



## **Testing Times – A US Recession and the BRIC Economies**

*By Deirdre Keown  
July 29, 2008*

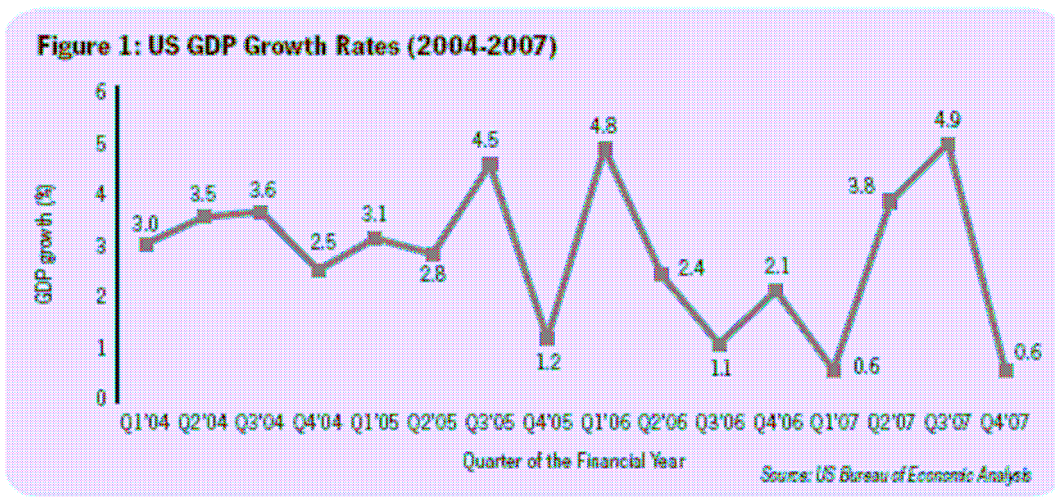
*Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.*

The prospect of a US recession is causing anxiety around the globe, including the BRIC economies, which are also battling steeply rising inflation. In a survey conducted in early 2008 by the US National Association for Business Economics, more than 45% of the 49 US-based economists surveyed believed the US was headed for a recession – double the number who foresaw a recession just three months earlier. Citing the biggest housing slump in 25 years, associated turmoil in financial markets and higher energy prices, the majority of those surveyed expected a “relatively muted” downturn, with growth of just 0.4% in the first quarter of 2008 and 1% in the second quarter, for calendar year growth of 1.8%. Those surveyed had become significantly more bearish since the prior survey in November 2007, when the prediction for 2008 calendar growth was 2.6%.

### **Recession – Or Just a Slowdown?**

The US National Bureau of Economic Research (NBER) defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.”

Fears of a US recession deepened in late March following the US Bureau of Economic Analysis’s announcement that real GDP growth suffered its steepest decline in four years in the fourth quarter of 2007, to just 0.6% (Figure 1). Domestic profits decreased 3.0% in 2007, in sharp contrast to a 12.3% increase in 2006.



The news followed the release of December unemployment figures, showing the US jobless rate jumped to a two-year high of 5%. David Rosenberg, Merrill Lynch's chief North American economist, said that the data "strongly suggests that an official recession has arrived".

"At no time in the past 60 years has the unemployment rate risen 60 basis points, from the cycle low, without the economy slipping into a slowdown, and we now have the jobless rate hitting 5% in December versus the [March 2007] trough of 4.4%," Rosenberg noted, adding that figures on aggregate hours worked in the economy contracted at an annual rate of 0.4% in the fourth quarter of 2007, following a 0.6% decline in the third quarter. "Back-to-back declines in total hours worked have always been associated with recession," he said.

"One can speak euphemistically, but there are no substitutes for outright 'recessions' – to say that the backdrop is 'recession-like' is akin to an obstetrician telling a woman that she is 'sort of pregnant,'" Rosenberg writes. "You either are or you are not."

Martin Feldstein, president of NBER denies the US is already in recession. However he did say he believes there is a serious risk of downturn, with the latest unemployment figures increasing the risk of recession by 50%.

Whether the US is in recession or not, no one denies there has been a significant slowdown in US economic growth brought on by a multitude of factors, the most prominent being the US housing slump and the associated sub-prime mortgage crisis, which by December 2007 saw borrowers defaulting on an estimated US\$300 billion of mortgages. With US banks cutting back on the provision of

credit to consumers and unemployment rising, US consumer spending increased by just 0.2% in December 2007.

## The Potential Impact on the BRIC Economies of a US Recession

**BRIC Exports** Exports from the BRIC countries will be adversely impacted by a US slowdown or recession. However the degree to which each country is exposed varies considerably. Brazil and China will feel the effects most.



Nearly one-fifth of Brazil's total exports in 2007 headed to the US and, as a result, it is predicting a slowdown of export growth from 16% in 2007, to 12% in 2008.

China's Ministry of Commerce estimates 19% of its total exports were to the US in 2007, with exports accounting for 70% of China's GDP. Citigroup estimates that a drop of 1% in US economic growth would shave 1.3% off China's growth rate, due to lower exports. However, that's not likely to make much of dent in China's economy given its double-digit growth. Citigroup estimates China's GDP growth will slow slightly to 11% in 2008, while Lehman Brothers is forecasting 9.8% growth.

India is also somewhat vulnerable, and will feel the effects of a US downturn, its government predicts. According to its Department of Commerce, about 15% of India's exports in 2007 were to the US, with exports accounting for 33% of GDP. The US remains India's largest trading partner. Rajeev Malik, an economist with JPMorgan Chase in Singapore, predicts that if the US enters a recession, India's growth is likely to slow from the current 9% to 7%.



Russia is the most insulated of the four BRIC economies, with just 3% of its total exports in 2007 going to the US (compared with 16% to Brazil, 19% to India and 21% to China). Russia's largest trading partner is Germany, a leading customer of Russian natural gas.

"In the long term, this will work to Russia's disadvantage by isolating the country from the benefits of exposure to the world's largest economy," said Yaroslav Lissovolik, chief economist at Deutsche Bank in Moscow. However, in the short term, it will cushion the country from a US downturn, he noted.

**Foreign Investment** By mid-February 2008, the world's major banks had lost a total of US\$140 billion as a result of the sub-prime credit crisis, according to Forbes.

If defaults spread beyond sub-prime mortgages to other areas, such as a rise in credit card debt and consumer debt, we'll see outflows of foreign direct investment (FDI) and foreign institutional investment (FII) from the BRIC economies, says prominent economist and former United Nations Under-Secretary-General for economic and social affairs, Nitin Desai.

Even if defaults remain at the same level, US investor sentiment may be dampened, impacting new investment flows into BRIC investment funds.

Andrey Kostin, chairman and CEO of leading Russian bank VTB Bank said in January that he "did not think either Russia's industrial or financial sectors will be affected – with the exception maybe of the stock price of Russian companies." That's because only 4% of Russia's FDI is dependent on the US, according to Rosstat, Russia's statistics bureau.

Furthermore, Russia's foreign currency reserves, earned from oil profits, sit at a massive US\$478 billion and are now the largest per capita in the world. These will "play the role of an air bag" for the country, said Finance Minister Aleksei Kudrin speaking in late January at the World Economic Forum in Davos, Switzerland.

Furthermore, it would take a steep fall in crude oil prices to a "now improbable \$50 a barrel" to flatten Russia's growth, according to Julia Tsepliaeva, Merrill's chief economist for the republics of the former Soviet Union.

China is also optimistic about its ability to weather a US downturn or recession. It expects its 2008 Olympics to continue to drive foreign investment to the country, even after the Olympics finish.



Justin Yifu Lin, the World Bank's new chief economist and senior vice president, said in February that a US recession will have only a limited impact on China. "China will experience a better economic growth after the Beijing Olympics, as investment, consumption, and exports – the three economic growth drivers – will remain strong."

The prognosis for Brazil and India is not as optimistic. According to the India Economic Advisory Council, the slowdown in the US will negatively impact foreign capital inflows, and FII is expected to decline by approximately 12% from US\$6.3 billion in October-December 2007 to US\$5.5 billion during January-March 2008.

Brazil too expects a hit to the flow of FDI into the country. According to World Bank estimates, FDI currently represents around 1.9% of Brazil's GDP. The US is Brazil's main source of foreign capital, and a US downturn is certain to bring a fall in FDI by that country into Brazil.

### **Grappling with Rising Inflation**

Simultaneously, the BRIC nations are each struggling to control inflation. Russia recorded the highest inflation rate of the BRIC economies in 2007 at 11.9%, according to Rosstat, far higher than its previous estimate of 8%. Inflation in China reached an 11-year high of 7.1% in December 2007, according to its government, and India's inflation soared to an eight-month high of 4.89% at the end of February 2008, according to its Ministry of Commerce. Brazil's inflation is the lowest of the four, at 4.56% for the 12-months to January 2008.

According to a December 2007 report by China's National Development and Reform Commission (NDRC), a macroeconomic management agency under China's State Council which formulates policies for economic and social development and guides the restructuring of the overall economic system, inflation in the BRIC countries (and some other emerging economies) is attributable to both internal and external pressures including:

- sustained growth of the world economy;
- a global problem of excess liquidity;
- the falling US Dollar;
- a decrease in the production of farm products;
- OPEC's output restrictions;
- excess speculative capital in the international markets; and,
- an increase in the demand for grain used to produce bio-fuel.



In its report, the NDRC noted that to curb price rises and ease inflationary pressures, the BRICs were adopting similar measures, notably using financial tools, price regulation and market adjustment, food subsidies to low-income groups and the adjustment of import and exports to increase domestic market supply.

China's central bank raised rates an unprecedented six times in 2007 to little effect – January's CPI rose 7.1%, its highest one-month rise in over a decade. Earlier this year, China's Premier Wen Jibao confirmed that China will tighten its monetary policy in 2008, to tackle inflation. "We must give priority to the quality rather than speed of development," he said at the annual National People's Congress. "The primary task for macroeconomic regulation this year is to prevent fast economic growth from becoming overheated growth and to keep structural price increases from turning into significant inflation."

The aim in 2008 is to ensure inflation holds steady at around 4.8%, Wen said, stressing that efforts would be made to rebalance the country's growth drivers. "We will continue to boost domestic demand, adjust the balance of investment and consumption, and promote the shift from the pattern of economic growth that relies mainly on investment and exports, to one that relies on a balanced combination of consumption, investment and exports."

In January 2008, Brazil's Finance Minister Guido Mantega announced that Brazil would not follow the US in cutting rates, despite widespread speculation it would, saying "Our monetary policy is aimed exclusively at controlling inflation [in Brazil]." Instead, Brazil's central bank left the Selic rate (the overnight lending rate) unchanged at 11.25%. This paid off in February 2008 when inflation rate fell to a seven-month low.

To control inflation, the Central Bank of Russia raised its key interest rate from approximately 10% to 10.25% in the beginning of 2008. Like Brazil, the decision was not driven by issues in the US. Russian Finance Minister, Alexei Kudrin, said in February 2008, "Both Russia and Asia are outside these problems related to the rate cuts in the US. Our banks had almost no sub-prime loans."

Instead, the decision to raise the official rate was aimed at "containing inflation and lowering the dynamic of the money supply," the Central Bank's statement said. Inflation has become a major political issue in Russia. Prices in Russia accelerated in January to a 30-month high as food costs increased and rising oil and gas revenue helped push up wages. And there's no respite in sight in the short term. "The oil price we believe will stay at the same level and the food price will also be rather high," Kudrin confirmed.



Unlike Russia, India does not consider itself to be immune to the US economy. The governor of the Reserve Bank of India, Y.V. Reddy, confirmed in September 2007 that US interest rate policy influences India's policy. Nonetheless, India did not follow the US in cutting key rates in January, which clearly indicated its intention to contain inflation, even if it means compromising on growth. "We are happy that inflation expectations are quite benign now," Reddy said in an interview at the time. "We are looking at a medium-term objective of 4% to 4.5%, and ideally a rate toward 3%."

### **Lessening the Impact on the BRIC Countries of A US Recession**

The slowdown in the US economy led to the US Dollar depreciating against all four BRIC currencies in the fourth quarter of 2007.

According to a weekly survey by Brazil's central bank which tracks the opinions of 100 analysts and economists from the country's banks and brokerages, the Brazilian Real (BRL) should strengthen and reach BRL 1.80 against the US Dollar by the end of 2008, due to efforts to shield the country from inflation and the US slowdown.

The Russian Ruble was the only BRIC currency that declined temporarily against the US Dollar in January 2008 after the US Federal Reserve cut interest rates. By the end of January, Russia's Central Bank decided to maintain the exchange rate at 24.7 Rubles to the US Dollar, to control inflation, according to an article published in February in Kommersant, Russia's online daily.

The Indian Rupee continued to appreciate against the US Dollar in January 2008. The Directorate General of Foreign Trade in India noted that the appreciation led to a decline in exports of industries such as handicrafts, textiles, and processed food. Exporters are now pushing the government to intervene and reduce the exchange rate.

The Chinese Yuan has appreciated by 13% against the US Dollar since China de-pegged it in July 2005. Ha Jiming, chief economist at China International Capital Corp. Ltd., said that People's Bank of China is considering changing its monetary policies to control the currency appreciation.

### **Domestic Investment and Demand**

Offsetting to some degree the vulnerability of BRIC countries to a slowdown in the US economy is strong growth in domestic consumption in each country. India's commerce and industry minister, Kamal Nath, said in January at the World Economic Forum in Davos that the world is "for the first time facing a US downturn with two other engines of world growth – China and India." He noted



that, while no economy in the world can be fully insulated from a US recession, the impact on countries such as India this time would be limited due to growing domestic demand.

Next week we will explore the growth of consumerism in the BRIC countries, highlighting that:

- from 2004 to 2008, consumer spending increased at a compound annual 19.6% in Brazil, 18.4% in Russia, 13.5% in China, and 9.0% in India, according to Euromonitor International;
- retail revenue accounted for 25.4%, 17.7%, 35.8% and 35.4% of GDP in Brazil, Russia, India and China in 2007, respectively, according to CIA Factbook; and,
- the 2007 AT Kearney Global Retail Development Index ranked India, Russia and China as the top three destinations, and Brazil 20th, for retail investments across the top 30 global emerging economies.

The likely impact of a US recession on the BRIC economies will remain under debate and close scrutiny for a long time to come.

However, as Dominique Strauss-Kahn, managing director of the International Monetary Fund, noted in February, “The industrial and emerging economies are like two horses yoked together – if one is tired, the other can take up more of the strain for a while. But if one stops in its tracks, neither is going to get very far.”

*This article is reproduced with permission from the BRIC+ Digest. The BRIC+ Digest is part of the BRIC+ Program which specialises in providing financial advisers with information about key global emerging markets and their place in portfolios.*

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>