

"Europe as a challenge – challenges to Europe"

Series of lectures on "Europe in Transition" – Fall 2007

China, Japan and India as Challenges to the European Welfare State

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Prelude.

- Help from the old poodle, Brad Pitt & Robert Redford.
 - Basic message:
 - 1: US economic slow down, no global recession as Asia is strong enough to maintain growth.
 - 2: Technology shifts to Asia.
 - 3: Shift in global economic and technological power points to shift in global political power.
 - 4: Asia. Two crucial factors. Supply chain and private consumption.
 - 5: Five fundamental observations:
 - Asian economic integration, multinational companies, comparative advantages, international investment policy, break down of present system.
 - 6: Risk factors. Eewi, terrorism, social losers – political system, foreign and security policy-US role.
 - 7: Impact on Europe.
 - 8: Conclusion.
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1. US economic slow down. Asia's economy is strong enough. 1/3.

first the us economy.

- ❑ US economy not as strong as generally believed.
 - ❑ Adjustment of growth prognosis for 2007 down from 2,9% to 2,3% to 1,9%. Recession? 2006 Figure: 3,1%. EUROLand 2,7% to 2,6%
 - ❑ The decisive factor is private consumption with approx 70% of total demand.
 - ❑ The housing sector critical. 3% of PCE.
 - ❑ A volume cycle, not a price cycle. Consumption cycle, not a business cycle.
 - ❑ US has spent when it should have saved.
 - ❑ Result: disturbing imbalances.
 - ❑ Threatening not only the US but also the global economy.
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1. US economic slow down. Asia's economy is strong enough. 2/3

then us economic policy.

- How can the imbalances be redressed?
 - Fiscal policy? Higher taxes!!!!
 - Monetary policy? Housing sector.
 - Currency rate? Global stability.
 - Protectionism? Other countries.
 - Why relevant for Asia? Burdensharing.
How do we make transfer or purchasing power?
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1. US economic slow down. Asia's economy is strong enough. 3/3

strength of Asia's economy to shoulder burden.

- Asia's economy is strong enough.
 - China and India 21% versus 19%.
 - China and India 108%, plus Japan, Korea and SEA gets 165% of US economy.
 - China 10% growth in 2005 2,7pp, 2006 2,2pp and 2007 1,6pp export to US.
 - Share of Chinas export to US was in 2000 31% but this year 23%. Rest of Asia. No change. Winner: rest of world. (16%→32%)
 - The armchair: US interest rate ↓, China interest ↑.
 - Interesting phenomenon: Asia-LA-Africa-ME. Africa growth 2006 5,5%, 2007 6,2%.
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2. Technology shifts to Asia.

China

- ❑ 509 mio subscribers mobilephone. 6 mio each month.
 - ❑ 123 mio internet, 77 broadband, 13% of households
→ 21% in 2010, prognosis 2005 said 57 mio in 2007.
 - ❑ SMS new language, 6 billion.
 - ❑ Year 2010 China number one with 178 mio PC´s.
 - ❑ India 185 mio, 7 mio each month.
 - ❑ Why is that important.
 - ❑ Technology, culture, organization as flywheel.
Interaction.
 - ❑ Productivity puzzle. Scarcity ↔ Critical Mass. A whole new game.
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3. Shift in global power.

- ❑ The US will overcome its economic slow down as before.
 - ❑ This time however different, economic pull factor has moved.
 - ❑ The world has never seen a shift in economic power without a corresponding shift in political power
 - ❑ We can choose to do it peacefully or fight it out as it was done twice during the last century.
 - ❑ The global system under intense pressure.
 - ❑ Relevant in this perspective, regional cooperation/integration.
 - ❑ Rest of Asia in particular SEA squeezed between the dragon and the eagle. Do not want to choose but for how long avoid to do so?
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4. Asia. Two crucial factors. Supply chain and private consumption. 1/1

- ❑ Two factors decide whether a regional economy is self-sustaining.
 - ❑ The supply chain showing that countries use their comparative advantage and most important of all the business cycle tends to move in parallel.
 - ❑ Private consumption appears as the driving force in the economy removing dependence on export.
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4A. Supply chain. 1/1.

- ❑ Supply chain in Asia. Chinas share of US import up three times, most other Asian countries share down to 1/3.
 - ❑ When Chinas export rises with 1% import to China from other Asian countries goes up with semi-manufactured goods 1,3% and investment goods 2,8%.
 - ❑ China has become the flywheel for an Asian supply chain.
 - ❑ Outsourcing starting from China to fx Vietnam.
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4B. Private consumption. 1/4.

- Two factors: trendsetters and mass consumption.
 - Trendsetters.
Upper end of market. Affluent class.
Important new tendencies emerge. Will preferences follow Western style or switch to a new Asian style?
 - Mass consumption. Middle class. Big sums.
Change of lifestyle.
 - Lower end. Mass migration from countryside to cities. Beginning to change lifestyle.
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4B. Private consumption. 2/4.

Trendsetters. Global cities. Hubs.

- ❑ Global cities, hubs will emerge as the place for trendsetters.
 - ❑ Almost all of them in Asia. Shanghai, Beijing, Guangzhou-Hong Kong. Mumbai. Tokyo maybe. Singapore-Johore. Saigon maybe.
 - ❑ All the brandnames put their money on the explosive market in these hubs expecting new trends.
 - ❑ In the future branding will overshadow everything. Without branding you are out, without being where new brands are born and tested you are dead.
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4B. Private consumption. 3/4.

Figures, affluent class, the trendsetters.

China.

- ❑ Household > 25.000 USD 2,9 mio in 2005, 8,5 mio 2015
- ❑ Third largest market luxury goods. 2015 number one with 29% share. Topbrand consumers 13%. Luxury goods 6 bio USD in 2004.

India.

- ❑ Prognosis for 2025. 20% of total consumption in top end sum of 343 bio USD.
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4B. Private consumption. 4/4.

The middle class, changing lifestyle.

□ The middle class will emerge having money to spend.

China.

□ 87 mio 6.000-25.000 USD 2005→317 mio 2015.

□ 19% of population in consumer class. 17,4% of urban households 5000 USD, in 2014 90%. Ref Hubs!

India.

□ Prognosis 2025 middle-class of 583 mio spending 1.5 trillion USD.

□ SEA the same

4C. Supply chain and private consumption. 1/2.

Link

- When China's GDP rises with 1% import of consumption goods from the following countries go up:
 - Japan 1,04%, Singapore 1,06%, Malaysia 1,29%, Korea 1,30%, Indonesia 1,46%, India 1,54%.
 - Key: Supply chain changes. Not geared to US, geared to Asia's domestic market.
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4C. Supply chain and private consumption. 2/2.

<input type="checkbox"/>	Intraregional trade (%) .	1980	2005
<input type="checkbox"/>	ASEAN	17,9	24,0
<input type="checkbox"/>	Plus China, Japan, Korea	30,2	38,2
<input type="checkbox"/>	Plus Hong Kong, Taiwan	34,6	54,5

PM

<input type="checkbox"/>	EU (25)	61,3	66,2
<input type="checkbox"/>	NAFTA	33,8	45,0

Why interesting?

Business cycle follows same pattern, specialization?

5. FOUR fundamental observations.

- Economic integration.
 - Multinational companies.
 - Comparative advantages.
 - International investment policy.
 - Break down of international system – replaced by?
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5A. Economic integration. 1/4.

- ❑ Asian integration. Not China or India, but China and India. Drivers. Japan?
 - ❑ Why? Political imperative, share benefits, stability.
 - ❑ China-India trade from 150 mio USD to 25 bio in 15 years. Powerhouse.
 - ❑ Triangle of FTAs. World never seen anything like that.
 - ❑ Free localization, comparative advantage, ref supply chain, cross borders M&As.
 - ❑ China and SEA look at it in a strategic perspective.
 - ❑ This is the vision, going to change the world.
 - ❑ Monetary zone emerging? Not yet. But dollarzone not anymore.
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5B. Asian Multinational companies (AMC). 2/4.

- ❑ Japanese multinationals? Not model for Asia.
 - ❑ Chinas multinational. Lenovo, Haier, CNOOC. Why? Learn how to manage a multinational company.
 - ❑ India. Infosys, Tata, Wipro yes but look at activities by Mittal and many others.
 - ❑ The Western multinationals going to meet them head on not only in Asia but globally. ASM have increasing returns on domestic market, access to technology, finance. ASM lack skilled labor and management know how.
 - ❑ Impact on corporate governance, corporate compliance.
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5C. Comparative advantage. 3/4.

- ❑ Now look at this. Comparative advantage China compared to India.
 - ❑ China labor productivity 50% better than India`s.
 - ❑ Indias capital productivity approx 30% better than China.
 - ❑ New driver in global economy.
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5D. International investment policy. 4/4.

- ❑ China is sitting pretty. You can say that about 1200 bio USD of which approx 400 bio in US treasury bonds.
- ❑ New investment policy. Blackstone as example.
- ❑ China FDI in 69 bio USD, out 16 bio. 32% y/y.
- ❑ India FDI out grosso modo FDI in. 16 bn USD.
- ❑ New trend. Institutional investors Funds.

Think about it? Who will lead? Where the money is and where is that – Asia, China, MEC.

This new pattern will shift economic power and probably also corporate power to China and India.

- ❑ SWF estimated 12 trillion USD in 2015, equal US economy today!!!!!!!
 - ❑ Savings rate in Asia stable or ↑.
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6. Risk factors.

□ In China.

- Energy, environment, water, inequality.
- Political stability. 17th Party Congress.

□ China-Southeast Asia.

- China look upon SEA.
- Southeast Asia look upon China.

□ Extremism-terrorism.

□ Social losers – political system.

□ Foreign and security policy.

Korean peninsular. Taiwan. Japan.

□ US role. Fundamental question.

Will US support Asian integration, try to prevent it or be disengaged.

7. Political systems/philosophy.

- ❑ Growing expectations for **L**egitimacy, **A**ccountability, **T**ransparency.
 - ❑ BUT in Asia not associated with a particular political model. Separate selection of political leaders from the substance of the system – contrary to US and Europe.
 - ❑ Future:
 - system will adjust to L-A-T without doubt.
 - selection of political leaders not necessarily so.
 - ❑ Monolithic system? Far from it. Fractions etc. In China fx the Shanghai group.
 - ❑ China. Combine these freedoms with the mandarin system. Meritocracy. The Mandarin system?
 - ❑ If yes political stability, if not.....trouble.
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8. Key words - Asia.

- ❑ The Asian economies strong for the next ten years.
 - ❑ No visible domestic policy risk factors.
 - ❑ Risk associated with adapting the economic and social structure to new circumstances. Depend on political leadership. 17th Party Congress crucial.
 - ❑ The most likely scenarium:
 - a: Continued strong growth in Asia,
 - b: Emerging Asian economic integration, precise form depend upon China and India`s willingness to share its wealth and involve other Asian countries in particular Southeast Asia in decision-making,
 - c: Diminished US role but US still present,
 - d: Asian multinationals players on the global scene,
 - e: China-Japan platonic marriage.
 - ❑ Somewhere between 2015 and 2020 a new paradigm will emerge reflecting a changed Asia and its role in the world.
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9. Europe. (1/6)

Recognize

- The shift, a trend shift, may be a reversal of 1492.
 - Diminished political influence, steering system anno 1945 no go anymore.
 - Labor market. Capital.
 - The big markets move.
 - Competitiveness?
 - Fight for resources.
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9. Europe. (2/6) steering system.

- The American dilemma
 - Europe even more
 - Europes policy goals and Asia. Human rights, environment etc
 - Very little can be done without Asian countries on board
 - If US/Europe say no the risk increases for a non-peaceful transition of powers
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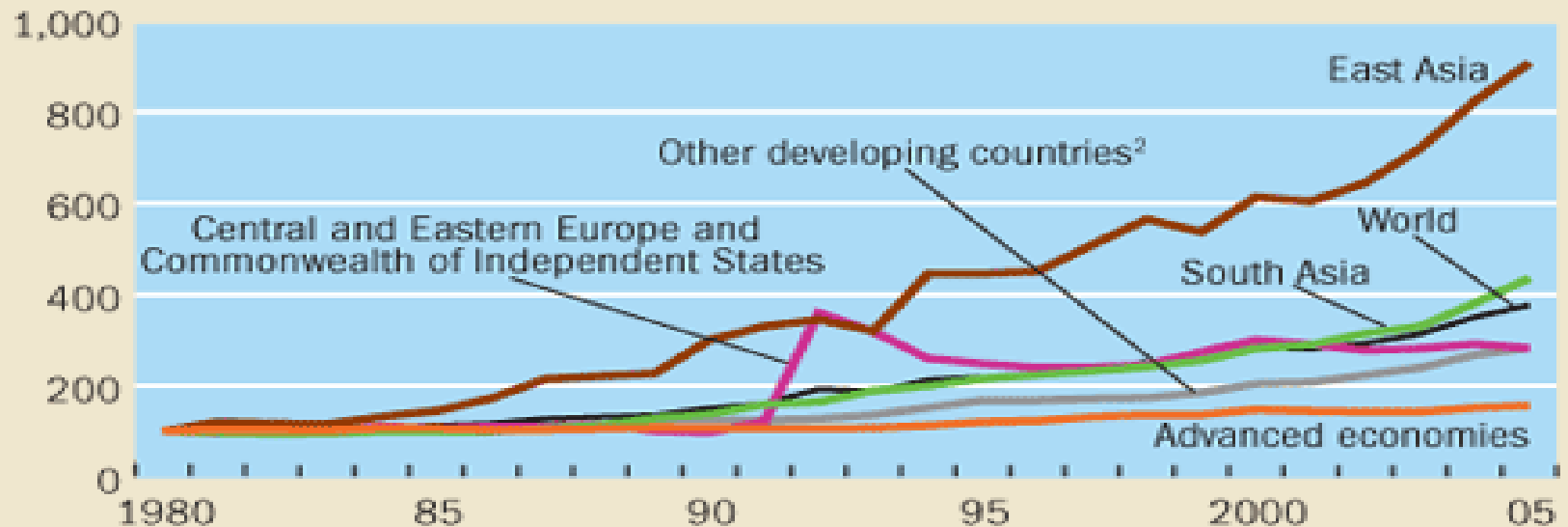
9. Europe. (3/6) labor.

- Where Europe and the European welfare states feel the punch hardest is labor compensation – wages – and employment.
 - Let us look at the figures and draw some conclusions.
 - Note. source IMF.
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9. Europe. (3a/6) labor.

The global labor supply has shot up since 1980 ...

(export-weighted labor force by region, index 1980 = 100)¹



Sources: United Nations, Population Prospects: The 2004 Revision Population Database; World Bank, *World Development Indicators*; and IMF staff calculations.

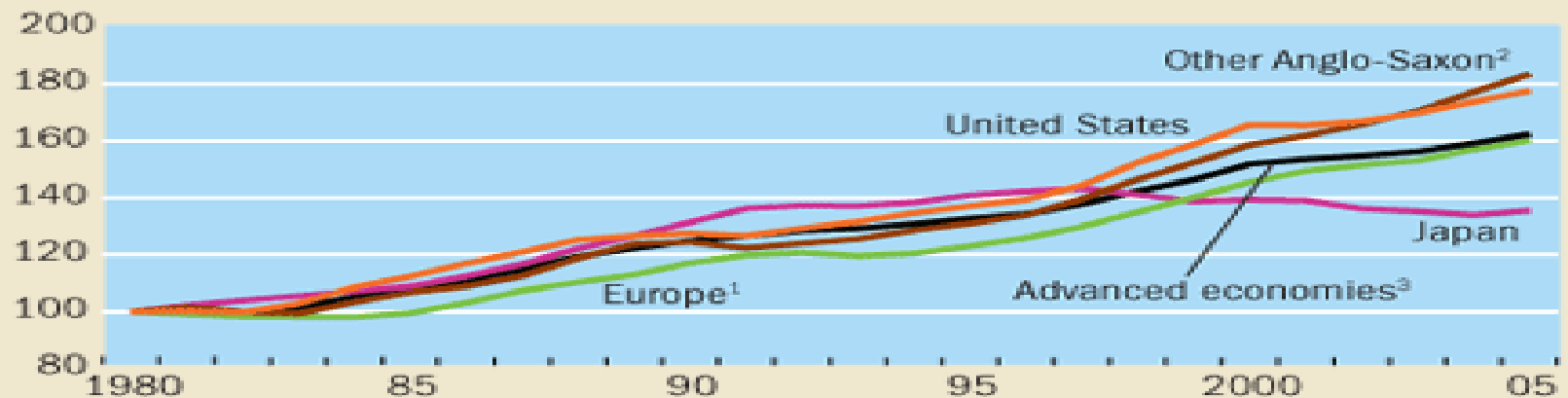
¹National labor forces scaled by export-to-GDP ratios.

²Western Hemisphere, Middle East and North Africa, and sub-Saharan Africa.

9. Europe. (3b/6) labor.

Labor compensation has been rising robustly in advanced economies, owing partly to globalization . . .

(real total labor compensation; index 1980=100)



Sources: Haver Analytics; International Labor Organization, Labor Statistics Database; OECD, Employment and Labor Market Statistics, National Accounts Statistics, and STAN Industrial Database; United Nations, National Accounts Statistics (2004); and IMF staff calculations.

¹Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Spain, and Sweden.

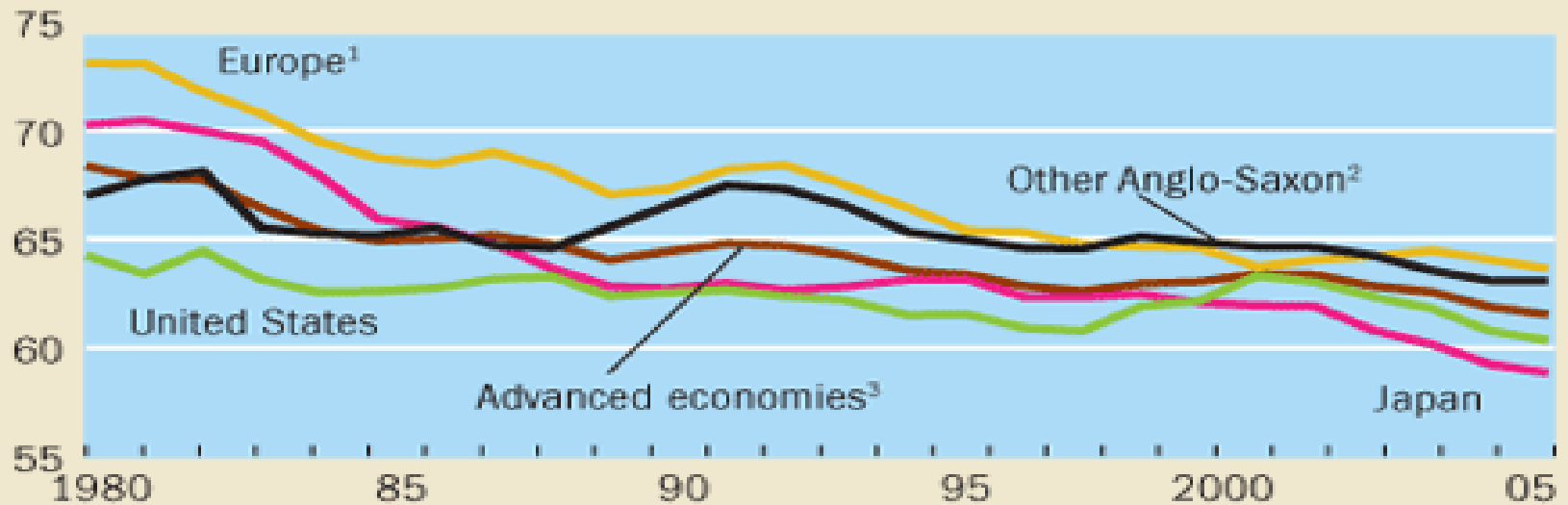
²Australia, Canada, and United Kingdom.

³Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, United Kingdom, and United States; weighted using series on GDP in current U.S. dollars.

9. Europe. (3c/6) labor.

The share of income going to labor has declined in advanced countries . . .

(labor share as a percent of GDP)



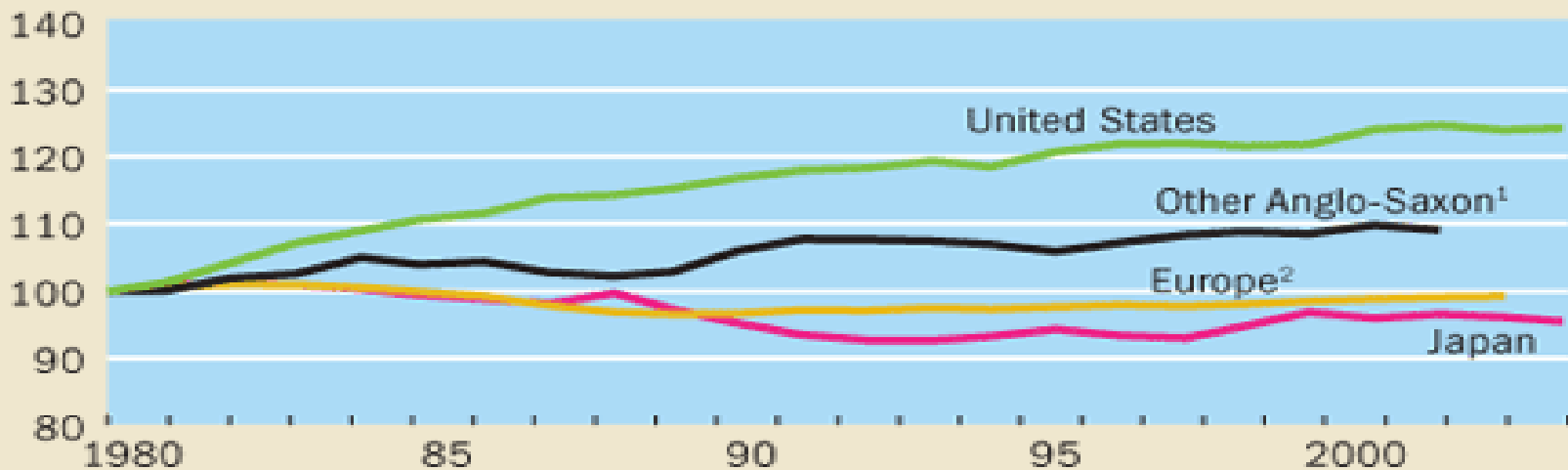
Sources: See Chart 3.

For footnotes, see Chart 3.

9. Europe. (3d/6) labor.

... especially in the unskilled sector, leading to a growing earnings gap in Anglo-Saxon countries.

(skilled to unskilled real labor compensation per worker, index 1980=100)



Sources: See Chart 3.

¹For analysis by skill level, other Anglo-Saxon economies include Canada and the United Kingdom.

²For analysis by skill level, Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden.

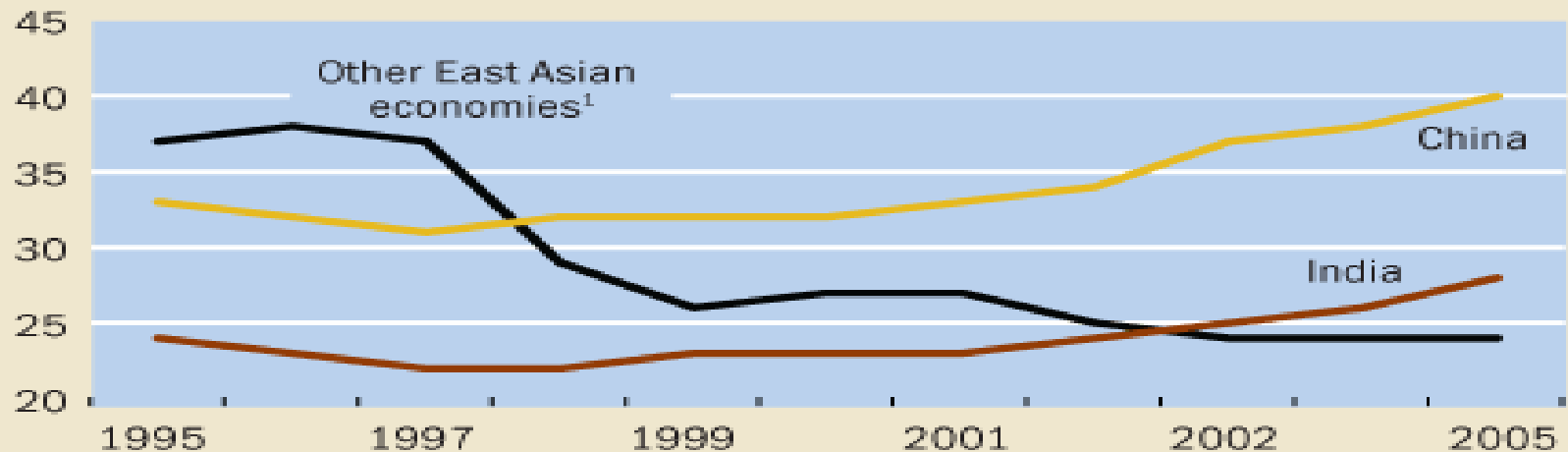
9. Europe. (3e/6) capital.

Chart 1

Investing a lot

China invests a far higher proportion of its GDP than its neighbors.

(investment-to-GDP ratio, 1995–2005)



Source: IMF, *International Financial Statistics*.

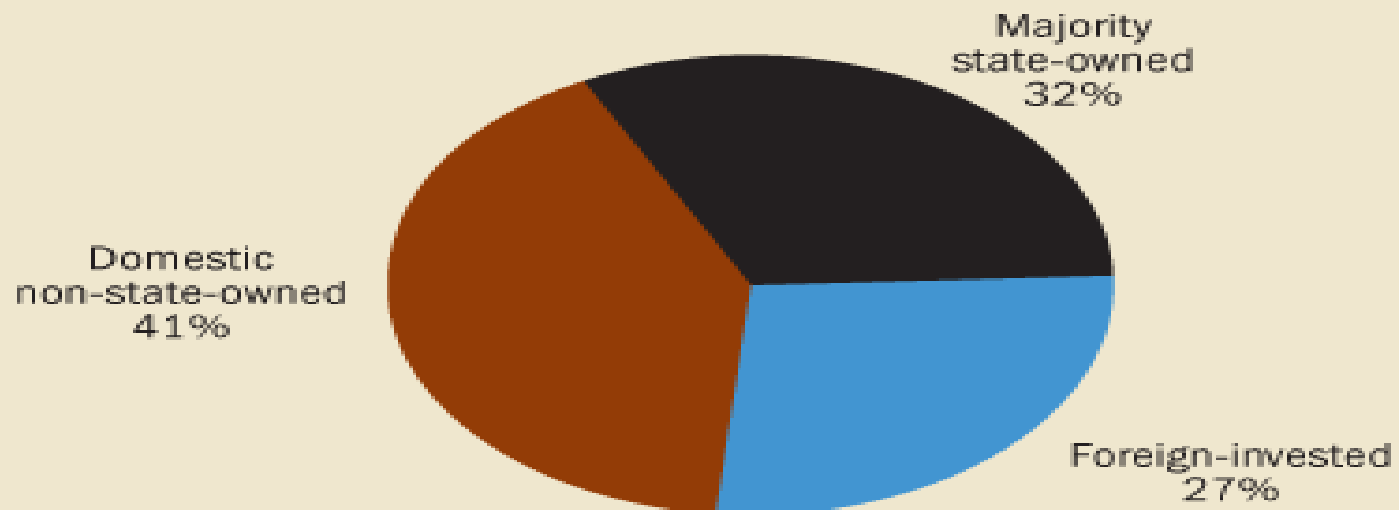
¹Average for Korea, Thailand, and Singapore.

9. Europe. (3f/6) capital.

Chart 4

... but state-owned firms are bigger

State-owned companies account for one-third of the manufacturing assets.



Source: Dollar and Wei (2007).

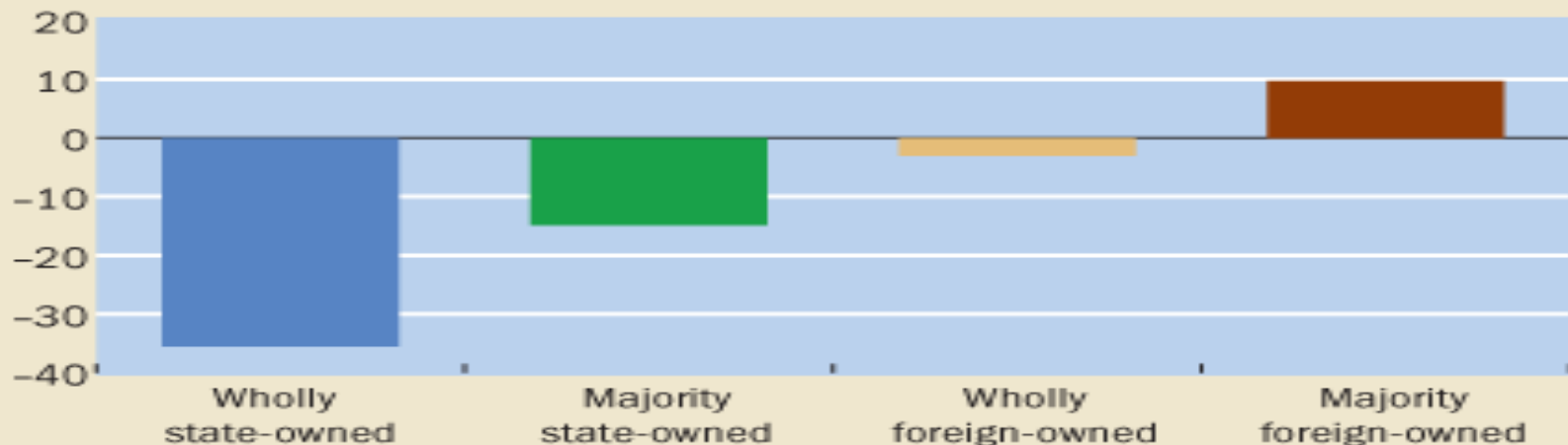
9. Europe. (3g/6) capital.

Chart 5

State-owned firms invest less efficiently

Relative to private firms, a given amount of investment by state-owned firms generates much less value added.

(MRPK¹ by ownership relative to domestic private firms, percent)



Source: Dollar and Wei (2007).

¹The marginal revenue product of capital (MRPK) is the increase in value added that results from an increase in one unit of capital, other inputs held constant.

9. Europe. (4/6) markets

- ❑ Transfer of purchasing power
 - ❑ No industry(company can prosper without understanding that
 - ❑ Trendsetters in Asia
 - ❑ But no animosity vis-a-vis European companies
 - ❑ Time is now to make links
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9. Europe. (5/6) competitiveness

- Europe cannot compete on costs
 - Performance levels yes.
 - Shift to other competitive parameters
 - Find other and new industries
 - Education is one of them
 - Skilled labor is becoming scarce
 - Link up with Asian multinationals
 - Find our own competitive niche
 - Comparative advantage makes room for everybody – a very simple law
-

9. Europe. (6/6) resources

- The age of cheap resources has gone
 - Agriculture, prices up
 - Raw materias prices up
 - Climate change is going to be the biggest fight about burden sharing
 - Europe – and the US – cannot hold on to privileged position
 - Unless of course we are ready for a big clash.
-

10. Conclusion.

- ❑ Global politics and economics is changing very, very fast
 - ❑ Europe`s position is also changing
 - ❑ Vis-a-vis US not bad
 - ❑ Vis-a-vis Asia more difficult
 - ❑ What shall we do?
 - ❑ Burden sharing
 - ❑ What we are best at, what nobody else is doing and nothing else
 - ❑ Concentrate, focus, sharpen our competitive edge where we have one and leave the rest to others.
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