



Domestic demand expected to rise in 'East', drop in developed economies

Why is this chart important?

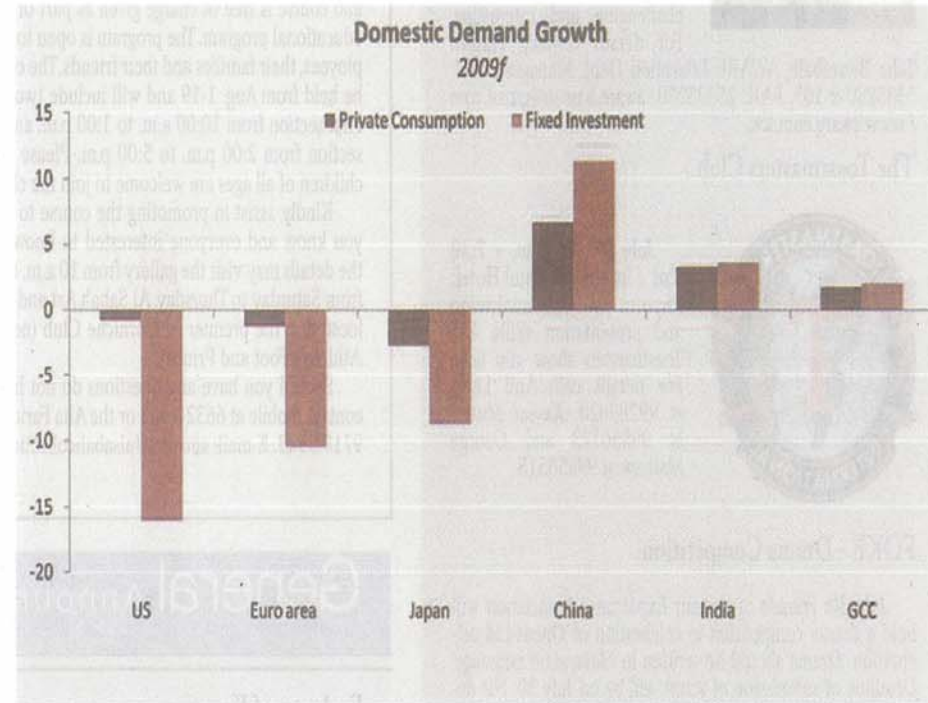
In 2009, domestic demand is expected to rise in the "East" and fall in developed economies. In particular, the chart shows the estimated growth of 'private consumption' and 'fixed asset investment' - two key components of domestic demand. Both indicators are forecasted to rise in China, India and the GCC, and to contract in the largest industrialized nations. As domestic demand is a key driver of GDP growth, Asian emerging markets are expected to grow faster than other, more mature, economies. In other words, Asia can count on domestic demand for its future growth. More generally, "de-coupling" is back in fashion: the emerging economies, thanks to their strong domestic markets are becoming more resilient to a recession in the "West."

What are these indicators, what do they tell us?

In a given country, domestic demand is the aggregate spending by all economic agents. In other words, it is the sum of all expenditures carried out by households and firms. Of course, it includes imports - all items purchased from abroad, for consumption or investment purposes - but not exports, which are classified as domestic demand in the importing countries. Roughly, households' expenditures are called "consumption," and firms' spending is called "investment." More precisely, 'private consumption' and 'fixed asset investment' are defined as follows:

a) 'Private consumption' includes the majority of personal expenditures by households. For example, a family spends money on food and drinks, clothing, in the rent of their house, in medical bills and also in luxury items. Buying a new home is not included in private consumption: "new housing" is classified as investment.

a) 'Fixed asset investments' are all capital expenditures carried out by business or households. For example, a factory buys new machinery and equipment, an oil company builds a new drilling rig, a business purchases the update of software for its operations. As mentioned, spending by households (but not government) on new



Source: Global Insight, 2009.

houses is classified as "investment." Understanding the dynamics of domestic demand is important to anticipate future economic trends. Indeed, an increase in demand can create benefits - but also troubles. What's going to happen largely depends upon the country's circumstances. For example:

- If the economy is below full capacity or in a recession, an increase in demand will result in higher economic growth, without causing inflation. As demand increases, firms step up production and demand more workers to produce the extra goods, reducing unemployment.

- If the economy is close to full capacity, a rising demand might directly impact prices, causing inflation.

Also, higher domestic demand could lead to an increase in imports, and cause deterioration on the current account and balance of payments.

What are the implications for the economy and the financial markets?

In the past few years, consumption in advanced countries (U.S. and U.K., above all) drove global economic growth and fuelled - via exports - Asian growth. Most of this consumption was propelled by borrowing; much of it came ultimately from the "East." Today, available resources are being dramatically reduced by global deleveraging. Consumers can no longer borrow (and are unlikely to consume) as much as they used to. In other words, the model "save

East" and "consume West" is not longer working.

So, what is going to happen next? In those countries where households need to save more, rather than spend, demand is likely to remain weak for a while. As consumer spending constitutes more than 70 percent of GDP in the U.S. and about 55 percent in Japan and in the EU, reduced households demand is likely to hamper economic growth in the industrialized nations; and the rest of the world - especially the export-driven economies - will suffer, because of reduced international trade.

In response, Asian governments, especially in China and India, are trying to rebalance their growth model - from exports to domestic demand, and are enacting forceful policies, such as sustained reductions in interest rates and sizable fiscal stimuli, via infrastructure, healthcare, and social security spending. Asian firms are looking at their domestic market more than ever before.

The results are already there. During the global downturn, in China and India annual spending rates increased by more than five percent. In China alone, fixed asset investment is growing at its fastest pace since 2006, and recent policy actions are designed to stimulate private consumption, such as auto sales and rural income. As a result, retail sales (including government purchases) have soared by 15 percent over the past year. Still, success is not guaranteed. For China's growth to be sustainable in the long run, the economy needs to progressively shift from state-sponsored investment to private consumption. India needs to carefully manage its government finances.

In sum, the "East" is not immune to continued global economic weakness, but for a few years it will do better than the most developed markets in the West (U.S., EU, and Japan). Global investors are growing more confident about these trends and - although Asian markets might see a correction in what is left of 2009 - in the long run capital markets are likely to respond accordingly.

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