17 Rebalancing the global economy: A view from the BRICs

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This chapter argues that the emerging markets' days of export-led-growth are over and domestic driven growth is the "new normal". It suggests this means dealing with capital inflows, exchange rate appreciation, current account deficits, and bubbles and overheating economies. Nevertheless, it is a more pleasant task than the one faced by the mature economies.

The 2008 financial crisis will change the global economy; perhaps not as much as was expected during the worst of the crisis, but possibly much more than many of us would currently like to admit. We're no longer in Kansas, but we haven't found Dorothy's rainbow yet. The US economy will be forced to rely less on consumption demand and the eurozone will be forced to restructure in order to survive. The emerging markets' days of export-led-growth are over. Domestic driven growth is the "new normal". This means dealing with capital inflows, exchange rate appreciation, current account deficits (or smaller surpluses) and, occasionally, bubbles and overheating economies.

For some time, markets instinctively looked for familiar patterns. The bubble burst, destroying financial wealth? Assets are already recovering. Struggling banks? Credit will eventually rebound. Are public debts too high? There is nothing to fear, confidence in the mature economies debt still exists. A long lasting recession? US consumers are back and investment in China is stronger.

It is now becoming clear that the consequences of the 2008 global crisis are far from over. The aftershocks are already evident. Tough financial reform is underway in the US. Debt dynamics have become a matter of concern sooner than expected, at least in the peripheral European countries. Emerging markets are dealing with overheating and inflation and tightening policies, in contrast with the expansionary policies of the mature economies.

Global growth, especially after fiscal and monetary impulses die down, will be less intense for several reasons:

- the destruction of financial wealth,
- the challenge of credit revival in mature economies,
- the rise in US savings and
- the uncertain transformation of China into a consumers' economy.

Because it follows a sharp contraction, the current rebound may be quite vigorous; but the challenge of sustained growth will remain.

In this world, the emerging markets would likely sustain relative strength. The idea of decoupling lost appeal after the synchronised contraction of the 4Q08. But, differentiation is on the agenda again, as emerging markets could well lead global growth. Stronger growth in the emerging markets means that growth asymmetry could be one of the important characteristics of the new global order.

A new consumer of last resort

Another important characteristic is the future search for the global consumer of last resort. It is essential to assess what the world will look like after the retreat of the US consumer (affected by loss of wealth and credit shortages in a deleveraging process). A prolonged contraction in US consumption will reduce global demand. This will mean lower exports everywhere, smaller trade surpluses, and a weaker US dollar relative to previously surplus countries. It also means pressure for consumption growth outside the US. Some countries will tend to export less and consume more. China is a natural candidate, but reducing savings will be a slow, reform-dependent process. Other countries will have to play a role too. Those with large potential growth in domestic demand and low risk will likely be graced with capital inflows; their currencies should strengthen against the dollar.

In this scenario of moderate world growth and higher growth in the emerging markets, capital should flow to the emerging markets, strengthen their currencies and worsen their current account balances.

Step forward Brazil

Brazil is as a natural candidate. As such, its current account deficit should widen as the search for a consumer of last resort continues. This is not solely due to global factors. Brazil still faces the challenge of raising its savings ratio, as a country in which there is a large potential consumption growth, due to a growing middle class (in the past five years, 33 million people joined its ranks). New investment projects could track these new consumers, fuelled by a lower risk environment.

In this environment, what scenario will unfold for Brazil within the "new normal" world? True, uncertainty is everywhere, including. Some trends, however, are taking shape. When organised, they sketch out scenarios for the coming years. In fact, it is easier to consider the long-term prospects (10 years ahead) than the short-term prospects (the next few years).

In Brazil, investment should grow quickly over the coming years, resuming the path of recent years following a temporary disruption in 2009. There are several reasons for this:

1. the global context favours investment in the emerging economies with a high potential to expand domestic consumption (the "search for the consumer of last resort" to replace the US);
2. Brazil's local market is buoyed by a growing middle class, with a greater propensity toward spending;

3. real interest rates will continue to fall in the medium run, favouring investment, particularly in real estate;
4. the investment required by the 2016 Olympics (our simulation suggests a 0.7 percentage point impact on GDP growth in each of the four years preceding the event);
5. investment in the sub-salt oil fields (we estimate about US$55 billion over the next ten years); and
6. investment for the 2014 World Cup.

In short, this represents a huge commitment. Investment could be even greater (25% of GDP?), but global weaknesses as well as existing bottlenecks in Brazil will probably moderate the impulse to invest.

Greater investment should lift potential growth to about 5% throughout this period, which is higher than the 4.0%-4.5% most analysts tend to build into their business plan for the coming years.

It is not only higher investment that may push up potential growth. An increase in the share of working age population (aided by a rising labour force) and gains in total factor productivity will also help.

Apart from its impact on potential growth, investment will demand more financing (savings). Financing will come from two sources. First, increased external financing (current account deficits). Second, some increase in domestic savings (about 1.0pp of GDP) in order to replace part of the external financing with more public savings from 2011 onwards. We estimate a modest increase in the government's fiscal effort, to about 3%-4% of GDP (primary surplus) in the coming years, with greater public investment (and savings).

We believe that external savings will finance most of the new investment. The current account deficit should trend upward from the current 1%-2% of GDP to approximately 4%-5% of GDP in 2016, and then slide back to about 3.5% of GDP by the end of the decade as spending on global sports events comes to an end and pre-salt revenues start to hit the trade balance.

Capital inflows to finance the current account deficit should maintain the currency appreciated in real terms, possibly close to the current levels. Brazil could grow at an annual rate of about 5%.

However, the horizon is clouded with uncertainty. There are other possible scenarios. One scenario is more pessimistic. As in other emerging markets, Brazil faces several bottlenecks – such as shortage of infrastructure, education or savings – that it may not successfully resolve. A double dip recession may cause external financing to become scarce, hampering investment and inhibiting growth. But an alternative scenario, of more reforms and a more aggressive fiscal adjustment (to free savings), could spur investment and economic growth even further (toward about 7%).

Even without these alternative scenarios, the new world would imply challenges for Brazil and other emerging markets. Could this shift in demand toward domestic markets and greater capital inflows to emerging markets be accomplished in a smooth manner? Currently, only a small percentage of wealth and investment is allocated to the emerging markets. A sudden shift could imply more inflows, exchange rate pressures and asset bubbles. How to deal with this?

Luckily, the world is just rationalising the lessons from the excesses and bubbles of the mature economies. Leaning against the wind in both monetary policy and financial regulations seems to be one of the new lessons. Emerging markets would do well to heed this and other lessons learned from the excesses of mature economies.

Part of the capital inflows has a natural outflow through the widening current account deficits. But how much is sustainable? Past exchange rate crises and sudden stop experiences suggest that deficits above 5% tend to end badly. But is this true in the new normal world? Few emerging markets and investors would risk finding out

To summarise, in emerging economies such as Brazil and China, unless the existing risks lead to a new global recession, the task ahead is to avoid excesses and growth rates that are unsustainable in the medium and long term. That is, no doubt, a more pleasant task than the one faced by the mature economies.

About the Author

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