

The Southern Silk Road

Turbocharging 'South-South' economic growth

The formation of new 'South-South' trading routes...
...linking Asia with the Middle East, Africa and Latin America...
...is set to revolutionise the global economy



By Stephen King

Disclosures and Disclaimer This report must be read with the disclosures and analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

The Southern Silk Road

- ▶ **We are witnessing the creation of a Southern Silk Road, a network of new “South-South” trading routes connecting Asia, the Middle East, Africa and Latin America.**
- ▶ *“South-South” connections are set to revolutionise the global economy. We believe that trade and capital flows between emerging areas of the world could increase tenfold in the next forty years.*
- ▶ **In the same way that trade between the developed nations exploded in the 1950s and 1960s, we expect the 21st Century to see turbocharged trade growth between the emerging nations.**
- ▶ *The scale of the opportunity is huge in part because the “economic borders” – tariffs, restrictions on migration, hostility - between emerging nations today are still high.*
- ▶ **Removing these “borders” won’t be easy but work is already underway. Countries in Asia have already formed new political alliances. Trade deals between China and countries in Latin America are becoming commonplace.**
- ▶ *The revolution in trade will be matched in capital markets. Asian financial centres are growing rapidly and, in time, the renminbi may become the world’s most important reserve currency.*
- ▶ **To facilitate South-South connections, the emerging nations will have to invest heavily in infrastructure. Already, China has five of the ten biggest ports in the world.**
- ▶ *Other emerging nations are not quite so advanced. But, with the help of Chinese investment, the process of infrastructure “catch-up” is slowly being established.*
- ▶ **Proposed railways coast-to-coast across Colombia and from China through to Turkey alongside new port construction in the Indian Ocean show the shape of things to come.**
- ▶ *Goods designed primarily for a domestic emerging customer base can be sold all over the emerging world. Domestic development will trigger new international linkages.*
- ▶ **Chinese and Indian cars, for example, are cheaper, lighter and simpler than their Western counterparts and may appeal to those who simply want transport rather than luxury.**
- ▶ *The political obstacles are still large: China, in particular, has not yet won hearts and minds. And, as it develops a naval capacity, it may be treated with suspicion in Washington.*
- ▶ **Nevertheless, the centre of economic and political gravity is heading South and East in a 21st Century version of the original Asian Silk Road, this time involving South-South connections over land, sea, air and the electronic ether.**

Ten South-South tasters

- 1 The number of Chinese tourists in Dubai increased 50% in 2009 and a further 50% in 2010.**
- 2 42% of the workforce in the United Arab Emirates is from either India or Pakistan*
- 3 Sinopec's USD7.1bn acquisition of a large stake in Repsol-YPF was the second-largest Brazilian M&A deal in 2010 while CNOOC's USD3.1bn investment in Bridas Corp was Argentina's largest M&A deal in 2010.**
- 4 In 2009, Korea secured a USD20bn deal with the Emirates to build nuclear power plants in the Gulf, its biggest ever export order.*
- 5 During Premier Wen's December 2010 Indian visit, USD16bn of trade deals were signed, outstripping the USD10bn signed by President Obama during his November visit.**
- 6 ICBC's 20% equity stake in Standard Bank represents the biggest FDI deal in South Africa since the end of apartheid in 1994.*
- 7 China is the largest foreign investor in Brazil, Laos, Myanmar, Iran, Mongolia and Afghanistan.**
- 8 China accounts for five of the world's top ten biggest container ports: twenty years ago, not one Chinese port was in the top twenty.*
- 9 Riversdale, the Australian-listed company developing coalfields in Mozambique, is 8% owned by China's Wuhan Iron and Steel, 22% owned by India's Tata and 16% owned by Brazil's CSN.**
- 10 Korean exports to the emerging world jumped from half to three-quarters of total exports over the last ten years.*

[Sources: 1. Dubai Department of Tourism and Commerce Marketing; 2. Gulf Research Centre "India's Growing Role in the Gulf", 3. Bloomberg, HSBC Argentina; 4. BBC; 5. Financial Times; 6. Johannesburg Stock Exchange; 7. Caixin Media, Chinese Ministry of Commerce, www.china.org.cn, www.ce.cn; 8. Containerisation International, The Economist; 9. Financial Times; 10. IMF DOTS.]

Turbocharged growth: how world trade will be transformed through South-South connections

Origin	Destination	2010 % share of total exports	2010-2050 % growth	2050 % share of total exports
China	Total	100	361	100
	South-South	47	621	73
	Ex-home continent/region	16	759	20
	Other	53	132	27
India	Total	100	504	100
	South-South	58	761	83
	Ex-home continent/region	29	823	45
	Other	42	147	17
Brazil	Total	100	431	100
	South-South	58	651	83
	Ex-home continent/region	36	901	68
	Other	42	121	17
Russia	Total	100	343	100
	South-South	19	1066	50
	Ex-home continent/region	19	1066	50
	Other	81	174	50

Source: IMF Direction of Trade Statistics, HSBC estimates

China export growth to 2050: the thicker the arrow, the bigger the increase



Source: HSBC estimates

Brazil export growth to 2050: the thicker the arrow, the bigger the increase



Source: HSBC estimates

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South-South Summary

- ▶ With the formation of new trade and capital market connections between the nations of Asia and the Southern hemisphere, South-South trade growth is about to become turbocharged...
- ▶ ...supported by rapid urbanisation, an infrastructure revolution and a fundamental change in the political and financial landscape.
- ▶ With trade between Asia and Latin America set to rise ten-fold in the years ahead and southern capital flows heading ever-higher, we are witnessing the creation of a Southern Silk Road



VIDEO COMPASS POINTS

Stephen King gauges the effect of shifting global trade patterns on the North, South, East and West

[Click to watch](#)

As the US fades, emerging nations trade

Knowing that China, India and other emerging nations are growing quickly is not enough to understand fully the revolution taking place in world economic affairs. We are witnessing the creation of new economic and financial connections that will fundamentally change patterns of economic endeavour around the world.

Today, it's the US but, in twenty or thirty years' time, China's biggest trading partner might be India. Brazil and Russia, in combination, will likely be threatening to overtake the US as important destinations for Chinese exporters.

And it's not just China's relations with its trading partners that will re-shape the global economy. The scope for India, Brazil and Russia to trade with each other is big enough to eclipse trading relations with the US and Europe. And what's true of the BRICs is also true at the continental level: we believe linkages between Asia, Latin America and Africa are set to expand at an exponential rate.

As South-South trade picks up, so should South-South capital flows, undermining the US dollar's reserve currency status and fostering the development of major new financial centres, notably in Asia.

Changes on this scale would be truly remarkable, taking us back hundreds of years to when world trade was centred not on Europe and North America but, instead, on Asia and Africa.

Yet, today, China, India, Brazil and Russia account for only a fraction of each other's trade. So how can we make such claims with any degree of credibility?

Recent history provides part of the answer. In the 1950s and 1960s, rapid growth in what is now known as the developed world was not just a story about post-war reconstruction. Expansion was also,

importantly, driven by the opening up of trade between nations. While the 1970s provided an awkward interruption, the 1980s and 1990s provided a second leg to the story, this time supported by the free flow of capital across borders. These “new connections” led to turbocharged growth in developed world trade.

The same patterns of turbocharged growth are now within reach for the emerging nations. To date, their growth has been unusually dependent on exports to the developed world. The western nations, however, are simply not growing fast enough to enable this model to be sustained. If the emerging nations are ever going to experience living standards approaching those now taken for granted in the developed world, they will increasingly have to trade with each other.

Dismantling the barriers

To a degree, it’s already beginning to happen. India and Brazil export more to the emerging world than they do to the developed world. China is, slowly, heading in the same direction. But there are huge hurdles in the way, notably the existence of thick “economic borders” throughout the emerging world. Tariffs, restrictions on migration, linguistic variations, conflict and disease all reduce the opportunities to trade. The open relationships taken for granted in the developed world are still but a distant dream across many parts of the emerging world.

If economic borders remain “thick”, south-south trade will struggle to take off. Yet the incentive to change is enormous. By reducing the chances to trade with the rest of the world, thick borders discourage capital inflows, keep people trapped in rural poverty and leave economies persistently underperforming. So far, those emerging nations which have opened up have done so either internally (allowing economic linkages between regions to expand) or by connecting with the developed world. Only if they can connect with each other will emerging nations be able to turbocharge their own economic futures.

New linkages

To do so, they’ll need to expand their infrastructure linkages. China shows what can be achieved. Today, mainland China accounts for five out of the world’s top ten container seaports. Twenty years ago, there wasn’t a single Chinese port in the top twenty.

China’s physical ability to connect with the rest of the world has been instrumental in driving its own economic development. It also underscores an important change in political attitude. China’s economic development over the last thirty years has only been possible by encouraging some areas to grow much more quickly than others: neither China nor the Soviet Union would have willingly tolerated such regional inequality under earlier regimes.

Elsewhere in the emerging world, however, linkages remain fragile. Outside Asia, only four container seaports are in the global “top 50”: three of those are big only because they happen to be at one end or the other of two of the world’s most impressive man-made waterways: the Suez and Panama Canals. That’s all beginning to change.

Beyond shipping, new linkages are taking hold via rail, air and the electronic ether. Indeed, growth of air travel (passenger and freight) and telecoms will increasingly be dominated by the emerging world in the years to come: incomes per capita across the emerging world have now reached levels where transport and communications demand should surge.

Chasing cars

Relative to other emerging nations, both China and India have the huge advantage of size. Like the US before them, they have the opportunity to create massive internal markets. These markets will work best if the products on offer are appropriate for people on low incomes compared with levels more typical in the developed world. And, as those internal markets develop, so the opportunity to sell the same products to people in other emerging nations will only increase.

Car production provides a fabulous example. Cars in the developed world have become bigger and heavier over the last thirty years partly because their occupants have become bigger and fatter and partly because of enhanced safety requirements. The Chinese and Indians are, on average, shorter and a lot lighter than their developed world cousins and even the simplest car represents a step-up in terms of safety for the Indian family previously perched precariously atop a moped in downtown Mumbai.

Chinese and Indian car companies are, thus, building small and cheap cars appropriate to their domestic markets. By implication, they are also building cars that can be sold elsewhere in the emerging world. It's no coincidence, for example, that Chery, a major Chinese car producer, now has 16 production facilities in foreign markets including Russia, Ukraine, Egypt, Iran, Indonesia, Uruguay and Brazil, not countries renowned for their high per capita incomes.

Joining up the dots

South-South trade won't take off automatically. It needs to be nurtured, most obviously through state interventions of one sort or another. Yet these interventions may lead to unexpected dividends for the countries involved.

Seeking to protect its Middle Eastern energy supplies, China is investing heavily – both politically and financially – in the construction of major ports in Pakistan, Myanmar and Bangladesh (the so-called “string of pearls”).

By doing so, China will be able to expand its naval presence in the Indian Ocean, raising big questions about a potential shift in both regional and global power. At the same time, however, the construction of ports will also create opportunities for some of the poorest nations in Asia to trade more easily with the rest of the world.

While China's deep pockets of savings have been mostly invested in pieces of US dollar paper, the opportunity to invest China's savings in other parts of the emerging world is increasing rapidly, helped by China's thirst for a wide range of raw materials. Proposing the funding and construction of a railway across Colombia is but one example of China's rising interest in Latin America and, indeed, Latin America's rising interest in China. Similar projects are taking place in Africa, recreating the linkages that made Mogadishu and Mombassa centres of world trade a thousand years ago. India, like China, is busily acquiring Western assets replete with technologies which can be “downloaded” into domestic production platforms: Tata's acquisition of Jaguar is but one of many examples.

As these (sometimes state-sponsored) trade and capital flows increase, so the financial oil that lubricates their growth will change. While the US dollar will remain the world's pre-eminent currency for the foreseeable future, we see every reason to believe that South-South connections may be funded in other

currencies, most obviously the renminbi. This is likely to go hand-in-hand with the development of new capital markets: if, over the last twenty years, China has managed to develop huge physical infrastructure, the next twenty years are likely to see the massive growth of China's financial infrastructure.

The missing link

South-South trade is the missing link in the global economy. If the dots can be joined, we may be on the verge of an economic revolution.

Admittedly, things may still go wrong. China and India may regard each other as rivals rather than partners. Nations in Latin America and Africa may view China's involvement in their affairs as a form of economic colonisation rather than as a mutually-beneficial relationship. Commodity producers may find their currencies driven ever higher as "southern capital" pours in, reducing their ability to diversify into manufacturing and services. Conflicts are still, sadly, a regular occurrence in Africa and Asia even as they have fallen away in the developed world.

Nevertheless, the opportunity is there. If connections can be established, the global economy has the potential to deliver outstanding performance in the years ahead even if the developed nations play only the most negligible of roles.

That, however, would be fitting: the Southern Silk Road is no more than a modern day incarnation of the original Silk Road, signalling the return of the world economy's centre of gravity to its origins.

We acknowledge the huge support of Matthew Abbam (HSBC Bank plc) and Stephen Brown (HSBC Bank plc) in the production of this report.

Heading South

- ▶ After centuries of Western economic dominance...
- ▶ ...the rules of the global economic game are being re-written...
- ▶ ...as South-South connections create a new dawn for the world economy

The new connections

It is time for a major re-think about the world economy. We are embarking on an extraordinary new phase of economic development dominated by the new superpowers of Asia and the Southern hemisphere. For many people familiar with a US or European-dominated world, this is an uncomfortable idea. It is an idea, however, that we need to get used to. We are witnessing the formation of new South-South economic connections which we believe will radically change the nature of global economic activity.

Our reluctance to recognise, understand and accept this change is partly based on our “built-in biases” about economic development. We are all, after all, victims of time and space. We succumb to our distorted views of the world. To an American, for example, the Statue of Liberty is an “old” monument: to an Egyptian, it is very new. To a European, modern civilisation began with the Renaissance but, for the Chinese, civilisation has been more or less continuous for over 4000 years. As we shall see, the new South-South connections are, in some ways, no more than the re-creation of trade connections which existed long before Europe and the US ruled the world. And to understand this process, it’s worth spending a bit of time on the history of world trade.



Old thinking

We tend to think about the world from a US perspective. Every month, the biggest economic release in the financial firmament is US non-farm payrolls, even though the initial “guesstimate” is subject to countless subsequent revisions. We argue about the degree to which the rest of the world is still ultimately dependent on the US economy. Yet to an economist or investor thinking about the world in the middle of the 19th Century, this focus on the US would seem bizarre. Back then, the US economy was relatively small. As the sixth biggest economy in the world, it ranked behind China, India, the UK, France and Germany and its incomes per capita were lower than those of the Netherlands and Belgium. Before the First World War, the Great Powers in Europe – the UK, France, Germany, Russia and Austria-Hungary – dominated the world political scene.

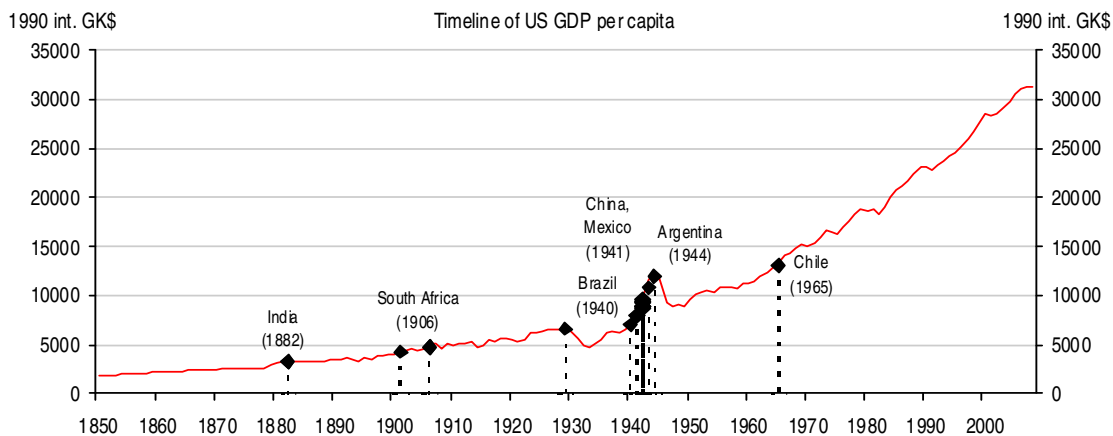
2. The world in 1850: The Top Ten Economies

	GDP (millions)	GDP per capita
China	247,200	600
India	125,681	533
United Kingdom	63,342	2,330
France	58,039	1,597
Germany	48,178	1,428
United States	42,583	1,806
Italy	33,019	1,350
Japan	21,732	679
Spain	16,066	1,079
Indonesia	14,633	637

Note: GDP and GDP per capita is in 1990 International Geary-Khamis dollars
Source: Maddison data

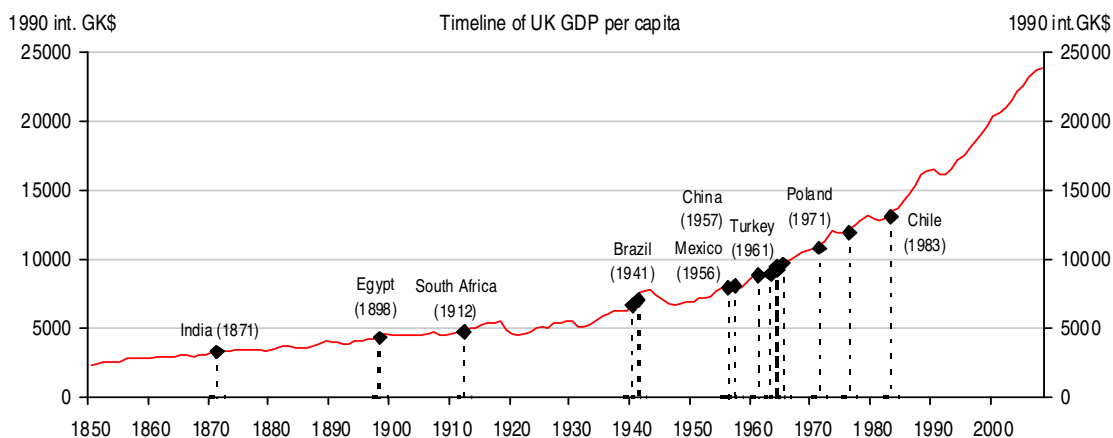
Still, to the extent that the US economy – alongside Australia and New Zealand – is an extension of European power (how many American Presidents have had European roots?), it’s still possible to argue that nothing very much has changed. There may be an “old world” and a “new world”, but both worlds are ultimately dominated by European values: democracy, the rule of law, freedom of speech, etc. As such, nations elsewhere in the world ultimately will succeed – so it is frequently claimed - only if they jump on the “Western” bandwagon. (A recent

3. Countries in the emerging world are half a century or more behind US economic development....



Note: GDP per capita is in 1990 International Geary-Khamis dollars
Source: Maddison data

4.and not doing much better relative to the UK



Note: GDP per capita is in 1990 International Geary-Khamis dollars
Source: Maddison data

example of this argument is *History is on the side of democracy*, penned by Philip Stephens in the *Financial Times* on 20 January 2011.)

It's not surprising that this belief is so deeply entrenched. Living standards in the Western world rose hugely through the second half of the 20th Century whereas those in other nations lagged behind. Charts 3 and 4 show per capita real income levels in the US and the UK since the mid-19th Century and highlight where other nations are today relative to these extended timelines. Despite the rapid recent growth of China, India, Brazil and others, their per capita incomes are still remarkably low. On average, the Chinese enjoy the living standards experienced by Americans just before Japan's attack on Pearl Harbor while the average Indian is subject to a standard of living last seen in the US during the Great Depression. And, with huge amounts of income inequality, many Chinese and Indians put up with living standards more familiar to Americans living in the 18th Century (an interesting discussion about income inequality can be found in Branco Milanovic's 2010 book *The Haves and the Have-Nots*: India and Brazil are both poor countries but, whereas a large number of Brazilians are relatively wealthy by western standards, the vast majority of Indians are truly poor).

Given all this, it's tempting to argue that unless and until emerging nations fully embrace Western democratic values, it's unlikely that they'll be able to make a great deal of progress. Yet, as Kenneth Pomeranz argues in his 2001 book *The Great Divergence*, the West's success over the last three hundred years did not just reflect the unique benefits of "Western values". After all, to an observer in the first half of the 19th Century trying to explain the unique success of the British industrial revolution, the temptation would surely have been to highlight peculiarly British values in contrast to "backward" nations elsewhere in Europe. Eventually, however, Germany, France and others caught up (often before democracy was properly established). They did so partly because they copied and stole the new technologies associated with Britain's Industrial Revolution – a familiar refrain in other parts of the world today, of course - but also because, like Britain, they engaged in land grabs and colonisation.

Travelling even further back in time, it's easy to show that a "Eurocentric" view of the world economy simply doesn't make sense. Table 5 sketches out inter-regional trade flows at the time of the Battle of Hastings in 1066. Western Europe traded with Eastern Europe and the Islamic world but, at the time, Western Europe found itself very

5. Inter-regional trade flows, ca. 1000

	To	Western Europe	Eastern Europe	Islamic World	Central Asia	Sub-Saharan Africa	South Asia	Southeast Asia	East Asia
From									
Western Europe		-	Swords	Slaves, swords	-	-	-	-	-
Eastern Europe		Slaves, furs, silver	-	Slaves, furs, silver	Furs, swords	-	-	-	-
Islamic World		Pepper spices, textiles, silk, silver	Textiles, silver	-	Textiles	Salt, textiles, manufactures, swords, horses	War horses	Gold	Spices
Central Asia		-	Silver	Paper, silver, slaves	-	-	Silver, re-exports from China and Muslim world	-	Horses
Sub-Saharan Africa		-	-	Gold, slaves, ivory, rice	-	-	Timber, iron	-	-
South Asia		-	-	Pepper, spices, silk, teak, textiles	Pepper, textiles	Textiles	-	Textiles, pepper	Textiles
Southeast Asia		-	-	Spices, perfumes	-	-	Silk, spices, teak, rice, rubies	-	Perfumes, spices, sandalwood
East Asia		-	-	Silk, porcelain	Silk, tea	-	Silk, porcelain	Silk, copper, cash	-

Source: Power and Plenty: Trade, War, and the World Economy in the Second Millennium, Findlay, R., O'Rourke, K. H.

much on the periphery of patterns of world trade. The centre of world trade was much further East, dominated by Islamic and Asian nations. This wasn't just a reflection of land-based trading routes: sea-faring trade linked Indian cities with Mombassa and Mogadishu in East Africa, with islands in modern-day Indonesia and with Canton (modern-day Guangzhou) in China.

As far as the West's supposed dominance in the 20th Century is concerned, it proved to be very much a "game of two halves". Even before the onset of the First World War, political upheavals were beginning to undermine moves towards an increasingly integrated world economy (think, for example, of the Russo-Japanese War of 1904-05, the abortive Russian revolution in 1905 and the rising nationalist sentiment that threatened 19th Century empires). Thereafter, however, the global economy completely disintegrated, torn apart by conflict, racism, and political ideology. The open global economy of the 19th Century shaped by imperial muscle was replaced by the financial and economic crises of the interwar years. Only in the second half of the 20th Century did the Western economies take off in a serious way (see table 6). Admittedly, the emerging nations also began to get a share of the spoils but, as we've already seen, they were starting from a very low base: Indian per capita incomes did nothing in the first half of the 20th Century while Chinese per capita incomes actually fell.

It's easy enough to suggest that the West's economic re-acceleration in the second half of the 20th Century simply reflected the avoidance of war and a return to the values which shaped economic progress in the 19th Century. While seductive, these assertions ignore the importance played by what can best be described as the "opening up" of world trade and (much later) world capital markets. This has happened in three different stages. The coming fourth stage of this process may bypass Europe and North America altogether. We are heading South-South.

6. Average annual GDP per capita growth*

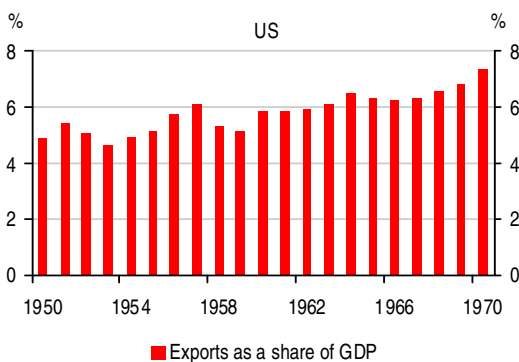
	1900-1950	1950-2000
United States	1.7%	2.2%
United Kingdom	0.9%	2.2%
Germany	0.5%	3.2%
France	1.2%	2.8%
Japan	1.0%	4.9%
Brazil	1.8%	2.4%
China	-0.4%	4.2%
India	0.1%	2.3%

Note: *GDP per capita is in 1990 International Geary-Khamis dollars
Source: Maddison data

Stage 1: developed world trade

The initial steps in opening up the global economy were made in the 1950s and 1960s as the desire to avoid the economic and political mistakes of the interwar period led to the gradual dismantling of trade barriers. Some of this was done within specific geographies – notably with the formation of the European Coal and Steel Community in 1951, the forerunner of the European Union. Most, however, came about as a result of close cooperation between democratic powers keen to escape from the conflicts of the first half of the 20th Century: the creation of the IMF and the World Bank, the delivery of successive GATT (General Agreement on Tariffs and Trade) rounds designed to reduce trade barriers, the development of the Bretton Woods system of fixed but adjustable exchange rates, the extraordinary ambition of the Marshall plan which helped deliver postwar reconstruction in a bid to avoid the mistakes contained within the Treaty of Versailles and the creation of the North Atlantic Treaty Organisation, a response to fears of Soviet expansion in Europe.

7. Exports rose modestly as a share of GDP in the US....



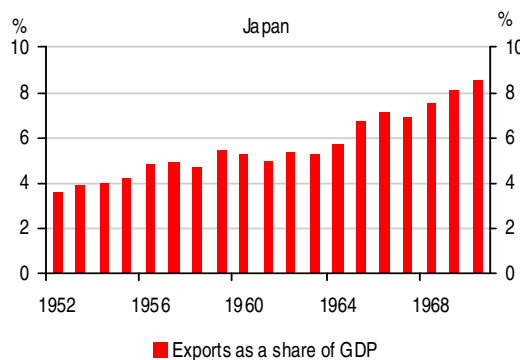
Source: Economist One Hundred Years of Economic Data

8. ...and in the UK....



Source: Economist One Hundred Years of Economic Data

9. ...but they rose much more quickly in Japan....

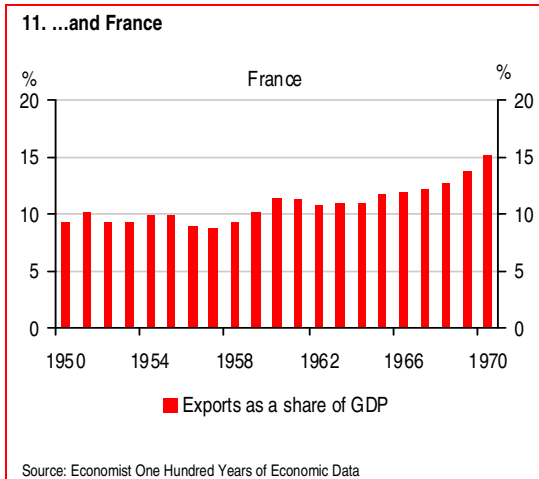


Source: Economist One Hundred Years of Economic Data

10. ...Germany....



Source: Economist One Hundred Years of Economic Data



12. The rich got richer, the poor remained poor

GDP per capita	1950	1970
US	9561	15030
Japan	1921	9714
Germany	3881	10839
UK	6939	10767
France	5186	11410
Brazil	1672	3057
Total former USSR	2841	5575
India	619	868
China	448	778

Source: Maddison data

The consequence of this reforming zeal was a massive re-opening of world trade. Yet only those countries which make up the core countries within the OECD (otherwise known as the “rich nations’ club”) really benefited. Because the reforms took place between like-minded consenting democracies, it seemed as though economic progress depended on democratic status.

Certainly other countries lagged behind. But how much of this story was the result of democracy and how much reflected, instead, the ability to exploit comparative advantages which had been largely dormant in the protectionist and conflict-obsessed first half of the 20th Century? After all, Singapore’s economy went from extreme poverty through to considerable wealth in the space of half a century even though it had no conventional democratic framework and went through significant political

upheavals (notably its integration into Malaysia in 1963 and its subsequent separation in 1965).

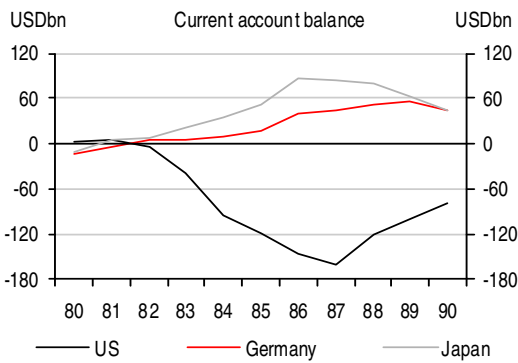
Stage 2: Opening up capital markets

The 1970s saw a series of hiccups, driven by expansionist monetary policies in the US associated with the funding of the Vietnam War, by the global consequences of the 1973 Yom Kippur War and the Arab oil embargo which followed, and because the Bretton Woods exchange rate system collapsed leaving the world without a nominal anchor. In response to this monetary mayhem, policymakers began to rethink their attitudes to international finance. Their response was to reject the straitjacket of capital and exchange controls which had contributed to frequent balance of payments crises and, instead, to embrace monetary targeting, flexible exchange rates and open cross-border capital flows. Each country became responsible, so it seemed, for its own economic destiny.

The result was a massive increase in cross border capital flows. The stock of foreign direct investment in 1980 rose beyond 20 per cent of global GDP for the first time since before the First World War and, by the beginning of the 21st Century, had rocketed through 100 per cent of global GDP.

In its initial stages, this huge increase was a story mostly affecting only the wealthy nations. The Japanese and Germans with their large current account surpluses mostly lent to the Americans. The British, with their North Sea oil revenues, invested abroad for a while (until oil prices collapsed in 1985 and the oil surpluses became a distant memory). Emerging nations were generally regarded as exceptionally risky, largely a reflection of the 1982-84 Latin American debt crisis which brought the US banking system to its knees. The 1990s weren’t much better: investors dabbling in Mexico and Asia ended up with their fingers burnt.

13. Imbalances used to be a G3 affair



Source: IMF and HSBC

Over much of this period, global imbalances rose. The creditors and debtors were mostly to be found in the developed world. The US ran a large current account deficit funded by ever-increasing surpluses in Germany (until reunification) and Japan. While these imbalances contributed to frequent bouts of financial turbulence – most obviously the dollar’s decline in the mid-1980s which eventually led to the October 1987 stock market crash – they were politically just about tolerable: the Japanese, for example, rightly recognised that, in return for funding America’s large budget deficit, the US provided military and diplomatic protection for Japan in the midst of the Cold War.

Stage 3: North-South and East-West linkages

The opening up of capital markets was truly a revolution. But it was not the only revolution taking place at the time. At the end of the 1970s, Deng Xiaoping’s China was tentatively beginning to open its doors to the rest of the world and turning its back on some of the stranger reforms introduced under Chairman Mao. And, as the 1980s progressed and President Reagan pursued his “Star Wars” initiative, the Soviet Empire’s economic weaknesses were finally exposed: unable to keep up with American military spending, Soviet power ebbed away and, slowly but surely, democracy spread eastwards.

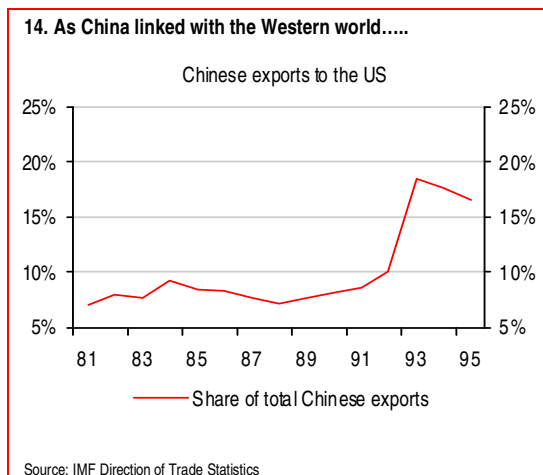
As old empires collapsed, so countries previously ambivalent about their relationships with the West began to have a re-think. India, which had deliberately adopted a post-colonial strategy following independence of protecting inefficient domestic industries and which had purchased many of its military supplies from the Soviet Union, began to rediscover connections with the Western world (this time on a voluntary basis). Countries in Eastern Europe, previously ruled by Moscow, clamoured to join the European Union. Latin American countries rejected the inflationary policies of the 1970s and began to embrace connections with the developed world. Mexico signed up to the North American Free Trade Agreement (NAFTA). Latin American nations created Mercosur (the Southern Common Market)¹, in effect a free trade zone. These developments didn’t stop crises from happening. There was, however, a slow realignment of ideas.

There were, of course, important exceptions. The Iranian revolution demonstrated that not all nations were keen to embrace so-called “Western

¹ Full membership for Argentina, Brazil, Paraguay, Uruguay and (as of December 2010) Venezuela and associate membership for Bolivia, Chile, Colombia, Ecuador and Peru

values”. Indeed, to the extent that Iran’s rejection of the Shah was a vote against Western influence (the Shah was, after all, supported by the CIA, amongst others), it represented the re-emergence of theocratic values which then spread rapidly through parts of the Islamic world, undermining Francis Fukuyama’s 1992 claim that, with the fall of the Berlin Wall, we were witnessing *The End of History*. (Events in Tunisia, Yemen, Egypt Libya, Bahrain and Syria at the beginning of 2011 only served to emphasise the extent to which bold claims can be undone through political upheaval.)

1990s (chart 14). Since then, exports to China as a share of total US exports have been increasing rapidly. China has become one of the world’s biggest recipient of foreign direct investment, thanks mainly to companies from the developed world prepared to use China as their “factory to the world” (table 15).



Nevertheless, there can be no doubt that the world is much more closely connected as a consequence of the opening up to business of much of the emerging world. A casual look at trade flows emphasises the point. China’s exports to the US rose dramatically as a share of its total exports at the end of the 1980s and the beginning of the

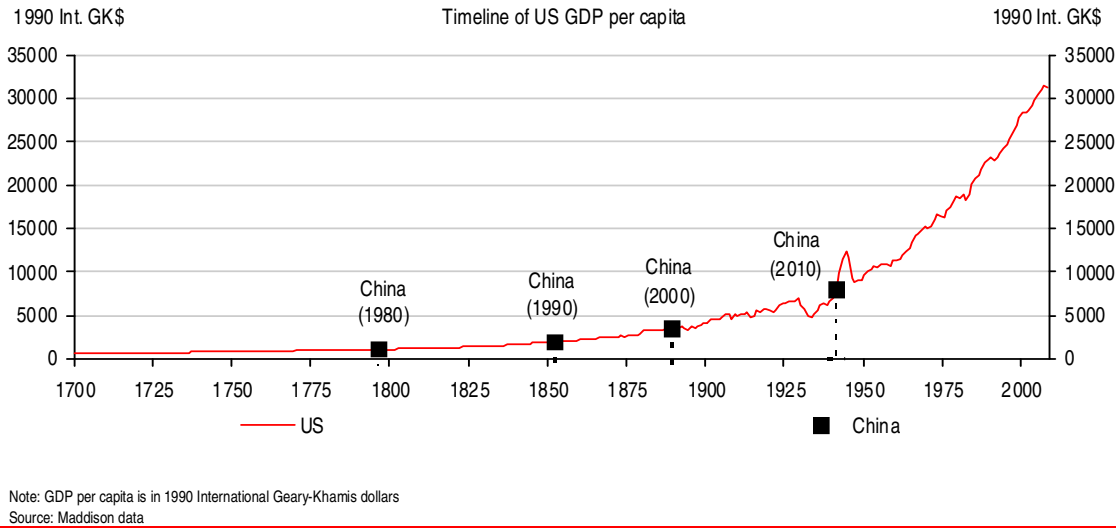
Given all these new connections, China’s share of world trade in goods has soared, rising from an insignificant 1% of the total in 1980 to 9% today (chart 16). And China and India are enjoying increases in living standards every decade which took the US between 30 and 50 years to achieve in the 19th and early 20th Centuries (charts 17 and 18). Their performance has been simply remarkable judged by any conventional economic yardstick.

15. The top 10 recipients of FDI inflows (USDmn)

Rank	1980		1990		2000		2009	
1	United States	16,918	United States	48,422	United States	313,997	United States	129,883
2	United Kingdom	10,123	United Kingdom	30,461	Germany	198,277	China	95,000
3	Canada	5,807	France	15,629	United Kingdom	118,764	France	59,628
4	France	3,328	Spain	13,294	Luxembourg	88,739	Hong Kong	48,449
5	Mexico	2,099	Netherlands	10,516	Canada	66,795	United Kingdom	45,676
6	Netherlands	2,005	Australia	8,479	Netherlands	63,854	Russian Federation	38,722
7	Brazil	1,910	Luxembourg	8,047	Hong Kong	61,938	Germany	35,606
8	Australia	1,866	Canada	7,582	France	43,252	Saudi Arabia	35,514
9	Luxembourg	1,545	Italy	6,345	China	40,715	India	34,613
10	Spain	1,493	Singapore	5,575	Spain	39,575	Belgium	33,782

Source: UNCTAD

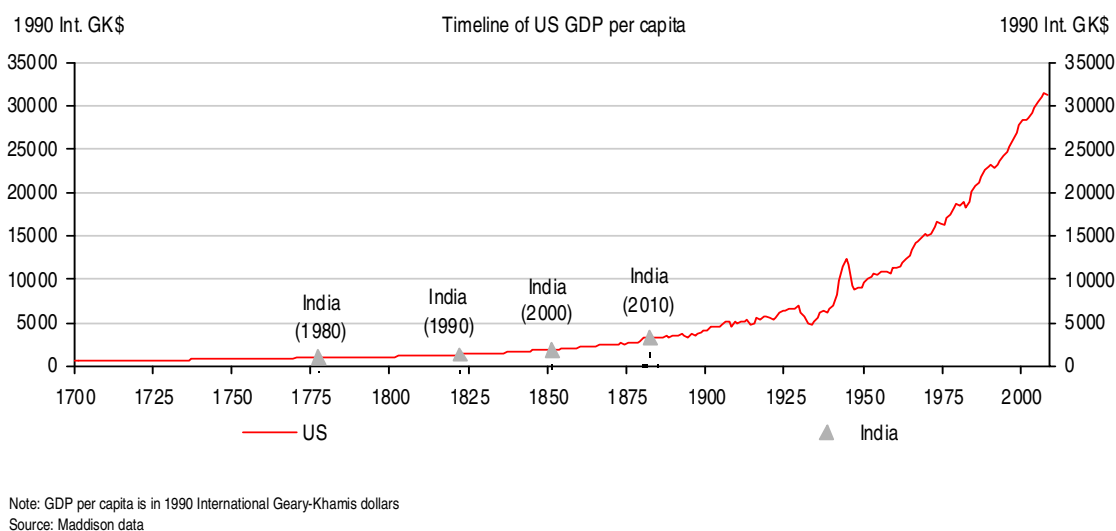
17. China is delivering fifty years of American economic advance every decade



All of this is ultimately a reflection of the enhanced mobility of capital. Yet for all the economic progress made by the emerging world, for much of the 1980s and 1990s, the developed world strengthened its grip on the world economy: the world's leading financial centres, after all, were New York, London and Tokyo. Emerging nations were an interesting adjunct to an investment philosophy that was heavily focused on making money in the developed world, whether through investments in real estate or in

developed world companies that might be willing to entertain the occasional investment in the emerging world. Financial investments in the emerging world were only for the brave or foolhardy, a view seemingly supported by the recurrent crises which led to huge losses for emerging investors in the 1980s and 1990s. As a result, even today, portfolio exposures to the emerging world remain very low.

18. India is delivering 30 years of US economic advance every decade



Stage 4: The Southern Silk Road

If connections can be made between the developed and the emerging world, they can also be made between countries in the emerging world. The incentive to do so is strengthening over time. As HSBC's Karen Ward notes in *The World in 2050* (January 2011), "By 2050, the emerging world will have increased five-fold and will be larger than the developed world.....19 of the top 30 economies by GDP will be countries that we currently describe as "emerging"".

Emerging nations will, therefore, be rewarded for trading with each other. Indeed, these rewards may imply that our 2050 GDP estimates for the emerging world are at risk of being too low, based, as they are, on domestic rather than international drivers of economic expansion. If nations really can exploit comparative advantages, the benefits of specialisation should see their

reward in terms of significantly higher economic activity. This is Adam Smith's pin factory in operation on the grandest of scales.

But can it happen? The next section offers some answers. Emerging nations are, in many cases, still disconnected from one another even as they have, individually, increased their connections with the developed world. That, however, is all about to change. We are witnessing the creation of a new Southern Silk Road.

The original Silk Road initially developed under the Han Dynasty in China, which ruled from 206BCE to 220CE. For the next 1000 years or so, the Road (or, more accurately, the various routes) linked China with India, Central Asia, Rome (for a while) and, eventually, the Arab Caliphate involving trade in everything from spices and silk through to precious stones, ponies and slaves. The great Eurasian empires that

19. The potential reshuffle between now and 2050 is no different from that seen in the last forty years

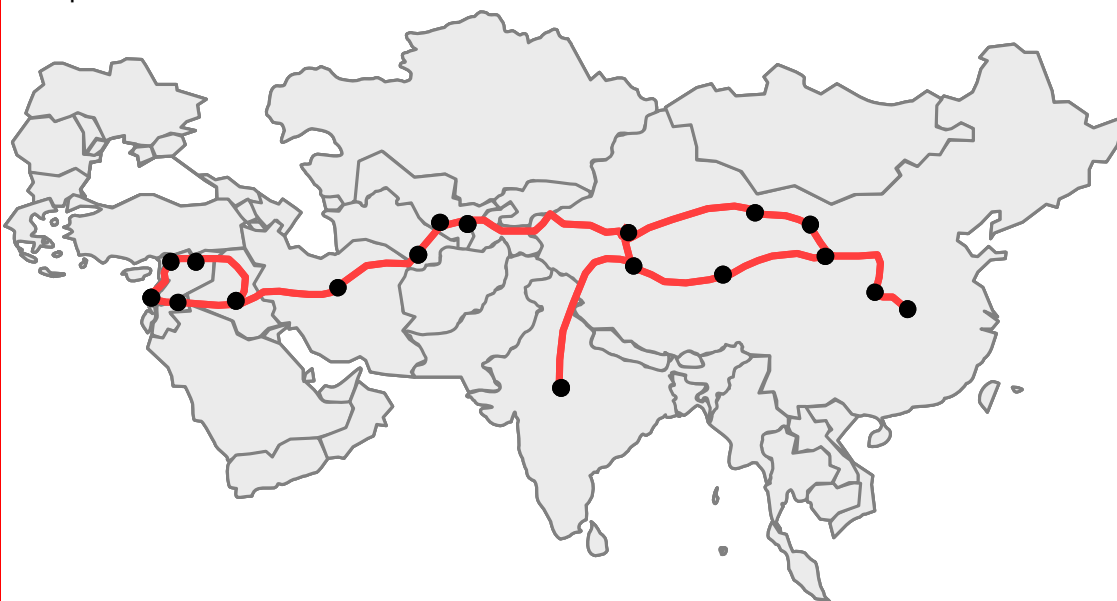
Order in 1970		Order in 2010		Order in 2050	
1	US	1	US	1	China
2	Japan	2	Japan	2	US
3	Germany	3	China	3	India
4	UK	4	Germany	4	Japan
5	France	5	UK	5	Germany
6	Italy	6	France	6	UK
7	Canada	7	Italy	7	Brazil
8	Spain	8	India	8	Mexico
9	Brazil	9	Brazil	9	France
10	Mexico	10	Canada	10	Canada
11	Netherlands	11	S. Korea	11	Italy
12	Australia	12	Spain	12	Turkey
13	Switzerland	13	Mexico	13	S. Korea
14	Argentina	14	Australia	14	Spain
15	Sweden	15	Netherlands	15	Russia
16	India	16	Argentina	16	Indonesia
17	Belgium	17	Russia	17	Australia
18	China	18	Turkey	18	Argentina
19	Austria	19	Sweden	19	Egypt
20	Denmark	20	Switzerland	20	Malaysia
21	Turkey	21	Indonesia	21	Saudi Arabia
22	South Africa	22	Belgium	22	Thailand
23	Venezuela	23	Saudi Arabia	23	Netherlands
24	S. Korea	24	Poland	24	Poland
25	Greece	25	Hong Kong	25	Iran
26	Norway	26	Austria	26	Colombia
27	Finland	27	Norway	27	Switzerland
28	Saudi Arabia	28	South Africa	28	Hong Kong
29	Iran	29	Thailand	29	Venezuela
30	Portugal	30	Denmark	30	South Africa

Source: World Bank and HSBC calculations

developed during this period became mutually dependent. It all went wrong when the Mongols, under Genghis and Kublai Khan, managed to spread not just total brutality but also bubonic plague across the Eurasian land mass. Connections were severed and the various routes fell into disuse. Later, as the European nations developed their ocean-going fleets, the case for expensive land-based trade across Asia economically collapsed.

Unlike the original, the Southern Silk Road won't only be confined to Asia and Europe. It stems from connections over land, across the sea, through the air and within the electronic ether. And because the costs of transportation and communication have collapsed in recent decades, it is much more geographically diverse, offering the potential to create hitherto-unimaginable linkages between Asia, the Middle East, Africa and Latin America. If it is able to advance, the Southern Silk Road will radically alter the dynamics of the global economy in the years ahead. The economic centre of gravity is about to undergo a major shift.

20. Map of the silk road



Source: HSBC

Breaking down borders

- ▶ While “economic borders” remain high between emerging nations...
- ▶ ...their steady abolition...
- ▶ ...will lead to dramatic rewards

Crossing the last great hurdle

Some consider the creation of a Southern Silk Road to be no more than an unlikely dream. Yet the incentive for southern nations to act is enormous. This was emphasised in May 2011 as China and Brazil discussed ways of opening up trade linkages. Brazil has a strong desire to move further up the “valued-added chain” in its dealings with its giant Asian partner and, during talks in Brasilia involving Chen Deming, China’s Commerce Minister, Brazil pushed for a reduction in trade barriers that have so far inhibited trade linkages between these two emerging superpowers. With Dilma Rouseff, the Brazilian President, having already visited China in April 2011 – one of her first overseas trips since assuming office– there can be no doubt that South-South trade linkages are rising up the international policy agenda.

As the World Bank puts it in its masterly 2009 report, *Reshaping Economic Geography*, the “economic borders” between the poorer nations of the world remain incredibly high. Yet it’s precisely because the starting position is so uninspiring that the opportunity for change is there. The developed nations found themselves in a rather similar position after World War Two yet, in the decades that followed, the slow and sometimes painful abolition of economic impediments reaped huge dividends. By showing

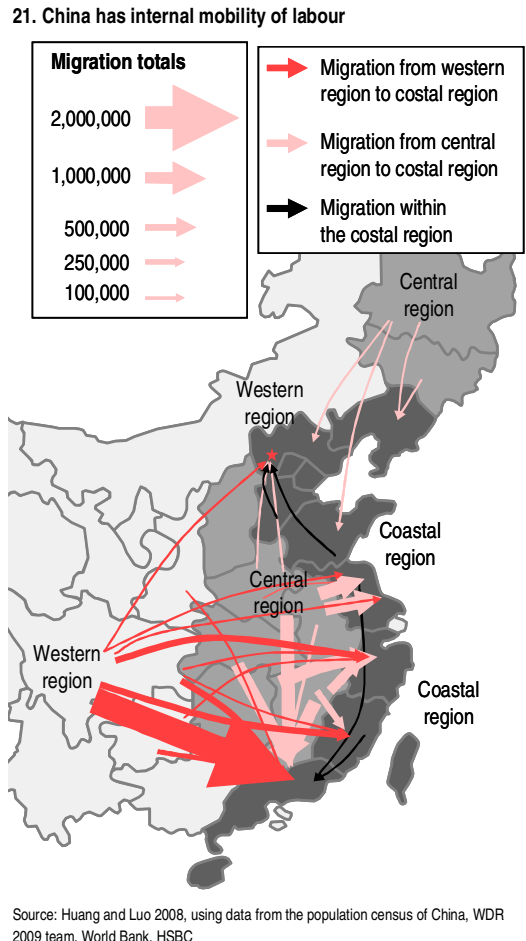
that southern borders are currently very high, we can also show why the opportunity for reform is so great.

Economic borders prevent mutually-advantageous connections from being made, thereby reducing economic efficiency. Comparative advantages remain untapped and per capita incomes stay relatively low. As noted by the World Bank, economic borders fall into a number of key categories:

- ▶ **Tariff and non-tariff (quotas, subsidies, antidumping duties, “red tape”) barriers to the free flow of goods and services:** These are currently at their highest in Africa, South Asia and Western Asia.
- ▶ **Restrictions on capital flows:** Again, these are at their highest in Africa and parts of Asia. And with countries currently reluctant to deal with rising inflationary pressures through currency appreciation, enthusiasm over capital controls is on the rise, a reversal of the trend seen over the last thirty years (see, for example, *Manning the Barricades*, HSBC Research, November 2010).
- ▶ **Migration:** While globalisation has led to an increase in migration flows, they remain low relative to trade or capital flows and those finding it easiest to move across borders are typically those on high per capita income.

They can afford to move. The receiving country, in turn, typically prefers university graduates to desperate refugees.

- ▶ **Landlocked countries:** Not all of these are economically disadvantaged – the Swiss, after all, have a very high standard of living, as do the inhabitants of Luxembourg – but those surrounded by poor neighbours or distant from world markets are likely to find themselves in trouble. Countries in Latin America, sub-Saharan Africa and central Asia spring to mind. (By the same token, some island nations – notably those in the Pacific – can be “sea-locked”, faced with high transportation, energy and rental costs.)
- ▶ **Country size:** The larger the nation, the easier it is for goods, services, people and capital to move around internally, thereby leading to a more efficient allocation of resources. China’s eastern provinces are, of course, open to the rest of the world but opportunities are also now beginning to appear in the landlocked western provinces: the borders with the rest of Asia may be substantial but linkages within China have grown very quickly. The pace of migration from Western to Eastern China, for example, has proceeded at an extraordinary pace.
- ▶ **Ethnic, cultural and religious divisions:** It’s tempting to believe that economic man is homogeneous but that clearly isn’t true. Think of Sunnis and Shi’ites, Hindus and Muslims, Indians and Chinese, Chinese and Japanese, Mainland Chinese and Taiwanese, Hutus and Tutsis, Israelis and Palestinians, North and South Koreans, Bosnians, Kosovans, Serbs and Croats, Turks and Armenians, Iraqis and Armenians. These divisions exist both within and across nations, leaving many people unfairly disadvantaged. And even if people try to be nice to each other, language differences prevent connections from being made. The eurozone cannot be as strong a political union as



the US for precisely this reason. The eurozone’s problems are tiny, however, relative to difficulties faced in sub-Saharan Africa where, near the equator, linguistic heterogeneity is greater than in any other part of the world.

- ▶ **Conflict and territorial disputes:** While Europe and the US still have their occasional difficulties – think, for example of the conflict between the former Yugoslavian states and the costs of US military involvement elsewhere in the world – it’s difficult to argue that daily life is affected by territorial disputes. Europe solves its problems peacefully under the auspices of the European Union (pre-1945 and pre-1989, Europe was a very different place) while US territorial disputes with Mexico were mostly resolved in the middle of the 19th Century.

22. Active armed conflicts in 2009

War/Conflict	Location
Europe	
	Russia (territory: Caucasus Emirate)
Middle East	
	Iran (government)
	Iraq (government)
	Israel (territory: Palestine)
	Turkey (territory: Kurdistan)
	Yemen (government)
Asia	
	Afghanistan (government)
	India (territory: Assam)
	India (territory: Bodoland)
	India (territory: Kashmir)
	India (territory: Manipur)
	India (government)
	Myanmar (territory: Karen)
	Myanmar (territory: Kokang)
	Myanmar (territory: Shan)
	Pakistan (government)
	Philippines (territory: Mindanao)
	Philippines (government)
	Sri Lanka (territory: Eelam)
	Thailand (territory: Patani)
Africa	
	Algeria (government)
	Angola (territory: Cabinda)
	Central African Republic (government)
	Chad (government)
	Ethiopia (territory: Ogaden)
	Ethiopia (territory: Oromiya)
	Mali (territory: Azawad)
	Nigeria (government)
	Rwanda (government)
	Somalia (government)
	Sudan (government)
	Uganda (government)
Americas	
	Colombia (government)
	Peru (government)
	USA (government)

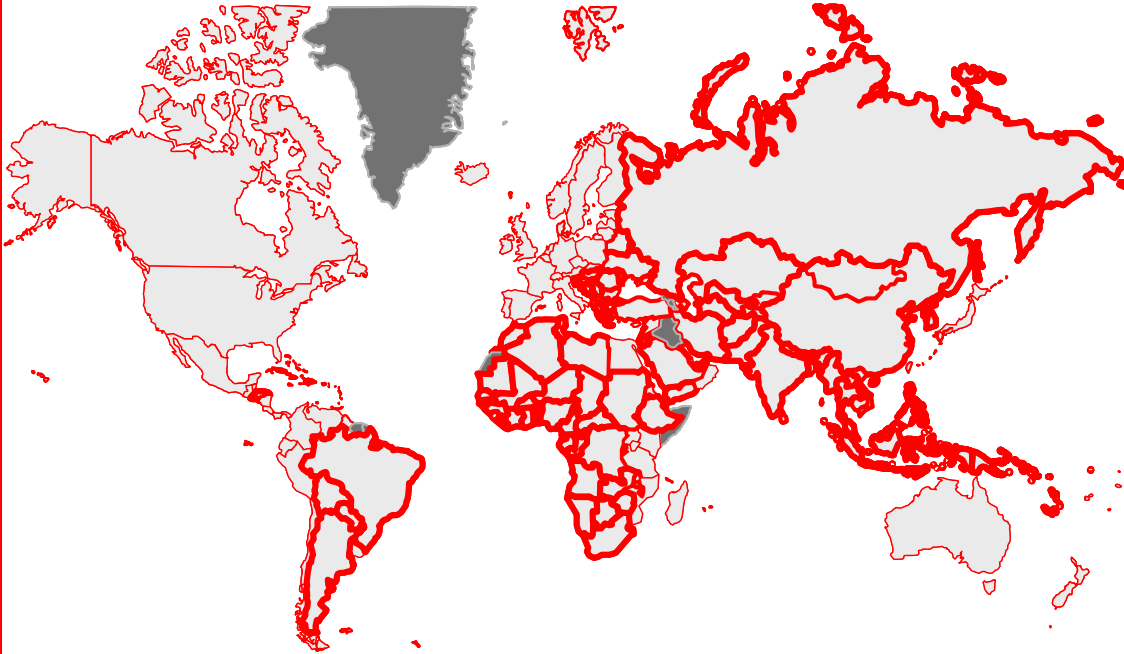
Source: Uppsala Conflict Data Program (Date of retrieval: 11/06/02) UCDP Database: www.ucdp.uu.se/database, Uppsala University

- **Disease:** Commonly cited as a major constraint on economic activity, disease has clearly prevented economic connections from being made. However, as parts of Asia have demonstrated in recent decades, disease can be overcome. Following its independence in 1965, for example, a programme of homebuilding led to dramatic improvements in sanitation in Singapore, reducing the incidence of disease and helping to raise life expectancy.

Putting this all together, there can be no doubt that emerging nations are not always well connected with each other. Chart 23, from the aforementioned *Reshaping Economic Geography*, shows that the “economic borders” are mostly far “thicker” around emerging nations than they are around developed nations. Yet this, in itself, is hardly an objection to the idea that emerging nations should be able to expand quickly in the years ahead. A similar map reflecting conditions in the 1950s and 1960s would have demonstrated that economic borders were, at the time, very high throughout what we now call the developed world. If economic borders could be removed between those countries, surely they can also, over time, be removed between the emerging nations as well.

Elsewhere in the world, however, the legacy of territorial disputes has restricted economic connections. Bolivia lost its access to the Pacific following a war with Chile in the late 19th Century and the two countries have since suffered a mutually-frosty relationship. More recently, linkages between Japan and Russia have suffered as a consequence of an ongoing dispute over the Kurile Islands. In the Middle East, territorial disputes are part of daily life, as they are in Sub-Saharan Africa. China and India gaze at each other uneasily across the Himalayas.

23. Economic borders are thicker in some places than in others



Note: The width of the borders is proportional to a summary measure of each country's restrictions to the flow of goods, capital, people, and ideas with all other countries. Dark grey areas = insufficient data

Source: WDR 2009 team, World Bank, HSBC

Trade connections

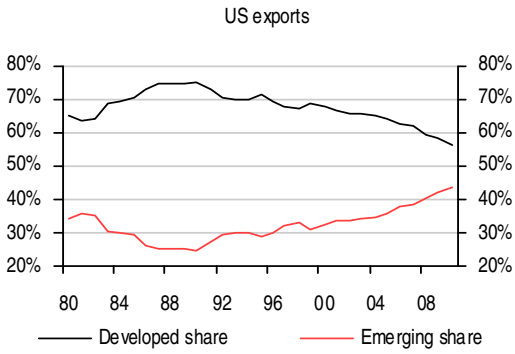
The evidence already points to huge changes in patterns of economic endeavour around the world. Connections involving the emerging world have been growing rapidly in recent years, so much so that, for many nations, trade with the emerging world is now more important than trade with the developed world.

Developed nations have, over time, exported less to each other and proportionately more to the emerging nations (charts 24 - 27). There are one or two exceptions, most obviously the UK, which now exports less proportionately to countries in the emerging world than it did at the beginning of the 1980s. Overall, however, the pattern is broadly consistent across nations. The experience of some nations in the emerging world is more compelling. While China has seen a modest increase in its share of exports heading to the emerging world, the really big changes have occurred elsewhere. Both Brazil and India now export more goods to the emerging

world than they do to the developed world, an extraordinary shift compared with their experiences in the late-1980s and early-1990s. Much of this story is related to China's growing demands, which India and Brazil have eagerly been satisfying in recent years.

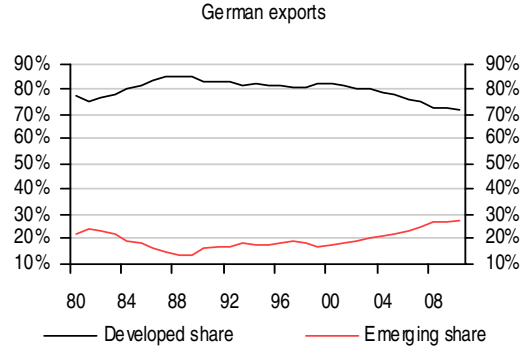
The story on imports is even more striking. Of the major developed nations, both the US and, to a much greater degree, Japan import more from the emerging world than they do from the developed world, a transformation relative to the situation at the beginning of the 1990s. India falls into the same category while both China and Brazil seem to be heading in the same direction.

24. US trade is now much more focused on the emerging world



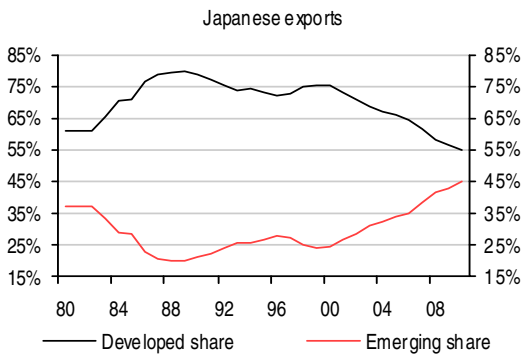
Source: IMF Direction of Trade Statistics

25. Germany is heading in the same direction



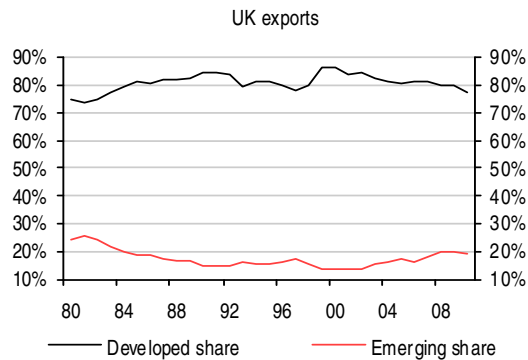
Source: IMF Direction of Trade Statistics

26. Japan exports to EM almost the same as DM



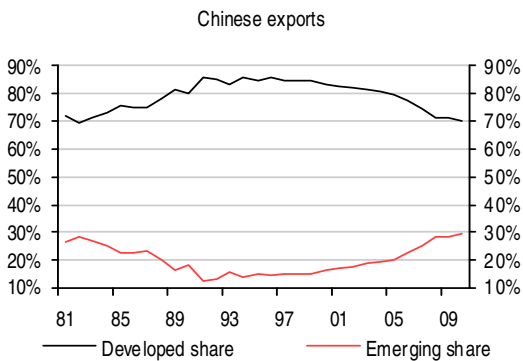
Source: IMF Direction of Trade Statistics

27. The UK has lagged behind



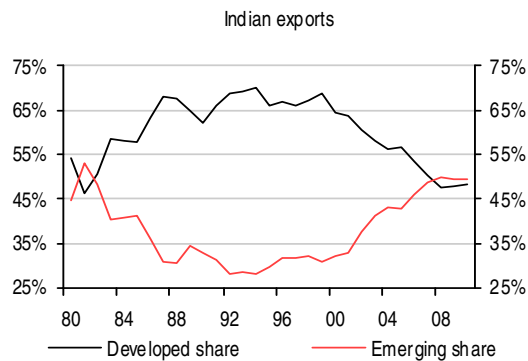
Source: IMF Direction of Trade Statistics

28. China is beginning to connect with other emerging nations



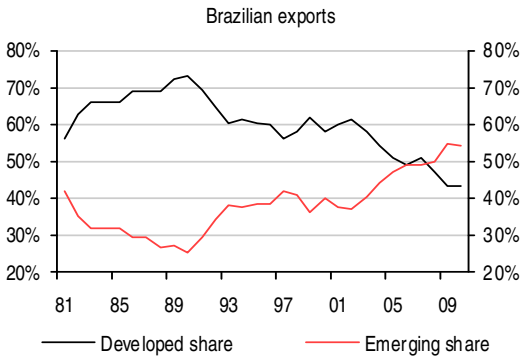
Source: IMF Direction of Trade Statistics

29. India is now dependent on the emerging world



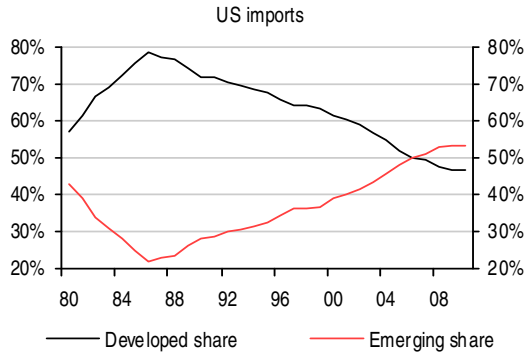
Source: IMF Direction of Trade Statistics

30. Brazil now trades more with the emerging world



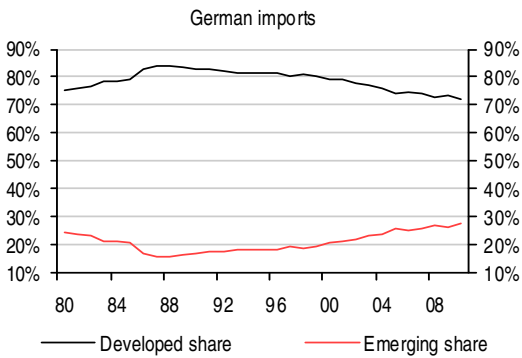
Source: IMF Direction of Trade Statistics

31. US imports more from the emerging than the developed world



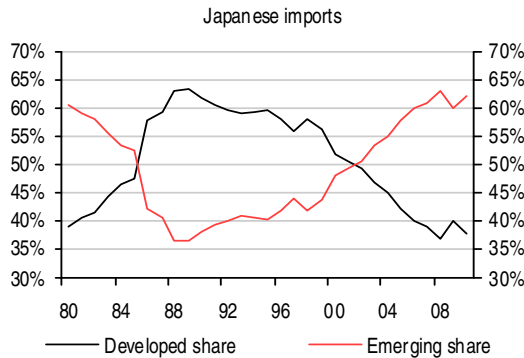
Source: IMF Direction of Trade Statistics

32. Germany is getting the emerging itch



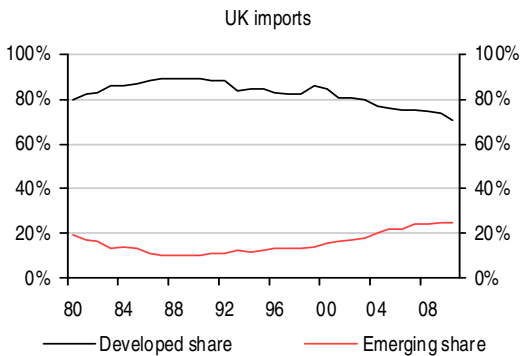
Source: IMF Direction of Trade Statistics

33. Japan loves products from the emerging world



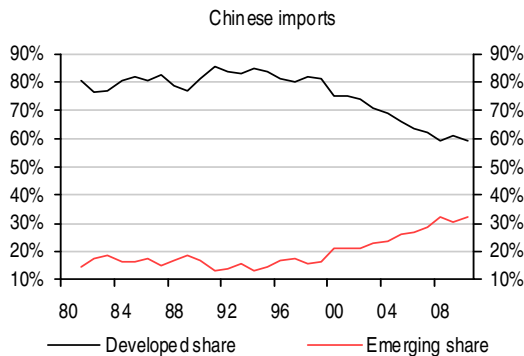
Source: IMF Direction of Trade Statistics

34. Emerging imports to the UK are on the up



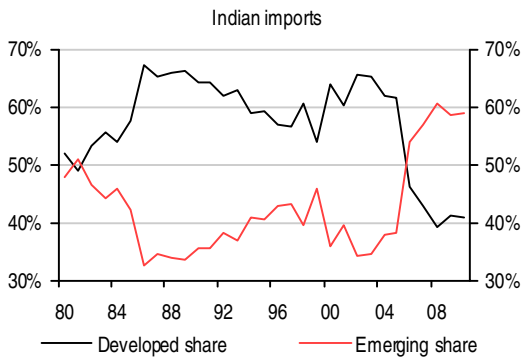
Source: IMF Direction of Trade Statistics

35. China is becoming a bigger market for the emerging world



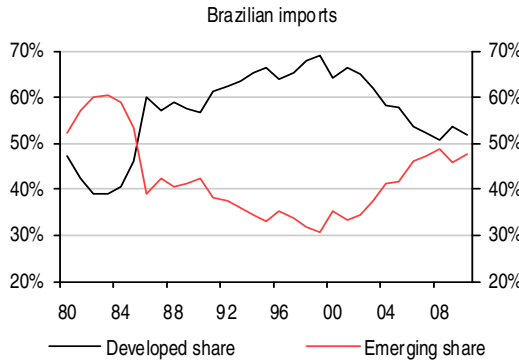
Source: IMF Direction of Trade Statistics

36. India has found an appetite for emerging imports



Source: IMF Direction of Trade Statistics

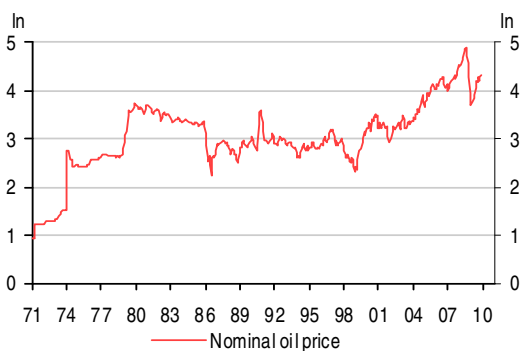
37. Brazil is not far behind



Source: IMF Direction of Trade Statistics

The import story is doubtless affected by changes in global commodity prices. One obvious reason why the value of imports from the emerging world has dropped and then subsequently increased is the impact of the oil price declines from the mid-1980s followed by increases more recently (see chart 38). As a consequence, the value of imports from oil-producing nations initially dropped only to rise thereafter. Yet the recent rise in commodity prices is, itself, a reflection of the increased buying power of emerging nations. China, for example, is now the world's biggest consumer of many metals and has become the biggest marginal consumer of oil. And the rise in Indian imports partly reflects higher demand for Chinese-produced electronic goods.

38. Big increases in oil prices change the value of trade



Source: Thomson Reuters Datastream.

Incentives to connect

The connections made so far between emerging nations are only the tip of the iceberg. While emerging nations within individual regions trade a lot with each other – notably in Asia – there is still little trade across regions. As a result, the opportunities to specialise are reduced and, hence, resources are allocated inefficiently.

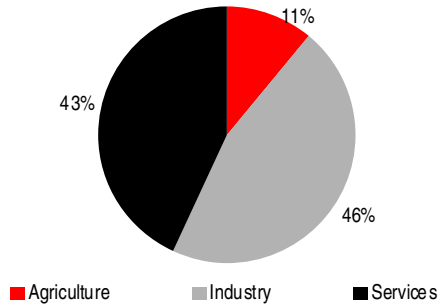
One consequence is the entrapment of many people in low-productivity and, hence, lowly-paid rural employment.

With low wages, the incentive to invest in capital-intensive (labour-saving) agricultural production will be limited. In the absence of trade connections, the chances of people leaving rural activity and being employed in better-paid manufacturing jobs will be low. Few investors will be keen on spending their money on factories or infrastructure, because the opportunities to trade will be limited. Governments are left short of revenues to be spent on, for example, education and health. The country ends up caught in a poverty trap, associated with economic inefficiency and weak incentives. And because incomes can't easily rise, corruption and a lack of respect for property rights become daily obstacles to economic progress (for a detailed discussion of these issues, see Paul Collier's 2007 book *The Bottom Billion*).

For much of the emerging world, this pattern of activity is easy to see. Whereas agricultural output makes up only 1% of total value added in the developed world, the numbers are considerably higher in the emerging world. Charts 39 through to 49 show that agricultural output makes up between 6% and 18% of total value added across emerging regions. Industrial value added – including manufacturing, mining and utilities – also has a high share within GDP across the emerging world, sometimes more than double the shares seen in the developed world. In contrast, the share of activity devoted to services – including health, education and financial services – is mostly very low in the emerging world. The resulting combination of low pay and back-breaking work is hardly conducive to rising economic wealth.

39. Emerging economies still depend on agriculture

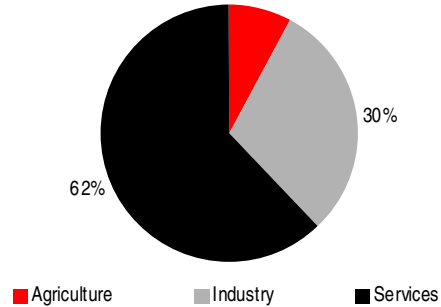
East Asia & Pacific



Source: World Bank

40 Services are a relatively small share of GDP

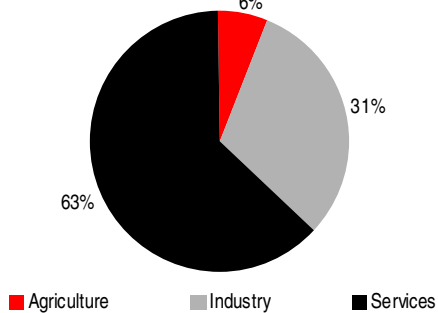
Europe & Central Asia



Source: World Bank

41. Eventually, these economies will need to escape from agriculture...

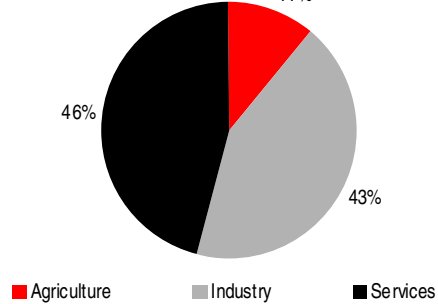
Latin America & Caribbean



Source: World Bank

42.and low-end industry

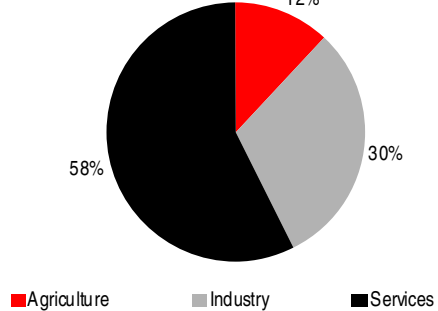
Middle East & North Africa



Source: World Bank

43. The situation in Sub-Saharan Africa is particularly acute...

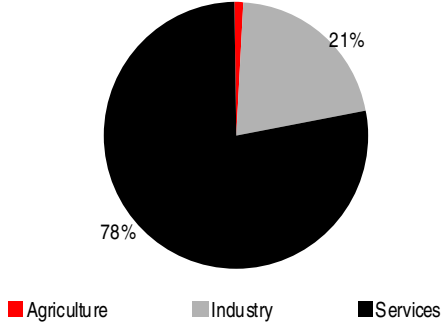
Sub-Saharan Africa



Source: World Bank

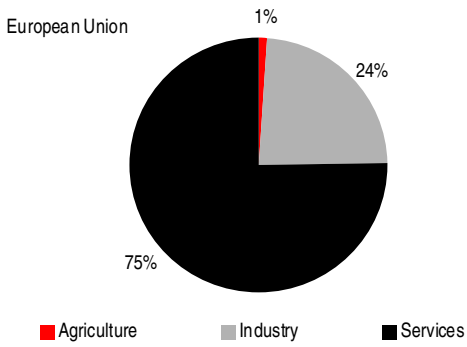
44. ...and stands in contrast to the US...

United States



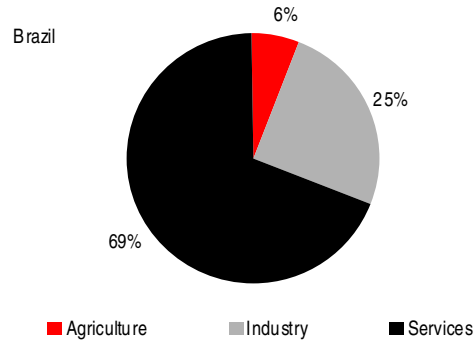
Source: World Bank

45. ...and the European Union



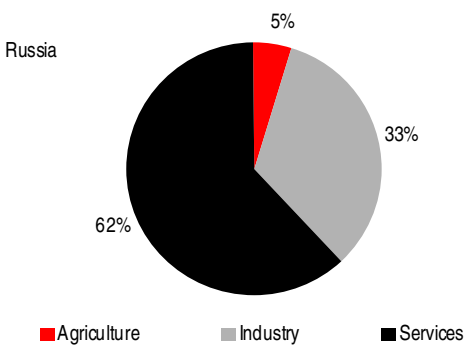
Source: World Bank

46. Brazil is in the middle of the pack...



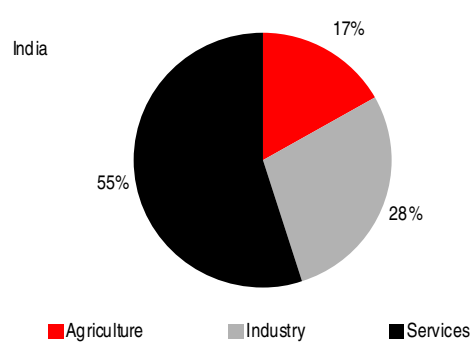
Source: World Bank

47. ...as is Russia...



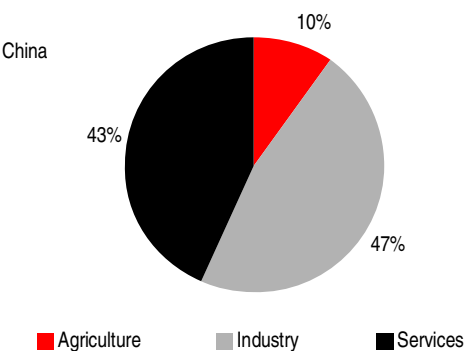
Source: World Bank

48. ...but India has a long way to go...



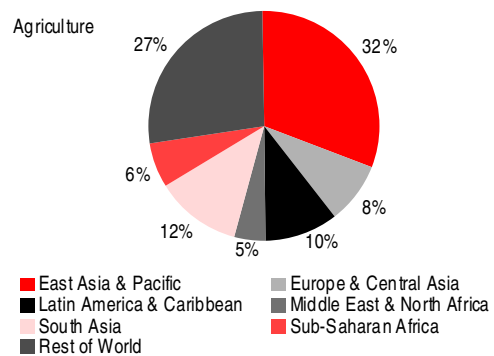
Source: World Bank

49. ...and, despite its growth, so does China



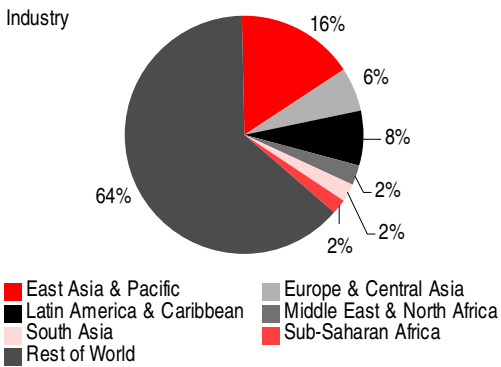
Source: World Bank

50. It's clear from global shares of agriculture...



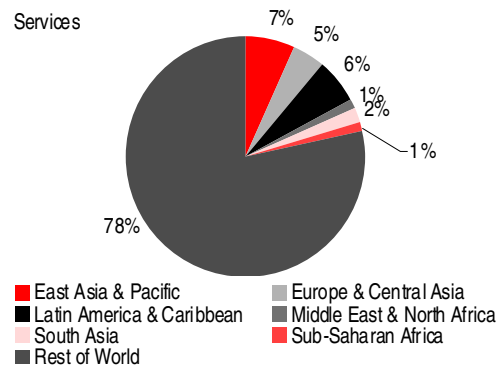
Source: World Bank

51. ...and manufacturing...



Source: World Bank

52. ...that emerging nations have a lot of catching up to do

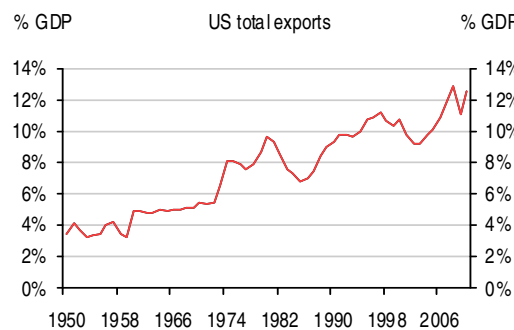


Source: World Bank

The incentives to connect are, therefore, incredibly strong. Opening up a country to trade can considerably change the structure of the economy, allowing levels of specialisation previously unattainable. In the developed world, examples abound. Measured by the share of exports within GDP, the US economy is a lot more open today than it was in 1950. Back then, exports measured by value stood at less than 4% of GDP whereas, today, they are up to 12% of a (much higher) level of GDP (see chart 53). Meanwhile, the structure of the US economy has shifted. In 1970, agriculture accounted for 4% of GDP with industry adding a further 35%. In 2008, those numbers had dropped to 1% and 21% respectively. The share of GDP accounted for by services had correspondingly risen from 61% to

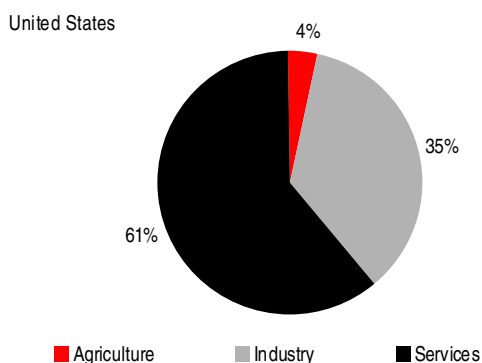
78%. With all these changes, the US has managed to retain its pre-eminent economic position in the world, underscoring the need for countries to be open to change, whether driven by internal or external influences.

53. The US has become more connected with the rest of the world



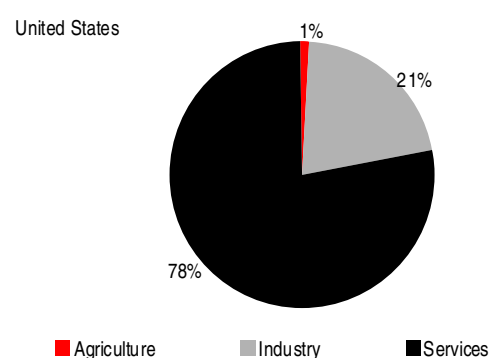
Source: Thomson Reuters Datastream

54. In the 1970s, the US made things....



Source: World Bank

55.but, in 2008, it offered services rather than manufacturing



Source: World Bank

Catalysts for change

- ▶ Density makes for inequality...
- ▶but it also is a key driver of economic growth domestically...
- ▶ ...and, as logistics improve, of trade between nations

New drivers

There are two obvious drivers for the opening up of borders along the Southern Silk Road:

- ▶ **The benefits of collapsing transportation and communication costs.** Japan and the US would never have seen an explosion of mutual trade in the absence of the container ship revolution. Meanwhile, air transportation has revolutionised connections both within nations and across nations. More recently, the internet and associated technologies have linked people and places together like never before, both for good (economic progress) and bad (the planning of terrorist atrocities).
- ▶ **The thawing of political relations between nations** that, for much of the 20th Century, didn't speak to each other, a consequence of war, ideology or post-imperial tension. There can be no doubt that the biggest barrier to economic connections is the human one, whether it's within nations, between nations or across whole regions.

Being dense

There is, however, more to the story than simple connections. To understand why, it's worth considering how changes within nations – particularly those who have now rejected failed economic ideologies – are having an unexpected global impact. It's all to do with what the World Bank describes as “density”.

Economies typically develop in a very uneven fashion. As they develop, so their wealth tends to be concentrated in heavily urbanised areas, associated with large increases in income inequality. This is true both at the national level and at the global level: 50% of the world's GDP is produced on a land mass equivalent in size to Sudan, Algeria or the Democratic Republic of Congo.

Yet, as the Western nations emerged from the Second World War, ideological objections to market forces persuaded Stalin, Mao and others to repress linkages with the West and to aim for “balanced” development, in an attempt to make sure that the spoils of industrialisation would spread far and wide across their nations. These policies failed. Inland investments in China and the Soviet Union offered little return and hampered the opportunity to build infrastructure which would allow connections with the rest of the world and an appropriate exploitation of Ricardian comparative advantage. Indeed, so

poor were the returns on these investments that, despite the best efforts of the communist leaderships, income inequality between the various regions unintentionally widened.

Deng Xiaoping recognised this failure, arguing that if China as a whole were to become prosperous, some regions would have to become rich before others (as opposed to some becoming poorer than others). China had to open itself up to the rest of the world. To do so, the coastal regions had to develop at a much faster pace than the inland regions, even if income inequality rose dramatically as a result.

Deng was right. As Zhang Zhiming points out in *Inside the Growth Engine* (HSBC Research, December 2010), China's Eastern Region contains China's top three municipalities (Beijing, Shanghai and Tianjin) and China's four largest economies (Guandong, Jiangsu, Shandong, and Zhejiang). Guandong alone has a population equivalent to Mexico's and, ranked by GDP, would be the seventeenth largest economy in the world if it were an independent state. It accounts for a quarter of China's international trade and has become a magnet for migrant workers from elsewhere in China: since the 1980s, an additional 30 million workers have arrived in the region.

A similar process is now underway in Russia. Under the Soviet leaders, huge emphasis was placed on developing inhospitable lands in the East. The country as a whole remained poor and underdeveloped. Since the Soviet regime's collapse, the difference between leading and lagging areas has grown hugely: Moscow and resource-rich Western Siberia have been the big winners while other regions have been left behind. The restaurants and nightclubs of Moscow are now more than a match – in terms of both price and glamour – for anything New York or London have to offer.

China's development is particularly remarkable, both in terms of the progress made but also in terms of the associated increase in income inequality. Yet, as we noted in *Losing Control: The Emerging Threats to Western Prosperity* (2010) the rise in Chinese income inequality is hardly unique. Many countries going through a period of rapid economic catch-up experience both rising income inequality (as the numbers of urban rich rise relative to the urban poor) and squalor (as urban land development typically fails to keep pace with a rapidly growing population). Anyone who's read Charles Dickens' *Oliver Twist* (1839) or *Hard Times* (1854) would recognise this universal and timeless truth (and, for those who prefer a more political slant, they could always try Friedrich Engel's *The Condition of the Working Class in England*, 1845).

There is, however, an important economic mechanism at work. Eventually, as the urban population increases in number relative to the rural population, rural incomes will rise as underemployment is reduced, productivity per worker rises and the level of competition declines. High income inequality creates political and social tensions but, at the same time, is a hurdle that any developing country eventually has to cross. Urbanisation has to occur first of all: all else then follows.

International spill-overs

Urbanisation is an important source of domestic wealth but it also creates spillover effects which have an impact on other countries. After all, the ports, railways, roads, bridges and airports which connect a country's urban centres are also the same linkages that join nations together. It is precisely these developments which have created the physical opportunity for an explosion in intra-Asian trade, lifting activity not just in China but also across many other nations which increasingly regard China as an important hub. Table 56

emphasises the point. Of the top ten container seaports in the world in 2009, only one is in Europe (Rotterdam) and only one is in the Middle East (Dubai). The other eight are all based in Asia. Of those, five are in Mainland China while the remaining three are in Singapore, Hong Kong and South Korea. The US doesn't even get a look in.

56. World's largest container ports

Volume, million TEUs*			
1989		2009	
Hong Kong	4.5	Singapore	25.8
Singapore	4.4	Shanghai (China)	25
Rotterdam (Netherlands)	3.9	Hong Kong	20.9
Kaohsiung (Taiwan)	3.4	Shenzhen (China)	18.2
Kobe (Japan)	2.5	Busan (South Korea)	11.9
Busan (South Korea)	2.2	Guangzhou (China)	11.2
Los Angeles (United States)	2.1	Dubai (United Arab Emirates)	11.1
New York/New Jersey (United States)	2	Ningbo (China)	10.5
Keelung (Taiwan)	1.8	Qingdao (China)	10.2
Hamburg (Germany)	1.7	Rotterdam (Netherlands)	9.7
Long Beach (United States)	1.5	Tianjin (China)	8.7
Yokohama (Japan)	1.5	Kaohsiung (Taiwan)	8.5
Antwerp (Belgium)	1.5	Antwerp (Belgium)	7.3
Tokyo (Japan)	1.4	Port Klang (Malaysia)	7.3
Felixstowe (United Kingdom)	1.4	Hamburg (Germany)	7
San Juan (Puerto Rico)	1.3	Los Angeles (United States)	6.7
Bremen/Bremerhaven (Germany)	1.2	Tanjung Pelepas (Malaysia)	6
Oakland (United States)	1.1	Long Beach (United States)	5
Seattle (United States)	1	Xiamen (China)	4.6
Manila (Philippines)	0.9	Laem Chabang (Thailand)	4.6

Note: * = Twenty-foot equivalent units
Source: Containerisation International, The Economist

Contrast this with the complete absence of Chinese ports from the equivalent rankings in 1989. Back then, the top ten included a European port, two US ports, two Taiwanese ports and one Japanese port all of which have subsequently been relegated from the list. In a relatively short space of time, facilities have been constructed which, in turn, are radically changing the shape of world trade.

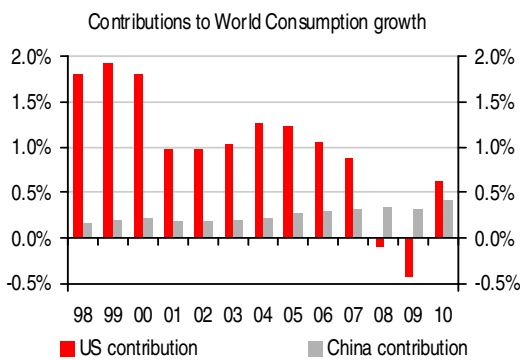
Building ports is all very well but their importance ultimately depends on the trade linkages subsequently established. Outside the US, Europe, Asia and the Gulf, only four ports in the rest of the world appear in the global "top 50": Port Said in Egypt (thanks to the Suez Canal), Santos in Brazil and Balboa and Colon in Panama (thanks to the

Panama Canal). Of these, three are, in effect, staging posts for trade which originates and ends up in other parts of the world. Put another way, for many parts of the emerging world, economic distances are still very great. If they fail to develop the necessary infrastructure, they may remain disconnected from the world economy.

It is easy enough to pretend that China's ports have only been constructed to satisfy either its own mercantilist ambitions or to allow heavily-indebted US consumers to live beyond their means by buying ever-increasing amounts of cheap Chinese products. Yet China's ports are not merely a story about exports, nor do they merely suck in imports of semi-finished products and raw materials which are then re-exported at a later date. They are also a catalyst for rapidly-rising Chinese living standards. It's not just that China is able to export more: China can now also import a lot more too, increasing the dependence of other nations on enduring Chinese economic success.

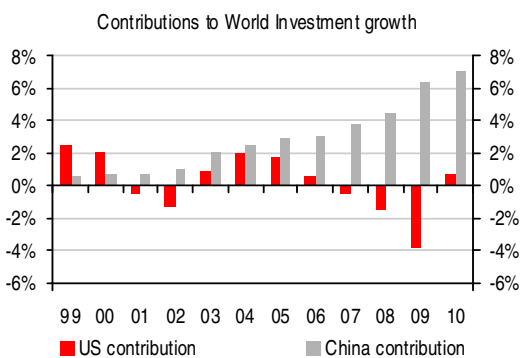
Reflecting this long term trend, China's contribution to global consumer and investment demand has been rising rapidly in recent years. Charts 57 and 58 compare China's performance with that of the US. Whereas China's consumers made very little contribution to global consumer demand at the end of the 1990s – a reflection of low per capita incomes – rapid growth and intensive urbanisation have since led to a radical change: during the global recession in 2008 and 2009, the contribution of Chinese consumers to global consumer demand outstripped that of their American cousins and remained close to matching the US contribution in 2010, despite US consumers rediscovering some of their earlier vim.

57. Catch me if you can: the growing role of China's consumers



Source: World Bank, HSBC

58. As US investment has slipped away, China shows the way forward



Source: World Bank, HSBC

In the field of capital spending, the shift in fortunes has been truly remarkable. 2001 may not have seen a space odyssey, but it certainly marked the beginnings of a Chinese investment odyssey. In that year, the Chinese contribution to global investment demand exceeded the American contribution for the first time in the modern era. This, however, marked only the beginnings of a remarkable transformation of fortunes. Chart 58 sums up the shift in investment demand around the world showing that, whatever the merits of America's economic system, they're being swamped by the magnetic attraction of all things Chinese.

Of course, America's capital stock is still a lot higher than China's, a reflection of many decades of successful business endeavour. As a consequence, the US is still the richer of the two nations by far. But for countries elsewhere in the world, China's economic success offers new opportunities. The incentive to trade with China is growing all the time. The incentive to trade with the US is, in contrast, shrinking. As one superpower declines, another is regaining its place in the international economic order. In the process of regaining its earlier status, China will dramatically shake up patterns of world trade.

And it's not just China that will begin to re-shape world trade. Karen Ward's *The World in 2050* suggests that the world's top three economies by the middle of the Century will be China, the US and India. China is already in second place in the global rankings but India is only in 8th place, despite its enormous population. In the years ahead, India should leapfrog Japan, Germany, the UK, France and Italy.

Big, but not rich

Despite all this progress, both China and India will still be relatively poor nations in the middle of the 21st Century: China's per capita incomes may be no higher than those prevailing in the US at the end of the 1960s or the beginning of the 1970s while those in India will be lower still. Their compound growth rates promise to be strong in the years ahead but their starting positions are, of course, very low. This matters: the basket of products consumed by China, India and other emerging nations as they "catch-up" with the developed world will, at the margin, be very different from the basket of products consumed by a typical Westerner. Who will produce these goods and services? And how will patterns of world trade change as a result?

Air, energy and ether

- ▶ Air travel between the emerging nations has taken off...
- ▶ ...as has the enthusiasm for all forms of mobile telephony...
- ▶ ...but these connections are still only in their infancy

In the raw

China and India are huge economic behemoths, they're both growing very quickly and, as we've already noted, their contribution to global consumer and investment spending is rising very quickly. But how are they re-shaping connections across the world? We know that demand for commodities tends to be extraordinarily income elastic until incomes reach a level of between \$15,000 and \$20,000, at least given the experiences of Japan and South Korea over the last six decades. Given that both China and India are a long way from achieving income levels within this range, the implication is straightforward: global demand for commodities should remain extremely buoyant in the years ahead, keeping commodity prices relatively high (unless and until there is a sizeable supply response, which doesn't appear likely any time soon). There should, as a result, be a redistribution of income at the margin from net commodity-consuming nations towards net commodity-producing nations. This shift in the balance of global demand immediately provides a reason for enhanced connections between Asia (the source of commodity demand) and key producers in Latin America, the Middle East and Sub-Saharan Africa (not forgetting Australia and Canada).

59. Who has the commodities...and who wants them?

Top ten (USDmn):			
Net primary exporters		Net primary importers	
Russia	308905	United States	-372332
Saudi Arabia	278071	Japan	-356708
Canada	140740	China	-330561
UAE	134482	Germany	-149852
Norway	114859	Korea	-132175
Iran	99545	Italy	-80371
Australia	92506	India	-78417
Kuwait	84930	France	-77415
Venezuela	79873	Spain	-57684
Nigeria	70731	United Kingdom	-56121

Source: World Trade Organisation

Chocks Away

Demand for raw materials is only one – by now rather familiar - example of the growing linkages between previously-detached parts of the world. Other sources are perhaps more compelling even if they are at the same time more anecdotal.

Consider, for example, the number of commercial flights emanating from different countries around the world. In 1980, the US was top dog and remains so today. The top 5 were all members of the industrialised world and, within the top 10, only Brazil and Mexico from the emerging world got a look-in. In 2008, the latest year for which consistent data are available, the US remained in first place by a considerable margin but in second position was China, chalking up almost 2 million flights compared with a paltry 50,000 in 1980.

India had also entered the top 10, although Mexico had fallen by the wayside.

60. Top countries for commercial flights

Order in 1980		Order in 2008		
1	United States	4962700	1 United States	9054478
2	United Kingdom	477500	2 China	1853088
3	Japan	396500	3 Canada	1200361
4	Canada	382000	4 Germany	1154472
5	Australia	257700	5 United Kingdom	1056206
6	France	248400	6 France	827851
7	Brazil	232500	7 Japan	655495
8	Spain	207900	8 Brazil	647753
9	Germany	187300	9 Spain	616893
10	Mexico	177100	10 India	592292

Source: World Bank

The emerging world's importance in air travel is set to increase further in coming years. Airbus Industries, for example, projected at the end of 2010 that "expanding regions" for air travel – the emerging world – would enjoy annual growth in revenue per kilometre travelled of 6.1% whereas the "maturing regions" – the developed world – would experience annual growth of only 3.7%. Airbus thinks that, by 2029, "Asia-Pacific airlines will lead world traffic". This is hardly surprising: many people in the emerging world are on the cusp of enjoying income per capita levels typically associated with a dramatic increase in the propensity to travel.

And this travel is not simply a matter of people from the emerging world taking holidays in the developed world. A casual look at flight departure boards from different airports around the world reveals that each major hub is connected to its own idiosyncratic spokes. The typical traveller from Heathrow is likely to head to New York, Dubai, Dublin, Amsterdam or Hong Kong (source: BAA). The typical traveller from Dubai airport might find their way to London or Frankfurt but is equally likely to be heading to Tehran, Mumbai, Islamabad or Karachi. And travellers from Beijing are most likely to be heading elsewhere in China which, in the 21st Century, is building the transcontinental connections last seen in the 19th

Century with the spread of the American railroads from East to West.

Many of these connections, of course, are not a story about beach holidays or the modern-day version of the 19th Century "Grand Tour". Instead, they reflect the increasing geographical mobility of labour: there are plenty of jobs for Indian and Filipino workers in the Middle East, for example, while Chinese workers increasingly find themselves supporting Chinese interests in, say, sub-Saharan Africa. And, from migrant workers come remittances: money sent back to the Philippines, for example, has risen from a little over 2% of GDP at the beginning of the 1990s to around 10% of GDP today while, in India, the remittances have risen from 1% to 4% of GDP over the same period.

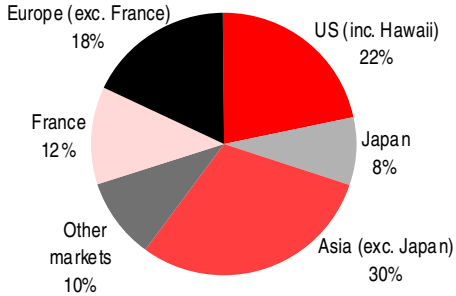
The mobile status symbol

There may be more demand for flights but that's not the only area of emerging market spending which is on the rise. Detailed data on Chinese household income and expenditure reveal how tastes change as incomes rise.

For the business traveller visiting Beijing, Shanghai or Mumbai, it's easy to be seduced into thinking that newly-wealthy Chinese and Indians spend their wealth in swanky boutiques stocking Western luxury brands. And there is certainly some truth in this. For Western luxury brands companies, the arrival of high earning and high spending Chinese and Indian consumers has been a huge shot in the arm.

61. LVMH sells a lot in Asia

LVMH Q1 revenue by region



Source: LVMH

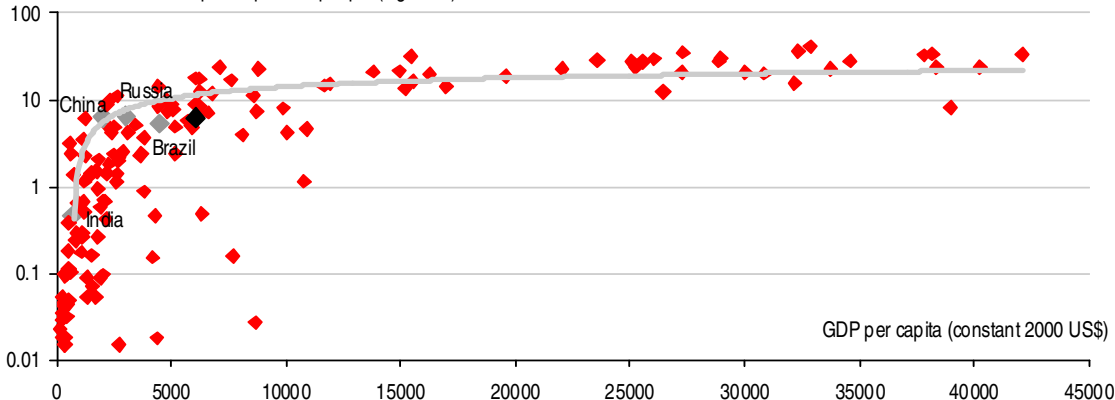
Given that, over time, incomes are continuously rising (the bottom 10% have incomes today in nominal terms the equivalent of those in the highest bracket in the early 1990s), we can gain an idea of how, over time, savings and spending patterns change.

Yet, for the vast majority of Chinese and Indian consumers, Louis Vuitton and Gucci products are but a distant dream. Their ambitions are more grounded and relate mostly to changes in diet, varying patterns of transportation and improved communications. According to Chinese urban household income and spending data, the bottom 10% of income earners spend around 40% of their modest incomes on food whereas those in the highest income bracket spend only 16% on food. Conversely, while the bottom 10% of income earners spend only around 6.6% of their incomes on transportation and communications (including, most obviously, mobile telephony), the top 10% spend around 12% of their much higher incomes.

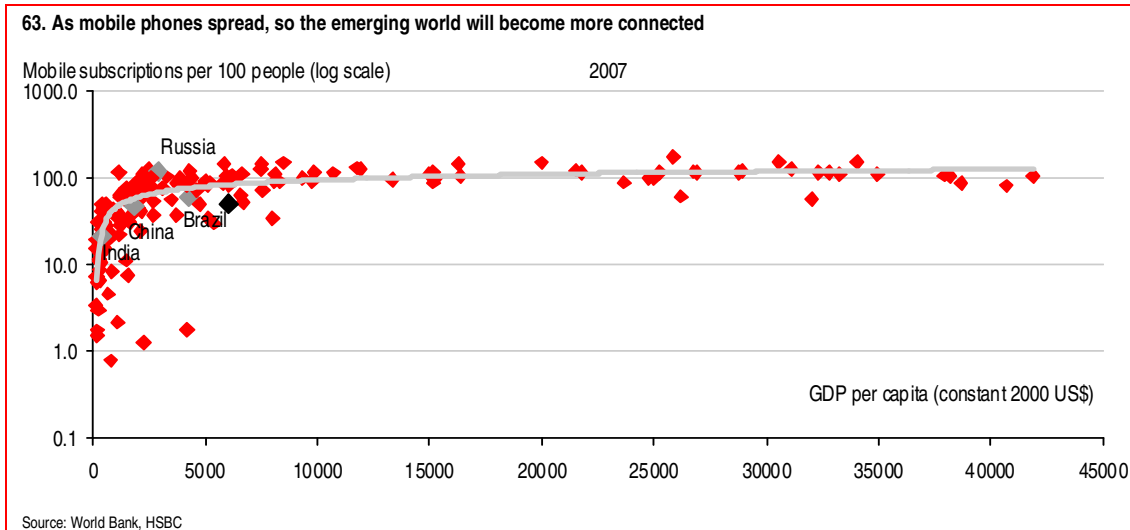
62. The internet is creating new links

Fixed broadband subscriptions per 100 people (log scale)

2008



Source: World Bank, HSBC



But we can say a lot more when we turn to cross-country comparisons. Even the highest-earning 10% in China have incomes that are modest by developed-world standards. Charts 62 and 63 show the volume of consumption across a range of transportation and communications technologies by country. The charts can be used to gauge the likely proportionate increase in demand for different products and services according to the level of income per capita. Whether it's internet usage, broadband subscriptions or mobile subscriptions, the BRICs nations appear to be at a demand "sweet-spot" where the mixture of low (but not too low) levels of income with large populations appears to be particularly potent. This digital revolution will create more and more economic connections that, in turn, will help lift trading activity both within and across countries.

But there is more. Emerging nations are becoming better at producing goods and services that meet the needs of those on low, but rapidly rising, per capita incomes. As the next chapter shows, the cross-border opportunities are immense.

Chasing cars

- ▶ Heavy westerners and enhanced safety requirements...
- ▶ ...all add up to big cars...
- ▶ ...which are not so good for first-time buyers in the emerging world

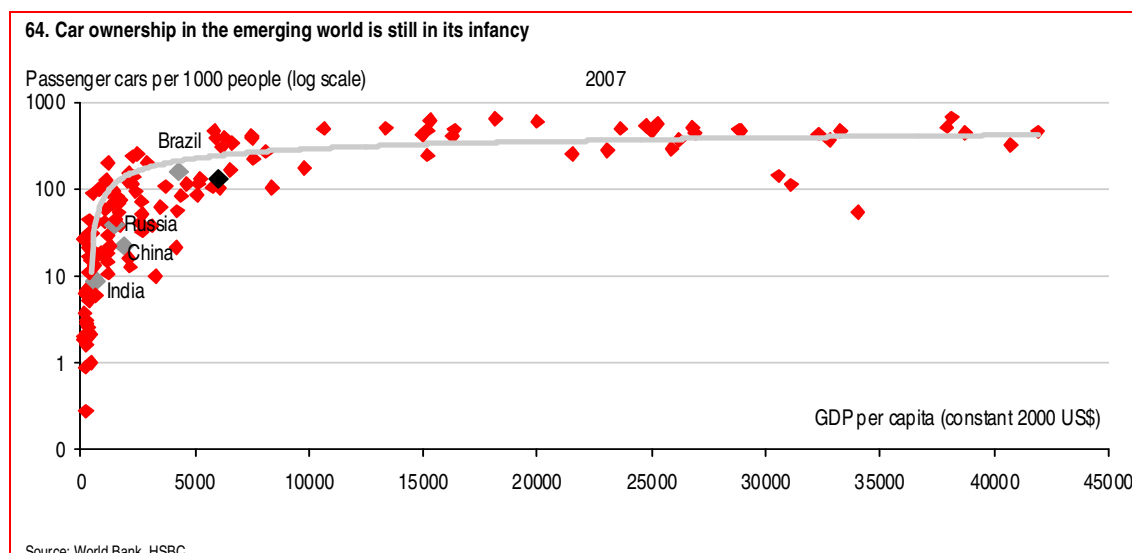
A heavy burden

One area of emerging consumption sticks out like no other. For the aspiring family, there is no better way to illustrate economic success than via the purchase of a car. Chart 64 shows that, for many emerging nations, car ownership is incredibly low relative to the developed world, reflecting a low level of income, in many cases, a lack of reasonable access to credit and the absence of a satisfactory network of roads. As incomes rise and as credit markets develop, this will surely change. Emerging nations will increasingly become car-owning and car-driving societies.

Many Western car producers have already taken advantage of this trend. A visit to Beijing or

Mumbai will reveal any number of sightings of Mercedes, Audi and Volkswagen cars (so at least the Germans have done well, even if others have been rather left behind). Yet Western car manufacturers are potentially hamstrung in their bid to sell cars to the emerging world, a consequence both of increased use of complicated electronics and of weight gain.

Even though gas-guzzling Chevrolets and Dodge Challengers bit the dust following the first oil price shock – with a corresponding drop in average car weight – enhanced safety requirements have contributed to a gradual return to relative obesity. According to the US National Highway Traffic Safety Administration,



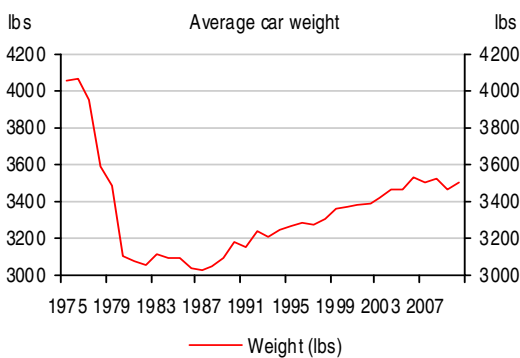
additional safety features – including safety belts, frontal airbags, side impact protection, lamps, head restraints and energy absorbing assemblies – now add 125.4lbs to the weight of a car compared with just 18.4lbs in 1968, at a cost of over \$800. Moreover, cars have increased in size. The original Mini was genuinely small. The new Mini isn't: it's 58cm longer, 50cm wider and 7cm higher than the original, with a kerb weight of 1144kg, almost double that of Sir Alec Issigonis's path-breaking design.

average American adult male weighed 75kg. By the beginning of the 21st Century, the average had risen to 87kg: too much popcorn and burgers. For women, the gain wasn't quite so extreme, with an increase from 64kg to 75kg, but the direction was nevertheless much the same (and, in percentage terms, the increase was actually greater). As for height, the average American adult male stands tall at 1.76m, a 2.5cm increase relative to the early 1960s, while the average American female tops out at 1.63m, a similar 2.5cm increase. (Source: "Mean Body Weight, Height and Body Mass Index, United States 1960-2002" by Ogne, Fryar, Carroll and Flegal, US Department of Health and Human Sciences, October 2004)

To accommodate all this extra baggage (of both the human and safety kind), average car weight in the US has halfway returned to where it was before the 1973 oil shock (see chart 65).

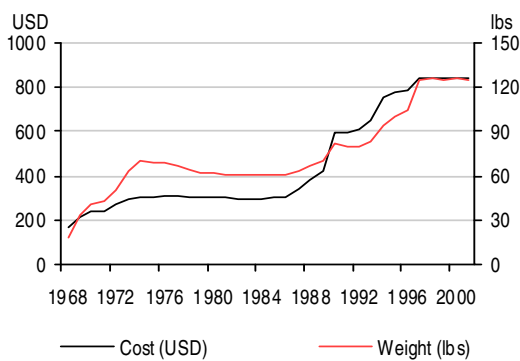
Put another way, most car manufacturers build cars for wealthy, tall and increasingly fat Americans and Europeans. They don't so obviously cater for poorer, shorter and thinner people living in the emerging world. The average urban Chinese young man measures 1.7m while his rural counterpart averages 1.66m. (Source: "Study on weight and height of the Chinese people and the differences between 1992 and 2002", Yang XG *et al*, National Institute for Nutrition and Food Safety, Chinese Centre for Disease Control and Prevention, July 2005) The average Indian man is a few centimetres shorter still (Source: "Height still a tall order for Indians", Times of India, April 2008). Their incomes are, as we have already seen, a tiny fraction of those in the US or in Europe.

65. US cars have regained lost weight



Source: US National Highway Traffic Safety Administration

66. The financial and physical cost of safety



Source: US National Highway Traffic Safety Administration

It's not just safety features which have added to the weight of a typical car. Western drivers and passengers are also bigger and heavier than they used to be, so they need bigger cars merely to feel comfortable. At the beginning of the 1960s, the

Lightening the load

The car that might appeal to the first-generation buyer in China and India is, thus, likely to be a very different proposition to the car that appeals to a rich and flabby Westerner. It needs to be frugal and, hence, low in weight. It needs to be easy to service, with replacement parts easily available at low cost. It needs to be reliable rather than massively safe: for the Indian family previously used to travelling around downtown Mumbai perched precariously on a moped it will offer a huge improvement in safety without even really trying.

67. China car sales (2010)

Car	Units sold
BYD F3	263,900
Volkswagen Lavida	251,600
Hyundai Elantra Yue Dong	233,300
Jetta	224,500
Buick Excelle	224,500
Shanghai-VW Santana	210,100
Xiali	198,700
Chevrolet Cruze	187,800
Chery Cowin	173,500
FAW-VW Bora	172,500

Source: Global Times

The data clearly support this view. Car sales in China are dominated by designs aimed at the local market. It's also worth noting that foreign involvement in joint ventures for the Chinese car market are capped at 50% so even foreign brands – which still account for a big chunk of total sales – have a significant Chinese flavour.

In India, where only 12 people in every 1000 own a car or utility vehicle, the results are similar. In January 2011, 270,000 passenger vehicles were sold, and those sales were dominated by Maruti Suzuki (51%, a joint venture between the Indian government and Suzuki), Hyundai (19%), Tata (14%), American brands (10%) and other Japanese brands (4%).

68. Tata Nano



Source: High Contrast: Der Tata Nano – Das "People's Car" aus Indien im Verkehrszentrum des Deutschen Museums - Halle I

Tata's Nano makes up only a modest amount of total sales but has become perhaps the ultimate attempt to produce an Indian "people's car", costing a mere USD3000. For those used to travelling around on a motorised scooter (and, according to the Society of Indian Automobile Manufacturers, two wheelers accounted for three-quarters of total vehicle sales in 2009/10), the Nano and similar very basic vehicles are obvious next steps on the road to prosperity.

Whether or not the Nano becomes a cheap Indian version of the original Volkswagen Beetle or the Fiat 500 – and, to be fair, the sales so far have not met ambitions – the key message from this story is surely that car producers in China and India are acquiring the skills necessary to produce cars for newly-aspirant consumers, not just in their own countries but also all over the emerging world. They may not be the safest cars in the world, but they are cheap, light and get people reasonably comfortably from A to B. They are also typically produced "behind closed doors", using the infant industry argument to allow the development of mass production techniques (taking lessons from the experience of Japan and South Korea in the 1960s and 1970s and from the US during its early industrial development in the 19th Century: tariffs on imported cars into India can be as high as 100%). And now, they are being unleashed on the

rest of the world. Indian exports are increasingly heading to Africa, ASEAN, the Middle East and Latin America while China's Chery now has 16 production facilities in foreign markets including Russia, Ukraine, Egypt, Iran, Indonesia, Uruguay and Brazil, not countries renowned for their high per capita incomes.

Meanwhile, with Jaguar/Landrover and Daewoo trucks acquired by Tata, Sangyong acquired by Mahindra and Volvo Cars acquired by Geely Auto, Indian and Chinese car companies have been able to take advantage both of developed world brands and, of course, developed world know-how.

Putting all of this together, it is becoming increasingly obvious that Chinese and Indian producers have taken advantage of rising incomes in their home markets – a consequence of opening up trade with the developed world – to create industries to produce goods for their newly-affluent domestic households. In the process of doing so, they have also created industries which increasingly can take advantage of trade with other parts of the emerging world. For emerging consumers, Cherys and Nanos may not be the most desirable cars, but they at least are affordable. And as sales of these cars increase in other parts of the emerging world, so cross-border investment in sales teams, after-sales service and so on will expand. The infrastructure to develop South-South trade is on the rise.

Piecing it together

- ▶ We are witnessing an economic revolution...
- ▶ ...with global investment and capital market activity heading south...
- ▶ ...as the emerging nations establish linkages barely imaginable just a decade ago

Only connect

For South-South connections to take off, they need to be facilitated through both infrastructure and capital markets. It's not good enough to point out that Cubans might one day like to buy Tata Nanos or that Nigerians might like to engage in a deeper level of commerce with the Chinese. After all, many people under the yoke of Soviet Communism would have given their right arm to have access to glamorous Western goods in the 1960s and 1970s. Yet political, intellectual and physical barriers prevented them from being able to do so.

As we've seen, the "economic borders" throughout the emerging world are still incredibly "thick". Opening up trade and capital flows between the emerging nations will not happen overnight. The port facilities which have contributed to the massive expansion of trade first within the OECD and then between the OECD and selected emerging nations simply don't exist universally through the emerging world and they cannot be created at the flick of a switch.

Change, however, is afoot. It involves both new ambitions and deep pockets of funding. And this change is coming about for a simple reason. The up-and-coming economic superpowers – China and India – cannot hope to expand unless they are

able to (i) increase trading opportunities beyond the industrialised world and (ii) gain guaranteed access to the world's scarce resources.

Already, China is the world's biggest consumer of many of the world's key raw materials. If the Chinese authorities are to fulfil their promise to their people of delivering substantial increases in living standards in the years ahead, they need to provide guaranteed connections with the rest of the world. And we believe those connections will ultimately come to depend on a huge expansion of South-South relationships.

It is not difficult to see why. Other emerging nations are key sources of the raw materials that China so desperately needs. And, with the US and Europe falling behind in the global economic league, China's export ambitions will only be met if it is able to tap into growth in other parts of the world undergoing economic "catch-up".

The easy way to do this, at least in theory, is for China to recycle its excess domestic savings not into higher domestic consumption – as the US would like to see – but, instead, into a sizeable increase in investment into other parts of the emerging world. China's current account surplus – a measure of the gap between domestic savings and domestic investment – amounts to around 4% of Chinese GDP (a few years ago, it was a

69. The world's main commodity producers: a selection

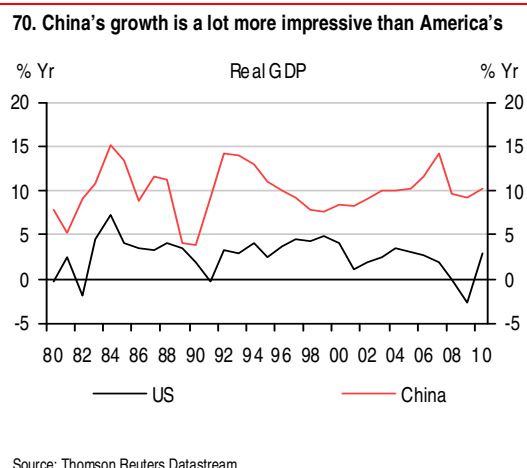
Rank	Copper	Oil	Wheat
1	Chile	Russia	China
2	China	Saudi Arabia	India
3	Peru	US	US
4	US	Iran	Russia
5	Indonesia	China	France
6	Australia	Canada	Canada
7	Zambia	Mexico	Germany
8	Russia	UAE	Ukraine
9	Canada	Iraq	Australia
10	Kazakhstan	Kuwait	Pakistan

Note: Copper data 2010, Oil data 2009, Wheat data 2008
Source: BP Statistical Review, Brook Hunt, Food and Agriculture Organization of the United Nations

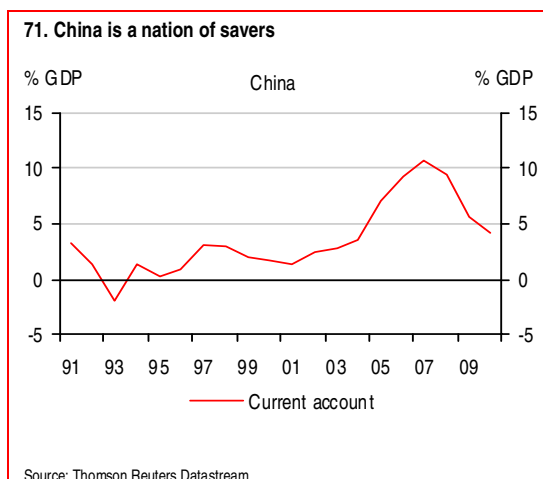
whopping 10% of GDP). As everyone knows, much of this surplus is currently invested in nice, safe, US Treasuries and other US dollar-denominated pieces of paper, via persistent increases in China's foreign exchange reserves.

Holding pieces of US paper, however, is not really a viable long-term option for China, in our view. Given the gap between Chinese and US growth (see chart 70 for the recent experience), it won't be good enough simply to subsidise the US cost of capital in the hope that US consumers will borrow more and more in order to satisfy China's desire to increase its market share in the US. Indeed, given the 2008/09 financial crisis and the ongoing difficulties within the US housing market, it should by now be as clear as day that the "China subsidy" has led not to lasting US economic strength but, instead, to the creation of

bubbles and busts: China's future cannot be based on US economic instability.



China's policy will surely be to go back to the Imperial economic models of the 18th and 19th Centuries, not so much in terms of colonisation and



slavery but, rather, in terms of heightened flows of investment all over the emerging world. In the 19th Century, for example, the UK ran a persistent current account surplus, using its excess domestic savings to invest in the four corners of the Earth. The Chinese appear to be doing exactly the same today (and the Americans, of course, have been doing exactly the opposite, hoping that the rest of the world will choose to invest in the US).

What evidence do we have of these new flows of capital? The most obvious areas currently are energy and infrastructure.

Energy security

Energy security is leading to a realignment of political linkages around the world. The Shanghai Cooperation Organisation (SCO) is a good example. Its key members are China, Russia and the Central Asian Republics of Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. India, Iran, Mongolia and Pakistan have observer status. On a map, it's not so difficult to regard this group of countries as being in the business of creating an

energy-centric version of the original Silk Road. But China's ambitions go beyond the creation of happy (or sometimes not so happy) political families with near-neighbours.

Striking examples of China's pursuit of energy tie-ups include heavy investments in Iran. In February 2011, for example, Iranian News Agency Mehr reported a \$2.5bn investment by China in Iran's South Azadegan oilfield. The aim is to increase production from 55,000 bpd to 320,000 bpd following the first phase of development. The ultimate ambition, however, is for production to rise to 600,000 bpd.

This investment follows on from the 2009 deal worth \$1.76bn signed by the China National Petroleum Company (CNPC) and the National Iranian Oil Company (NIOC) to develop the North Azadegan field. Meanwhile Sinopec, another key Chinese oil player, is already developing the neighbouring Yadavaran field. Intriguingly, Yadavaran was originally going to be developed by the Japanese company Inpex but that deal collapsed

73. The Shanghai Cooperation Organisation: A Silk Road for Energy



Source: Shanghai Cooperation Organization, HSBC

as a consequence of the international sanctions imposed upon Iran in response to its nuclear programme. Those sanctions, in effect, opened the door for China to pursue its own interests irrespective of the views of the US and other nations in the developed world.

But it would be wrong to suggest that interest in Iranian oil is a simple case of Chinese opportunism. For many years, a lack of refining capacity in China meant that it was heavily dependent on light oil from West Africa and from Oman. As Chinese refinery capacity is widened and increased, so China is able to broaden its sources of oil towards those producers – both across the Persian Gulf and elsewhere – whose oil is a little heavier and, thus, more difficult to refine.

Other examples of significant Chinese investments include a 60% stake in Aktobemunai-gas in Kazakhstan and a substantial stake in the Greater Nile Petroleum Operating Company (GNPOC) in Sudan (the stake rose as a consequence of the decision made by Canada's Talisman Energy to exit from its investment in GNPOC in response to pressure from international human rights groups, leading to persistent downward pressure on the value of its stock.) The Sudanese deal, in turn, was helped along by the sale to Sudan of Chinese arms. (nothing new there, of course: Western nations have always been happy to enter into the murky world of arms deals to secure their own economic interests).

Energy security, however, doesn't simply depend on doing deals with regimes which, in some cases, the West finds distasteful. China also needs to guarantee that it can bring the fruits of its energy investments back home. The aforementioned SCO provides political security but, not surprisingly, the Chinese want to go further. If the oil is to be transported from the Gulf to China, it needs to be protected. To do so, China is enhancing its Navy.

The first part of China's military approach is to establish naval access arrangements with ports along the Indian Ocean – the so-called “string of pearls” - with a focus on Pakistan (the port of Gwadar, not far away from the Straits of Hormuz), Bangladesh (the port of Chittagong) and Myanmar (the port of Sittwe). In exchange for access, China is providing financial and technical assistance to these relatively poor nations. As these ports develop, however, they will provide not only security for the Chinese but also greater access to the outside world for Pakistan, Bangladesh and Myanmar. The strategy also includes the construction of a railway line through Cambodia to provide China with direct access to the Gulf of Thailand. There are many other examples. Each of them provides “connections” previously unimaginable.²

² By the same token, they also change the balance of power: one reason why Pakistan was so keen to strike a deal with China was that its most important port – Karachi – was blockaded during the 1971 India-Pakistan War and was again threatened during the 1999 Kargil conflict, reflecting its proximity to India

74. The string of pearls – with India in the middle



Source: HSBC

The second part of the military approach is for China to build up its naval hardware. If Britain ruled the high seas in the 19th Century and the US does so today, China will surely be challenging for regional, if not global, supremacy during the 21st Century.

The ultimate naval status symbol is the aircraft carrier. One of the UK's – HMS *Invincible* – has already been sold for scrap in Turkey, another is up for auction on the Ministry of Defence website and the UK's forthcoming carrier will have no planes: a modern day version of the *Marie Celeste*. The US, of course, has plenty (around a dozen). China is about to fulfil its long-held ambition to join the club, meeting the proposal originally made by Chairman Mao in 1958 to build "railways on the high seas", fleets of merchant ships escorted by aircraft carriers. While that claim may have suffered from a touch of hyperbole at the time, it looks a lot more achievable today.

Infrastructure spending

China's energy interests extend well beyond the Persian Gulf. In a deal struck with Costa Rica in 2007 – in which Costa Rica formally recognised Beijing, and not Taipei, as China's capital – China National Petroleum Corporation signed a \$1.2bn joint venture with Refineria Costarricense. This was followed by 2010's free trade deal, in which Costa Rica became the third Latin American country to agree free trade terms with China following Chile in 2006 and Peru in 2009. Meanwhile, China has invested in hydro-electric schemes in Ecuador.

Yet for linkages with Latin America to develop, Beijing needs to back its actions with hard cash (and hard work). Ever since the 1823 Monroe Doctrine, in which Washington declared Latin America to be in its own backyard, largely to keep those pesky Europeans at bay, no other superpower has really been able to displace US interests in the region. True, some Latin American regimes have proved to be more than a thorn in America's side – most obviously those in Cuba and, more recently, Venezuela – but the 1962 Cuban missile crisis surely demonstrates that, when the chips are down, the US is still the key force in the region. Certainly Nikita Khrushchev thought so (eventually).

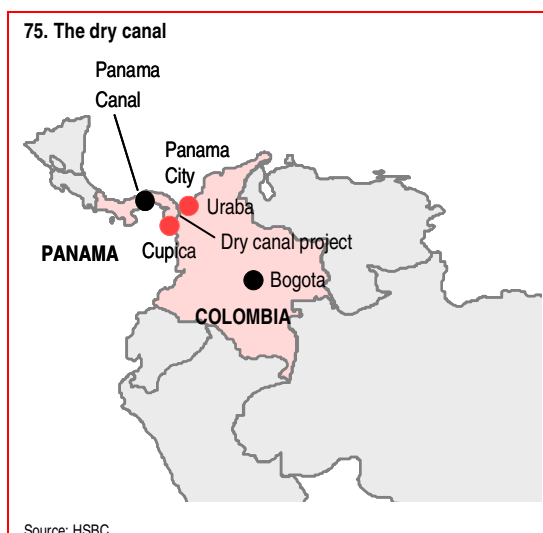
That's beginning to change, not so much because countries in Latin America are rejecting democracy (mostly, they're not) but, instead, because they rightly recognise that their own economic futures increasingly lie to the west, in Asia, rather than to the north, in the US. And China is keen to cement those relationships for the simple reason that Brazil, Chile and others are big global players in metals, food and (bio)fuel. If China's population is to be fed and clothed, its leaders know where to go.

A grand (dry) canal?

The most ambitious example of China's aims in Latin America is surely what has been termed the new "Panama Canal", even though the proposed new investment has nothing to do with Panama nor, indeed, with canals.

Today, if China wants to trade with Brazil, it has to send its goods overland across the Andes (difficult), through the Panama Canal (an eye of a needle which many in Beijing still think is indirectly under US control even though the Canal was handed back to Panama in 1999), around Cape Horn (a long way around and not very popular with sailors) or by air (prohibitively expensive).

The new plan – reflecting talks between Beijing and Bogota – is to build a Chinese-funded \$7.6bn railway that will connect Colombia's Pacific and Atlantic Coasts. Whether or not the plan will eventually come to fruition – it's vulnerable to both financing and engineering hiccups – it marks an extraordinary ambition on behalf of both the Chinese and the Colombians.



Moreover, to the extent that Colombia had been America's best friend in Latin America – helped along by a big chunk of military aid provided by Washington in recent years, largely to stamp out

guerrillas and drug dealers – Bogota's decision to establish an important link with China is remarkable. Yet as Washington dithers over a free trade agreement with Colombia (largely because of opposition from unions keen to protect the interests of American workers and worries over a disturbingly-large number of union member deaths in Colombia), it's hardly surprising that Bogota is looking for new economic relationships. At the moment, one of its main exports is roses to Russia: a fragrant trade, perhaps, but unlikely to provide the wealth that Bogota craves.

And if the Colombian project seems ambitious, it pales into insignificance relative to the UN-sponsored "Trans-Asia Railway" (TAR). The idea is to build a railway from Xinjiang through Kyrgyzstan, Tajikistan, Afghanistan and into Iran before branching out into Syria and Turkey, making connections along the way with Cambodia, India, Mongolia, Korea, Russia and Thailand. Importantly, it will give landlocked countries access to ports, enabling them to take advantage of new trading opportunities with the rest of the world.

The tip of an iceberg

The Colombian and Trans-Asian rail projects are only the tip of an investment iceberg fuelled not only by China but also by Brazil, Russia and India. Outward investments from BRIC countries reached \$147bn in 2008 - before inevitably falling back during the 2009 financial crisis – accounting for almost 9% of total world outflows.

Admittedly, a big chunk of this investment involved mergers and acquisitions rather than investments in green-field sites: through the first decade of the new Millennium, Indian companies finalised 812 foreign deals, with China at 450, Russia at 436 and Brazil at 190 (source: UNCTAD). The geographical spread of these deals, however, is ever more impressive. In the mid-1990s, the rest of Asia accounted for three-

quarters of Indian investment abroad but, by 2008, India's investments outside Asia had risen to 61% of the total. And the deals being struck are often based on strategic considerations that may have little to do with short-run profit and everything to do with long-run technical advantage. The majority of Chinese investments abroad are made by state-owned enterprises, particularly in the energy sector, while the acquisition of Western car brands may have as much to do with the acquisition of technologies as it does with offering an immediate boost to the bottom line.

The development of capital markets

Facilitating trade and capital flows requires the development of capital markets. For the time being, the West has an enormous advantage in this area. Yet perceptions are slowly shifting. If the last twenty years have seen a massive expansion of Chinese physical infrastructure, the next twenty are likely to see a major expansion of financial infrastructure.

One way to show this is to take some of the results from Long Finance's *The Global Financial Centres Index 9*, published in March 2011. While London and New York remain in positions 1 and 2 in the list of the world's top financial centres, the most striking feature of the results is the growth of Asian centres. Hong Kong and Singapore, in positions 3 and 4, have narrowed the gap with London and New York over time (and, in the process, have overtaken Tokyo). Shanghai has also now moved ahead of the Japanese capital. And, when respondents were asked which centres were likely to become more significant in the future, the top 5 were all Asian: Shanghai, Singapore, Seoul, Hong Kong and Beijing.³

³ Although, amusingly given Ireland's recent financial woes, Dublin popped up in sixth position

76. Top 10 financial centres

Rank	Centre	GFCI 9 rating
1	London	775
2	New York City	769
3	Hong Kong	759
4	Singapore	722
=5	Shanghai	694
=5	Tokyo	694
7	Chicago	673
8	Zurich	665
9	Geneva	659
=10	Sydney	658
=10	Toronto	658

Source: The Global Financial Centres Index 9, March 2011

77. The financial centres most likely to advance

Financial Centre	Number of mentions
Shanghai	62
Singapore	38
Seoul	37
Hong Kong	33
Beijing	17
Dublin	15
Amsterdam	12
Channel Islands	11
Dubai	11
Tel Aviv	10

Source: The Global Financial Centres Index 9, March 2011

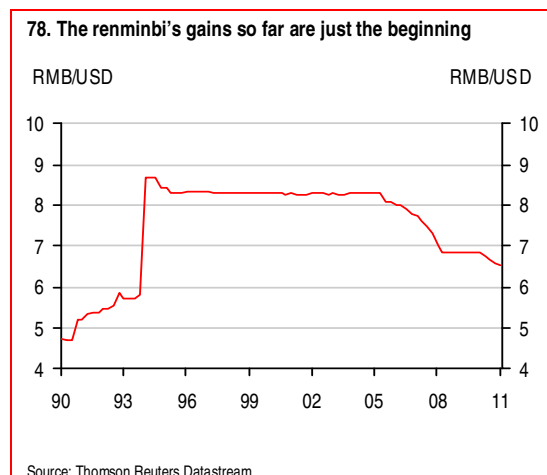
The need for these centres to develop reflects, in part, the need to finance internal growth. After all within emerging nations, the gap between urban economic strength and rural poverty is enormous. Part of the challenge, therefore, lies in creating internal connections which must rest on the creation of much more substantial infrastructure. To raise the funds to facilitate investment on the appropriate scale undoubtedly will require much deeper, more liquid and more sophisticated financial markets.

As these capital markets grow, however, they will also increasingly connect with each other. How might those connections be facilitated? Two developments are likely to be hugely influential.

From greenbacks to redbacks

As HSBC's Qu Hongbin and his team have argued (see *The rise of the redback*, November 2010), we are witnessing the slow decline of the US dollar as the world's reserve currency and its possible replacement by the renminbi. Already the world's biggest exporter, China's economy is big but its currency punches well below its weight in international trade and capital markets.

There's an obvious reason for this. China still has a relatively closed capital account. But this is slowly changing, not least because foreign investors increasingly regard the renminbi as an alternative to the dollar as a useful store of value. Policymakers in the heavily-indebted US have every incentive to pursue a policy of dollar depreciation, not least because it's a useful way to defraud foreign creditors of their international savings: in renminbi terms, for example, China's holdings of US paper assets would fall in value should the dollar's value drop on the foreign exchanges.



It's easy to forget that, despite all the criticism China receives for its "inflexible" exchange rate policy, the renminbi has already risen by more than 20% since the fixed peg regime ended in 2005. As an alternative to a wheezing US dollar, it already looks attractive from the perspective of international reserve managers. And with more

than 50% of China's international trade conducted with emerging nations, China has every incentive to pursue, on its own terms, the internationalisation of its currency: after all, it's cheaper for China to conduct international business in its own currency than to do so via "third party" dollars.

The process of renminbi internationalisation will be encouraged via the introduction of multiple accommodative taxation, trade finance and capital account measures. Should the current trend continue, at least half of China's trade flows with emerging nations could be settled in renminbi within the next 3-5 years. And as trade flows pick up, so too will cross-border capital flows: the pool of offshore renminbi cash deposits has already seen an impressive surge, notably in Hong Kong.

A change of ownership

The internationalisation of the renminbi is only one part of this story. Increasingly, emerging nations with current account surpluses and large holdings of foreign assets will be able to set their own terms for foreign investment. If, as now seems increasingly likely, the Western world is unable to stage a decent economic recovery, held back by bucket-loads of debt, the obvious risk is that its financial system, having lent too much and short of capital, continues to creak. Capital injections may, for the time being, come from generous shareholders with deep pockets but it is not difficult to imagine that, in time, emerging investors will be looking not just to buy copper mines in Chile but also financial institutions in the US and Europe. And by purchasing the institutions, the hope will surely be that the skills necessary to develop south-south capital markets will be enhanced.

The return of state capitalism

Opening up trade on a South-South basis is unlikely to work without a strategy. The infrastructure isn't there. The capital markets haven't been fully established. The financial system is still very "developed world-centric". Yet there can be no doubt that, with their deep pockets, those emerging nations which have built up vast holdings of overseas assets have the opportunity to transform their own futures and, indeed, the future of the world economy. There is a model for these aspirations. The British East India Company, ostensibly a commercial entity, became a key agent of British imperial policy in the 18th and 19th Centuries, ensuring that markets were rigged for the benefit of its shareholders and for the British national interest. While other nations won't be engaging in the drug dealing and colonisation that became part of the British East India Company's activities, the lesson is clear. Forget about Adam Smith's invisible hand: the 21st Century will be characterised increasingly by commercial deals struck at the state level. The free market system that reached its apotheosis at the end of the 20th Century is now under tremendous pressure, undermined by the contradictions exposed during the financial crisis and by the growing strength of countries that had never fully signed up to the so-called Washington consensus.

Overcoming impossibility

- ▶ South-South trade is set to increase tenfold in the first half of the 21st Century...
- ▶ ...turbocharged via the opportunities for hitherto unexploited connections...
- ▶ ...and, in the process, shifting the centre of global economic gravity along a Southern Silk Road

The fallacy of composition...

While it may be the case that China and India will be the first and third biggest economies in the world by 2050, they won't be able to achieve these lofty heights unless there is a radical shift in the linkages which govern the global economy.

To see why, it's worth thinking about the implications of rapid economic growth for patterns of global trade. It's often thought, for example, that China's economic model ultimately depends on the deep pockets of US consumers. If it does, however, we see no way that China could ever hope to become the biggest economy in the world.

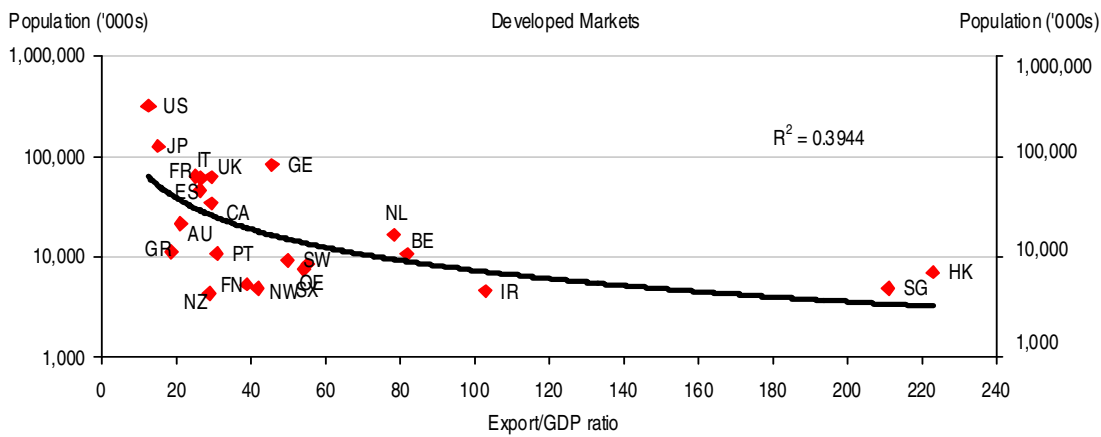
Table 79 shows why. Assume, for a moment, there is no change in the structure of the Chinese economy in the future. More precisely, exports remain in a 25-30% of GDP range, in line with recent experience. If China and other nations then grow in line with HSBC's 2050 projections, China's exports will end up rising from 2.6% of world GDP currently to 7.4% of world GDP by 2050, reflecting the massive increase in China's relative economic clout. Expressed as a share of US GDP, China's exports would rise from 10.8% to 46.8%.

79. Will the world add up? Making room for Chinese exports won't be easy

	As % of this country's GDP																				
	US		UK		Germany		France		Japan		China		Brazil		India		Russia		World GDP		
	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	2010	2050	
This country's exports	US	-	-	81.9	71.2	55.7	56.5	71.3	69.6	33.6	47.1	31.3	7.8	88.0	49.9	112.9	24.3	124.2	49.9	3.0	1.9
	UK	4.5	4.7	-	-	20.0	22.5	25.7	27.7	12.1	18.8	11.2	3.1	31.7	19.9	40.6	9.7	44.7	19.9	1.1	0.7
	Germany	10.3	9.5	67.3	57.1	-	-	0.6	0.6	27.6	37.8	25.7	6.2	72.3	40.0	92.8	19.5	102.1	40.0	2.4	1.5
	France	4.4	4.4	29.0	26.3	19.7	20.8	-	-	11.9	17.4	11.1	2.9	31.2	18.4	40.0	9.0	44.0	18.4	1.1	0.7
	Japan	5.7	4.0	37.0	23.9	25.2	19.0	32.3	23.4	-	-	14.1	2.6	39.8	16.8	51.1	8.2	56.2	16.8	1.3	0.6
	China	10.8	46.8	70.3	280.8	47.8	222.6	61.3	274.2	28.9	185.7	-	-	75.6	196.6	97.0	95.7	106.7	196.7	2.6	7.4
	Brazil	1.6	3.0	10.4	18.2	7.1	14.4	9.0	17.8	4.3	12.0	4.0	2.0	-	-	14.3	6.2	15.7	12.7	0.4	0.5
	India	2.3	10.4	15.0	62.5	10.2	49.5	13.0	61.0	6.2	41.3	5.7	6.8	16.1	43.8	-	-	22.7	43.8	0.5	1.6
	Russia	3.0	7.3	19.8	43.8	13.5	34.7	17.3	42.8	8.1	28.9	7.6	4.8	21.3	30.6	27.3	14.9	-	-	0.7	1.1

Note: calculations base on assumption that export to GDP ratio remains at the current rate.
Source: Eurostat, national statistics offices IMF and HSBC long-term growth estimates.

80. The larger the domestic population, the lower the share of exports within GDP



Source: Thomson Reuters Datastream

On the face of it, these numbers suffer from a “fallacy of composition”. The world as a whole simply isn’t big enough to accommodate China’s future economic expansion if trade remains either “North-South” or “East-West”. Something, then, will have to change.

...and how to solve it

Excluding the possibility of trading with Mars or Venus, there are two primary options: either more of each emerging nation’s growth comes from internal sources or more comes from the emerging nations connecting economically with each other. The developed world simply won’t be big enough to accommodate the emerging world’s ambitions and expectations.

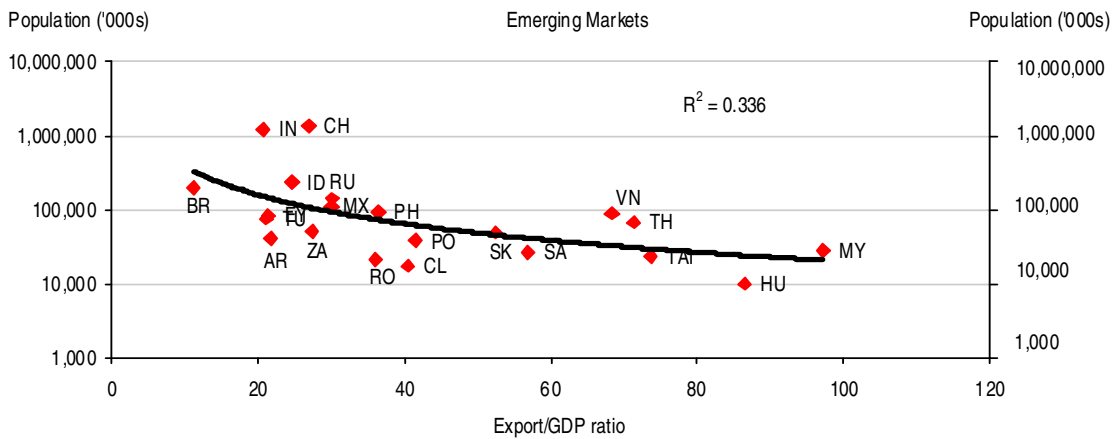
The options for change are certainly there. Consider, first of all, the difference in economic structure between the US and China. The biggest and second biggest economies in the world are fundamentally different: as we’ve already noted, the US runs a large current account deficit while China runs a large surplus: US exports of goods and services stand at around 12% of GDP whereas China’s are, as we’ve seen, not far short of 30% of GDP.

While there are no rules governing the appropriate size of exports as a share of GDP there is, nevertheless, a relatively clear pattern, at least within the developed world: countries with “large” populations tend to have relatively low export shares in GDP (in other words, they are relatively “closed”) while countries with “small” populations tend to have high export shares in GDP (see chart 80).

There’s an obvious reason for this. Countries with large populations can do lots of things while those with small populations typically have to specialise in specific areas. That means having to engage in trade with other nations in order to achieve significant gains in living standards. Countries within the European Union are mostly incredibly open – exports as a share of GDP in the Netherlands, for example, are close to an extraordinary 80% of GDP. The EU as a whole, however, is rather closed: its exports to the rest of the world account for 15.5% of GDP, not so different from the figures for the US.⁴

⁴ If we had data for state-to-state trade in the US, we’d doubtless discover something very similar: in both the US and the EU, there is a large internal market

81. The same holds true for the emerging world but China and India appear to export too much...



Source: Thomson Reuters Datastream

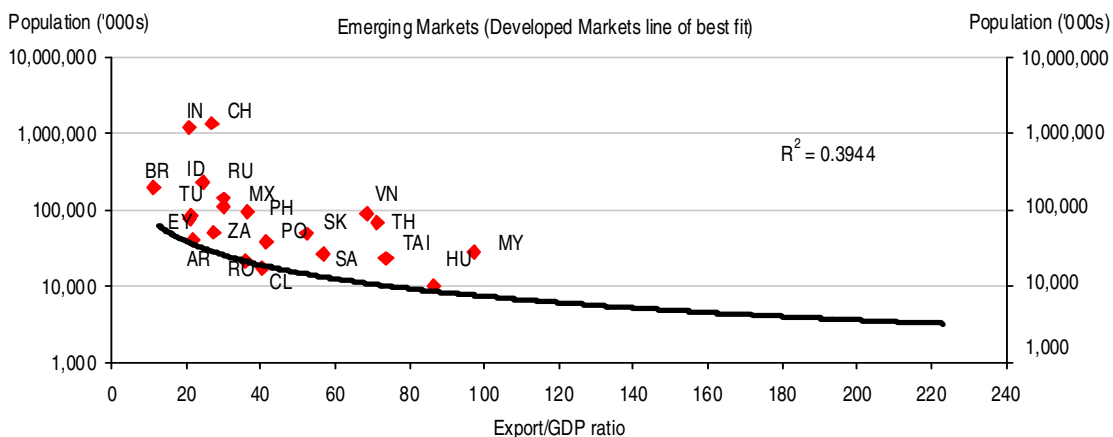
The emerging world's dependence on exports

China, then, looks odd. The share of its exports within GDP is closer to the model associated with a small but mature European country that needs to trade heavily with its neighbours and not a large continental economy which should benefit from a large internal market. And it's not just China which looks peculiar. Chart 81 shows that India, too, is an outlier. Like China, its exports are an unusually high proportion of GDP given the enormous size of its domestic population. And by superimposing emerging nations onto the "line of best fit" for developed nations (chart 82), it's easy

to show that, although China and India are outliers relative to other emerging nations, almost all emerging nations are outliers compared with the developed world. Given the size of their populations, they export too much.

Admittedly, it's a bit rich to claim that these countries are "outliers" when their combined populations account for the vast majority of the human race. Maybe they've got it right while the developed world has got it wrong. Yet there's something peculiar about devoting so many resources to exports when nations could, in theory, benefit from a large internal market.

82. ...and, relative to the developed world, almost all emerging nations are unusually "export dependent"



Source: Thomson Reuters Datastream

The emerging nations' export dependence doesn't just reflect their hunger for commodities (and, thus, the need to pay for those commodities). It has a lot more, in fact, to do with the lack of domestic markets. With poor rural populations and with only modest urban incomes – by developed world standards – the opportunities to sell goods and services domestically are essentially limited. And, to the extent that exports are a reflection of foreign capital investments in China and India (roughly 60% of China's exports are made by foreign companies who have invested, often on a joint-venture basis, in China), it's not so difficult to see why exports are so high as a share of GDP.

Opening up inside and out

This observation also offers the beginnings of a solution to the fallacy of composition. The solution is twofold:

- 1 As emerging nations urbanise, their domestic product and capital markets will grow. With credit markets becoming larger and more sophisticated, and with the development of social security systems, savings ratios will decline and the balance of growth will naturally shift away from exports to the developed world. Rather than selling to developed foreign markets, producers within the emerging world will increasingly be able to sell to their domestic markets.
- 2 However, as emerging nations develop their domestic markets, those markets will become more sophisticated: better flows of information, more established property rights and improved physical and institutional infrastructures. They will thus increasingly be able to sell to each other. This, in turn, helps overcome the fallacy of composition problem. China's share of global domestic demand, for example, should rapidly increase in the years ahead: under these circumstances,

it's quite possible for other emerging nations to shift away from a "developed world" export strategy towards an "emerging world" strategy. Emerging nations will come to depend on each other, and not on the established markets in the developed world. And, as this happens, emerging market to emerging market trade will soar.

To provide a flavour of what might happen, tables 83 to 85 show how patterns of trade developed across the major industrialised nations in the 1950s and 1960s relative to economic growth. It's not possible to show these numbers in real, inflation-adjusted, terms (which would be ideal) but we can at least compare changes in export values with changes in the *value* of GDP.

83. Average annual growth rate % (nominal)

	1950-1960	1960-1970
US	6.0	7.0
Japan	15.0	16.4
Germany	11.9	8.4
France	11.5	10.2
UK	7.0	7.2

Source: The Economist One Hundred Years of Economic Statistics

84. Average annual growth in exports (%) 1950-1960

To	US	Japan	Germany	France	UK
From					
US	-	13.3	11.3	4.3	10.8
Japan	19.7	-	20.6	4.5	16.6
Germany	24.2	31.1	-	18.6	19.5
France	12.3	20.1	14.6	-	2.1
UK	11.5	26.7	12.6	6.0	-

Source: IMF Direction of Trade Statistics

85. Average annual growth in exports (%) 1960-1970

To	US	Japan	Germany	France	UK
From					
US	-	12.4	7.9	7.7	5.5
Japan	18.5	-	23.6	23.4	14.8
Germany	13.3	16.1	-	14.6	9.1
France	9.1	18.8	14.6	-	7.7
UK	7.9	15.3	9.0	11.4	-

Source: IMF Direction of Trade Statistics

The numbers show clearly that growth in cross-border trade significantly outstripped growth in GDP. Throughout the 1950s and 1960s, as postwar construction took hold, growth in bilateral trade outstripped GDP growth often by a factor of 1.5 to 2.

The same process has, of course, taken place on a bilateral basis between individual emerging nations and nations within the developed world. However, the process has yet to take off in a major way on a bilateral basis between nations in the emerging world.

Yet the seeds have been sown. Imagine, then, that our 2050 GDP projections are about right and that trade on a bilateral basis between nations in the emerging world grows much more quickly than world trade as a whole. Imagine, in other words, that emerging market trade is turbocharged using the benchmarks set by the developed world back in the 1950s. How might the world look in the next few decades?

A three-stage process

Tables 86 to 98 provide a “three stage” process to assess patterns of trade across the BRIC nations, both with each other and relative to the G5 nations of the developed world.

Stage 1 simply shows how trade patterns develop on the basis of likely growth rates in GDP. It provides a benchmark against which the effects of 1950s-style turbocharging can then be assessed.

Those incremental effects are shown in the turbocharged results in stage 2. In stage 3, we focus not so much on bilateral links between nations but, instead, the growing links between nations and whole continents.

Stage 1: an upheaval

In stage 1, Chinese exports to the G5 plus BRICs would more than double in value between now and 2050. Indian exports would go up threefold while those of Brazil and Russia would more or less quadruple. Reflecting the relatively rapid growth of other emerging markets, each nation becomes increasingly dependent on the other BRICs for its trade growth. Thus, out of its total G5 and BRIC exports, the share of Chinese exports going to the US would drop around 6% between now and 2050 while the share going to India rises by 12%, in our scenario. For Brazil, the share going to the US would drop almost 16% while the share going to China would rise 33%.

86. China exports to G5 plus other BRICs

	Share 2010 (%)	Share 2050 (%)
US	45.7	39.5
Japan	20.1	11.8
Germany	10.4	8.5
France	6.5	5.4
UK	6.2	5.9
India	4.5	17.3
Brazil	3.7	5.5
Russia	3.0	6.2

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

87. India exports to G5 plus other BRICs

	Share 2010 (%)	Share 2050 (%)
US	37.2	21.3
Japan	6.4	2.5
Germany	11.1	6.0
France	6.7	3.7
UK	12.4	7.8
China	20.5	52.4
Brazil	3.7	3.6
Russia	2.0	2.8

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

88. Brazil exports to G5 plus other BRICs

	Share 2010 (%)	Share 2050 (%)
US	28.2	12.5
Japan	5.1	1.5
Germany	11.0	4.6
France	5.1	2.2
UK	6.4	3.1
China	33.5	66.5
India	5.9	4.4
Russia	4.8	5.1

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

89. Russia exports to G5 plus other BRICs

	Share 2010 (%)	Share 2050 (%)
US	12.7	6.5
Japan	11.8	4.1
Germany	19.8	9.6
France	8.5	4.2
UK	11.3	6.3
China	26.4	60.5
India	8.0	7.0
Brazil	1.4	1.7

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

Stage 2: a turbocharged revolution

Adding the stage 2 turbocharger enormously magnifies these trends, in our scenario. If South-South barriers to trade can be demolished, the opportunities created will be huge. Using the developed world benchmarks from the 1950s, it appears that Chinese exports to the G5 plus BRICs may be able to rise more than threefold with Indian exports up fourfold and Russian and Brazilian exports up a staggering fivefold.

The numbers are vast but they are entirely driven by increased South-South connections. We expect the share of Chinese exports to the US to drop rapidly – by around 6% - while the share to India grows hugely, by 25%. With India, the relationship is reciprocated: its exports to China rise at a rate of knots – up tenfold over the entire period - while its reliance on the US steadily drops. Brazil and China also become a lot more dependent on China as a source for their exports in the year ahead. The US, Europe and Japan, by implication, steadily become a lot less important, in our scenario.

90. China exports: turbocharged

	Share 2010 (%)	Share 2050 (%)
US	45.7	28.2
Japan	20.1	8.5
Germany	10.4	6.1
France	6.5	3.9
UK	6.2	4.2
India	4.5	31.6
Brazil	3.7	9.6
Russia	3.0	7.9

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

91. India exports: turbocharged

	Share 2010 (%)	Share 2050 (%)
US	37.2	17.3
Japan	6.4	2.0
Germany	11.1	4.8
France	6.7	3.0
UK	12.4	6.3
China	20.5	55.4
Brazil	3.7	7.1
Russia	2.0	4.0

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

92. Brazil exports: turbocharged

	Share 2010 (%)	Share 2050 (%)
US	28.2	10.6
Japan	5.1	1.3
Germany	11.0	3.9
France	5.1	1.9
UK	6.4	2.6
China	33.5	62.7
India	5.9	9.2
Russia	4.8	7.8

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

93. Russia exports: turbocharged

	Share 2010 (%)	Share 2050 (%)
US	12.7	5.0
Japan	11.8	3.2
Germany	19.8	7.4
France	8.5	3.3
UK	11.3	4.9
China	26.4	60.8
India	8.0	13.2
Brazil	1.4	2.4

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

94. How BRIC trade could overtake G5 trade

Origin	Destination	2010 % share of total exports	2010-2050 % growth	2050 % share of total exports
China	Total	100	308	100
	G5	89	76	51
	BRIC	11	1256	49
India	Total	100	411	100
	G5	74	86	33
	BRIC	26	944	67
Brazil	Total	100	507	100
	G5	56	84	20
	BRIC	44	813	80
Russia	Total	100	483	100
	G5	64	78	24
	BRIC	36	928	76

Source: IMF Direction of Trade Statistics, HSBC estimates

Stage 3: The Continental angle

We can also carry out the same analysis at the continental level. By widening the scope, we can provide a truly global picture of changing trade patterns and, importantly, the emergence of the Southern Silk Road. Tables 95 to 98 show the continental results, emphasising once again the growing links between the major nations in Asia and the southern hemisphere. The relative importance to China of North America and Western Europe halves while the relative importance of many parts of the “Southern world” doubles. The same findings are broadly true of India, Brazil and Russia.

And we have also offered a “now and then” comparison on four maps where the thickness of the arrows represents the proportionate increase in trade flows over the next four decades. The picture is clear: trade is heading south. We are witnessing the reshaping of economic geography.

95. China exports: turbocharged by continent

	Share 2010 (%)	Share 2050 (%)
Latin America	4.6	8.1
Middle East	4.3	9.3
Asia-ex Japan & China	30.9	43.6
CEE	2.4	5.1
CIS & Mongolia	3.5	6.2
Africa	3.4	5.9
North America	20.5	9.1
Western Europe	20.6	8.9
Other advanced	9.8	3.9

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

96. India exports: turbocharged by continent

	Share 2010 (%)	Share 2050 (%)
Latin America	3.8	5.1
Middle East	18.5	30.4
Asia-ex Japan & India	28.9	38.2
CEE	2.7	4.3
CIS & Mongolia	0.9	1.3
Africa	5.9	7.9
North America	14.7	5.0
Western Europe	20.1	6.6
Other advanced	4.5	1.4

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

97. Brazil exports: turbocharged by continent

	Share 2010 (%)	Share 2050 (%)
Latin America ex Brazil	22.2	14.3
Middle East	6.3	11.8
Asia-ex Japan	24.0	47.5
CEE	1.2	2.3
CIS & Mongolia	2.4	3.8
Africa	3.5	5.2
North America	12.9	4.9
Western Europe	23.3	8.7
Other advanced	4.2	1.4

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

98. Russia exports: turbocharged by continent

	Share 2010 (%)	Share 2050 (%)
Latin America	1.2	1.3
Middle East	2.6	3.1
Asia-ex Japan	14.3	44.0
CEE	18.2	21.6
Africa	0.8	1.4
North America	8.5	4.5
Western Europe	49.1	22.0
Other advanced	5.2	2.1

Source: IMF Direction of Trade Statistics for 2010, HSBC calculations for 2050

99. Turbocharged growth: how world trade will be transformed through South-South connections

Origin	Destination	2010 % share of total exports	2010-2050 % growth	2050 % share of total exports
China	Total	100	361	100
	South-South	47	621	73
	Ex-home continent/region	16	759	20
	Other	53	132	27
India	Total	100	504	100
	South-South	58	761	83
	Ex-home continent/region	29	823	45
	Other	42	147	17
Brazil	Total	100	431	100
	South-South	58	651	83
	Ex-home continent/region	36	901	68
	Other	42	121	17
Russia	Total	100	343	100
	South-South	19	1066	50
	Ex-home continent/region	19	1066	50
	Other	81	174	50

Source: IMF Direction of Trade Statistics, HSBC estimates

100. China export growth to continents 2010-2050: the thicker the arrow, the bigger the expansion



Source: HSBC estimates

101. India export growth to continents 2010-2050: the thicker the arrow, the bigger the expansion



Source: HSBC estimates

102. Brazil export growth to continents 2010-2050: the thicker the arrow, the bigger the expansion



Source: HSBC estimates

103. Russia export growth to continents 2010-2050: the thicker the arrow, the bigger the expansion



Source: HSBC estimates

The political hurdles

Economic impossibility can, then, be overcome. The opportunities are there. The outstanding question – and it is not one to take lightly – is whether the nations that stand to benefit can really make the political leap of faith that will allow cross border connections to be created and sustained. Trading with other nations is easy if there is a climate of mutual trust and respect. It's a lot more difficult if political hostility gets in the way.

From a Western perspective, the big geopolitical event in 1962 was the Cuban missile crisis. From an Asian perspective, the big event was the Sino-Indian war which, oddly enough, coincided with the transatlantic bust-up between Khrushchev and Kennedy. China and India haven't forgotten that event, eyeing each other uneasily across the Himalayas. Suspicions on both sides have only been made worse by the Dalai Lama's sanctuary in India and China's ongoing economic and political relationship with Pakistan. What could be a mutually beneficial relationship often seems, instead, to be dangerously poisonous.

Meanwhile, many people believe that, while China is slowly mastering its "hard power" – associated with economic and military muscle – it is winning few friends with "soft power" (see, for example, Joseph Nye's 2011 *The Future of Power*). Too many potential beneficiaries of trade with China don't want to jump on board for fear of being dominated by a country intent on economic colonisation.

As we have seen, this is a long way from being universally true. The connections being made between China and nations in the southern hemisphere are becoming friendlier. While some of those connections may not be universally welcomed – think, for example, of the string of pearls in the Indian Ocean – others seem to be mutually beneficial. Much depends, of course, on the terms of China's investments abroad,

including whether the jobs created are for the indigenous population or, instead, for Chinese "guest workers" and whether there are any spill-over benefits for the host nation that might allow increased commerce with other parts of the world.

Yet, strangely enough, the biggest constraint on China's incursions into the rest of the world may not be opposition from countries elsewhere but self-restraint on behalf of the Chinese themselves. Deng Xiaoping once famously urged China to "observe calmly, secure our position, cope with affairs calmly, hide our capacities and bide our time; be good at maintaining a low profile; and never claim leadership". The so-called "24 character strategy" has served Beijing well over the years, even if more nationalist elements in the Communist Party are now calling it into question.

If, however, China sticks with Deng's policy, it will encounter an obvious problem. How will it be able to defend its economic interests elsewhere in the world if it wants to hide its capacities or, indeed, has no well-defined strategy to defend its interests? The outbreak of civil war in Libya in 2011 offers a useful example. More than 35,000 Chinese nationals were evacuated but whereas the Americans, French and British used military hardware to get people out, China had to charter Greek ships in bid to evacuate its citizens. While this strategy proved to be a success, it surely reveals that China's military reach around the world is still modest relative to its economic reach, leaving China very much in America's shadow. Might this lack of global reach diminish China's ambitions on the world stage? And might any attempt to enhance its global reach only serve to sour relations with the US?

Only time will tell. It would be wrong, however, to suggest that China has completely failed to win the hearts and minds of people elsewhere in the world. The HSBC offices in San Francisco overlook Chinatown. A few years ago, fluttering

in the breeze on the rooftops of Chinatown was a medley of Star-Spangled Banners, Taiwanese “Blue Sky, White Sun and a Wholly Red Earth” emblems and Hong Kong flags. Most of those symbols have now gone. In their place is the national flag of the People’s Republic of China. This may only reflect the changing views of China’s own global Diaspora but there is, in all likelihood, much more to this story. The balance of power in the world economy is relentlessly shifting eastwards and southwards. And, in the process, we are witnessing the creation of a Southern Silk Road.

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