

# the BRIC economies: conclusions

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# introduction

- Global Monetary Easing in 2001-3
  - Fuels consumer boom in West (esp. USA)
  - Fuels investment boom in China
- China enters WTO in 2001
  - Huge potential to switch workers from fields into factories
  - Also has fixed wages, input prices, interest rates, consumer prices, and exchange rate!
- Consider effects on four industries: consumer goods, commodities, banking, and services.

## the East

- As China begins to run huge trade surplus and FDI rises, Chinese firms find themselves receiving large quantities of dollars.
- They sell these to central bank in return for renminbi, reserves hit \$800bn this year.
- Property rights in China uncertain – payments on equity and debt don't rise in response to rise in earnings.
- Upward pressure on wages, prices, interest rates and the exchange rate, but elastic labour supply and state controls keep things fairly stable.
- Nothing else to do with retained earnings than re-invest. Investment rate hits 45% of GDP, net exports 5%, so only half of GDP remains for consumption, government spending and stockbuilding.
- To recap, half of Chinese output is either exports or investment (that is, steel, concrete, factories, tools and buildings!).

## the West

- Firms selling commodities to the East and banks financing the consumer boom in the West make huge profits and free cash flow.
- There is no boom in Western consumer goods and no rise in investment
- The boom in Western services has a low ICOR so no rise in investment except in US ICT-using services which can take advantage of new technologies and organisation.
- So, investment in West is flat, but aggregate profits and cashflow rise (driven by commodities, banks, and firms serving consumers).
- Valuations of equities remain moderate, since consumer goods and services not very exciting and market thinks that profits of commodities and banks are temporary not permanent.
- Private equity and hedge funds seek profit in exotic locations leading to asset & commodity price booms.

# China syndrome?

- A sudden dollar collapse could unwind this!
  - Demand falls, interest rates rises, US trade deficit shrinks
  - Private equity, hedge funds, commodities and banks suffer
  - China discovers excess capacity (qv Japan)
  - Russia's commodity boom crashes
  - India's services do just fine
  - Brazil is a far-away country
- Or gradual adjustment is benign...
  - Dollar falls slowly, helping to correct deficit
  - Europe and Japan take up some of world demand slack
  - Reforms to wages & prices turn the Chinese from 'mercantilists' to 'consumerists'.

## ‘hard landing’ or ‘soft landing’

- Difficult to estimate probability of recession for US economy.
- Estimates based on yield curve (01/09/06: overnight 5.25, 3 month 5.03, 10 year 4.76) suggest as high as 45% on basis of past history
  - <http://politicalcalculations.blogspot.com/2006/04/reckoning-odds-of-recession.html>
- ... past performance not necessarily a guide to the future...
- Even a hard landing is likely to push down BRIC growth only over a 3-5 year period...
- Key issue for growth over next 30 years is fundamentals

# convergence

- Scope for catch-up growth and redeployment of labour is high across BRICS, probably highest in China (although note demographics)
  - As BRICS develop, growth needs to be accompanied by reform. In particular, Chinese reform needs to be handled carefully.
  - Plausible scenarios show India and China constituting between 25-40% of world GDP (at PPP) by 2030.
  - By which time, their ratios of PPP to market exchange rates will have fallen from 3 to perhaps 2, so their economies will look much more like ours. More services, more domestic consumption, lower investment and lower net exports.
- The key term is 'convergence'... as they grow, the BRICs will become more like the West, rather than less like the West. Recent world trade growth driven by inter-industry trade based on factor endowments will be replaced by growth driven by intra-industry trade based on technology and tastes (quality and variety).