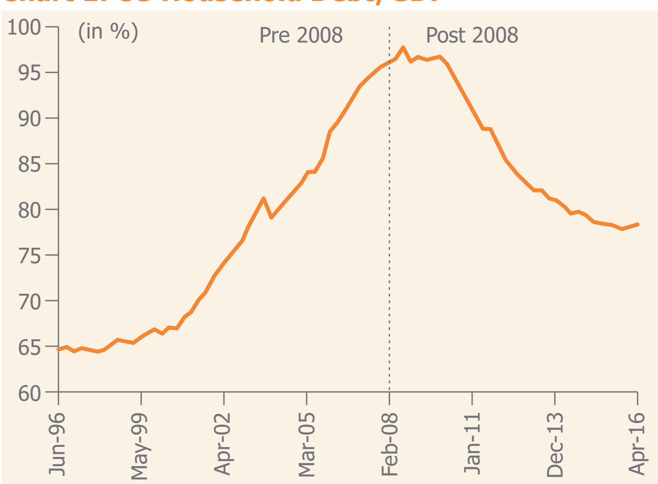
China is the new US & India is the new China

- China is successfully guiding its economic growth model toward consumption
- India with clear policy framework and improving fiscal is now focusing on infrastructure
- US with high household debt is no longer able to claim title as largest consumer nation
- China is filling the vacancy created by US as leading global consumer
- India set to adopt China type infrastructure led growth model to supplement its domestic consumption model

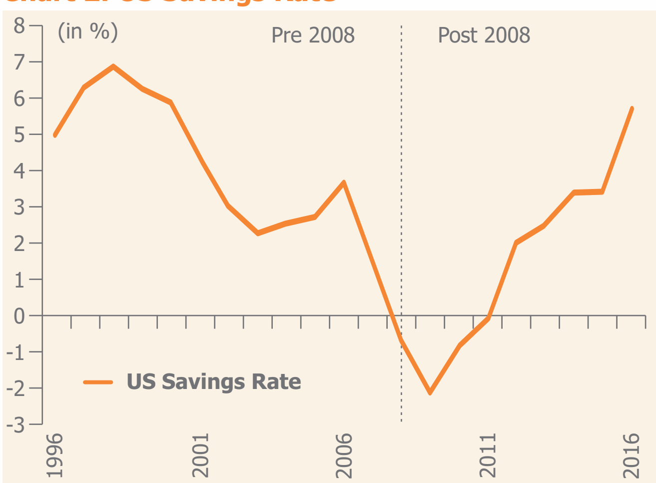
Over the last couple of decades, United States (US) has remained the main consumption center of the world, especially for the emerging Asian economies. This was reflected in increasing US household debt (Chart 1), declining savings rate (Chart 2) and ballooning balance of trade in US (Chart 3) in early part of 21st century (for Pre 2008 period).

Chart 1: US Household Debt/GDP



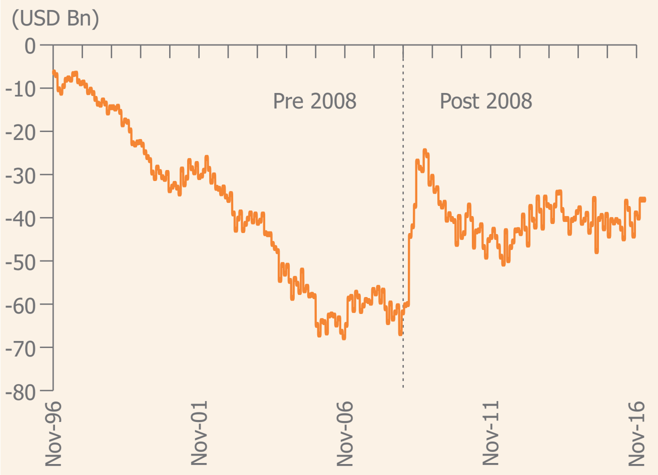
Source: Bloomberg, 30th November, 2016.

Chart 2: US Savings Rate



Source: Bloomberg, 30th November, 2016.

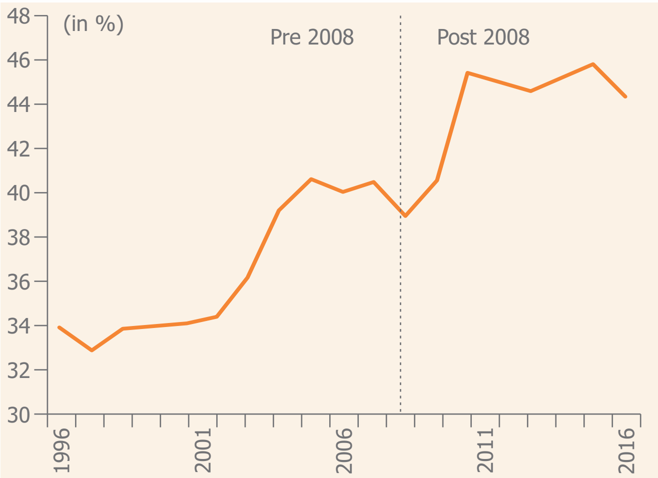
Chart 3: US Trade Balance



Source: Bloomberg, 30th November, 2016.

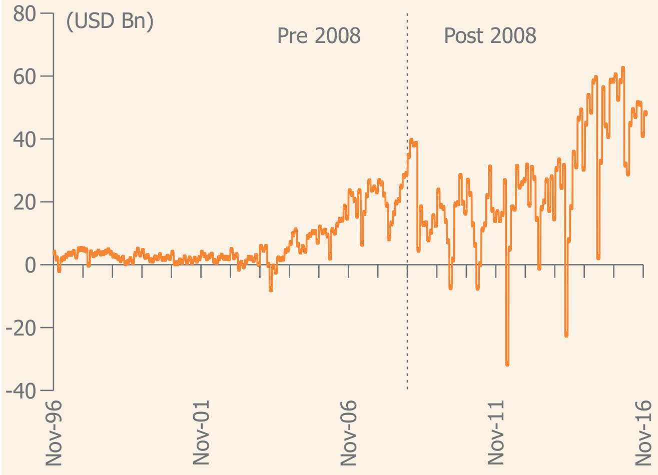
Countries like China have been at the forefront of taking full advantage of this trend. Competitively priced low cost exports helped China create huge wealth and accumulate largest foreign exchange reserves in the world. This wealth was then judiciously used to build world-class infrastructure. Growing exports allowed the govt to spend generously on creating infrastructure facilities like roads, ports, new cities, bullet trains etc. Even as the attention of all economists and analysts was on the export surplus that China was accumulating, domestically policy makers were busy executing even more ambitious infrastructure projects to further facilitate exports. This is reflected in China's growing contribution of fixed asset investments in GDP growth (Chart 4) after the initial surge in trade surplus (Chart 5).

Chart 4: China gross fixed capital formation (% of GDP)



Source: Bloomberg, 30th November, 2016.

Chart 5: China Trade Balance

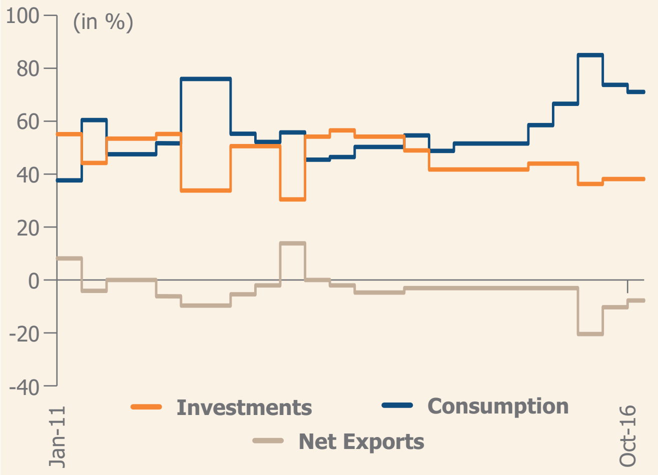


Source: Bloomberg, 30th November, 2016.

However, financial crisis of 2008 seems to have permanently changed this equation. Following sharp increase in fiscal deficit and large quantitative easing programs by Federal Reserve, US fiscal situation deteriorated somewhat. Combined with devastating negative wealth effect of a property market crash, household savings rate at a record low of (-) 2% and with household outstanding debt skyrocketing to near 100% of GDP, there was little room left for US consumer to continue playing the role of the leading consumption center of the word for much longer. A clear reversal in trend in these factors is visible in Charts 1, 2, 3 post 2008.

Around the same time, China was nearing a saturation point in term of infrastructure creation. Massive pump priming to deal with financial crisis suddenly started to show signs of excess capacity creation. In addition, most of the large infrastructure projects were laden with heavy debts and the revenue was not growing fast enough for these projects to be profitable. While on the one hand, infrastructure requirements were reaching a saturation point, high debt and lack of profitability was making it difficult for the govt to push for more projects. Alongside, increase in local wages and other costs and increased competition from other countries in South-east Asia was making it increasing difficult for China to continue relying on traditional model of exports and asset creation led economic growth. Under such situation, Chinese authorities figured out another sustainable and scalable growth model and that was to strive for consumption led growth by focusing on newly rich middle and upper middle class in China. Pretty much the residual choice that US followed for much of the last decade. Again a visible change in trend can be seen in Chart 4& 5 post 2008. The changing composition of the GDP in favour of consumption spending is also clearly visible in Chart 6.

Chart 6: China GDP Components



Source: Bloomberg, 30th November, 2016.

With a huge middle class, the now increasingly successful new growth model can potentially generate demand enough in next decade to even draw imports from other countries and potentially keep factories in those countries working. Thus, we conclude that China is the new US as much as it, in coming decade, can support global consumption growth.

India is the new China?

During this period, India witnessed a huge swing of fortunes. From almost at its worst ever macro fundamentals around the time of taper tantrum in 2013, it now perhaps has amongst the best ever macro fundamentals. In 2013, India had near 10% CPI inflation, almost a (-) 5% CAD, widening fiscal deficit inspite of inflating subsidy arrears and a crashing currency with little visibility on how the things could turn around from there. Following the crisis, the then Indian govt along with newly appointed central bank governor took series of pragmatic tough measures and the situation begun to settle down. In May 2014, Indian public elected its first absolute majority govt in over three decade with the election of Mr. Narendra Modi as the prime minister. A collapse in global oil prices in particular and commodity prices in general that followed shortly, resulted in huge savings for India, it being amongst the largest importer of oil globally. The new govt focused on fiscal consolidation successfully and utilized this windfall in reducing subsidy payments and to introduce market linked pricing of key resources like oil. Addressing some of the long-standing supply side issues and supported by continued low commodity prices, govt managed to bring CPI inflation down to near 4% currently. Current account is almost on the verge of turning into surplus and government is confident of meeting the fiscal deficit target of 3.5% in spite of additional expenditure on army pension and govt employee salaries. Alongside, Mr. Modi focused on a few key initiatives like Make in India and Digital India and put emphasis on building modern infrastructure in key areas like road, power, ports etc. Govt sorted out majority of policy bottlenecks and gradually opened door for an accelerated development of infrastructure. In November, a demonetization scheme for high denomination notes was launched with the objective of rooting out corruption and black money. A vastly improved financial situation, continued low commodity prices and a well-structured policy framework for infrastructure, at a time when private sector is still struggling to recover out of the difficulties of 2013 crisis and where new private investment has been negative for last couple of years, govt spending on infrastructure has suddenly become the backbone of economic growth for now.

It is increasingly clear that the next phase of growth for India will be led by infrastructure creation which in turn remains dependent on a govt with clear policies in this area and a strong financial situation. As such, much like China, India will most likely see growth lead by infrastructure development, primarily financed by public sector. Hence, we conclude that India is the new China.

To summarize, China is the new US, becoming the new consumption hub and India is the new China with focus on growth lead by infrastructure development.

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