When Emerging Markets Demand More

The United States is likely to start growing over the next few quarters. Corporations will start rebuilding inventories, and the effects of the massive monetary and fiscal stimulus will kick in. But as the recent data on retail sales and on consumer confidence suggest, the U.S. household is likely to remain subdued for some time, as it copes with its high debt load and continued prospects of unemployment. As the fiscal stimulus wears off, and as a massive build up in U.S. government debt limits more spending, the world will look elsewhere for demand growth.

The obvious candidates are the emerging markets. But they would have to change strategy, from pushing exports to expanding domestic demand. For countries like China, this would bring a welcome rebalancing of growth, from the red hot coastal areas to the more remote Western provinces. It would reduce regional inequality and the accompanying political tensions.

But something more dramatic could happen when emerging market demand grows over the medium term. Today, over three quarters of the value added in a $200 Apple iPod consists of services such as design, marketing, advertising, and finance, which are provided by firms in developed countries that are close to the final consumer (who is still predominantly a citizen of a developed country). Less than a quarter of the value-added comes from the manufacturing and assembly, typically done in an emerging market far away. But when the emerging market consumer accounts for a greater share of world spending, it is companies closer to her that will be better able to anticipate her needs, and innovate, design, and market to her taste.

In India, for example, Tata Motors has started producing a people’s car, the Tata Nano, which is priced at $2000. The Nano is aimed at India’s growing middle class. This may seem surprising. In the United States, middle class families would like a safe vehicle in which to transport their children, typically a minivan or a sports utility vehicle. A tiny cheap car would hardly be their idea of safety. Mr. Ratan Tata, the Chairman of Tata Motors, however wants to appeal to the desire for greater safety in the Indian middle class.

How so? Today, the typical Indian middle class household can only afford a motorcycle. As anyone who has been on crowded Indian streets can see, the household travels precariously, with the husband driving, number one son seated astride the gas tank, the wife sitting demurely behind holding the new born baby daughter in her arms, and number two son clinging on behind her. Horrendous accidents happen frequently on India’s roads, even though the fact that they are crowded reduces the speed vehicles can travel at. That the Nano does not have a powerful engine does not matter when top speeds are significantly constrained by the crowded roads. But the resulting lower price, and the fact that the entire family now travels within closed doors, has made safety affordable. While you do not need to be an Indian, to understand the demand for such a car and how it can raise safety considerably, it helps to have travelled the roads of a country like India, and empathized with the needs of that family perched on the motorcycle.
The point is that innovation and services like marketing and advertising will be driven by corporate managers who are closer to the consumer, if not physically, then mentally. This will constitute an enormous advantage for corporations that have a significant presence in emerging markets. And they can take their innovations across borders to other, similar, emerging markets, increasing emerging-emerging trade. If all goes smoothly, these companies will account for a much greater portion of the world’s pie in innovation and value added services, increasing emerging market prosperity substantially. Everyone will gain, including rich countries, as markets expand.

Before they celebrate though, emerging markets have much to do. For the shift in demand to take place smoothly, they have to allow their currencies to appreciate. A collective commitment, especially in Asia, to not intervene except under conditions of extreme volatility would make for smoother adjustment. Hopefully, China will allow the renminbi to reach its true value in the interest of making it a reserve currency, and will support such a commitment.

Emerging markets also have to create the human capital to provide the value-added services that will increasingly be demanded. This is an area where countries are following a variety of approaches – China is building world class universities while Chile is outsourcing higher education, offering scholarships to any student who gets admission to a top foreign university.

Finally, emerging markets have to proceed with care – export-led growth has allowed them to stabilize their finances and build foreign exchange reserves. A refocusing on domestic demand carries with it the danger of excess, of runaway government deficits and credit fuelled growth. As the United States has shown, domestic-demand-led growth is not easy to manage, even for the most sophisticated economies. The crisis may have brought forward the possibility of the age of the emerging markets. They have to make it a reality.

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