable: if China's consumption share of GDP was brought into line with its G7 peers, this would add over U$2 trillion to global consumer spending, roughly equivalent to the entire Russian economy in 2012.

The Chinese government has recognised the need for this shift, signalling a clear intention to quicken the pace of economic reforms. These include: strengthening the country's social safety net to reduce the need for high precautionary savings; enforcing property protection (especially in rural areas); and reviewing the interest rate regime to enable better capital allocation in the economy.

The themes that will shape China's next decade – transition from investment-led growth to consumption, financial liberalisation and a gradual move to a more freely floating exchange rate – will also shape global consumption. For most international businesses, this is a reason to be optimistic, but competition from domestic firms for a share of the fast-growing Chinese consumer market will remain intense.

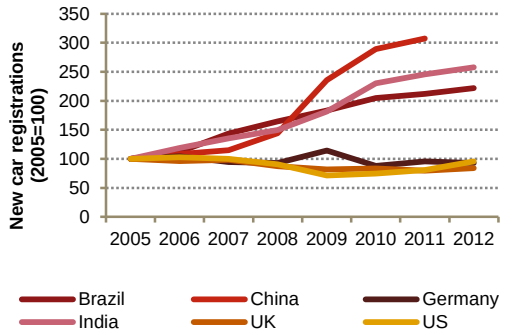
Fig 3: GDP components of China and G7 (2011)



Source: UN Database, PwC analysis

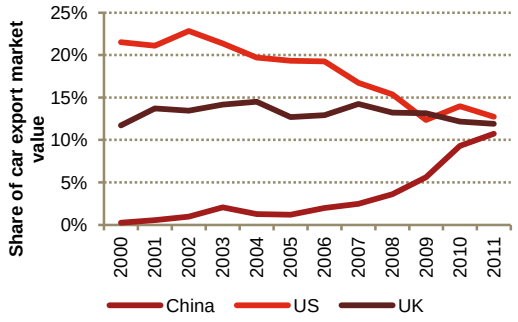
The growing 'mass affluent' middle class of emerging markets will be in the driving seat

Fig 4: New car registrations show the divergence of emerged/emerging markets



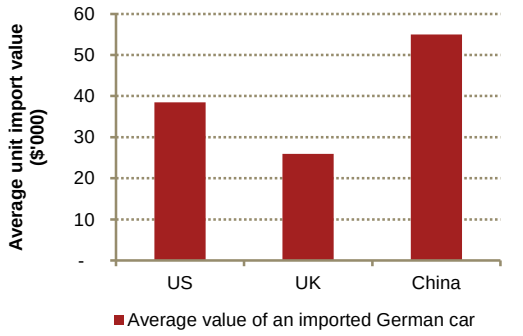
Source: Datastream

Fig5: The Chinese car export market has become vital for German car producers



Source: OECD, PwC analysis

Fig 6: The average value of an imported German car in China is double that in the UK



Source: VDA, Eurostat, PwC analysis

Looking for a growth indicator?

The global economy may now finally be approaching escape velocity. Major developed economies, most recently the Eurozone, have exited recession, global consumer confidence seems to be picking up and financial markets have generally been on an upward trend despite periodic bouts of volatility. But if this is the start of a sustained economic recovery, what will be the key driver of this growth?

Our view is, with governments still cutting back, private consumption will need to lead the way in most economies; car sales may be one useful indicator of broader trends.

This reflects the fact that, after housing, cars are the next big-ticket items that consumers buy. New car registrations are therefore a potential bellwether of industrial production and consumer confidence. Trends in car registrations in emerging and developed markets (Figure 4, left) demonstrate the divergence between consumption growth in emerging and developed markets since the financial crisis.

Taking the autobahn to China

The evolution of China's trade relationship with Germany is a useful guide to wider economic trends. The German car industry is one of the largest in the world. Its output was around €280 billion in 2012, of which about 70% was accounted for by exports.

Figure 5 (left) shows how important the Chinese consumer has become to the German car industry. China is now the third largest individual export market for German cars, accounting for a 10.7% share of export value (compared to 0.2% in 2000). Over the past five years, the value of imported German cars has grown at a compound annual rate of 37%. So far, this growth has been generated by the fast-growing newly affluent population for whom brands like Mercedes Benz, BMW and Porsche are major status symbols. This is shown by the fact that the average value of a German car exported to China is significantly higher than in the UK and US markets (Figure 6, left).

Looking ahead

As discussed in this month's focus box (opposite), Chinese households will take an increasingly prominent role in driving global economic growth. In the longer run, this is also likely to be true for other emerging Asian markets, where consumption remains relatively low by international standards.

There are wider lessons for exporters to emerging markets. So far, consumer goods imports have been driven by 'luxury' items, as noted above. But as wealth spreads, the 'mass affluent' middle class in emerging markets will become more important in shaping the global consumer spending story over the next 20 years.

Financial liberalisation will be an important catalyst for Chinese consumers. A freer floating exchange rate is likely to lead to a stronger Renminbi, increasing their purchasing power. The end result will be cheaper imports for Chinese consumers and a sales boost in foreign currency terms.

Bringing it home, implications for business

Ambitious companies should be looking to take advantage of this emerging market consumer growth story. However, they will have to make difficult decisions. One is often deciding whether to export from home, or produce in the local market.

While the global economy is moving towards greater trade liberalisation, trade barriers will be a hurdle for some time. Production in 'gateway' locations, in or close to the local market ('build where you sell'), can be a cost effective mitigation strategy.

But companies shouldn't turn their back on developed markets yet. The effects of the financial crisis mean that labour is relatively cheap and there is excess capacity in many economies, making them a good base of production. For example, several global car firms have brought production back from the Far East to Europe. Fierce domestic competition, as well as challenging regulatory regimes, may also cause some Western companies to focus more on lower growth, but also lower risk markets, nearer to home.

Projections: September 2013

	Share of world GDP		GDP			Inflation		
	PPP	MER	2013p	2014p	2015-9p	2013p	2014p	2015-9p
Global (market exchange rates)			2.3	3.1	3.1	4.7	5.1	4.6
Global (PPP rates)			2.9	3.6	3.7			
United States	19.1%	21.7%	1.8	2.6	2.4	1.5	1.9	1.9
China	14.3%	10.5%	7.5	7.6	7.0	2.9	3.2	3.4
Japan	5.6%	8.4%	1.6	1.4	1.2	0.2	1.5	1.5
United Kingdom	2.9%	3.5%	1.3	2.3	2.4	2.7	2.4	2.0
Eurozone	14.2%	18.8%	-0.5	0.9	1.5	1.6	1.6	1.9
France	2.8%	4.0%	0.1	0.9	1.6	1.4	1.6	2.0
Germany	3.9%	5.1%	0.5	1.3	1.5	1.6	1.8	2.0
Greece	0.4%	0.4%	-4.2	-1.0	2.5	-0.3	-0.5	1.0
Ireland	0.2%	0.3%	-0.5	1.9	2.7	1.5	1.3	1.7
Italy	2.3%	3.2%	-1.7	0.8	0.8	2.0	1.8	1.7
Netherlands	0.9%	1.2%	-1.2	0.9	1.6	2.6	2.0	2.1
Portugal	0.3%	0.3%	-1.7	0.9	1.8	0.8	1.2	1.5
Spain	1.8%	2.1%	-1.4	0.4	1.7	1.5	1.1	1.7
Poland	1.0%	0.7%	1.1	2.3	3.9	1.2	2.3	2.5
Russia	3.0%	2.7%	2.6	3.3	3.8	6.4	5.6	5.6
Turkey	1.4%	1.1%	3.4	4.5	5.3	7.2	6.2	4.8
Australia	1.2%	2.1%	2.5	2.7	3.1	2.1	2.5	2.7
India	5.7%	2.4%	5.2	6.4	7.0	5.7	6.5	6.0
Indonesia	1.4%	1.2%	5.8	6.1	6.3	7.4	7.0	5.1
South Korea	2.0%	1.6%	2.7	3.3	3.8	1.7	2.6	2.9
Argentina	0.9%	0.6%	2.6	2.3	3.3	10.7	11.4	9.7
Brazil	2.9%	3.6%	2.8	3.5	4.0	6.0	5.4	4.8
Canada	1.8%	2.5%	1.6	2.4	2.2	1.3	1.9	2.1
Mexico	2.1%	1.7%	3.0	3.9	3.6	3.8	3.8	3.6
South Africa	0.7%	0.6%	1.9	3.5	3.8	5.5	5.5	4.8
Saudi Arabia	0.9%	0.8%	4.4	4.2	4.3	4.0	4.6	4.0

Interest rate outlook of major economies

	Current state (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	QE tapering expected before 2014	17-18 September
European Central Bank	0.5% (May 2013)	On hold at least until 2014	5 September
Bank of England	0.5% (March 2009)	On hold at least while unemployment is above 7%	5 September

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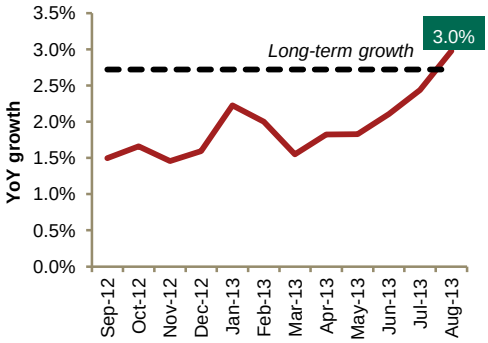
PwC's Global Consumer Index – August 2013

We are increasingly confident that the global economic recovery is gaining traction and should translate into a sustained improvement in consumer spending later this year. Our view is backed up by the August GCI which improved by 3.0% – breaching the long-term growth mark and the highest level since we started tracking the Index a year ago.



The GCI provides an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit *www.pwc.co.uk/globalconsumerindex*

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