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BRICs, emerging markets and the world economy

Not just straw men

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The biggest emerging economies are rebounding, even without recovery in the West

EPA



THE inaugural summit of the BRICs—Brazil, Russia, India, China—came and went in Yekaterinburg this week with more rhetoric than substance. Although Russia's president, Dmitry Medvedev, called it "the epicentre of world politics", this disparate quartet signally failed to rival the Group of Eight industrial countries as a forum for economic discussion.

But that should be no surprise: to realise how disparate they are, consider that Russia and Brazil are big commodity exporters, whereas China is a big commodity importer; China is a proponent of the Doha trade round, India a sceptic; India and China vie for influence in the Indian Ocean, Russia and China compete in Central Asia.

Instead, the really striking thing is that four countries first lumped together as a group by the chief economist of Goldman Sachs chose to convene at all, and in such a high-profile way. And that when they met, they discussed topics such as reforming the IMF; their demand for more say in global policy-making; and, in the case of China, Brazil and Russia, a plan to switch some of their foreign-currency reserves out of dollars and into IMF bonds.

All this reflects growing self-confidence. The largest emerging markets are recovering fast and starting to think the recession may mark another milestone in a worldwide shift of economic power away from the West. Estimates for their national incomes in the first quarter were better than expected. In the year to the end of March GDP rose by

around 6% in China and India. The two accounted for no less than half the world's increase in wireless-technology subscriptions in that period. In Brazil gdp fell slightly in the first quarter but it is growing faster than the Latin American average and most economists think growth will return to its pre-crisis level as early as next year. In contrast, output in most large industrial economies is still falling. The exception in the BRICs is the host: dragged down by plunging oil prices last year, Russia's economy shrank by 9.5% in the first quarter, the worst performance in the G20 after Japan.

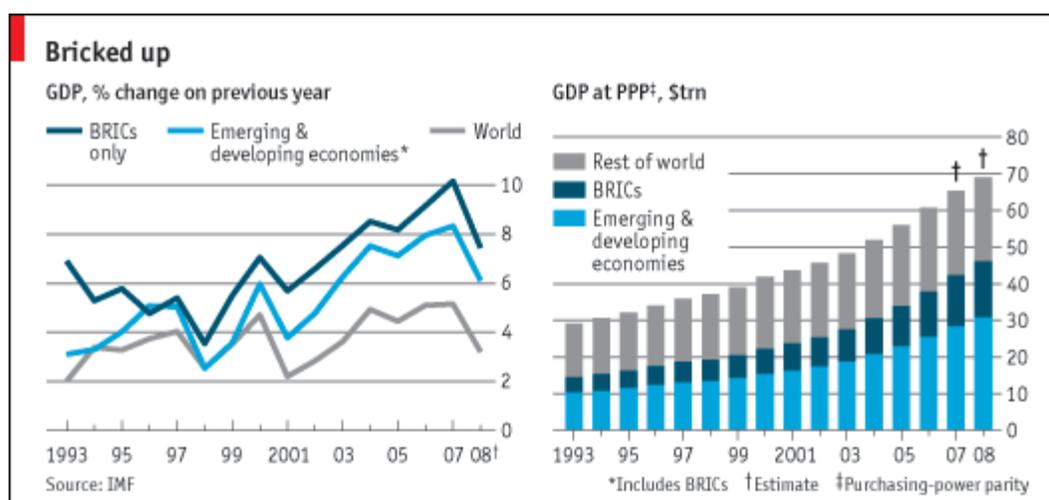
The fortunes of the others mark a sharp rebound since the turn of the year. Then, it seemed, the largest emerging markets faced being overwhelmed along with everyone else. Chinese exports in January were 18% lower than they had been a year earlier. Industrial growth fell by two-thirds in November and December. And around 20m migrant workers were wending their way back to their villages, jobless after the collapse of construction and export booms in coastal cities. The notion of "decoupling"—that emerging markets were no longer mere moons revolving around planet West—suffered a severe setback.

So what should one make of the turnaround? Might there be something to decoupling after all? Why are the BRICs recovering? And what are the implications for the rest of the world?

Decoupling means not simply that emerging markets tend to grow faster than rich industrial ones, although that is certainly true; it also implies that to some extent the two groups dance to different tunes, with emerging markets growing or shrinking autonomously, not just under the influence of rich ones. A study last year by Ayhan Kose of the IMF, Christopher Otrok of the University of Virginia and Eswar Prasad of Cornell University gave some support to this idea.

You would expect less decoupling as a result of globalisation. The cycles of output, consumption and investment should become more closely aligned in countries engaged in world trade. Yet when the authors looked at these indicators, they found something different. The cycles of output, consumption and investment did indeed become more closely aligned in rich countries. And the same thing happened in emerging markets. But when the authors compared the two groups, they found they were diverging. The business cycles of America and Europe converged. The business cycles of India and China converged. The business cycles of rich and emerging markets had decoupled.

When this study came out in mid-2008 the worldwide crash seemed to render it instantly obsolete. Yet the sheer size of the meltdown may temporarily have swamped deeper trends that are now reasserting themselves as the initial shock recedes. In 2000 developing countries accounted for 37% of world output (at purchasing power parities). Last year their share rose to 45%. The share of the BRICs leapt from 16% to 22%, a sharp rise in such a short period. Almost 60% of all the increase in world output that occurred in 2000-08 happened in developing countries; half of it took place in the BRICs alone (see chart).



If this pattern of growth were resuming, it would be good news: nearly half the world economy would be bouncing back. And there are one or two signs that the benefits of growth in the BRICs are being felt farther afield. Anecdotal evidence suggests "south-south" trade and investment by richer emerging markets in poorer ones

continued to rise even as global capital and trade flows fell. One example of this is the “land grab” in which China and Gulf countries are buying millions of acres of farmland in Africa and South-East Asia. China overtook America to become Brazil’s largest export market in March and April; it is also now the largest exporter to India. China is using its \$2 trillion of foreign reserves to invest in other emerging markets: for example, putting \$10 billion into Petrobras, Brazil’s state-run oil company.

China’s appetite for raw materials to fuel resurgent growth probably explains the 36% rise in industrial raw-material prices since the start of this year, benefiting exporters of things like copper—though how long this will last is an open question. If it comes from the boom in Chinese investment spending, then the boom could continue. If China is merely filling its stores temporarily after a period of destocking, then prices could fall again.

But the resilience of China, India and Brazil cannot offset the dire state of the rest of the world economy. While the three giants recover, developing countries as a whole are mired in recession. The giants seem to be decoupling not only from the West but from many of their smaller emerging brethren, too.

A series of reports confirms how badly things are going there. A review of ten poor countries by the Overseas Development Institute, a think-tank in London, concludes that they were worse hit than anyone expected, with sharp declines in remittances, employment and revenues and widespread balance-of-payments problems. As the study’s author, Dirk Willem te Velde, points out, the differences are often striking. In some countries—Indonesia, Kenya, Bangladesh—foreign direct investment has held up reasonably well; others—Ghana, Nigeria and Zambia—are facing sharp declines. Cambodian textile exports have been hit harder than Bangladeshi ones. But because import demand, capital flows and the need for foreign workers declined precipitously in the West, almost all developing countries are suffering.

In its most recent assessment, the United Nations says at least 60 poor and emerging markets will this year suffer falls in income per person. The UN’s forecasts for eastern Europe and sub-Saharan Africa are especially dark. For eastern Europe, Russia and its neighbours, the body predicts a fall in output of 5%. Arvind Subramanian, an economist at the Peterson Institute for International Economics, a think-tank in Washington, DC, argues that the recession in eastern Europe sounds the death knell for one of the two main growth strategies of the past 20 years—capital-account liberalisation (growth through exports is the other). The east European countries threw their financial sectors open to the world. In 11 of the region’s countries, foreign banks account for over 60% of bank assets. The flood of foreign-currency borrowing destabilised their economies and left them vulnerable when Western banks reduced lending.

In Africa, the UN predicts, output will now fall by 0.9%. That might not sound too bad but only two months ago the IMF was forecasting a rise of 1.7% and at the start of the year the UN had projected a 4.8% increase. To return to pre-crisis growth, says the African Development Bank (AFDB), would require the continent to attract \$50 billion of new money this year. Africa is nowhere near those levels because world capital flows are falling. The latest forecast by the Institute of International Finance says total net flows will collapse from \$890 billion in 2007 to just \$141 billion this year.

The AFDB fears that “a growth crisis” may be turning into a “development crisis”, leading to sharp increases in poverty and malnutrition. By the end of 2009, says the UN, there will be between 105m and 143m more people in poverty than if growth had continued at its pre-crisis levels (see [article](#)). The main exception is in smaller East Asian countries, where industrial output is rebounding and GDP growth is likely to resume in the second quarter.

At the moment, then, recovery in the BRICs is coinciding with recession in the developing world as a whole. If this does not point to any change in global economic conditions, what does it reflect?

Partly, that the BRICs depend less on exports than do many emerging markets. In Brazil and India exports are less than 15% of GDP. China, too, exports less than many people think. Though exports were 34% of GDP in 2008, these included “processing exports”—goods imported into China, processed and exported without much value having been added. All three were thus less affected by the slowdown in world trade than most.

The BRICs were cautious in liberalising their financial systems, so have been less affected than, say, eastern Europe, by the West’s financial heart attack. And their recoveries have been boosted by governments which have dramatically loosened monetary policy and increased government spending. But many other countries are relatively closed to trade and finance. Smaller ones like Chile and Taiwan have had a large fiscal stimulus. But few have done so well. Something more is needed to explain the recovery of the giants. A plausible explanation is size.

Size matters when world trade is falling because large economies have millions of domestic consumers to turn to when foreign markets fail. China is the best example. Small economies need trade to specialise, but the pressure of selling into a big domestic market helps companies in large economies remain competitive even without a lot of competition from imports. Big economies also tend to be diversified. India, for example, exports not just garments and cheap electronics—characteristic of many countries with similar levels of income per head—but ships, petrochemicals, steel and business services. Being diversified means little when markets all fail at once. But it is a big advantage when recovery begins since you are more likely to be in a business in which demand is rising.

Size and variety may also help the economic stimulus programmes of China, India and Brazil. In general, one of the commonest problems of government reflation is that the benefits leak out beyond your borders because the programme sucks in imports. Giant economies do not face this problem so acutely because even when trade has been liberalised, imports naturally tend to be a lower share of GDP.

The other challenge is to ensure that government stimulus programmes are broadly based. This could be more difficult in small economies which specialise in relatively fewer sectors. A handful of big companies may be able to use political clout to grab the benefits of spending for themselves. In principle, giant countries such as India or China have more companies competing to manipulate the government for a share of the spoils. That is speculation, but the fact is that the stimulus programmes in the big emerging markets have been, mostly, large and effective.

China's stimulus package was the earliest and best-known example of fiscal shock and awe. But it is only part of the story. The government is using the state-owned banks to pump out loans at astonishing rates. According to Josh Felman, of the IMF's Asia research department, state banks and others issued 5.5 trillion yuan (\$800 billion) of new loans in the first quarter—more than in the whole of 2008. This is producing a spending splurge on steroids. Excluding SUVs, almost as many cars are being sold in China as in America. In 2006 Americans bought twice as many.

Brazil and India are following suit, albeit more modestly. Brazil reduced reserve requirements and gave banks and its deposit-insurance fund incentives to buy up the loan portfolios of smaller banks. These measures injected 135 billion reais (\$69 billion) into the domestic credit markets, according to Otaviano Canuto of the World Bank. Domestic credit rose sharply between September 2008 and January 2009 and consumer confidence is rebounding.

The source of India's resilience, argues Mr Subramanian, was "goldilocks globalisation": neither too dependent on foreign capital, like eastern Europe, nor too reliant on foreign customers, like parts of East Asia. Foreign capital dried up in the crisis, so India relied on domestic savings, which amounted to almost 38% of GDP in the year to March 2008. Companies thus turned for loans to India's unfashionable state banks, which hold almost 70% of bank assets, rather than borrowing overseas or raising money on the stockmarket.

India's growth was also shored up by government outlays, such as a generous pay rise for state employees, the cancellation of small farmers' debts, and the expansion of its rural-workfare scheme. Announced before the crisis struck, this spending was fortuitous. It left the public finances deep in the red, even as it helped the government to a decisive election victory. So far, this political triumph has boosted confidence in India more than the budget deficit has dampened it.

State of triumph

The question is whether such splurges are efficient and how long can they last. Consider China's investment (see [article](#)). According to the IMF's Mr Felman, in early 2008 all the contribution of investment to growth came from non-state-owned enterprises, mostly the private sector; since December 2008, more than half has come from state-owned enterprises. Something similar is happening in Brazil. Between last September and this January credit from foreign-owned and domestic private banks rose by 3%; credit from public banks rose by 14%. The beneficiaries seem to be large firms, where loans are growing four times as quickly as at small ones.

It is not clear how far, in the long run, the BRICs will be affected by a big rise in the size of the government and large state-owned firms. But that rise is probably inevitable. China and, to a lesser extent, Brazil and India, benefited hugely from America's appetite for imports in 2000-08. That appetite has fallen and is likely to remain low for years, as American consumers adjust their spending and savings habits. The rise may also be difficult to reverse: the experience of the West has been that the public sector expands relentlessly until it reaches between 40% and 50% of GDP. But if the BRICs cannot export their way out of recession, the expansion of government is the main alternative to the slump being endured in those other big capital exporters, Germany and Japan. It is part

of the price China and others are paying to clamber out of recession before everyone else.

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