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HIGHLIGHTS

THE GLOBAL CRISIS AND THE IMPLICATIONS FOR DEVELOPING COUNTRIES AND THE BRICs

Is the *B* Really Justified?

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The new millennium has been characterized by exceptionally positive performance for most developing economies. Growth rates increased on a sustained basis, accompanied by a general reduction in consumer prices. But even more important was the elimination of the external constraint on growth in developing countries, as virtually all of the non-Asia developing world managed to generate current account surpluses that fed the increase in foreign exchange reserves. How the current financial crisis will affect developing countries in general and the BRICs—Brazil, Russia, India, and China—in particular depends on the source of this sharp increase in growth and external accounts.

The counterpart to these improvements is the change in U.S. policy in the 1990s that led to a massive increase in global trade and imbalances, when the United States forced the rest of the world to convert to policies of export-led growth. There were four basic factors driving global trade during this period, virtually all of them linked to changes in financial regulation and competition in the United States. The first was the influence of private equity firms in driving U.S. firms to increase rates of return (and outsource production), which tended to place downward pressure on domestic wages and employment. The second factor was the expansion of household borrowing as a means of preserving consumption in the presence of falling real wages—a

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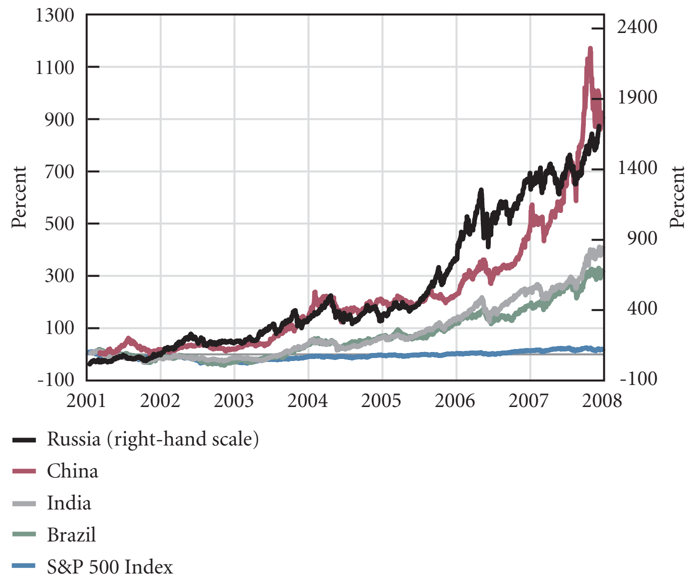
response that created rising demand for the exports of developing countries. The third factor was the creation of the so-called "shadow banking system" and the increase in leverage that precipitated sharp increases in international capital flows. And the fourth factor was the emergence of "real return" investment (return above inflation) that turned primary commodities into an asset class and helped to accelerate the growth of commodity prices, which produced similar growth in terms of trade (and rising incomes in developing countries).

It seems clear that all of these factors were driven by the evolution of financial conditions in the United States. If the crisis leads to the permanent elimination of recent (high) levels of leverage in the U.S. system, and if households move to pay down debt and increase savings, and if there is a return of manufacturing employment to the United States, then it would be prudent to conclude that we cannot foresee a return to the extremely positive conditions recently experienced by developing countries.

The term "emerging market economy" (as opposed to a "developing" economy) was created by sell-side investment firms. It relates to a country's emergence from default and becoming once again a destination of potential investment (e.g., Latin American countries after the 1980s debt crisis). Finding alternative lenders to bail out the banks' syndicated loans, the opening of financial markets accompanied by the privatization of state assets, and Washington Consensus policy expectations of above-market returns produced both price stability and slower growth—as well as periodic financial crises. Thus, the success of emerging markets has been limited to the financial institutions of developed countries that intermediated this process.

It has also become commonplace to distinguish a small number of emerging market economies—the BRICs. But this category is itself an invention of developed-country financial institutions such as Goldman Sachs (O'Neill 2001) seeking similar intermediation profits. Initially, the BRICs were a class of middle-income emerging market economies of relatively large size that were capable of more or less self-sustained expansion. By the end of 2007, they accounted for 15 percent of the global economy. The real interest in these countries was the performance of their financial markets; particularly, their equity markets. Between 2001 and 2007, equity markets rose 314 percent in Brazil, 1648 percent in Russia, 405 percent in India, and 902 percent in China (based on the Hang Seng China Enterprises Index) (Figure 1).

Figure 1 **U.S. and BRIC Equity Markets, 2001–08 (change in percent)**



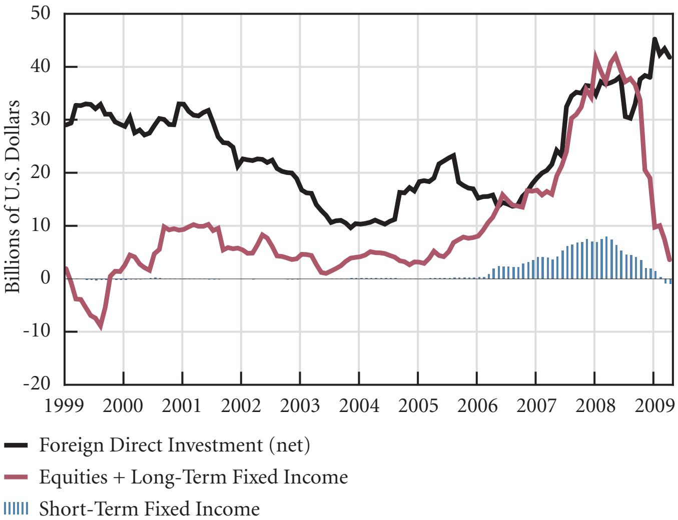
Sources: Yahoo! Finance; Russian Trading System Stock Exchange

The Impact of the Crisis

It is important to note that the BRIC grouping was not based on economic similarities. Indeed, the four countries could not be more different. India and China are peasant economies with relatively closed, state-controlled, regulated capital markets; Brazil and Russia are primarily natural resource–based economies that are open to foreign trade and financial flows, and have a mixture of state and private sector control of capital markets. India and China have guided their exchange rate and practice development strategies based on domestic industrialization (manufacturing and services) for export, while Brazil and Russia have more flexible exchange rates and follow export strategies in directing productive structures that are guided by international comparative advantage. While this latter subgroup has experienced exchange rate and financial crises that were usually accompanied by high inflation, the former subgroup has not. Moreover, the latter has borrowed from the International Monetary Fund (IMF) and employed structural adjustment policies to access IMF funding, while the former has not.

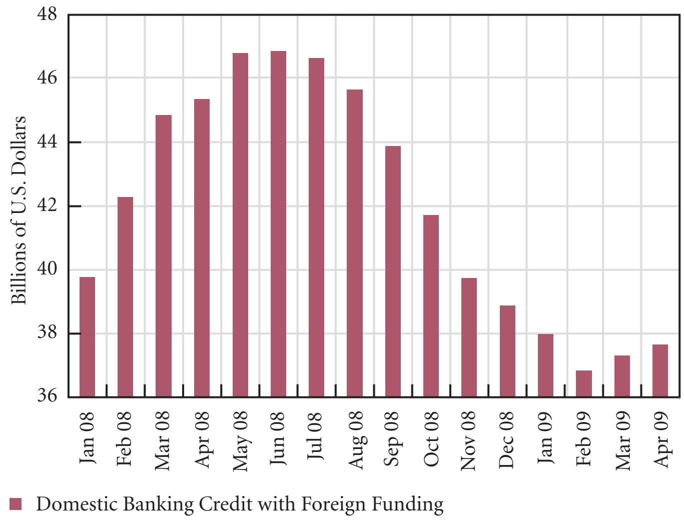
All of the governments in the BRIC countries play a role in guiding the economy and directing the capital markets. There is a basic difference, however, with respect to the role played by BNDES, the Brazilian Development Bank. This institution is

Figure 2 **Foreign Direct Investment and Company Equity in Brazil, 1999–2009 (in billions of U.S. dollars)**



Source: Banco Central do Brasil

Figure 3 **Brazil's Domestic Banking Credit with Foreign Funding, 2008–09 (in billions of U.S. dollars)**



Source: Banco Central do Brasil

not only formally independent of the private capital market but also largely supplants this market.

Goldman Sachs has recently raised the question, "Can we justify the *B* in BRIC?" Since the initial impact of the current crisis was felt in the financial sector, the analysis should start with the BRIC financial systems. The second issue is how the economic slowdown in industrialized countries impacts global trade, particularly with regard to emerging market countries and the BRICs.

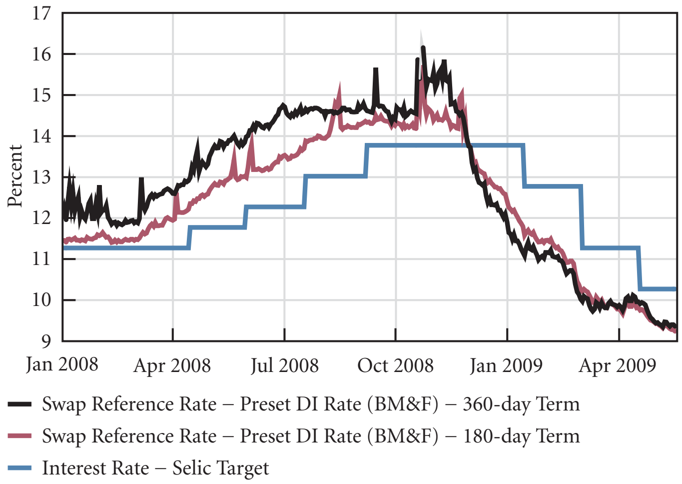
The evolution of the current financial crisis has been two-dimensional. The first dimension was the relatively contained difficulties in the U.S. subprime mortgage market that spread to the entire U.S. financial system and then to Europe. It has called into question the very operation of the spread-trading model, which is based on high degrees of leverage (and the need for high volumes and short-term funding in order to profit from extremely small rate spreads) and was especially evident in the shadow banking system.

The second dimension was derivatives, which allowed market exposure against negligible margin payments and were another source of leverage. Derivatives also implied substantial credit exposure in the form of counterparty risk. Based on expectations of tighter restrictions and margin requirements, the ultimate outcome of the financial crisis will be a decline in returns due to rising capital requirements, accompanied by a reduction in leverage. This process of deleveraging has already led to a reduction in asset prices and deflation of the asset "bubble," and forms the basis for the current stalemate in policy responses and in the lending behavior of banks. The liquidity machine based on structured investment vehicles, margin positions, and default insurance will not be part of the new financial system.

There are thus two basic impacts on the BRICs' financial systems. The first concerns intrinsic value prices, but holdings of U.S.-issued asset-backed securities were not substantial and there do not appear to be significant investments in the types of securities that will be affected by price deflation. Thus, deleveraging and falling asset prices should not have any bearing on the surety of BRIC banking systems.

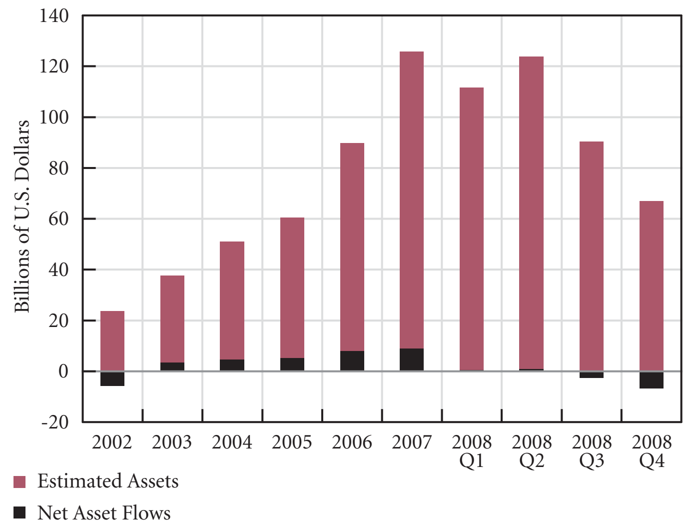
High liquidity levels, coupled with the Federal Reserve's decision to push interest rates to historic lows, led to a secondary impact, as capital flowed to BRIC equity markets. For several years, Brazil had the highest total return on equities of any country in the world. When Brazil's central bank was unwilling to offset the massive capital inflows, there was a very rapid rise in the effective exchange rate. At the same time, monetary tightening, in response to rising prices, led to extremely high interest rate differentials. The Brazilian *real* became a large positive-carry currency, producing substantial short-term, speculative interest-arbitrage inflows[1] (Figure 2). The combination of these factors produced a rising current account surplus in the

Figure 4 **Interest Rate and Swap Reference Rates, Brazil, 2008–09 (in percent)**



Source: Banco Central do Brasil

Figure 5 **Emerging Market Hedge Funds: Estimated Assets and Net Asset Flows, 2002–08 (in billions of U.S. dollars)**



Source: IMF, Global Financial Stability Report, April 2009

presence of *real* exchange rate appreciation, rising asset prices, and improvements in the terms of trade that translated into higher incomes and growth rates—more than enough to justify the *B* in BRIC.

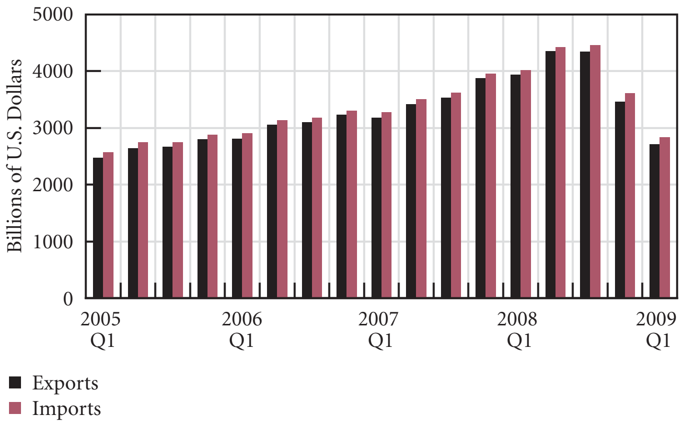
However, for the rising number of Brazilian export firms, the appreciation of the *real* was a mixed blessing. Many sought to temper the blow to their external competitiveness and profitability by hedging against a further decline in the dollar. When the exchange rate started its rapid decline in early 2008, many corporate buyers of these contracts could not make payment. It is estimated that outstanding corporate exposure to these derivatives was 49–74 billion *real*.

Heavy losses on currency derivatives have been reported by Brazilian companies such as Sadia, a food processor; Votorantim, an industrial conglomerate; and Aracruz, one of the world's biggest pulp and paper manufacturers, among other firms. The possibility that hundreds of companies may wish to renegotiate their exposure to derivatives with issuing bonds prompted the Brazilian legislature to enact a provisional measure to, among other things, authorize Brazil's central bank to put in place currency swap lines with other international central banks and increase its potential to provide market liquidity (Figure 3). It is estimated that the eight largest Brazilian banks will take losses in excess of $5 billion as a result of their own positions or counterparty failures. These banks did not engage in the same kinds of originate-and-distribute activities as U.S. banks, nor did they invest in these kinds of assets to gain higher yields. However, the (indirect) impact of exchange rate appreciation and rising asset prices produced conditions that were typical of prior crises.

One reason for Brazil's greater financial stability is undoubtedly the rigorous regulation of its derivatives market. The interest rate policies of Brazil's central bank and their impact on government financing (even in surplus conditions) meant that Brazilian banks had no need to increase risks for higher yields (Figure 4). Higher returns at minimal risk were available through government securities, so there was little incentive to move into mortgage-backed securities issued abroad. As a result, the return on equity for Brazilian banks during the subprime crisis has been roughly double that for the United States, and substantially higher than that for other BRIC countries.

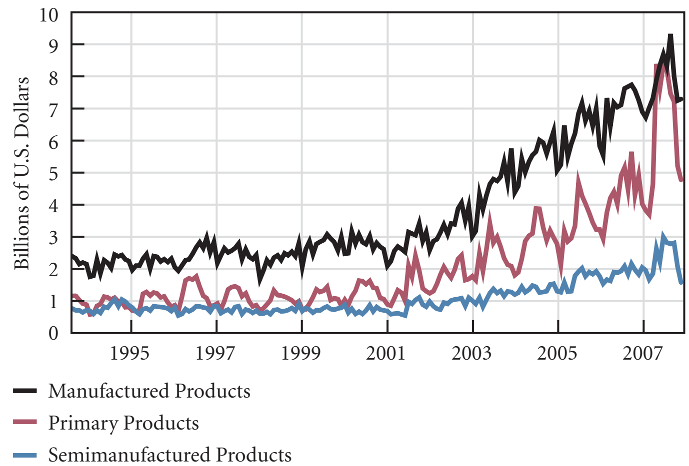
Deleveraging not only let all the air out of the asset and commodity bubbles but also required U.S. financial institutions to repatriate capital to cover losses and close positions. These actions produced a dollar scarcity that brought about a capital reversal and global liquidity shock similar to that in the 1990s, along with a sharp reversal of emerging-market currency appreciation. Global and domestic trade declined sharply (Figure 5). Falling demand for imports worldwide, coupled with the disappearance of trade finance, spread the collapse of U.S. and European demand throughout the developing world

Figure 6 **World Exports and Imports, 2005–09 (in billions of U.S. dollars)**



Source: World Trade Organization Secretariat

Figure 7 **Brazilian Exports, 1994–2008 (in billions of U.S. dollars)**



Source: Ministério do Desenvolvimento, Indústria e Comércio Exterior, Brazil

(Figures 6 and 7). Thus, virtually all of Brazil's positive performance and initial membership in the BRIC group appears to be linked to a financial model and financial flows that are unlikely to be reestablished.

The Response to the Crisis

Of the two possible responses to the crisis, one involves an attempt to restore the status quo (i.e., wait until prices return to intrinsic values), while the other recognizes that the status quo is not an option given the likely structural changes in developed financial markets. Brazil and the other BRIC countries seem well placed to follow the first response, since their financial systems have been relatively untouched by the crisis and they have maintained high levels of foreign reserves to cover temporary external deficits caused by the decline in global trade.

The second response raises the question of who will provide the capital and demand for a growth rate above 3 percent when conditions cannot return to normal because of structural changes; that is, a reduction in U.S. households' propensity to consume and the disappearance of leverage from the global financial system. All BRIC economies depend on expanding demand by increasing global trade and maintaining global imbalances financed by global financial flows. If China decides to offset the decline in global demand by increasing its domestic expansion, and to pursue a policy of diversifying its reserve holdings (by increasing its stockpiles of natural resources), it may become the source of Brazil's external demand. It is unlikely, however, that China can provide internal stimulus sufficient to replace U.S. demand on a global scale.

It is tempting to advocate a return to the Brazilian development strategy of the 1990s, when policies were designed to attract external capital and build on external demand. Policy based on this strategy, however, would be a mistake.

The experience of the last decade—which includes Chinese demand for primary commodities, external investment, and the resumption of the carry trade—implies that development strategy should be left to the vagaries of foreign governments and international monetary conditions. Abandoning this strategy would substantiate the increasingly voiced opinion that it is not possible for an economy to develop on the basis of external savings.[2] Rather, all development depends on the mobilization of domestic resources and the direction of domestic policy to fully utilize domestic resources.

The most obvious path is a transition to growth based on domestic income growth and consumption through diversification of markets and production. The key is to continue the transformation from export-led to domestic demand–led growth in economies where large peasant or agricultural populations and associated income inequalities remain.

From this point of view, Brazil seems much better placed than the other BRIC countries. Indeed, Brazil already has a transition policy that it is ready to implement, one based on the Plano Plurianual de Ação (PPA; 2004–07), the Agenda Nacional de Desenvolvimento (AND; 2006), and the Programa de Aceleração do Crescimento (PAC; 2007). These programs sought to augment the rate of domestic demand and growth through government-supported infrastructure investment projects (including housing and roads) that were often aimed to improve the plight of the disadvantaged members of Brazilian society.

The PPA was precisely the kind of program required to shift dependence from foreign to domestic demand without creating domestic inflation or external imbalances. The presence of a strong national development bank to finance the supply side of the program, combined with the ability to influence incomes through an increase in the minimum wage, enabled the program to generate balanced growth during a global recession.

The proposed increase in the *renda basica* (minimum income) is, however, an inefficient tool for building domestic demand and reducing inequality because it only affects those who are employed. Thus, it would be necessary to implement the PPA in combination with a well-designed government program of employment or job guarantees. India has already taken steps in this direction with its National Rural Employment Guarantee Act (2005), while Brazil has proposed the Programa Cidade Cidadã for large urban areas.[3]

At the outset, PPA, AND, and PAC were never fully implemented because of external considerations affecting government finances and the need to gain investment-grade status to deal with the problem of debt sustainability. Indeed, if the prior global growth structure is unlikely to be restored, then domestic policy should be made compatible with this new global structure. The most attractive selling point would be the ability to grow domestically without external demand and foreign financing, and within the bounds of international trade agreements (i.e., implementing a PPA in combination with a national job-guarantee program). In addition, it would be necessary to transform the domestic financial market from an institution providing government financing to one providing long-term capital for domestic productive investment.

From this perspective, Brazil has an advantage over the other BRIC countries given its existing structures supporting research and development, and its ability to provide a balanced expansion based on industry, natural resources, and agriculture. The country also has a banking system that could develop a capital market complementary to BNDES that could concentrate on supporting growth in new technologies. If Brazil can wean itself from dependence on external demand and external finance by implementing a sustainable transition to domestic demand-led growth, it will remain solidly within the BRIC camp.

Notes

1. According to Cutler and Nielsen (2009), this position has been maintained throughout the crisis: "Borrowing U.S. dollars at the three-month London interbank offered rate of 1.13 percent and using the proceeds to buy real and earn Brazil's three-month deposit rate of 10.51 percent would net an annualized 9.38 percent, as long as both currencies remain stable." The same is true for many of the BRICs and other developing countries: "Goldman Sachs recommended on April 3 that investors use euros, dollars, and yen to buy Mexican pesos, real, rupiah, rand and rubles from Russia, where the benchmark central bank rate is 13 percent. Using equally weighted baskets, that carry trade would have returned 8 percent in the past month, for an annualized 165 percent, data compiled by Bloomberg show. 'Group-of-three currencies are expensive while emerging-market currencies are cheap,' said Themos Fiotakis, a London-based Goldman Sachs analyst. 'The downside risks have declined significantly for emerging-market currencies. Even if these currencies remain flat, the carry is still attractive.'"
2. See Bresser-Pereira (2009) and Kregel (2008). This position simply reflects the tradition of development pioneers such as Raúl Prebisch, Celso Furtado, Ragnar Nurkse, Gunnar Myrdal, and others. It is also present in the Trade and Development Reports issued by the United Nations Conference on Trade and Development in the 1990s.
3. Increasing the number of urban jobs available may have the added benefit of reducing pressures on rural land redistribution, as the majority of those in the Sem Terra ("without land") movement are reportedly industrial workers who have given up looking for employment and are seeking farmland from which to make a subsistence living; see www.desempregozero.org. For more general information on job guarantee programs employed in other economies, see www.economistsforfullemployment.org.

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Kregel studied primarily at the University of Cambridge, and received his Ph.D. from Rutgers University. He is a life fellow of the Royal Economic Society (U.K.) and an elected member of the Società Italiana degli Economisti.