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Economic Crisis and the BRIC Countries

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ECONOMIC CRISIS AND THE BRIC COUNTRIES

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INTRODUCTION

The world as a whole is currently facing an economic downturn that some feel would drag the U.S. and the rest of the world into a deep economic depression. The affected countries are undergoing a credit crisis that has now resulted in an economic crisis of gigantic proportions. The mess caused by fast-and-loose mortgage lending in the U.S. has now blown into a perilous global crisis of confidence that has revealed both the scale and the limitations of globalization. Linked together in an increasingly tattered web of loans, banks around the world have dragged one another down. At the root of the troubles are the toxic assets, that is, the highly leveraged securities mainly linked to U.S. mortgages that banks around the world still have on their books.

The financial crisis engulfing both the developed and developing countries is raising the specter of market panic and even social unrest. The list of countries under threat is growing by the day, and now includes such emerging market stalwarts as Brazil, China, Russia, South Africa, and Turkey. They have become collaterally damaged in a crisis that began in the American subprime market. Analysts in all corners of the world simply missed the boat when it came to the current crisis. No one was able to tell the extent, timing, and breadth of the collapse.

It was expected that the self correcting powers of the free markets would somehow manage to steady the economies and avert a catastrophe. But, this did not happen; the problem was too vast and too complex for the market forces to correct something that is beyond correction. The self-correcting market forces had failed to anticipate the self-destructive power of wanton mortgage lending.

The fast growing economies of the world depend on money from Western banks to build factories, buy machinery and export goods to the United States and Europe. When those banks stop lending and the money dries up, as it has in recent months, investor confidence vanishes and the countries suddenly find themselves in crisis.

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The break-down of the credit markets has triggered fear and uncertainty across financial markets the world over. The crisis has triggered a profound liquidity crunch not just among vehicles supporting mortgage debt, but across a wide array of asset classes. Mortgage lenders are not lending at fair and logical rates even to prime borrowers.

In normal times, problems in the economy cause problems in the financial markets because hard-pressed consumers and businesses have trouble repaying their loans. But this time, the problems in the financial markets are slowing the economy. If the economy continues to spiral down, that could cause a second dip in the financial system.

The global economy is undergoing a gut wrenching deleveraging process. The desire by policymakers and central bankers to destroy savings through the debasement of money is manifesting itself into a massive destruction of capital. Given the dearth of liquidity, even defensive strategies can be hyperactive trading strategies. Following is a brief exposition of the economic crisis as it relates to Brazil, China, India, and Russia (BRIC countries) that were until recently models of economic growth and stability.

I. THE BRIC COUNTRIES

Brazil, China, India, and Russia (BRIC) were collectively one of the strongest economies of the world, with growth rates that were higher than the well established industrial countries of Europe, Japan, and the U.S. For example, between 2002 and 2008, China's economy grew on an average of 10 percent per year. Similarly, India's economy grew by an average of 8 percent per year. But, the recent economic crisis that is fanning the world has also affected these high flying four economies with potential to derail their phenomenal resurgence in the world economic order.

A. Brazil

Brazil, part of the high flying BRIC economies had a robust five year average growth of 4.6 percent, a substantial flow of foreign capital of 328 billion and a surplus in its current account balance (Table 1). The globalization and its resulting decoupling of the economies were supposed to protect countries in regions that did not create or participate in the economic downturn and, hence, continue their drive for economic sustainability. But, Brazil's economic data released in February confirmed that decoupling was just another myth. Indeed, the Brazilian economy hit the proverbial BRIC wall, with industrial production plunging 14.5 percent. This was in addition to dropping 6.4 percent in November. Manufacturing and white goods were the hardest hit, as banks curtailed credit facilities.

Brazil, despite having modernized its economy with trade liberalization and high capital flows, has plunged into an economic crisis that might be difficult for it to extricate itself from[1] (http://www.twnside.org, 2009). Even though the Brazilian economy is considered to be a relatively closed economy, the downturn in global demand has had a devastating effect on industrial output, and this is rippling throughout the rest of the economy.

For the first time in more than seven years, Brazil has posted a trade deficit. Exports plunged 29 percent in January, posting a shortfall of $518 million. In contrast, Brazil at the end of 2008 reported a $2.3 billion trade surplus. Exports to the U.S. have dropped by 36 percent and embarkations to the European Union fell 27.4 percent. If the current trend continues, Brazil is expected to report a current account deficit of $32.9 billion by the end of 2009 and will probably face similar shortfalls until the economic crisis facing the world is lifted.

Brazil and its citizens are expected to face difficult times as companies trim their expansion programs. In addition, the pre-salt offshore oil fields do not look so promising now with crude oil prices hovering below the $40 barrel mark. There is a general foreboding among business executives that the global downturn will be long and hard. The economic crisis that is being felt in Brazil is cutting a broad swath across all socio-economic classes. There is a dearth of trade finance in Brazil, which is having a devastating effect on small producers. For example, the fruit industry, concentrated in the northeastern region of the country, has seen a decline in exports by more than a third as small exporters cannot get the credit to ship their produce. This slowdown in fruit production and exports has forced many of these farmers and small businesses to furlough 20,000 workers in one of the poorest regions of the country.

To compound the problem facing Brazilian policymakers, there is a looming stock of consumer debt. Because of the growing economy and consumer spending, consumer credit was on a tear for the last five years, expanding at an annual rate of 20% per year. Therefore, it is not surprising to see non-performing loans rise as the economy decelerates. Brazilian banks and financial institutions have also practiced their version of subprime lending in the form of automobile loans that are risky at best. The banks have given very generous terms to people who were not qualified to take such large obligations, sometimes for terms that go beyond the useful life of the automobile. In hard times, people tend to default on loans, and banks hold vast non-performing portfolios.

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[1] Michael Bailey & Heinz Stecher, *The Brazilian economic crisis* (Mar. 4, 2009), *available at* http://www.twnside.org.sg/title/brazil-cn.htm.

Brazil with its closed economy was expected to weather the international storm, but is now facing the grim realities of globalization. The forecast for the Brazilian economy for the near future is a contraction in almost all sectors of the economy. Unless the policymakers act aggressively by tightening budgets and bailing out some of the financial institutions, the prospect for Brazil is dim. Critical public works projects to modernize the economy are being delayed, further compounding the crisis[2] (Kraul, 2008). The effects of European and U.S. governments stabilization initiatives are not going to trickle down to Brazil until these economies themselves come out of a tailspin that many economists predict will take years to materialize.

Table 1
Selective Economic Data for Brazil (2002-2008)

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	14	15	16	15	15	13	10
External debt (000,000 current US$)	230	234	219	187	194	229.4	236.6
FDI Net flows (000,000 of current US$)	100.9	132.8	161.3	195.6	236.2	328.5	345.6
GDP Growth rate (%)	3	1	6	3	4	5	5.2
Imports (% of GDP)	13	12	12	12	12	11	9
Inflation (%)	16	14	8	8	4	4	5.8

Source: http://devdata.worldbank.org/data-query , March, 2009
http://cia.gov/library/publications/the-world-factbook/geos/html, March, 2009
http://unctad.org/templates/startpage.asp/ , March, 2009

B. China

Among the BRIC group of countries, China had the most vibrant economy with a GDP growth rate averaging over 10 percent, a large trade

[2] Chris Kraul, *Economic Crisis Hits as Brazil Builds*, Los Angeles Times, Oct. 27, 2008, at C1.

balance with the rest of the world, and FDI flows averaging $250 billion for the past five years (Table 2). Additionally, China had about $2 trillion in foreign exchange reserves. But, the economic crisis that is engulfing the world has also affected this once powerful economic behemoth. The belief that China would lead us out of the morass has proven false. Indeed, the Asian economies have turned out to be the least resilient. Their open structures have been immediately impacted by the contraction in U.S. demand and the collapse of trade finance. Their export-led growth models withered a drop from 37 percent of GDP in 2007 to an estimated rate of 19 percent in 2008 (See table 2), posting dramatic declines in economic activity. For example, China's electricity demand dropped 9.3 percent in December and imports plunged more than 20 percent, suggesting contraction in total output.

China's economy is growing at its slowest pace in five years, from an average growth rate of over 10 percent for the previous decade to under 10 percent for the year 2008. China's industrial production growth for September slowed to 11.4 percent, the lowest in several years[3] (Schearf, 2008). The quarterly economic growth was the weakest since 2003, when China was hit by the SARS outbreak. Many of Chinese leaders and some leading economists agree that the global financial crisis is largely to blame for the current downturn.

It was not surprising for many of the leading economists that China faltered in spite of its stellar economic performance over the past decade. Given the high level of dependence on exports, China's economy could not escape the impact of the global slowdown. After 30 years of fast growth, China's investment-driven and export-oriented development model, with exports accounting for close to 40 percent of GDP, had become increasingly difficult to sustain[4] (Chen, 2008). For example, China's auto export declined by 22.18 percent in August alone and has continued to decline since [5](Xu, 2008)

The current situation has also cast a doubt on China's long-term economic growth, as it is so closely tied to the rest of the world. Policy makers and government leaders are trying to bail out many sectors and build infrastructure by infusing capital into the system. This alone is not expected to propel the economy on the way to recovery. The massive lay offs in the manufacturing sector, coupled with a weak financial structure, are definitely going to create economic chaos for the Chinese economy during foreseeable

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[3] Daniel Schearf, *Global Financial Crisis Drops China's Economic Growth to Slowest Pace in Five Years,* Voice of America News, Oct. 20, 2008, at 1.

[4] Zhiwa Chen, *Economic Crisis Could Push Reform in China* (Mar. 4, 2009), *available at* http://yaleglobal.yale.edu/display.article?id.

[5] Shenglan Xu, *Financial Crisis Hits China's Auto Exports*, China Daily, Oct.15, 2008, at 1.

future. It is believed that the current crisis might be an impetus for Chinese leaders to introduce some badly needed reforms into the Chinese economy. These reforms include promoting land-use rights, subsidizing education, and development of a mechanism to distribute wealth much more widely and evenly.

Table 2
Selective Economic Data for China (2002-2008)

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	25	30	34	37	40	37	19
External debt (000,000 current US$)	186.1	208.0	247.0	281.0	322.0	373.6	420.8
FDI Net flows (000,000 of current US$)	216.5	228.4	245.5	292.1	292.6	327.1	-
GDP Growth rate (%)	9	10	10	10	12	12	9.8
Imports (% of GDP)	23	27	31	32	32		15
Inflation (%)	1	3	7	9	10	16	6

Source: http://devdata.worldbank.org/data-query , March, 2009
http://cia.gov/library/publications/the-world-factbook/geos/html , March, 2009
http://unctad.org/templates/startpage.asp/ , March, 2009

C. India

India, with its thriving middle class and consumption driven economy, was considered a model economy that has had phenomenal economic success with its technology and software related exports. Through liberalization initiatives and opening of the country for foreign investors, India had gained considerable economic stability that was unthinkable just two decades ago. By encouraging FDI flows and holding inflation under 6 percent, India's annual average GDP growth rate was just under 10 percent (Table 3).

India's economy grew at its slowest pace in nearly six years in the third and fourth quarters of 2008 as the Asian giant started to feel the full brunt of the deepening global downturn[6] ("India's Economy Suffers Sharp Slowdown", 2009). The economy grew by 5.3 percent, down from 8.9 percent a year earlier. Even with this slowdown, the mood in the country and among its leaders is a sense of resiliency. While most of the world grapples with a crippling financial crisis and a recession, optimism reigns in much of India as its economy continues to grow albeit at lower rate[7] (Timmons, 2009).

Compared to the rest of the world, India's economy remains robust and its chances of weathering the current crisis are high. Thanks to its rigid banking policies, the slow grinding bureaucratic process and its protectionist policies, India seems to be insulated from the global recession and economic crisis faced by many countries of the world. The conservative approach taken by regulators and policy makers, at its banking and financial institutions has safeguarded the financial sectors from the upheavals of mortgage backed securities and other instruments of high risk and volatility. Moreover, the state dominated financial system is virtually unconnected to foreign markets.

India's exports to the rest of the world are relatively low. Being largely a domestic economy with exports including software at around 17% of GDP, India is relatively insulated from foreign economic turmoil [8](Malkani, 2008). Whereas, China and Russia, two large countries like India boast of exports as a percentage of GDP in the range of 30 to 40 percent, India's exports are under 20 percent of its GDP (Table 3). In addition, other economic indicators have remained relatively stable - inflation is under 8 percent and growth for the year is estimated to be above 7 percent. India's banks are much stronger in capitalization than many European and U.S. banks. For example, the market capitalization of State Bank of India recently surpassed that of Citigroup.

In spite of India's relative stability, there are some troubling signs for the country. The government deficit as a percentage of GDP will probably double to 11.4 percent, and Standard & Poor's revised the outlook for Indian long-term sovereign debt from stable to negative. It is also possible that the country would receive lower remittances from abroad as the economies of some of the Middle East countries cool. Remittances by Indian's working in the Middle East not only add to the country's foreign reserves but also provide consumption expenditures for many families that depended on these remittances.

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[6] *India's Economy Suffers Sharp Slowdown*, Times of India, Feb. 27, 2009, pp1-3.

[7] Heather Timmons, *India Maintains Its Sense of Optimism and Growth*, The New York Times, Mar. 2, 2009, at B1-B4.

[8] Rohibi Malkani, *Will Financial Crisis Derail India's Economy?*, The Economic Times, Sept. 23, 2008, pp1-3.

Overall, the prognosis for India is good. With the stability in its financial sector, demand for its technology outsourcing services, high savings rates, and foreign investor's confidence in its economy, India is expected to turnaround much faster than many other countries. According to Palaniappan Chidambaram, India's Finance Minister, India will not face an economic meltdown as the fundamentals of the Indian economic system are sound[9] (Chidambaram, 2008). India's economy is expected to grow in the range of 5 to 7 percent for this coming year.

Table 3
Selective Economic Data for India (2002-2008)

Variables	2002	2003	2004	2005	2006	2007	2008Estimate
Exports (% of GDP)	14	15	18	20	22	21	11
External debt (Current US$)	105	112	124	123	153	201.4	163.8
FDI Net flows (000,000 of current US$)	25.4	31.2	38.2	44.6	52.4	76.3	142.9
GDP Growth rate (%)	4	8	8	9	10	9	7.3
Imports (% of GDP)	15	16	20	23	25	24	9
Inflation (%)	4	4	6	4	6	4	7.8

Source: http://devdata.worldbank.org/data-query , March, 2009
http://cia.gov/library/publications/the-world-factbook/geos/html , March, 2009
http://unctad.org/templates/startpage.asp/ , March, 2009

[9] P. Chidamabaram, *India's Economy is Capable to Weather Financial Crisis*, The Economic Times, Oct. 9, 2008, at P1.

D. Russia

For the last five years, Russia was one of the shining stars of the emerging markets, with huge current account surpluses, massive capital flows, and towering international reserves (Table 4). Its geographic location astride the Eurasian land mass left it well-prepared to cater to the fastest growing markets on the planet. With its vast natural resources, well-educated workforce and treasure-trove of financial resources Russia became the envy of the world.

The Russian markets held up well, initially withstanding the credit crunch that was savaging much of Europe and North America. But, the wheels began coming off the Russian behemoth during the third quarter of last year, and, now it finds itself in a mess similar to the one it faced in 1998. A problem faced by Russia is its reliance on commodities to drive its economy. Despite Moscow's attempt to move the economy up the value-added chain, it is still based on commodities. Energy and metals remain the dominant sectors of the economy. Therefore, the collapse in commodity prices was a devastating blow for Russia.

Furthermore, Russia is still mired in its central planning mode of the past. The state plays a domineering role. Its leadership converted many of the previously privatized companies back into the arms of the state. As a result, the state became the main driver of economic activity. In short, Russia became a mixed economy with most of the largest and powerful companies owned by the state, and the small and medium-sized companies owned by the private sector. This resulted in a change in the national incentive structure, where the brightest and ambitious graduates of prestigious universities headed to state owned enterprises leaving a lack of talent for the small and medium-sized companies. In addition, corruption has been on the rise further eroding the confidence of the people in the government and its bureaucrats. The result of the shift in private sector, loss of talent pool and corruption is the creation of an inefficient system that was hit hard when commodity prices declined.

All the above confluence of forces has left Russia with very few options to tackle the current economic crisis. In addition, there is some infighting going on among the Russia's inner circle of policy makers whose incentives and benefits are being drastically cut back and, hence, their mind is not on the country's problems but, on their own[10] (Scott, 2009). In trying to stem the economic crisis, Moscow tried various initiatives to provide rescue and assistance programs which then reduced the incentive for the private sector to make the painful adjustments needed to confront the global liquidity crisis. The

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[10] Michael Scott, *Fewer Economic Spoils Prompt Fight among the Elite*, The Guardian, Mar. 4, 2009, at p1.

problem is, as we now know, that all liquidity crises mutate into solvency crises if left unattended. The government is also trying to stabilize the ruble so as not be affected by the speculators who see an opportunity to gain from exchange rate fluctuations [11] (O'Brien, 2009).

In light of the current crisis, Russia has been one of the biggest disappointments considering its enviable economic position just a few years ago. Having taken comfort in its massive reserves and huge current account surpluses, no one imagined the rot that lurked below the surface. Unless Russia's leaders use the current crisis as an opportunity to shift more of its activities into the private sector, the checks and balances needed to keep some of its instinctive behavior handed down over its long history of socialistic leanings, the country is probably going to be economically handcuffed for the foreseeable future.

Table 4
Selective Economic Data for Russia (2002-2008)

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	35	35	34	35	34	30	21.4
External debt (Current US$)	147.3	175.6	196.7	229.0	251.0	356.5	527.1
FDI Net flows (000,000 of current US$)	70.8	96.7	122.3	180.3	271.6	324.1	491.2
GDP Growth rate (%)	5	7	7	6	7	8	6
Imports (% of GDP)	24	24	22	21	21	22	14
Inflation (%)	6	14	20	19	16	14	13.9

Source: http://devdata.worldbank.org/data-query , March, 2009
http://cia.gov/library/publications/the-world-factbook/geos/html , March, 2009
http://unctad.org/templates/startpage.asp/ , March, 2009

[11] Emma O'Brien, *Russia to Keep Ruble with Tight Band Survey Shows* (Mar. 4, 2009), *available at* http://Blomberg.com.

CONCLUSION

Brazil, China, India and Russia had achieved extraordinary economic success through a well-planned economic program that was built on trade liberalization, FDI flows, and domestic consumption. With a large population base these countries were able to provide huge markets for both domestic and foreign producers. It was expected that these four countries would continue their economic growth patterns and be less vulnerable to the economic cycles that often peril smaller countries. Then came the economic meltdown. The economic crisis now engulfing the world has also affected these four countries with a probable exception of India which seems to have the potential to weather this storm.

The forecast for the BRIC countries is a slow economic recovery that will place extra burden on its populations and cause severe contraction of the economies. It is apparent that without strong policies and a generous stimulus package, the countries of Brazil, China, India and Russia will see their economies flounder in the short-term. China and Russia seem to have enough reserves to implement stimulus packages that might help to elevate the problem. But, for Brazil and India, with ballooning fiscal deficit, the governments of these two countries cannot introduce any impact driving stimulus packages and may have to rely on interest rate cuts to jumpstart the economy.

The economic recovery of the four BRIC countries is also to some extent dependent on the recovery of the U.S. and other western European countries that provide the export opportunities for these countries. The global financial crisis, and subsequent economic slowdown, will continue to have a negative effect on export growth for these countries. In the case of the U.S, its recovery is very much tied to the success of the current economic stimulus package and the way in which the rewards of the package are distributed. There is a growing trend towards capital protectionism which if it does materialize would allocate capital resources to domestic operations that in turn will force an inefficient allocation of capital at a time of extreme scarcity. The global economy needs to work through the cycle, thus permitting inventories and capacity to deplete below demand, and sowing the seeds for an eventual recovery.