How the US financial crisis will impact the BRICs

Trusted Sources > EM Themes > Trade and finance nexus **05 Sep 2007**

Overview

Worries that the spill-over from US-generated financial shocks will undermine the domestic demand explosion in BRIC countries are overblown. In our view, the on-going demand for imports to fuel this continuing domestic boom in the BRICs will cushion the drop in US growth, turning today's panic arising from the housing collapse into a more bearable slowdown. The underlying support for such demand comes from a massive increment to liquidity available to spend and invest on the part of both the BRICs and the Mideast oil exporting countries. This year nearly $1.0 trillion will be added to these countries' international reserves.

The biggest risk to the sustainability of the BRICs' continued economic expansion is posed by inflation. Our assessment suggests that India and Brazil are best prepared to roll out anti-inflationary monetary policies if needed. In Russia and China, inflation will get worse before remedial policy actions are launched. We explain why the reasons for this outcome are very different in the two countries.

Core Case

Worries that the US financial crisis will undermine the BRICs' continuing economic boom are overblown

Assumptions and Evidence

Recent TS publications on themes highlighted in this study

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Core Case

Is there a risk that the demand explosion in the BRICs and other emerging countries could be derailed by the current US financial crisis?

Many commentators see the global economy in dire straits with recession just around the corner. Martin Feldstein, Harvard professor and president of the National Bureau of Economic Research, told the Fed's recent conference in Jackson Hole, Wyoming that the US economy could suffer a very serious downturn and urged the Fed to cut interest rates by as much as 100 bps. He added that, while such a move might push up inflation, it was the lesser of two evils. Variations on this theme have become the daily fare of the financial press.

From doom to boom

In contrast to such gloomy pronouncements, other data paint a surprisingly bullish picture of the global economy. Take, for example, the Baltic Dry Index, the shipping industry's benchmark for the costs of transporting bulk commodities such as iron ore, coal and grains. Though quite volatile, the Baltic Dry is a good forward-looking indicator of global demand.

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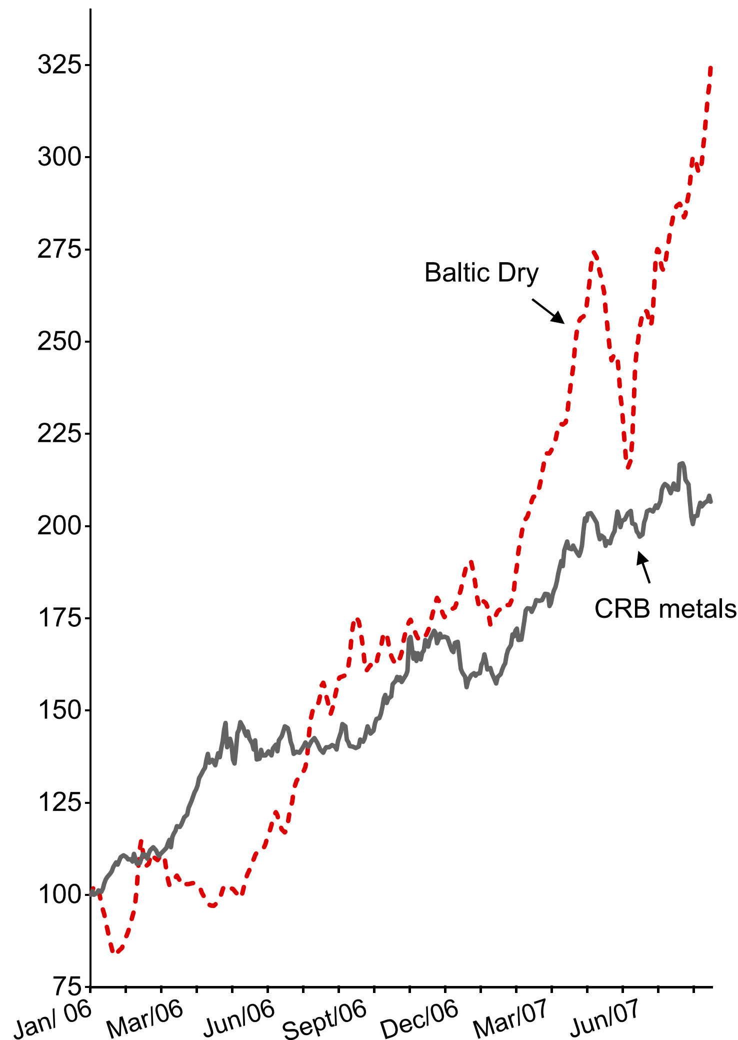
Commodity price trends, Baltic Dry and CRB Spot Metals (Index 01/01/06=100)



Source: Bloomberg

During the month of August - that is, during the height of the financial crisis - the index rose 9.4 per cent to an all-time high; since January it has increased 78.8 per cent. The CRB metals index shows a similar, though less marked, trend. If a recession is on the way, someone forgot to tell the shipping folks.

What is it then - an incipient global recession with deflationary overtones or a continued strong economic expansion?

Liquidity everywhere but not where it's needed

To throw light on this question, we distinguish two aspects of financial liquidity. *Market liquidity* is the ease of converting financial assets into cash at close to their intrinsic value; *macro liquidity* represents liquid assets available for investment or purchase of goods and services.

The current financial situation is characterised by sharply divergent trends in these two aspects of

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liquidity. Market liquidity has evaporated, hence the crisis in money markets. But macro liquidity - that is the pools of money available to be invested or spent - has continued to increase, driven by growth in the BRICs and booming world commodity prices.

One proxy for macro liquidity, total international reserves held by emerging market countries, shows this trend gaining strength. In 2007 we project that international reserves of the BRICs and the Midde East oil exporting countries will rise by $950 billion; this comes on top of an actual $1,460 billion increase during the previous four years.

International reserve accumulation, $ billion

	2003-06	2007F
Brazil	37	94
Russia	210	146
India	67	74
China	653	438
BRICs total	967	752
Middle East oil exporters	501	200
Industrial countries	299	50

Source: IMF and TS forecasts

If trends in market liquidity dominate macro liquidity, as the gloom-and-doomers implicitly assume, then the global economy is, indeed, headed for a rough patch. We believe the opposite outcome is more probable, namely that macro liquidity will buoy world demand, despite the knock to spending from the on-going financial crisis.

In essence, the key question is whether the spill-over onto the global economy from US-generated financial shocks will be stronger than the impact of rapid growth in the BRICs on the developed economies. The important point is that the channels linking the two regions run both ways. Analyses warning of an impending downturn in the global economy typically ignore the global market impact of the BRICs.

Roots of the financial crisis...

Although the current financial turmoil has all the characteristics of an old-style run on the banking system, it is taking place not in the commercial banking system but in the non-bank financial system. Commercial banks have responded by hoarding liquidity and moving assets onto their balance sheets, funding them in part by withdrawing liquidity they typically provide to the markets.

Non-bank borrowers, including investment banks which must fund themselves in the money markets, have therefore had to scramble for funding to roll over illiquid positions and make good on lending commitments. A number of commercial banks with commitments to off-balance sheet conduits and structured investment vehicles (SIVs) have also been squeezed by a withdrawal of credit.

The resolution of this crisis will come from two primary sources. One is the transfer of these homeless assets - the banks' off-balance sheet distressed debt and pending underwriting commitments - onto balance sheets. The second is via the disposal of such assets at fire sale prices to new investors active in distressed debt.

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Both processes are under way, but still have far to go. The slowness of the adjustment reflects the fact that central banks cannot supply liquidity directly to the non-bank sector and the obvious reluctance of holders of the debt to realise losses by cutting prices to market clearing levels.

The crisis will reach a head in the coming weeks because a number of investment funds holding various structured credit products are scheduled to roll over existing funding. Rising interbank lending rates in early September reflect a growing scramble to line up this needed funding.

Further market turmoil lies ahead, especially if the Fed fails to meet widespread market expectations of a cut in the Fed funds rate at its 18 September meeting. While commercial banks should be able to continue adding new assets to their balance sheets with the blessing of the regulators, the banks' concerns about counterparty credit risk will push up lending rates and deny some borrowers any credit at all. For their part, central banks are likely to widen the list of securities accepted as collateral in repo transactions, though at penalty rates.

The bottom line is that prices for many structured securities have further to fall before reaching market clearing levels. Sizeable losses and bankruptcies associated with these securities will inevitably follow.

...and their impact on the BRICs

Given the prospect of continued financial turmoil, how will these developments impact the BRIC economies?

The direct impact from financial market losses will be minimal. Holdings of mortgage-related structured credits by BRIC banks and governments are relatively modest. Three large Chinese banks have revealed investments of some $12 billion in such paper, apparently rated no lower than AA and none of it subprime. This debt can easily be held on the banks' balance sheets until maturity. Losses, if any, will be deferred, although the largest holder, Bank of China, has already taken a modest reserve against its exposure. No other significant investments in such debt have come to light in other BRIC countries.

A second channel for any potential financial impact on the BRICs is via trade linkages. There is consensus that the crisis will severely affect US residential housing, in particular prices of existing homes as well as new construction. A slump in the housing market will dampen consumer confidence.

These developments will obviously have a negative impact on US demand for BRIC imports, but they must be weighed against the impact on US growth and employment from US exports to the emerging markets. Residential construction accounts for some 3.0-4.0 per cent of US GDP. Exports, by contrast, generate in total 12 per cent of US GDP, and export growth is currently running at 11 per cent year-over-year in real terms.

In our view, the ample macro liquidity (highlighted above) coupled with a depreciated US dollar will provide a continuing boost to US exports, cushioning the fallout of the current liquidity crisis on US growth. The global impact of demand from the BRICs will turn today's panic about housing into a more bearable slowdown in economic growth.

Does inflation threaten sustained economic expansion in the BRICs?

Rather than a US economic downturn, the biggest current risk to the sustainability of the BRICs' continued economic expansion is inflation. Our previous GMI Outlook, *Why global inflation will rebound* focused on the impact of the demand explosion in the BRICs on global inflation. This time we turn our attention to evidence of rising inflation within the BRIC economies and examine the monetary and fiscal tools that policymakers will employ to deal with it.

The reaction of BRIC policymakers to the US financial crisis has been remarkably upbeat,

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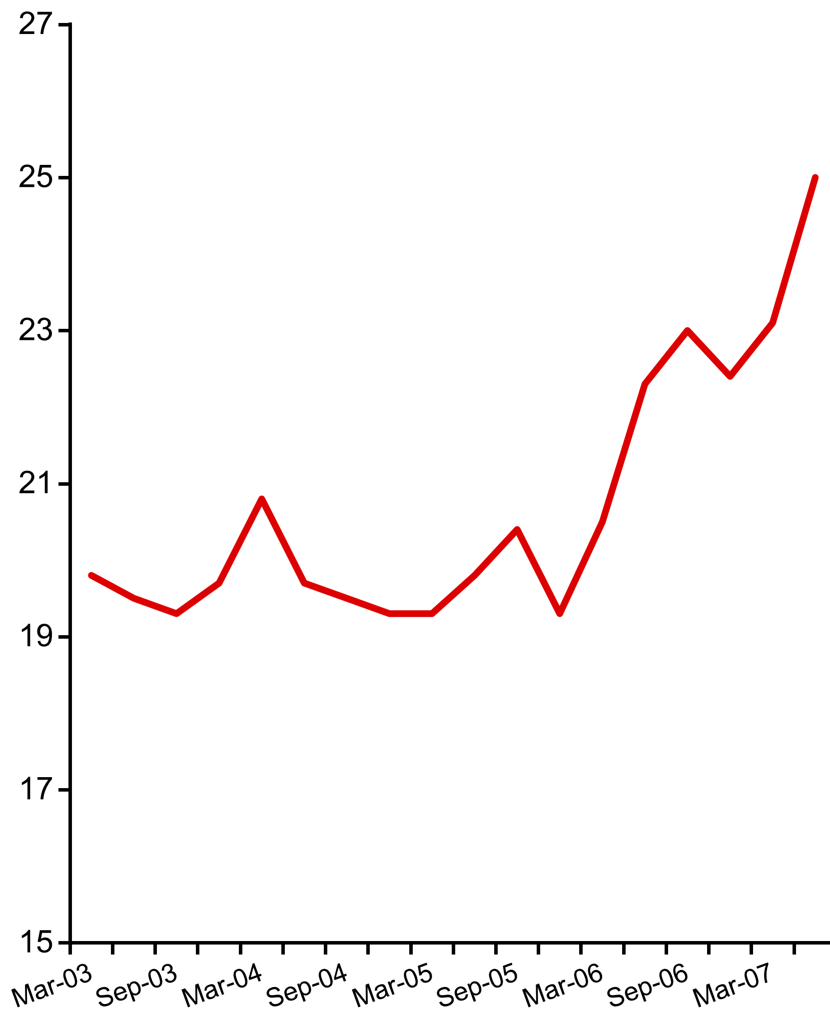
pointing to the resilience of their economies in the face of reversals of capital flows and gyrations in their domestic equity markets. In fact, one senses that some BRIC policymakers welcome a bit of imported deflation, given overheating in their domestic economies.

Looking at BRIC-wide trends, a recent upturn in credit growth and inflation is evident. In addition to the reserve and commodity indices already noted above, our composite index of BRIC credit growth to non-financial borrowers (see below) shows a clear acceleration beginning in mid-2006: the year-on-year rate of growth moves from about 20 per cent during the period 2003-05 to a 25 per cent rate of expansion at the latest reading in mid-2007.

Total BRIC bank credit, year-over-year % change



Source: National Sources

Note: Change in domestic bank credit outstandings to non-financial sector and households, weighted by country annual dollar GDP

There is mixed evidence so far that policymakers have taken strong action against emerging inflationary trends. The following chart, which shows trends in real interest rates, highlights two facts:

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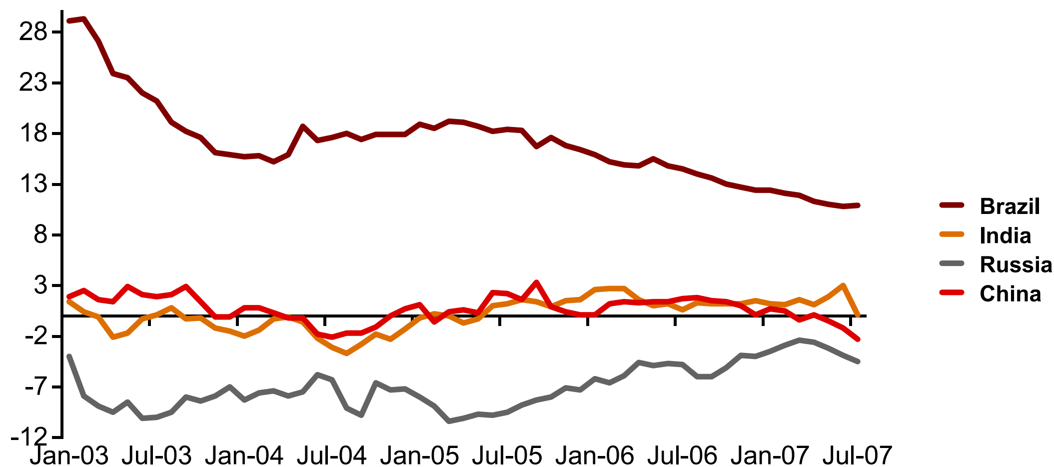
1. With the exception of Brazil, real interest rates have remained extremely low, even strongly negative in Russia's case
2. There is no evidence of rising real interest rates, indeed just the opposite is true; Russia's real interest rate gradually became less negative from 2005 until early this year, but it remains solidly entrenched in negative territory.

Estimated real interest rates, in per cent



Source: National Sources

Note: Three month T-bill rate minus annual inflation rate; for Brazil 360-day real swap rate

Such aggregate macro trends serve more to highlight puzzles than to suggest solutions. For this, we now turn to an overview of the inflation situation in individual BRIC countries.

China

China's inflation problem has roots in both structural and demand factors. As the chart below illustrates, the annual rate of food price inflation over the past 12 months has accelerated from less than 1.0 per cent to more than 15 per cent. Meanwhile, non-food inflation has continued stable at around 1.0 per cent over the same period. With overall CPI inflation running at 5.6 per cent, there is little prospect that the government will come close to meeting its 3.0 per cent target.

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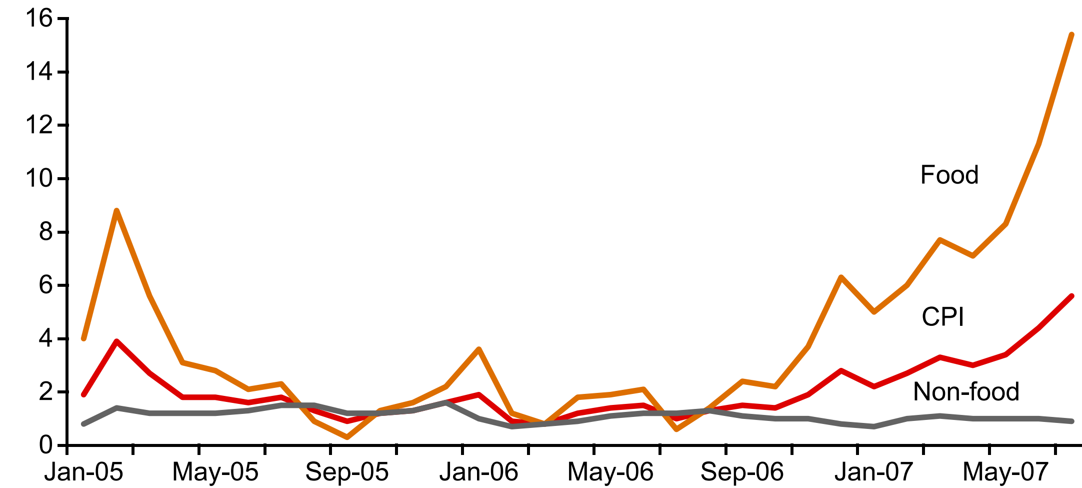
Consumer price index, year-over-year % change



Source: NBS

Chinese officials maintain that increases in food prices are "temporary," reflecting the impact of rising world prices for grains and soy and the reduction in pork supplies due to a widespread viral infection of pigs. They are quick to add, however, that it will not be until next spring that significant declines in pork prices will feed through to the retail level.

Such expectations will undoubtedly prove overly optimistic. Our recent study of China's conflicting policies on land use (here) concluded that continued shrinkage of arable land will put steady upward pressure on food prices, especially for meat and dairy. The only viable medium-term policy option is for the government to relax its "self-sufficiency" policy and increase imports of foodstuffs. Even if some relief on pork prices does show up next spring, today's rapid food price inflation will boost consumers' inflation expectations.

Evidence of price pressures is showing up elsewhere in the economy. Since the end of last year, prices of US imports from China have begun rising after a prolonged period of deflation (see chart below).

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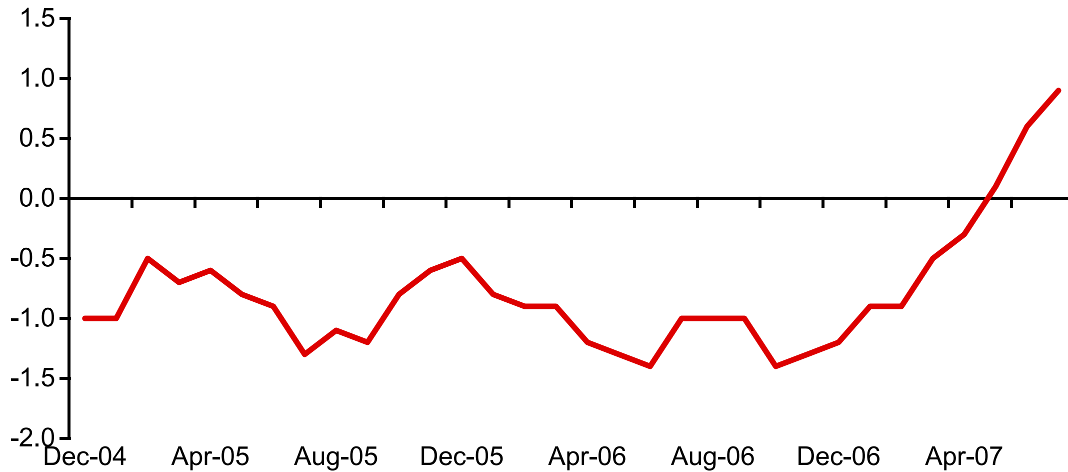

Source: US BLS

Changes in the labour market lie behind these price pressures. Although surplus rural labour is still very much in evidence, manufacturers in China's costal regions are encountering increasing difficulties in recruiting young rural workers willing to endure the spartan conditions of factory work. Rising farm incomes, in part due to rising food prices, have also acted to tighten labour supply, adding upward pressure on wages. Anecdotal evidence suggests that annualised wage inflation for unskilled factory labourers has moved into the 12-14 per cent range.

Government efforts to cool the country's rapid pace of economic growth - modest interest rate hikes and increases in reserve requirements - have so far had limited effect. The authorities appear wary of acting for fear of puncturing the domestic bubble that is driving the stock market, especially in the run-up to the Communist Party conference in October. A recent initiative to open a limited window for private capital to invest in Hong Kong stocks has met with determined resistance within the government bureaucracy; as a result, all kinds of restrictions on such flows are likely.

This policy paralysis suggests that China's inflation problem will get worse before the authorities decide to take action. For now, buying time is the order of the day. Chances that the October party conference will ease the barriers to reform do not look good (our assessment is here). Past experience teaches that the leadership will avoid doing anything that could upset the growth juggernaut. Given the size of domestic imbalances, virtually any new initiative poses such risks.

Paradoxically, the one development that the country's leadership might secretly welcome is a US slowdown. That would help cool the economy without the need to thrash out difficult policy compromises.

India

Although India's 9.4 percent pace of economic growth lags not far behind China's, the authorities have been more successful than the Chinese in dampening inflationary pressures. The key role in this effort has been led by the Reserve Bank of India.

Rising inflationary pressures in mid-2006 triggered an aggressive tightening of monetary policy by the RBI. This was reflected in interest rates hikes and a decision to let the rupee appreciate

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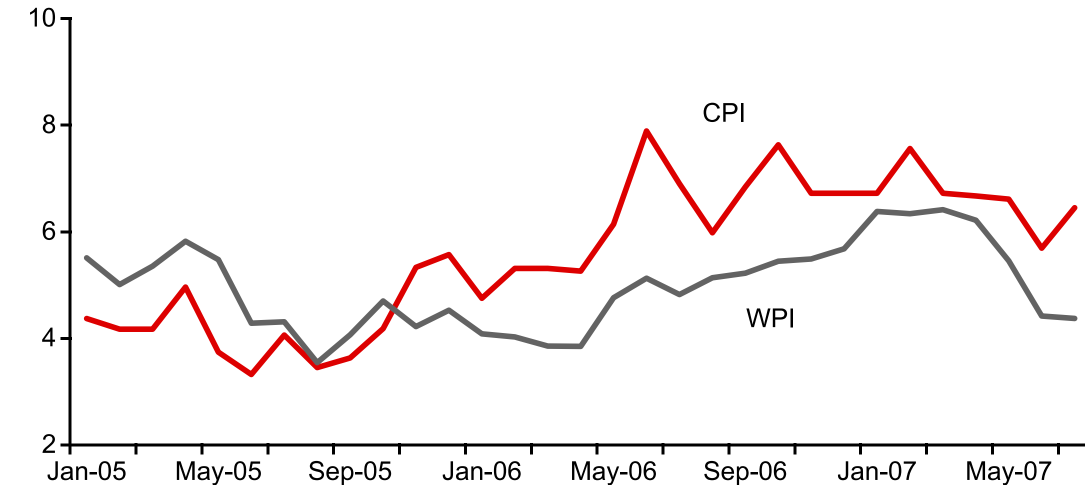
(details are here). As the chart below illustrates, these moves have capped the inflationary surge, but it is not yet clear that inflation is headed back down. Separate data on bank credit show that loan growth has slowed from an annual rate of more than 30 per cent to a still high 26 per cent rate in June.

Retail and wholesale price indices, year-over-year % change



Source: Bloomberg

Note: For CPI, retail price index for industrial workers

In its annual report, published this week, the RBI highlighted inflation as the major downside risk to the economy. Although wholesale price inflation has eased, retail price inflation remains stubbornly high - in the range of 6.0-9.0 per cent for the various CPI inflation measures.

There are two important conclusions to draw from this overview. First, the RBI appears ready to act, should inflation turn up again. Second, its monetary policy measures have proved effective in dampening inflation, even if they have not succeeded in reducing inflation to previous levels.

Russia

Russia's inflation dilemma has two inter-related causes. One is the massive inflow of foreign capital that followed last year's elimination of capital controls on the ruble. Inflows of foreign and repatriated Russian capital have responded, in turn, to strong economic growth, driven primarily by a domestic-led investment boom. The combination of volatile external capital flows in the context of a newly liberalised and still not fully developed domestic financial market places unusual strains on Russia's monetary authorities.

The government's inflation target for the year is 8.0 per cent, but there is little hope that this goal can be met. Economic growth, meanwhile, will also exceed forecasts. Minister of Economic Development and Trade German Gref said in early September that the official 6.5 per cent target was likely to be raised to 7.2-7.4 per cent; the final outcome is likely to be closer to 8.0 per cent.

In contrast to past periods of rapid growth, led by rising world oil prices, the current economic expansion is driven wholly by domestic factors. Real capital investment, for example, is booming, currently up more than 25 per cent year-over-year. The volume of industrial output is growing at a steady 8.0-10.0 per cent. Retail sales and personal incomes are both increasing at double digit rates.

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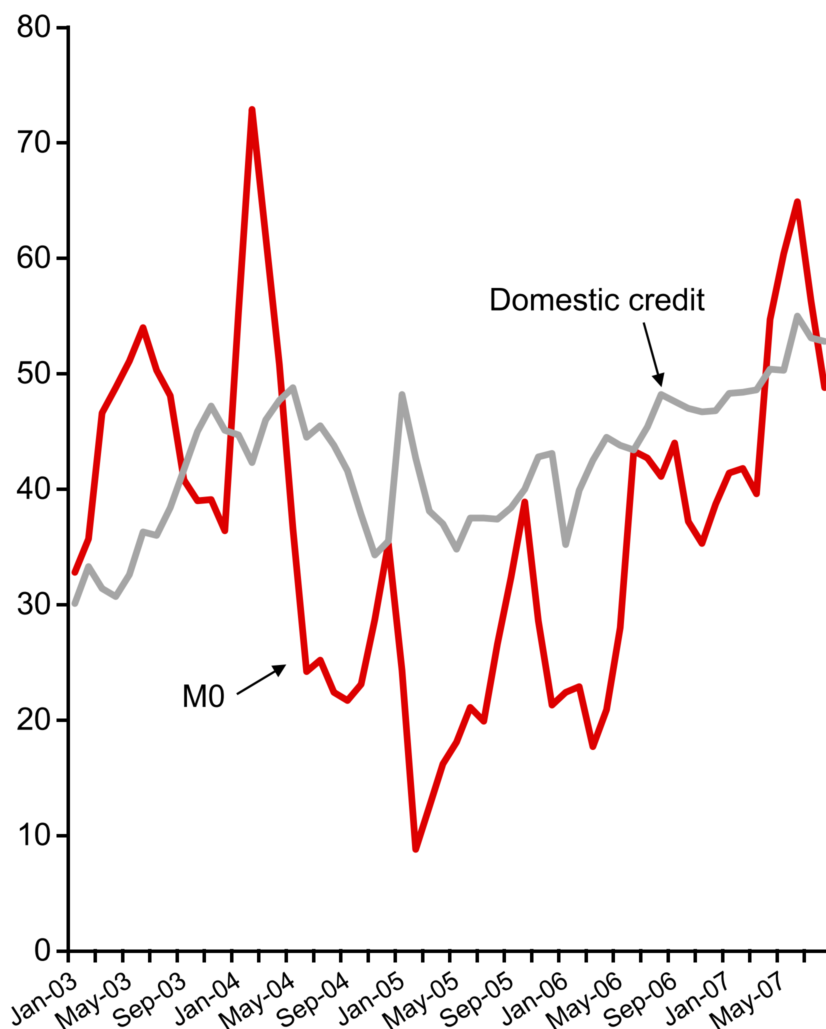
Capital inflows posed major problems for monetary control earlier this year. By midyear total private capital inflows exceeded $70 billion, compared with $41 billion for the whole of 2006. The eruption of the US financial crisis in August led to a reversal of these trends; outflows for the month totalled $7.6 billion.

Money and credit aggregates illustrate the dilemma facing the Central Bank. The rate of growth of base money, for example, rose from 22 per cent in January 2005 to a peak of 65 per cent this June, before falling back to 49 per cent at the beginning of August. Several special factors should be noted to put these trends into perspective. One is the secular increase in the demand for rubles. This demand is driven in part by steady dedollarisation, as dollars are extracted from under citizens' mattresses and converted into ruble cash and deposits. Accelerating growth in personal incomes has also led to increased demand for holding rubles.

Still, there are reasons to worry. Given nominal GDP growth of some 15 per cent during this period, there is a clear risk that some of the monetary growth may spill over into inflation.

Monetary base and credit to non-financial sector and households, yoy % change



Source: CBR

In *New policy responses to Russia's inflation*, published last month, we argued that monetary

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policy would have to bear a much bigger burden in fighting inflation. Further, we saw the government and the Central Bank moving gradually towards an active interest rate policy, including a regime of positive real interest rates.

The Central Bank used the opportunity provided by capital outflows in August to nudge up interest rates and establish control of market liquidity. We take this as an encouraging sign that a move to tighten monetary policy is indeed in the works, although how quickly it will be implemented is unclear.

Part of the problem is that there is a limit to how fast the economy can transition to a regime of positive real interest rates. Money markets still lack the depth to absorb large swings in private capital flows, thus forcing monetary authorities frequently to operate in a reactive mode. Also, today's high oil prices feed a steady stream of dollar liquidity into the market that the Central Bank has to sterilise.

Brazil

Brazil's historical inflation record during the 1980s and 1990s is arguably the worst among the BRICs. Its recent performance, though, is clearly the best.

The key to Brazil's success lies with Central Bank policy. In January 2003, at the beginning of President Lula's first term, real interest rates were nearly 30 per cent (see chart above on real interest rates). A declining trend set in during Lula's first year in office, but average real rates remained very high, in the mid-teens, before declining to a still high 10 per cent currently (measured by the 360-day swap rate).

During this same period, retail inflation (measured by the IPCA index) declined from just over 10 per cent to a low of 3.0 per cent at the beginning of this year. A sharp decline in wholesale prices, especially foodstuffs, lay behind this trend. In recent months, retail prices have begun edging up, reflecting a rebound in the underlying wholesale price trend.

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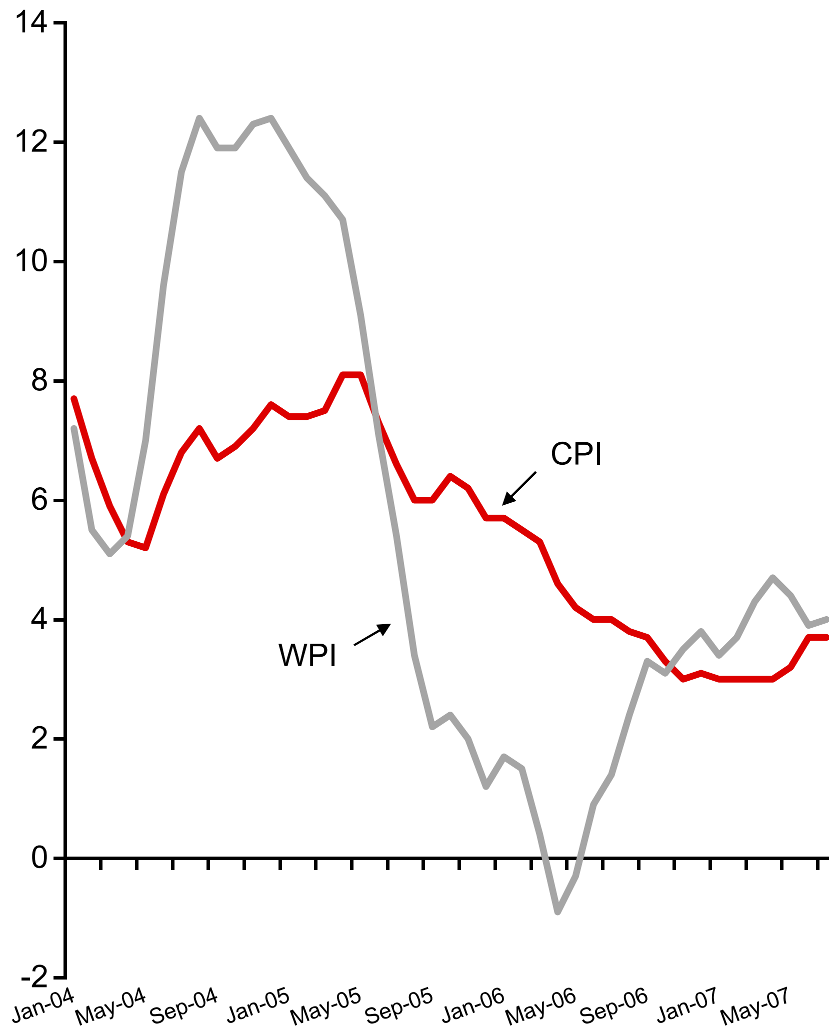
Consumer and wholesale price indices, year-over-year % change



Source: Central Bank

Note: CPI is the IPCA index; WPI is IGP-M index

Worries about future trends in inflation mostly concern potential structural blockages to growth. Chronic underinvestment in the country's infrastructure is to blame. Now that the economy has finally achieved a 4.0-4.5 per cent growth rate, there is a risk that this growth may reignite inflation.

Given this prospect, we expect the Central Bank to modify its current policy of periodic reductions in its base rate. Inflation will remain under control, but at the cost of continued relatively high real interest rates.

A summing up

There are compelling reasons to believe that both Brazil and India will address signs of a revival of inflation by tightening monetary policy, despite consequent upward pressures on their

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currencies and grumbling by politicians. Based on each country's track record, such measures should be effective - at the very least - in putting a cap on inflation, even if they do not succeed in lowering inflation. This augurs well for the sustainability of each country's continued economic expansion.

In Russia and China, by contrast, inflation gets worse before remedial policy actions are launched. The reasons for this outcome, though, are very different in each country.

We believe Russian monetary officials are prepared to tighten monetary policy, but they are moving very cautiously in this direction. In addition to the very practical constaints on policy mentioned earlier, there are other considerations that explain why the transition is moving slowly. One is the upcoming elections, in December for the Duma and in March for the presidency. Also, a hostile bureaucracy, unprepared to accept any spending cutbacks, is also to blame.

There are several factors that would help speed up this transition. For example, a reduction in the country's huge current account surplus would help reduce net dollar flows flooding into local markets, thus facilitating a move to tighter monetary conditions. A second factor acting to reduce dollar inflows would come from a government decision to redirect borrowing by state-owned companies and banks into the domestic bond market. Both of these developments appear probable during the coming year or two.

However, until a clear inflation danger is recognised by the top political leadership, monetary authorities are unlikely to venture into the bureaucratic crossfire. Russia's domestic economic boom, therefore, appears vulnerable to a cyclical correction, although any such monetary tightening is likely to be deferred into the second half of 2008 or early 2009.

China's economic leadership appears to be in a state of denial about the country's inflation problems. Rather than choosing between conflicting policy objectives, the leadership appears unable to act. Meanwhile, the internal imbalances continue to mount.

This situation may reflect a weak leadership that knows what should be done, but lacks the will and authority to implement such measures. But it also could reflect fundamental disagreement within the leadership on what to do. The only sure conclusion is that the eventual policy challenges will grow in complexity the longer such decisions are deferred.

For now, the bottling up of financial liquidity resulting from the country's huge trade surpluses will continue to feed a domestic stock market bubble and be recycled abroad into an increasing range of investments assets and raw materials. This, in turn, will trigger new asset and commodity price bubbles wherever China directs these flows.

A final word

If the current financial crisis has proved anything, it is that the developed world's central banks are ill equipped to deal with a crisis in the non-bank financial system. It is doubly sure that they will be even less able to deal with the shockwaves emanating from China should its leadership fail to address internal economic imbalances.

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