G.G.A. Note...

Global Growth Advisors - Global Strategic Consultancy Group

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The BRICS Story: where are they now?

*** Flags of South Africa, India, Russia, Brazil & China**

Introduction

Dear Readers,

In this short essay on BRICS, Amirali Motahari - GGA's Research Associate based in Tehran (Iran) and London (UK) responses to the BRICS paper presented by the Commerzbank. In this writing, he attempts to present a critique to the methodology of the study and shed further light on the recent developments in the BRICS.

Mr. Motahari departs from the Commerzbank paper as it attempts to highlight the structural differences between the BRICS members. He concludes that, although the convergence argument needs further work and research, first we must accept the divergence between the BRICS members themselves in order to better understand what lies ahead for the BRICS. Such divergence stems from the differences between these emerging economies. In the first part of this writing Mr. Motahari explains the differences among the BRICS.

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In response to the BRICS paper presented by the Commerzbank[1] this writing attempts to present a critique to the methodology of the study and shed further light on the recent developments in the BRICS. The writing departs from the Commerzbank paper as it attempts to highlight the structural differences between the BRICS members. It concludes that, although the convergence argument needs further work and research, first we must accept the divergence between the BRICS members themselves in order to better understand what lies ahead for the BRICS.

[1] "Has the BRICS Story Failed", Commerzbank, 16/09/2016

Such divergence stems from the differences between these emerging economies. The first part of this writing explains the differences among the BRICS.

1)How the Financial crisis affected the BRICS?

Although all the members of BRICS were hit by the financial crisis, it is important to note that there were important differences in the mechanism and the extent to which these economies were affected. Russia was hit the hardest by the financial crisis. This was due to the fact that Russia was not only dependent on natural resources exports, but also – unlike Brazil – the economy's banking sector had significant exposure to the toxic assets. Furthermore, Russia's political adventure in 2008 (occupation of Georgia) added further complexity. As the ruble came under severe pressure, the central bank had to resort to depleting 600 billion of its reserve in order to support the currency. In sharp contrast to that is Brazil, which, despite its dependence on commodity exports, had a banking system with little exposure to the US mortgage crisis. In addition, the Brazilian real was one of the few currencies that experienced appreciation. The reason for this anomaly requires further research, which is outside the scope of this writing. China's dilemma during the financial crisis was high unemployment, with foreign companies downsizing their overseas operations leaving 42 millions of its population unemployed. Since each economy was exposed to the financial crisis in a different way, it would be plausible to expect varying outcomes – the graph below clearly demonstrates this.

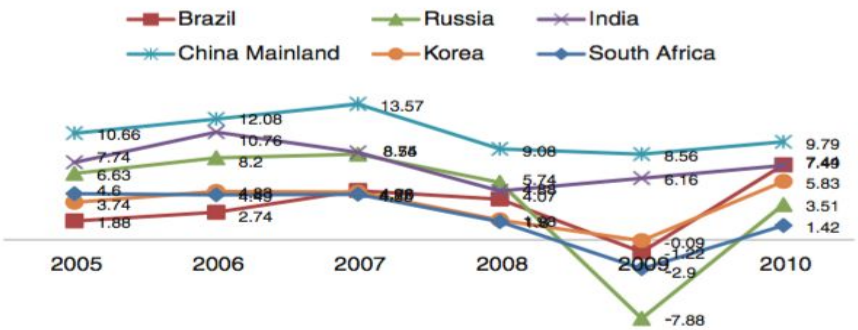


Fig. 2.1 Real GDP growth per capita of Brazil, Russia, India, China, Korea, and South Africa from 2005 to 2010

B. Where are they now?! what are the similarities and differences between the BRICS?

As noted above, during the crisis each BRICS member had unique economic vulnerabilities due to a unique economic structure. The economies may have evolved and changed, but that does not guarantee their convergence to one another, let alone to developed economies capital per labor, which serves as proxy for economic development.

Russia:

Russia is still an oil and gas-dependent economy with low level of export diversification. In general, when a country's currency takes a dip and the current account worsens, an improvement in export competitiveness due to a weaker currency is what makes exports competitive, leading to the improvement in current account. However, this may not be the case for Russia. As an economy prone to Dutch Disease, Russia could face a prolonged J-curve effect, putting pressure on the country's current account and the balance of

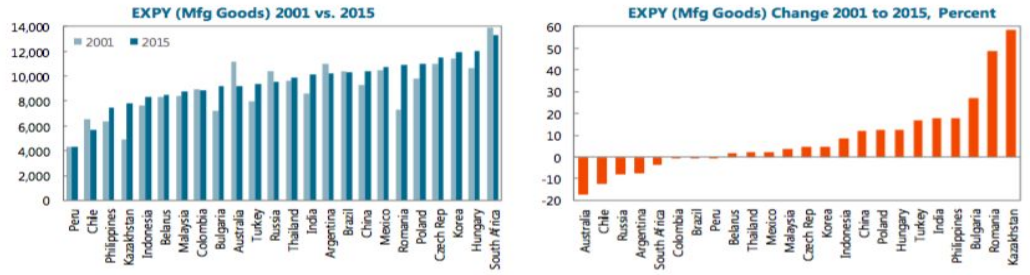
payments. This phenomenon is due to the asymmetric response of exports to the exchange rate movement, or elasticity of supply in the tradable sector.

There are three reasons behind this. First, in such economies, the tradable sector is already driven out of the market and cannot compete with the economies of scale (increasing returns to scale, New Trade Theory) earned by other global exporters. Second, the uncertainty about the exchange rate leads to tradable producers delaying sunk costs. Third, due to the linkages effect, it's not only labor, but also financial resources, that are misallocated to the non-tradable and booming sector. As the banking sector of the oil exporting countries have significant exposure to the booming sector, the rise of the NPLs and financial stress deprives the tradable sector of the financial resources necessary for a timely expansion in order to benefit from the falling currency. The prolonged J-curve effect (although the Marshal Learner may still hold), fall of the currency and the build-up of NPL's are some of the reasons behind the country's recent banking crisis. In addition, Russia has very little trade agreements compared to other BRICS members, such as China and India. This also puts the Russian tradable (export) sector at a compromised position, rendering it ineffective in improving Russia's current account balance and the free fall in the exchange rate.

China:

As an industrialized diversified economy, China has a complete different economic dilemma to deal with, i.e. moving from an economy driven by investment to consumption. But before moving to explore this dilemma, it is worth mentioning, that apart from the different economic structures between China and Russia, the latter also seems to be deprived of the sound economic policy-making as well[2]. Unlike China, Russia has not allowed itself to benefit from further integration into the global economy by signing free-trade agreement and setting up free-trade economic zones. It is believed that these free-trade economic zones were instrumental in driving in FDI heling technology diffusion and rising productivity. As a result of these sound economic policies China, an economy behind Russia in terms of export sophistication (EXPY index) in 2001, overtook Russia in 2015.

Figure 11. EXPY for Manufactured Goods: Levels and Changes for Large Ems



Source: Author's calculations based on data from COMTRADE, IMF WEO and Hausmann, Hwang, Rodrik 2007).

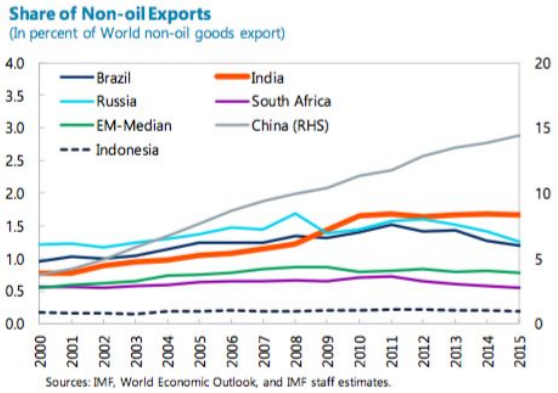
During the 2000s and 2010s China demonstrated a very high saving rate in the corporate sector. This can be attributed to an undervalued exchange rate, a thriving export sector and a strict capital controls leading to a significant rise in saving/GDP ratio. Although the ratio still remains high, it is important to note that the composition has shifted from the corporate sector to the households. China's one-child policy (involuntary higher savings), transition to market economy, i.e. SOEs' reform and breakup of the social safety nets (precautionary savings), lower governmental spendings on education, health and social security are among the reasons contributing to this shift. An aggregate demand tilted towards an excessive investment by households and low consumption leads to households delaying consumption for future higher consumption. With capital unable to

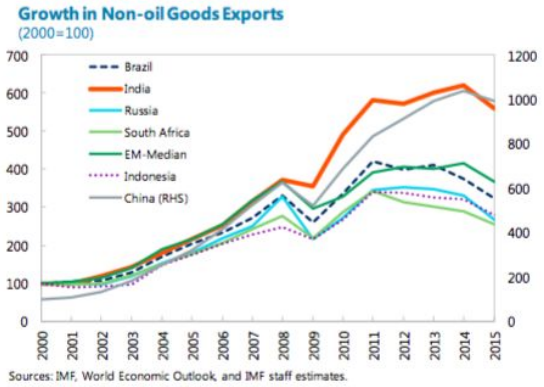
[2] In the last decade the Russian economy has fallen victim to a number of political adventures such as the 2008 attack on Georgia and the 2014 annexation act of Crimea.

seek better return abroad due to restrictions, domestic allocation of resources yields negative returns and defaults.

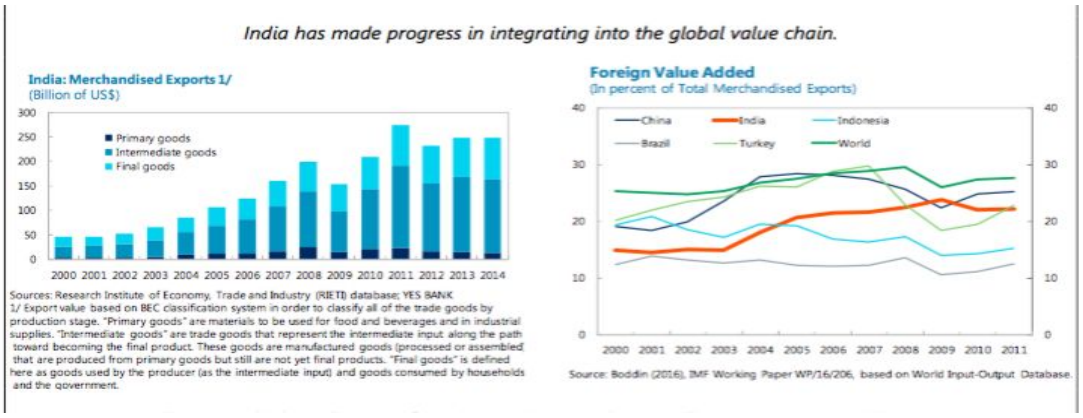
India:

India's economic challenge can be summarized in two key points: a) fall in non-oil exports growth b) tightening liquidity conditions as a result of new banking supervisory regulations. India has experienced a significant drop in non-oil export growth since 2013 compared to the other BRICS members. Although a growth in non-oil exports has been affected, Indian exports have not fallen as much as its peers, compared to other emerging economies (EMs).





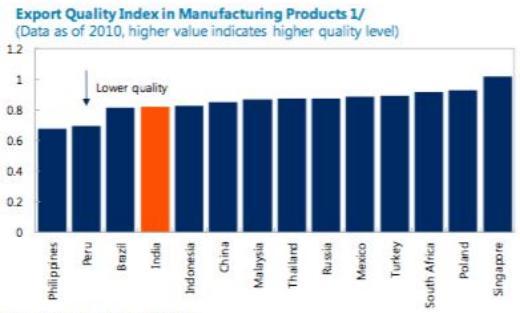
There are two key points explaining how India has been able to maintain a better export performance compared to the other BRICS members. Firstly, India has a well-diversified exports in terms of product composition and destination. Secondly, India has integrated well into the high end of the global value chains.



Nevertheless, the reasons behind the slow growth deserve attention and can be attributed to demand weaknesses in trading partners and distortions in international relative prices. The former is due to the recent slump in oil prices affecting export growth as refined petroleum constitutes 20% of today's Indian exports. Price distortion, on the other hand, is attributed to the real appreciation of exchange rate affecting competitiveness. India appears to have a higher import tariff relative to other EMs which feeds into the final exported products. Nevertheless, India has the potential to rectify these issues. It is worth mentioning that apart from export quality India scores higher in diversification and integration to global value chains compared to the other BRICS members.

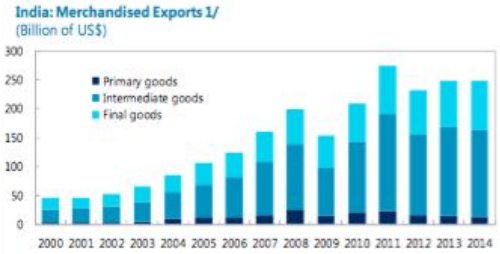
India exports high quality manufacturing products but there is still room to catch up with peers.

Source: IMF's Export Diversification Database.
https://www.imf.org/external/np/res/dfidimf/diversification.htm
1/Product diversification occurs through introducing new product lines (the extensive margin) or through exporting a more balanced mix of existing products (the intensive margin). The The index is used to measure the extent of diversification across a country's exports.



Source: IMF's Export Quality Database.
https://www.imf.org/external/np/res/dfidimf/diversification.htm
1/Methodology presented in Henn et al (2013) IMF Working Paper WP/13/108. The estimated export quality is based on panel regression for export unit values and quality-augmented gravity equation, in order to decompose for unobservable quality.

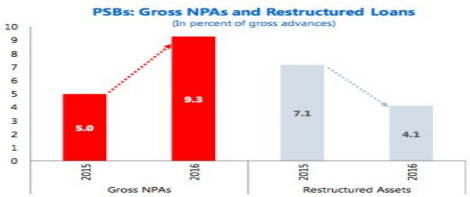
India has made progress in integrating into the global value chain.



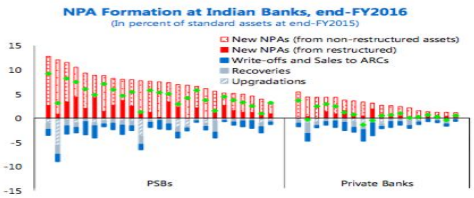
Sources: Research Institute of Economy, Trade and Industry (RIETI) database; YES BANK
1/ Export value based on BEC classification system in order to classify all of the trade goods by production stage. "Primary goods" are materials to be used for food and beverages and in industrial supplies. "Intermediate goods" are trade goods that represent the intermediate input along the path toward becoming the final product. These goods are manufactured goods (processed or assembled that are produced from primary goods but still are not yet final products. "Final goods" is defined here as goods used by the producer (as the intermediate input) and goods consumed by households and the government.

Source: Boddin (2016), IMF Working Paper WP/16/206, based on World Input-Output Database.

With the introduction of Asset Quality Review (AQR) India's banking system is experiencing a significant shake up. The reform has led to significant built up of NPA's as many previously restructured loans have now been classified as NPAs. Low provisioning and weak debt recovery is a challenge that could possibly lead to a need for future capital injections.



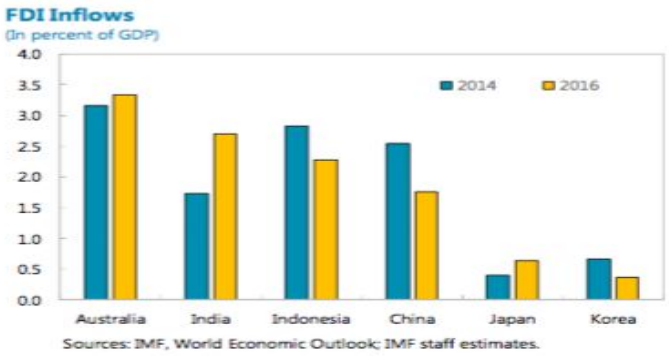
Source: Reserve Bank of India (RBI).



Sources: Reserve Bank of India (RBI); and IMF staff calculations.

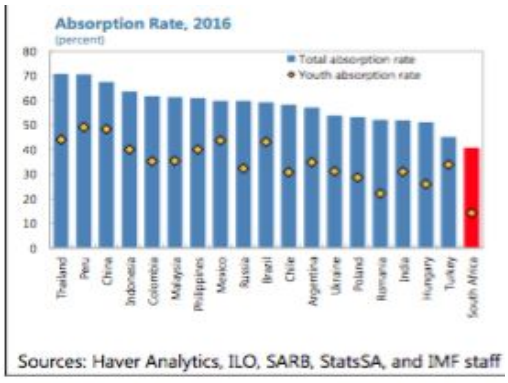
This can have significant ramification for India's economic (export) growth, since India has a highly leveraged corporate sector. Studies have shown a significant correlation between the performance of the financial sector and a highly leveraged corporate sector. As a result, the performance of the corporate sector would be highly dependent on how accommodative the central bank policies are going to be during the introduction of the AQR. In the absence of accommodative measures, AQL can dry up credit leading to an increase in Indian Libor and cause exchange rate volatility. As export and economic growth could come under pressure, we should also note that the domain for fiscal and monetary policy in particular are also limited.

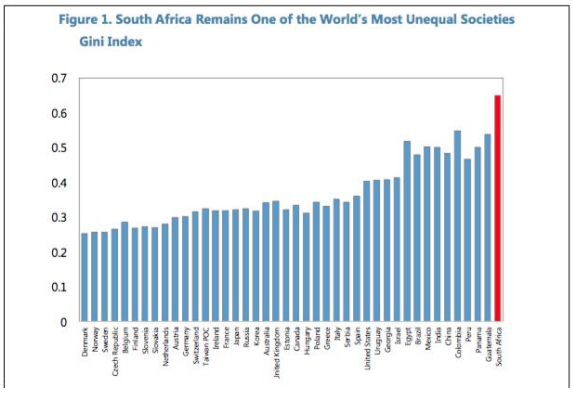
Despite such difficulties, FDI could act as a cushion and maintain India's GDP during the tight capital and liquidity conditions. This is more likely to happen as India has introduced new initiatives to attract more FDI. These policies appear to be successful as India has been among few EMs experiencing a rise in FDI inflows.



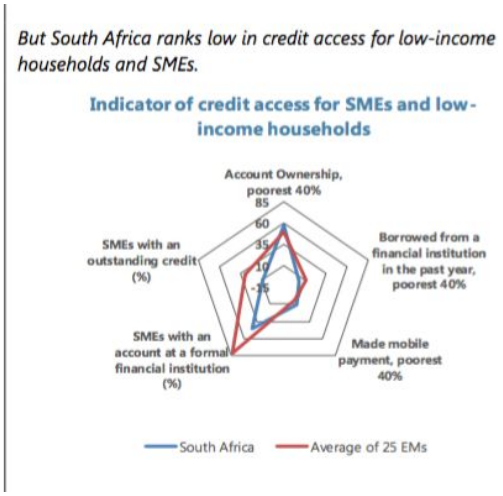
South Africa:

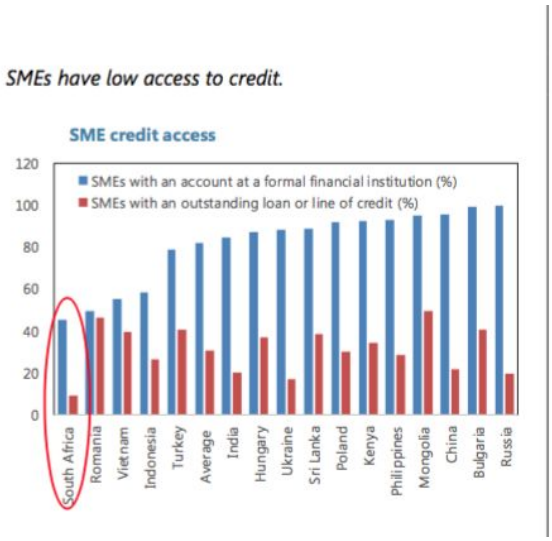
Unemployment and inequality are of greatest concerns while financial inclusion remains a drag on the economy. South Africa's unemployment rate stands at a record of 27.7%, a high figure for international standards. The outlook remains bleak as the projected future growth is expected to lag behind population growth therefor insufficient to curb unemployment. It is important to note that South Africa scores poorly on labor absorption capacity compared to the other BRICS members and EM economies. In addition, South Africa is one of the most unequal societies.





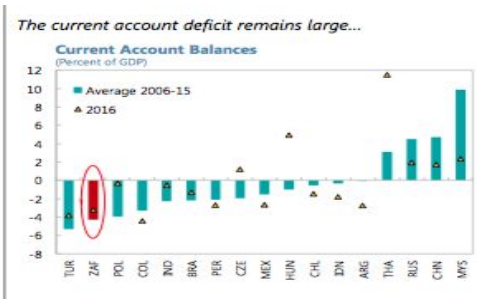
Although South Africa scores well in financial development indices, Inequality in financial inclusion (ie. Access to credit) remains a major problem. This shows the dual nature of the economy where the richest have incomes close to OECD levels, while the poorest are closer to other sub-Saharan African countries. Of major concern is that Households and SMEs are among the groups deprived of access to credit. South Africa ranks poorly in SMEs access to credit compared to other BRICS and average of 25 EMs. The SMEs low level of access can be one of reasons behind South Africa's low labor absorption rate.





The low level of financial inclusion among households and SMEs can be explained by both demand and supply side factors. The former stems from the high level of unemployment while the latter is the result of high costs associated with banking services in South Africa. The South African banking industry is highly concentrated with 80% of financial assets being controlled by only 4 major banks. As a result of such market concentration South African banks are highly profitable with little incentives for serving low margin high risk customers such as low income households and SMEs. One solution could be introduction of tier 2 bank with the sole purpose of serving SMEs and household in the lower income category. At the same time, access to credit should be expanded with proper supervision to prevent an increase in financial stability risks, as illustrated by the recent bankruptcy of African Bank arising from its unsecured lending to low income customers.

With government debt projected at 52.6 percent of GDP by the end of fiscal year 2017, and the public sector's balance sheet exposed to significant contingent liabilities (for SOEs at 10 percent of GDP), one concludes that prospects for fiscal stimulus to be limited. Foreign demand is unlikely to bridge the gap in domestic aggregate demand as South Africa still appears to be running a sizable current account deficit with balance of payment financed by capital inflows.



As it can be seen South Africa could be on the verge of falling into a vicious circle with a feedback loop. For South Africa all four major sources of aggregate demand are underperforming. High unemployment coupled with households limited access to credit reduces consumption (C). Political uncertainty, limited access to credit for SMEs and low prospect for profitability affects private investment (I). High government debt and inflation at an elevated level leaves little room for fiscal (G) and monetary stimulus with exports (X) unable to compensate for the shortfall in domestic aggregate demand[3]. As a result, South Africa's recent sovereign and corporate rating downgrade should come as no surprise. The rating actions reflects weak growth resulting in a worsening fiscal outlook, sizable contingent liabilities in state-owned enterprises (SOEs), and perceptions of uncertainty regarding the direction of economic policies.

Brazil:

After emerging from a deep recession, weak labour productivity and ease of doing business are main reasons for divergence of per capita income between Brazil and Advanced economies. Until 2011, The Brazilian economy benefitted from a strong demand for its commodity export (iron ore, soybeans and raw sugar) from its trading partners, particularly China. A fall in commodity prices put the economy under pressure and the authorities used fiscal and monetary policies measures in responding to the external price shock. Coupled with capital inflows, the expansionary policies kept the economy afloat. However, the 2013 tapper tantrum proved the modest economic recovery short lived as a change in investor sentiments led to capital outflows. This prompted the authorities to tighten the fiscal and monetary stance in search for macroeconomic credibility amid modest economic recovery. However, Brazil's GDP continued to shrink and inflation sore to 10% leading to a resurface of structural economic weaknesses. The economic turmoil and the inability of the government to generate sufficient surpluses to lead a Brazil's first sovereign downgrade in seven years.

Although the economy is showing signs of recovery Brazil is still facing a number of dilemmas. Brazil annual productivity growth stands at 1 percent. This figure falls short of the 4.5 percent across all upper-middle-income countries at the same stage of economic development. High levels of regulation and low market flexibility are obstacles that are expected to prevail even after the upcoming reforms. In addition, Brazil is a relatively closed economy with average tariffs well above its peers which limits trade and the productivity enhancing effects associated with trade. A highly complex tax system and wearing infrastructure are also a drag on productivity growth. Brazil is also prone to external risk factors such as weaknesses in trading partners. A slowdown in China could depress commodity prices, affecting investor sentiments and impose pressure on the Brazilian real. Slowdown in advanced economies could also hamper Brazil recovery from the recession such as a Fed hike pushing up the USD against the real causing capital outflows.

To sum up, the first part of this writing argued that bundling the BRICS into one group in order to examine any economic phenomena like convergence cannot bring fruitful results. The material presented above attempted to highlight the structural differences among the BRICS members during the financial crisis and in the current global economic climate. The following part of this writing briefly summarized the author's objections to the paper's methodology.

[3] We can conclude that all components of aggregate demand AD=C+I+G+(X-M) have been affected.

2) Methodological Objections:

A. A better way to start the analysis would be to determine the main drivers of the BRICS economies and dilemmas, which the first part of this writing briefly alluded to.

B. The paper appears to favor a growth driven by capital accumulation (supply side) over demand driven growth created by international trade and export growth. It states:

"An acceleration of growth of this scope is demand driven and cyclical, though. It is not an expression of rising factor productivity. A growth rise during a period such as this is more likely to exaggerate the long term growth potential of an economy" (p.6)

However, one cannot ignore the staples of the New Growth theory and the increasing returns to scale associated with export driven growth.

C. The Solow-Swan model may not be the best analytical tool, as it fails to distinguish between hot money (foot-loose capital) and FDI. Even if one decides to study supply side factors (capital inflows), one must distinguish between capital in the form of hot money and FDI. By devising FDI unbundling policies, FDI can lead to significant technology diffusion and a shift of the production function upward. This could result in the shift of the steady-state capital per labor to the right. In other words, an FDI accommodative to growth can assist BRICS members to achieve a higher level of economic development at convergence.

D. It is worth mentioning that capital flows in the form of hot money can create destructive shocks to the EMs such as currency crisis, leading to capital restrictions or prevent the monetary authorities to conduct an independent monetary policy (the impossible trinity argument).

E. The paper also states that an economic thrust, such as the opening of China to the international trade, may not happen due to the lack of political freedom. However, one must notice that there has not been a significant change in China's political structure. If the China's political system in the early 2000's allowed for such a major growth encouraging policy, there is no reason that such thrust cannot repeat itself.

F. The theory of state-business alliance, i.e. "Biedermeier" may not be applicable to rentier economies like Russia. As such economies rely on using windfall resources and social mobilization for maintaining the status-quo. As a result, for rentier states, having the natural resources at their expense, it is unlikely for them to give up their economic power and monopoly to the private sector in order to secure future political stability.

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About G.G.A.

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