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Global Economies 2015 – Once More Off-the-Cliff, Dear Friends…IV - BRICs

WRITTEN BY: ASHOK DHILLON

Ashok Dhillon has 40 years of front-line business experience in Canada and International markets.

Mr. Dhillon's experience includes start-ups, venture capital, seed funding, and heading companies in construction and international power development. His extensive experience gives him in-depth knowledge and intuitive insights into macro and micro, national and international, geo-political and economic realities and trends. He has been invited to speak on international business at various forums, including as an expert witness for the Standing Senate Committee, Government of Canada, on "The Rise of Russia, China and India".

We covered in Part 1, the 2nd and 3rd largest economies of the World, China and Japan; in Part 2, the EuroZone and the U.K.; in Part 3, the U.S., Canada and Australia. And now in Part 4, we shall look at the BRIC countries (*Brazil, Russia, India and China*), save China which was covered in Part 1. As to the other economies of Asia and South America we will cover them in the New Year in an additional White Paper considering the size and scope of some of those markets.

The consensus in the mid-2000s was, the BRIC economies were going to take over from the advanced economies of the West as the new prime drivers of global growth and wealth. To a degree that did take place, till the global financial crisis of 2008.

After the crisis, even though the BRICs held their own and kept a relatively high pace of growth, it became increasingly clear that it would be difficult for them to maintain that pace as the demand from the West fell sharply, and never did recover.

Over the recent years, two of the BRIC economies, Brazil and Russia, have faltered significantly. India slowed materially after the initial bounce back, post the crisis, but started to improve by mid-2012, and is now perhaps one of the fastest growing major economies. China, of course started its slide from its lofty heights of double digit rates of growth, and is going to continue to slow down materially.

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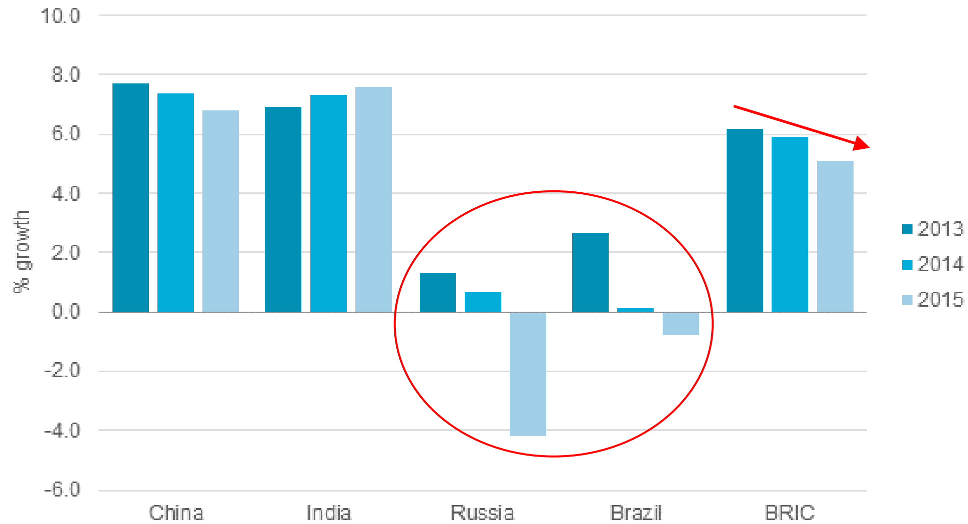
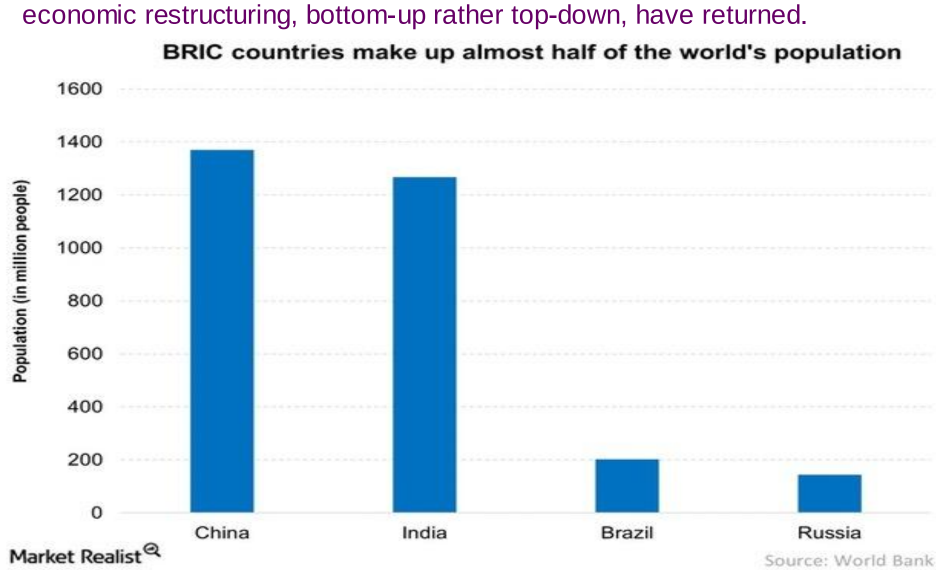
On a combined basis, the output of the BRIC economies is shrinking, and we expect it to get worse as global demand continues to be sluggish, and capital leaves riskier markets, seeking safety in select developed economies, and the most liquid currencies. This flight to safety will put pressure on the BRIC economies, further eroding their capacity in this downturn.



In 2015, the combined economic output of the BRIC countries is estimated to be approximately $14.8 Trillion, which is getting closer to the output of the U.S. economy at about $17.8 Trillion, and just over 20% of the total global output. That percentage has shrunk in the latter part of this year as most of the BRIC economies contracted significantly, but there is no doubt that the future growth of the global economy is going to come from the emerging economies, including BRIC.

These four countries make up almost 50% of the world's population and probably half of those (*by Western standards*) are really poor. That is where the new global demand is going to come from in the future, once the era of financial engineering to promote growth is over, and more traditional ways of economic restructuring, bottom-up rather top-down, have returned.



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For now, the promise of the BRICs for the most part has been rescinded.

Two of its economies, Brazil and Russia, are in deep trouble, and if global economic conditions do not improve materially (*and we don't expect them to*), these economies could struggle for a long time. If conditions worsen (*and we certainly expect them to*), these two economies could come apart further. China is also in trouble, and could be a trigger for a global crisis if internal conditions in China get worse, and instead of a '*hard-landing*', it has a '*crash-landing*'.

As usual India is on a '*slow burn*'. It is the most stable out of the four due to its built-in slow-moving systems that prevent over-heating in any major area. That characteristic is usually India's curse, as it has held India back for decades. But, in this instance, it may turn out to be an accidental blessing by preventing a major crisis from developing in India, as conditions continue to deteriorate externally. And though the conditions may not be as positive as the government numbers make it out to be, systems overall have improved somewhat over the past years.

The BRICs are a shadow of their former selves and, for now, will remain so. But let's take a closer look at the individual economies.

Brazil is a land of magical wonders that fire the World's imagination. It is the World's fifth largest country by geographic area and population and the ninth largest by nominal GDP. Brazil has been the largest producer of coffee for the last 150 years. It is a country that is full of economic promise for its people and the rest of the World. A country endowed with tremendous natural resources, and a creative and energetic people that have built an economy that is a '*heavy weight*' in South America, and a rising '*middle weight*' amongst the major global economies. And of course it is still considered the '*king*' when it comes to the game of '*Futebol*'.

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But as in its performances in football in the past World Cup 2014, internal weaknesses have taken Brazil apart politically and economically. A few years ago, it was doing so well that the global economic experts hailed it as an up and coming '*star performer*' amongst the BRIC economies. Prior to the 2008 crisis, Brazil's economic output expanded steadily. After the crisis its economy like most others tanked, but then rebounded in a 'V-shaped' recovery only to plunge in 2010-11 in an inverted 'V', mimicking China's, and most of the World's GDP trajectories.

But as one can see in the next Chart its primary exports to China of iron ore, oil and soybeans kept surging, inflation was under control, the currency was relatively stable, standard of living was rising, and Brazilians were happy and hopeful. But exports peaked in 2011 and then turned sharply down as China

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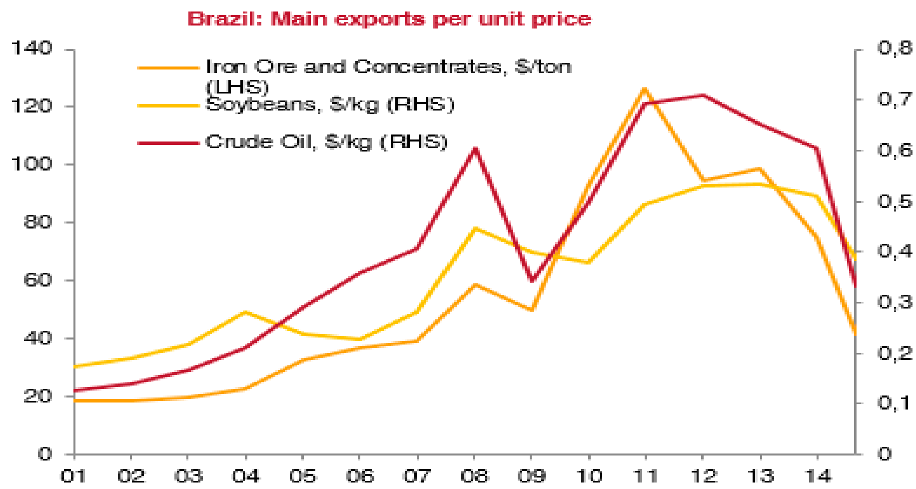
(*by then Brazil's largest trading partner*) started to slow. From late 2013, Exports plummeted as China's economy started to shrink, and then went into a nose dive, taking Brazil with it. The escalating economic crisis uncovered Brazil's political weaknesses which have materially added to Brazil's current considerable problems.

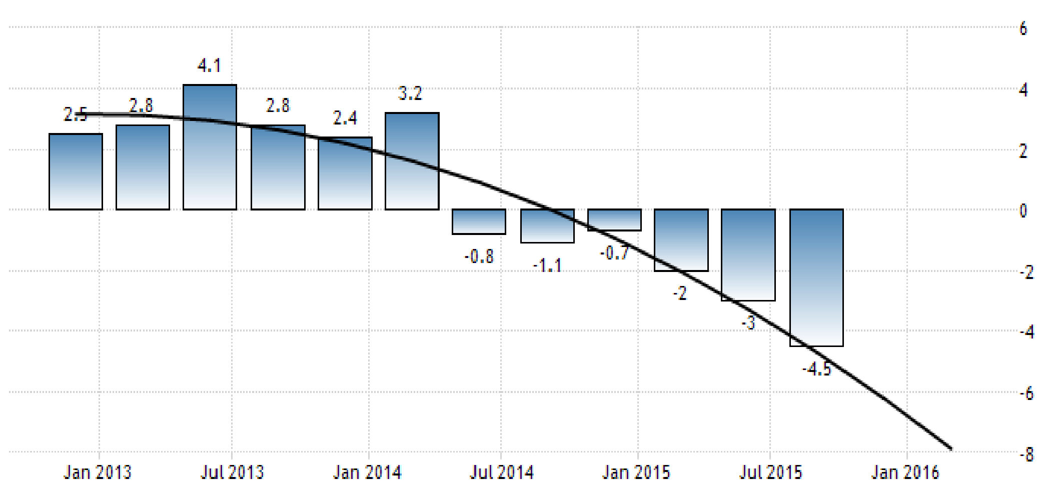
Figure 7. Brazil: main exports per unit price, 2001-15



Source: Bloomberg, Natixis.

As global conditions continued to deteriorate, and China's problems mounted, forcing it to curtail imports further, from the middle of last year (*2014*), Brazil's GDP has plunged into negative territory, aided and abetted by then, by Brazil's growing internal political crisis, regarding corruption at the highest places, and multi-Billon dollar scandals in its largest company, Petroleo Brasileiro SA (*Petrobras*), in which the current Government and the President are heavily implicated. All the political and economic turmoil is driving the economy into deep negative territory.

BRAZIL GDP ANNUAL GROWTH RATE



SOURCE: WWW.TRADINGECONOMICS.COM | INSTITUTO BRASILEIRO DE GEOGRAFIA E ESTATÍSTICA (IBGE)

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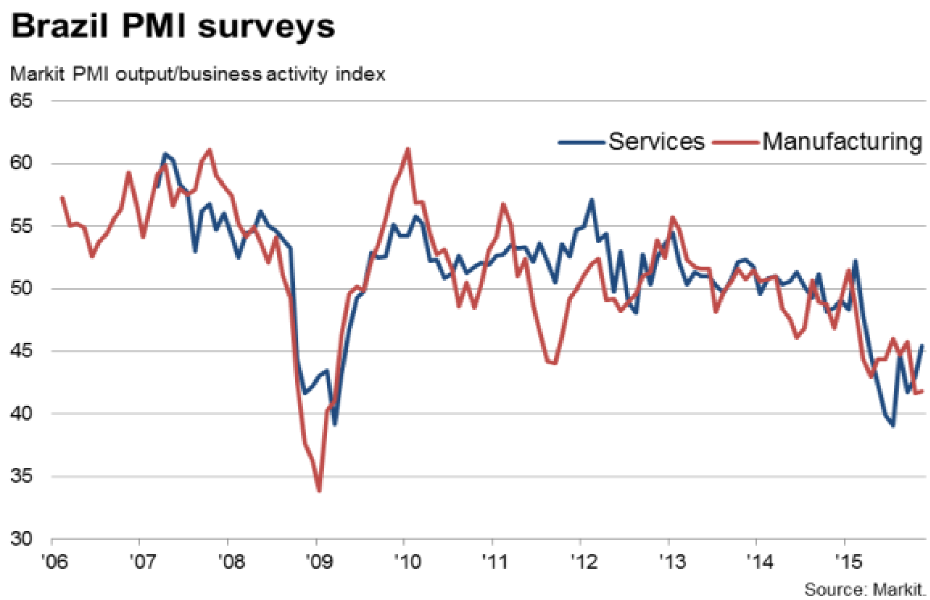
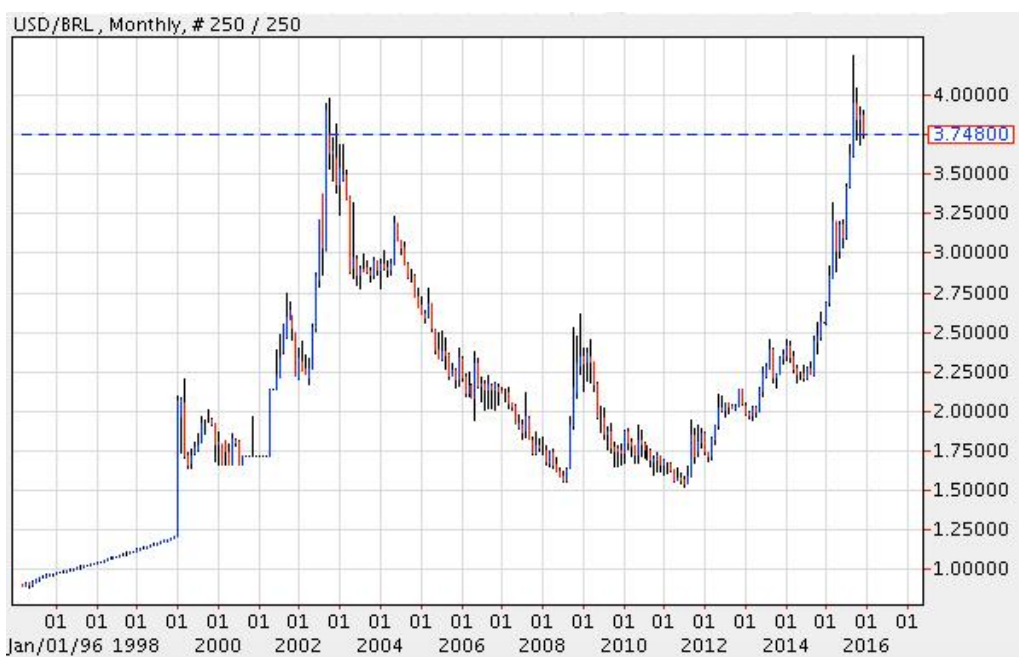
Predictably with the Country in a growing economic and political crisis, manufacturing and services sectors, both, have been in a steady decline, with the drop having quickened in 2015.



As a result of its declining fortunes, the Brazilian currency has been losing significant value against the U.S. dollar. The '*Real*' has lost more than a half its value since 2011, and is back to its weakest point which was in 2002.



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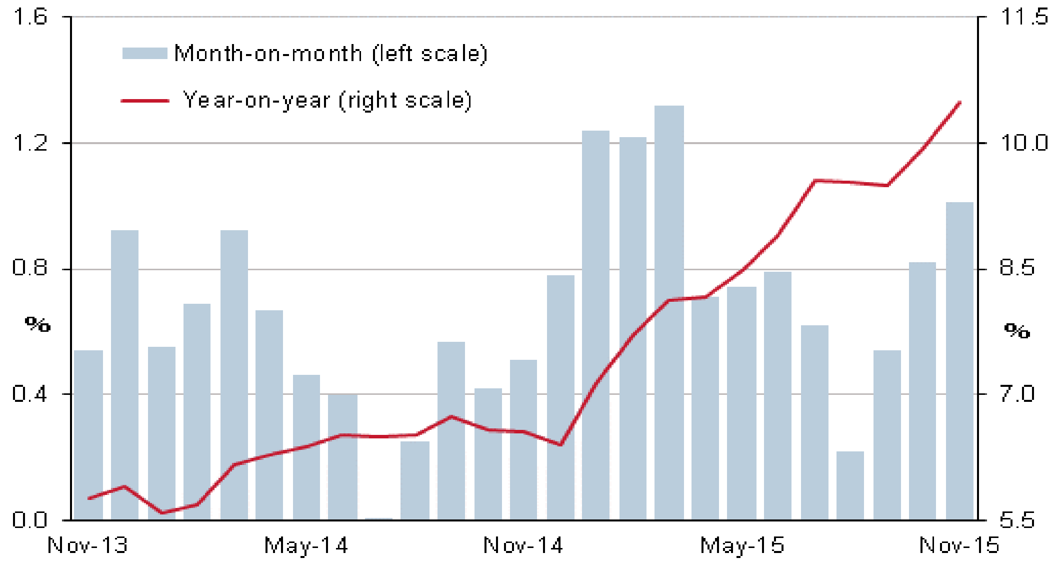
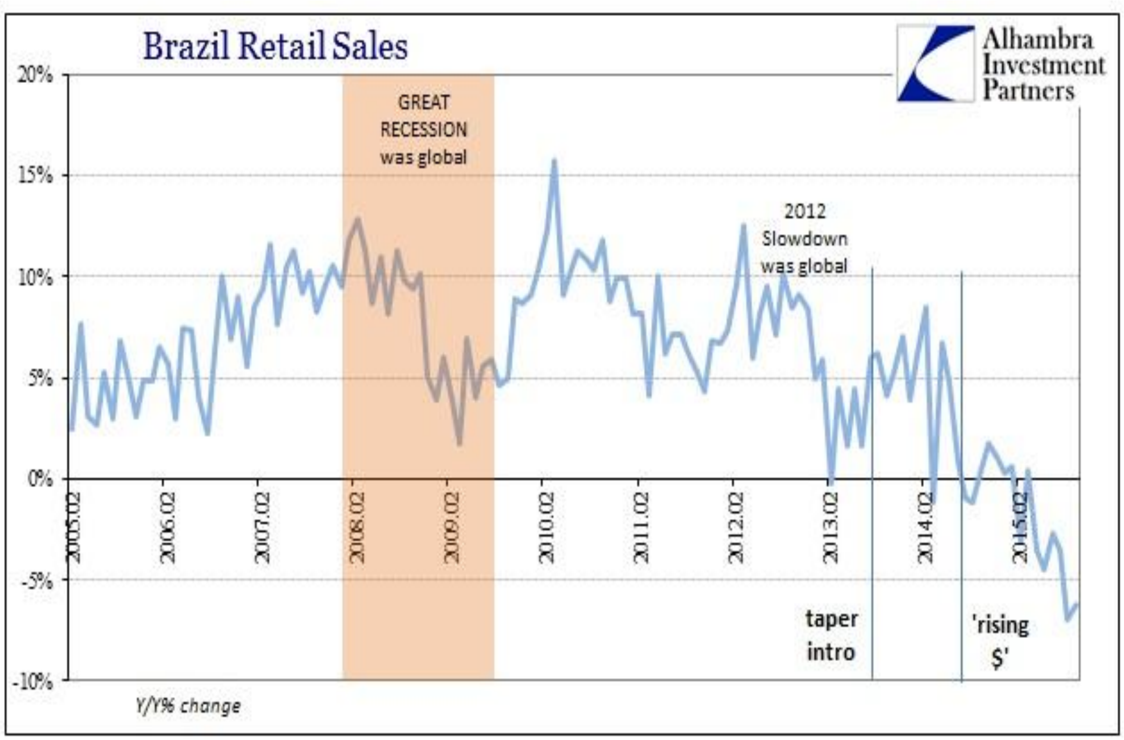
With a weakening currency and deteriorating Government finances, inflation is taking hold and gaining momentum. Inflation is now at above 11% and climbing.



Source: Focuseconomics

With the economy falling steadily since 2010 and prices climbing inexorably, consumers have also been cutting back on personal expenditures, adding to the economy's woes.



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Brazil's large and inefficient public sector, as well as private wages, which have kept rising, has become an additional burden in the era of falling revenues.

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Brazil's foreign reserves have shrunk at an alarming rate, as export revenues continue to drop, and the Government finds itself under siege on a number of economic and financial fronts, including the defense of its falling currency. If Brazil runs out of foreign reserves, it will risk an international default, as it would not be able to pay its international obligations with dollars. To make matters worse, in September of this year, Standard & Poor's cut Brazil's credit rating to junk status, making it much more difficult, and expensive, for the Government to raise money in local and foreign currencies. Brazil had been the proud recipient of an '*investment grade*' rating in 2008, when it was the rising star among emerging economies.

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Exacerbating Brazil's current problems is the fact that it has a large percentage of its population that is very poor, like a lot of emerging economies, which experience great difficulty in taking care of themselves even minimally, and therefore they look to the government for employment, and extensive social services and support. In trying to take care of the basic needs of their populations, such governments enact large programs in areas of employment, health services, education and subsidies for fuel, food and transportation, at times with housing, and of course law and order. With extensive involvement of government, at all levels, comes bloated bureaucracy and really big government, and even larger public sector entities in business, with bloated payrolls and pensions, and poor productivity. It is legend that in most cases of emerging economies they are blighted with very poor governance, and all its byproducts - corruption, crime, legendary inefficiencies, and massive waste. Traditionally, Brazil, like most other emerging economies has been afflicted with it all. Currently, these problems are being magnified because of the global economic wasteland that has been developing since the 2008 crisis.

In the good times, a few years back, when revenues were robust from healthy and rising exports, under President Lula, the Government spread its good fortunes amongst the people by upping wages, benefits and pensions. When those good times ended in 2011, and President Dilma Rousseff took over (*bad timing*), revenues plummeted, and tough times arrived, along with the exposure of massive multi-Billion dollar scandals. Charges of corruption coupled with the inability of government to maintain its largess, and the cut back in jobs and benefits, automatic in a contracting economy, brought on public anger and frustration, massive demonstrations and calls for the President's head. Currently, President Rousseff is under the threat of impeachment.

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To compound the problems, her Government is paralyzed by a lack of support in Parliament for the critically needed reforms and austerity measures, to steady Brazil's worsening financial position. The country is hurtling towards an economic and political '*Armageddon*' as it stands now. Unable to cut back on government expenditures, wages, benefits, and pension commitments made in far better times, Brazil is economically and politically coming apart, just like their men's football team did in their match with Germany in the last World Cup.

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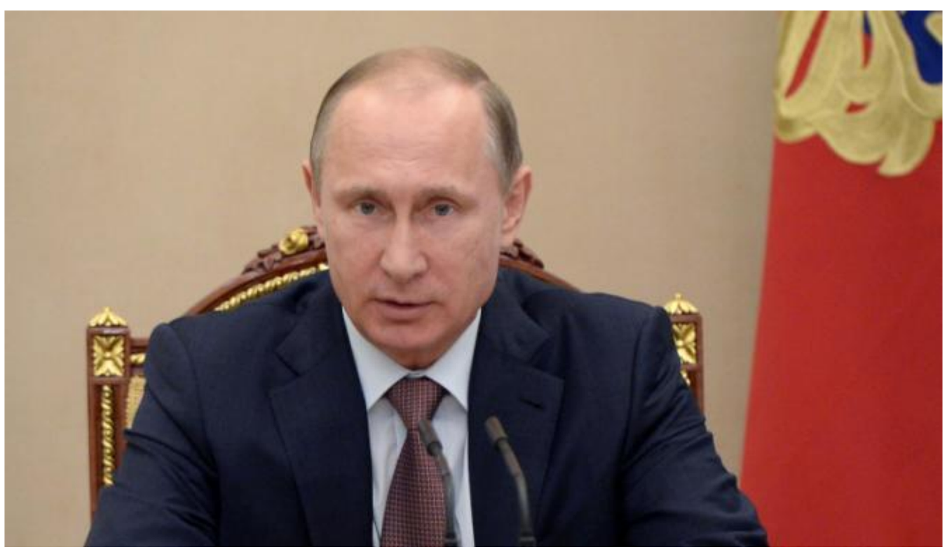
Russia, economically, is in deep winter.

Its current problems started when it decided to annex the Crimea Region of Ukraine in March 2014. Prior to that the Russian economy, although no star performer, was still holding its own after it rebound post the 2008 crisis. But after is annexation of Crimea, it faced the displeasure of the Western countries who decided to punish Russia with economic sanctions. Russia's economy felt their impact almost immediately, and growth started to stall, even though President Putin remained defiant and dismissive of World opinion.



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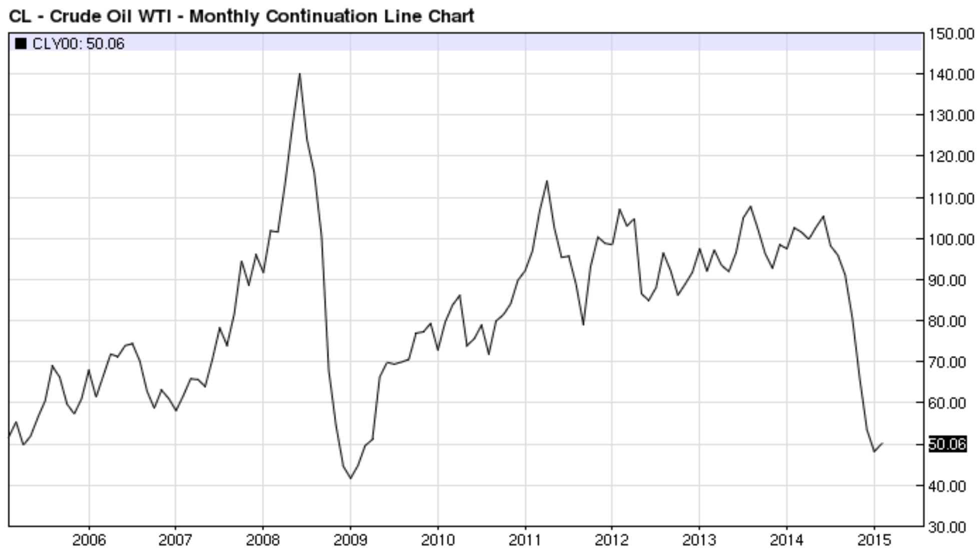
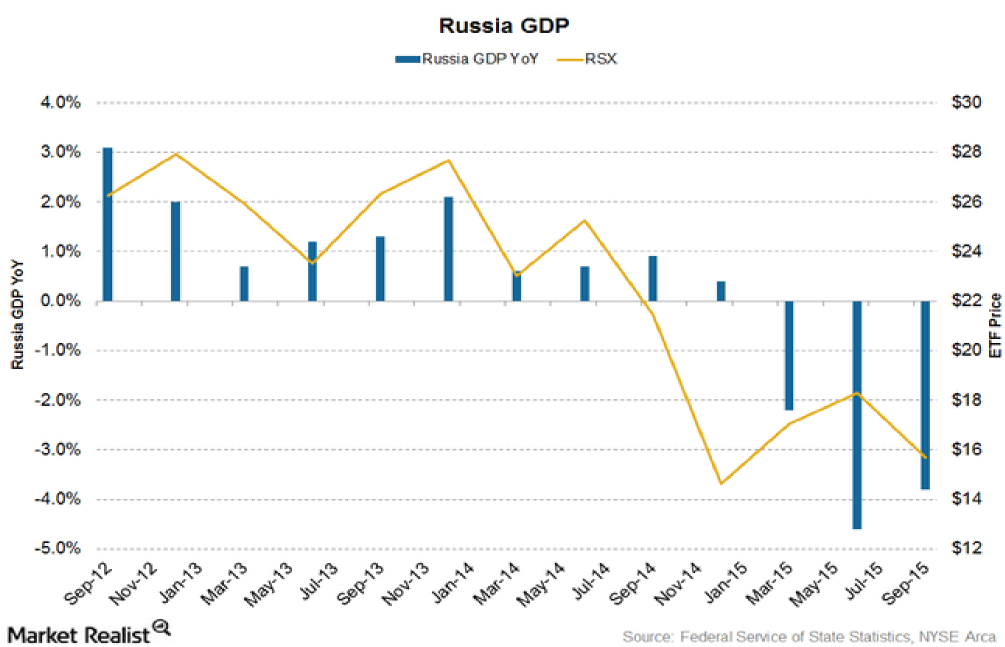
But then, in mid-2014, the World crude oil prices collapsed, and Russia fell with them.



As energy export revenues fell (*exports of oil and natural gas*), Russia's heavily energy dependent economy (*74% of GDP*) took a nose-dive into full blown contraction.



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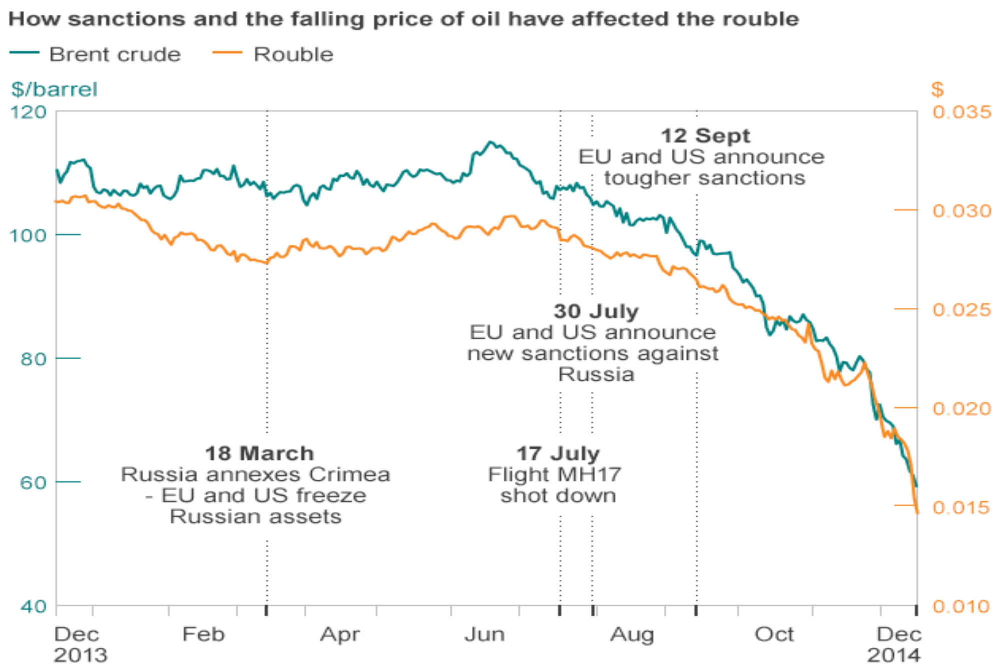
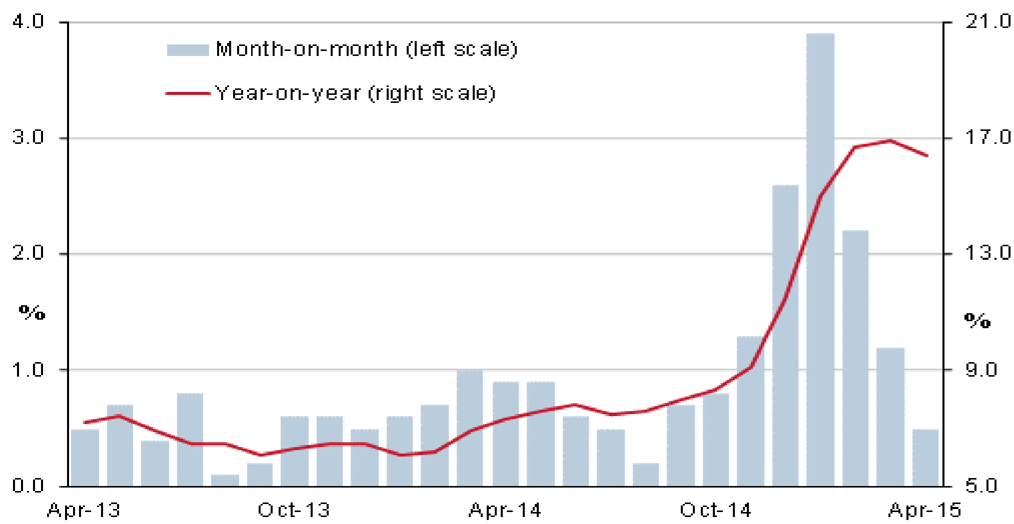
Russia's currency, the '*Ruble*' collapsed, and the Russian Central Bank had to drastically raise its lending rate to 17%, on December 15, 2014, in an era of near zero percent interest rates in the West, to stop the slide. As oil prices have continued to fall, the Ruble has continued its lock-step decent against most major currencies, and is now at approximately 0.142 of the American dollar.



With the material devaluation of the Ruble, high interest rates, falling revenues, slashed jobs, eroded wages, and soaring prices, inflation has soared.



Source: Focuseconomics

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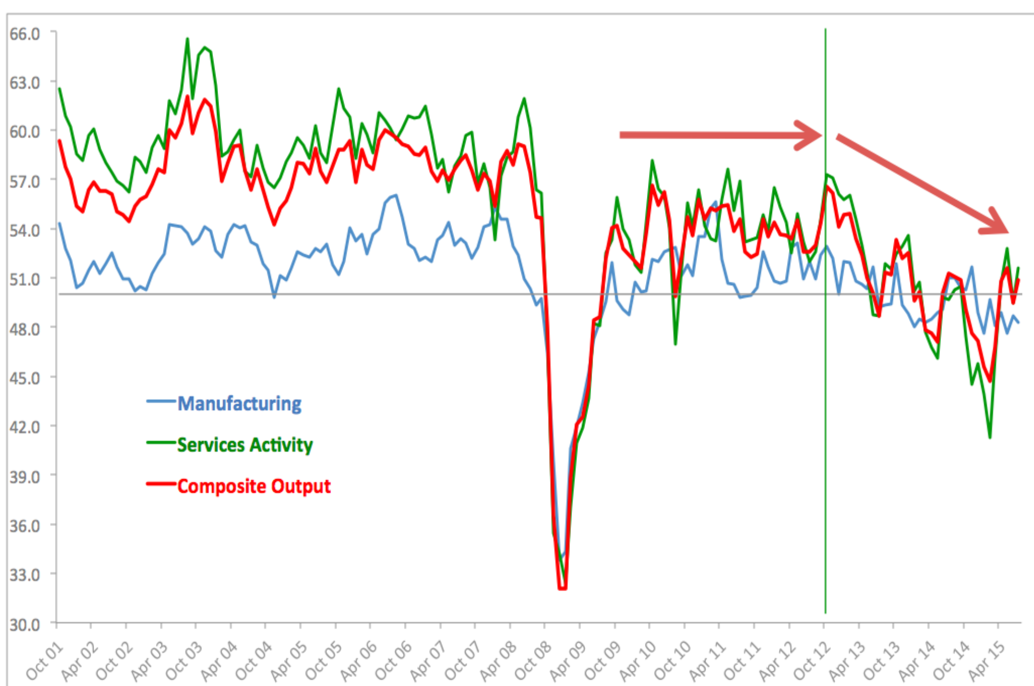
Russia is a natural resource rich country and therefore like all resource exporting countries, is negatively affected by the global commodities slump in demand. In addition to the drop in demand, Russia is further hurt by the economic sanctions imposed by the West, especially by European countries, some of which are its largest energy customers and trading partners.

As the sanctions and the drop in oil prices took hold, manufacturing and services output shrank.



Source:Trueconomics

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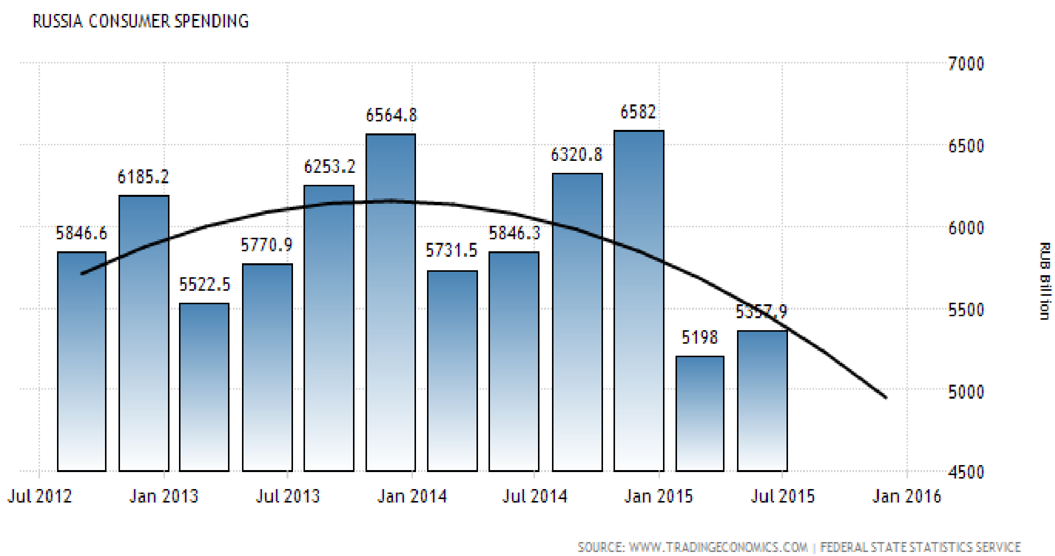
With the economy tanking, the beleaguered Russian consumers had no choice but to curtail their spending dramatically, which in turn put additional pressure on economic growth, which further impacts the consumer. And thus the Russian economy is locked into a downward spiral until, either the sanctions are lifted and some relief is obtained or, and more importantly, the international price of oil rises materially, restoring a major portion of Russia's energy export revenues.



Russia's economy is overwhelmingly weighted in hydrocarbons (*74%*) and therefore very susceptible to energy price drops. Unless global oil prices rise, and stabilize at much higher price levels than where they are currently (*sub $40*), Russia will descend towards a deeper crisis.

Russia has tried to diversify its energy market dependency on Europe and near Europe, such as Turkey, by entering into long term energy and trading deals with China. While those deals have been signed, including agreements to pay in their respective currencies, thereby bypassing the need to pay in U.S. Dollars, the reality of actual, meaningful transactions are still years away, as the massive infrastructure required to transport large quantities of oil and gas from Russia to China are still to be built.

Russia is in a difficult position that gets progressively worse as global oil prices stay low. Its political and economic spats with the West do not help it. But President Putin is determined to win the war against what he perceives as unfair dominance of the United States and the North Atlantic Treaty (*NATO*), of Russia, and its relevance in international affairs. That war he has been handily winning.

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Prime Minister Modi's election in June 2013, generated an almost euphoric glow of optimism and hope within Indians and foreigners alike, based on the premise that finally a strong and experienced leader had come to power that would transform India for the better and unleash its full potential. Unfortunately since then, the speed of change has been far below expectations, and currently there is a sense of tremendous disappointment amongst all except his core supporters.

We think it too early to pronounce the verdict just yet. India is affected by the global slowdown and its industry is struggling in the face of erratic demand internally, and weakening demand externally. Plus, a few years ago, the biggest companies in India took on significant foreign currency denominated debt because of the significantly lower interest rates available outside of India. Now, even though interest rates are still at their lowest, the foreign currencies have appreciated significantly against the Rupee, especially the U.S. dollar, increasing the amount of the debt in Rupees to be paid back.

Additionally, Modi's Government has been hampered in its efforts to pass meaningful reform legislation in key areas, by the lack of control of the Upper House (*just like the blocking of the U.S. President Obama's agenda in the Congress and the Senate by the Republicans*). Elections for the Upper House take place in 2017 and *if* - Modi's Party, the BJP, wins control, then progressive change, at least in the area of economic development, should accelerate. Until then change is coming to India, in most cases for the better, but in smaller and slower increments than had been hoped for by most everyone in and outside of India.

Regardless of the pace of change, and the current challenges due to the

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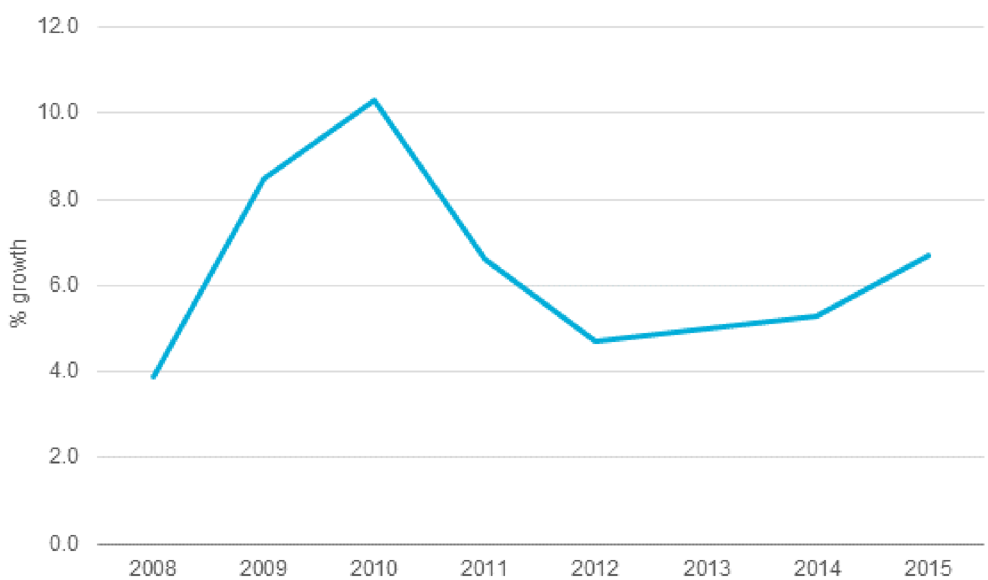
global slowdown, India's fundamentals remain stronger than most economies.

India may not be an economic powerhouse like the U.S., or a powerful speed demon like China, but its economy is also not facing immediate threats from internal excesses of over-stimulation, problematic debt and rampant speculation like both those countries. Instead India is chugging along, as is its wont, modestly but solidly, mostly in the positive economic territory. GDP is estimated by Indian Government, currently, to be well above 7%, making it one of the fastest growing economies, but, more independent sources estimate the number to be more in the range of 5% to 6% (*and we are in this camp*). One thing is certain though, India is growing, albeit modestly compared to former highs, and recent expectations, while others are slowing down significantly.

India's Economic Growth Rate (GDP)



Source: Euromonitor.com

India's economy is now supposed to be growing the fastest, certainly among the BRIC economies, as China continues to slow. For India, it is not the rate of high growth that is particularly necessary, as this generally leads to excesses in the wrong areas; like the current situation in China. What India needs, more than anything else, is better governance to manage its unwieldy size, myriad social problems due to its complexity and diversity, and its lack of basic infrastructure; which China has a lot more of and is therefore light years ahead. But India's one strength has been its internal consumption, approximately 60%; compared to China's 36%, which shields India better from external shocks.

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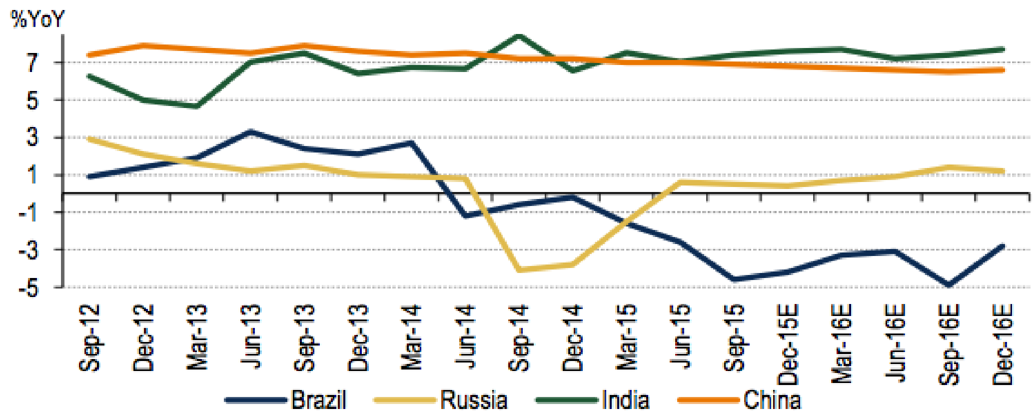
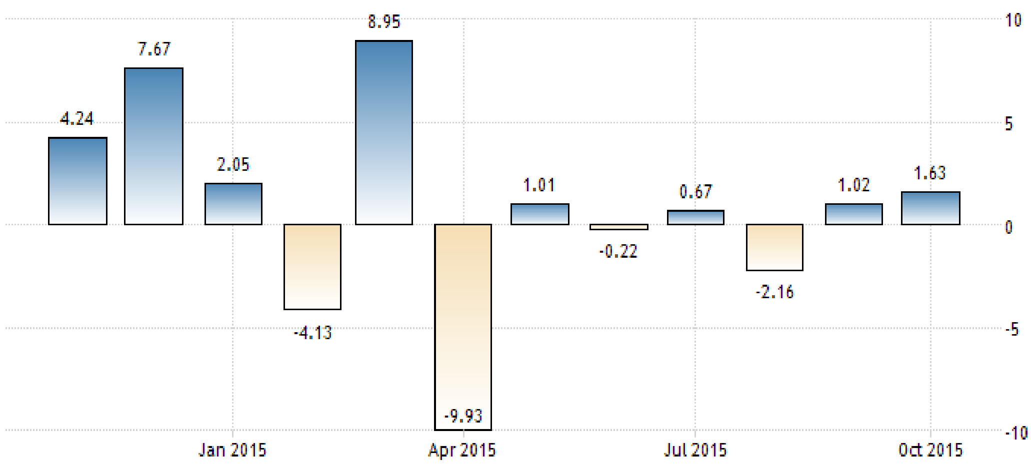
Chart 2: India has emerged as the fastest growing BRIC this year overtaking China



* For India, data is reported on FY basis. 2009 stand for FY2009-10 and so on. Source: BofA Merrill Lynch Global Research estimates.

India's industrial production has been volatile this year reflecting international and internal volatility, and because the Government is struggling to implement pro-business and pro-reform policies that are being blocked by the opposition parties. The lower commodity prices, especially those that are imported, would be very helpful to the Indian industry but the high interest rates and the lower Rupee will to some extent negate that advantage. Plus the general global and national uncertainty will impact the Indian business and consumer, making for a weaker market.

INDIA INDUSTRIAL PRODUCTION MOM



SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF STATISTICS AND PROGRAMME IMPLEMENTATION (MOSPI)

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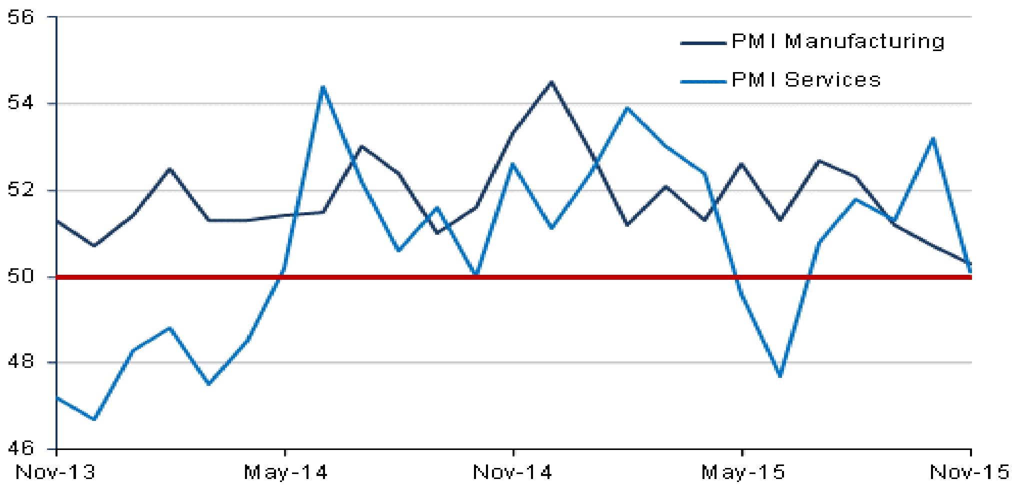
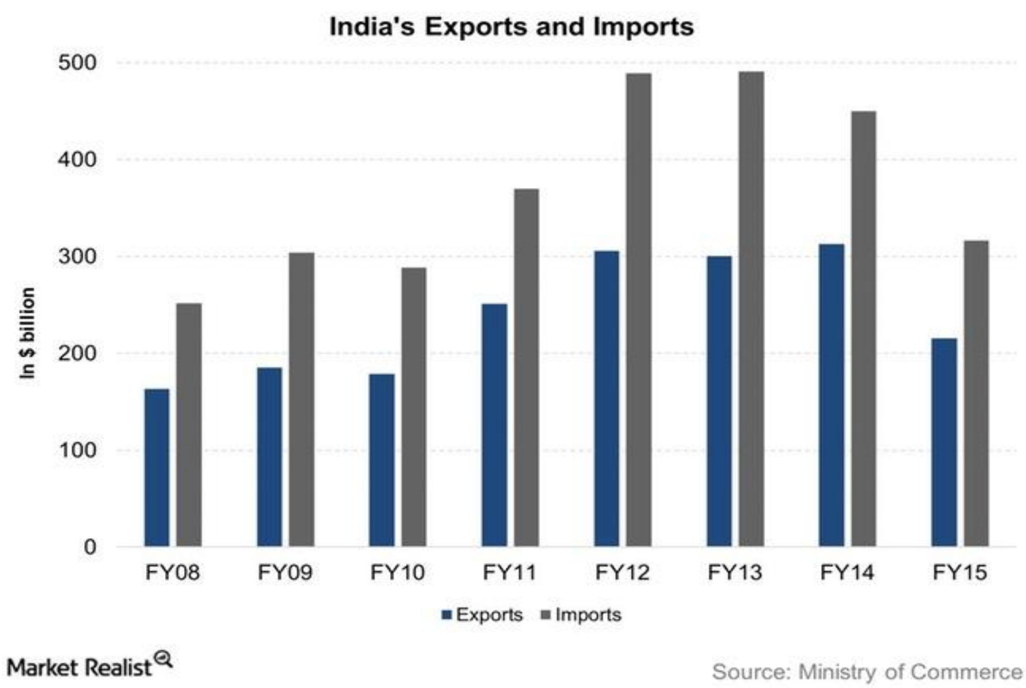
Its Purchase Managers Index has managed to stay mostly in expansion mode from mid-2014, although at the end of 2015 it is reflecting global and internal weakness.



Source: focus-economics

India's imports and exports have been declining since the peak of post 2008 crises years of 2012-2013, albeit the slide is not as dramatic as some of its fellow BRIC economies.



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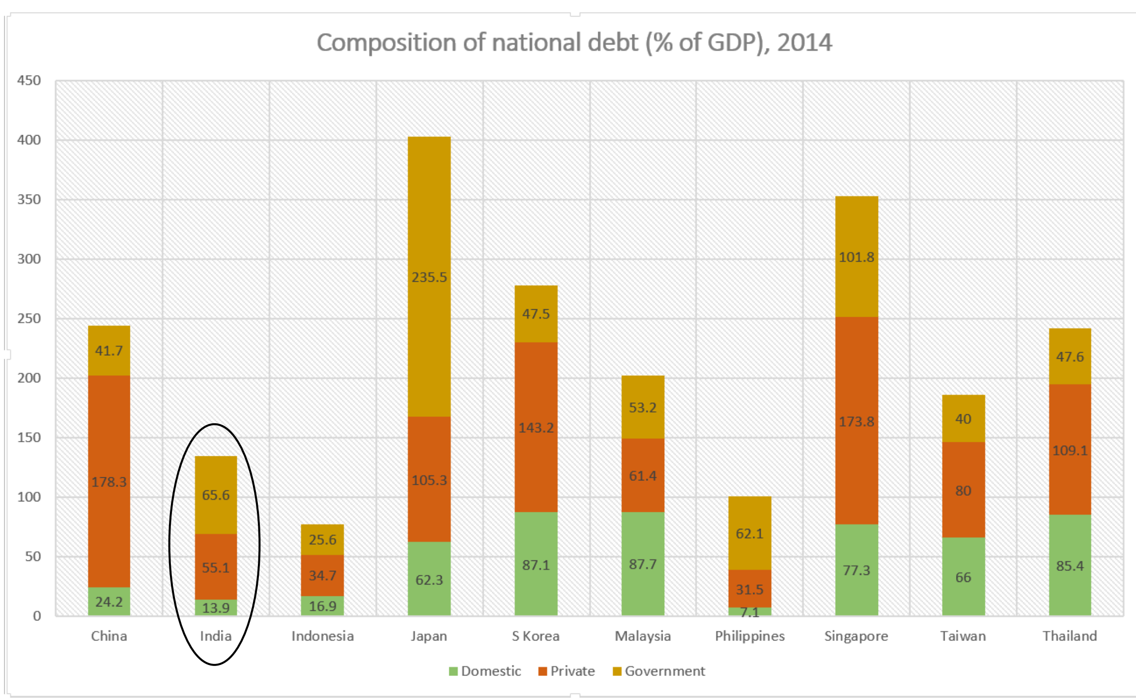
On the more positive side, India's Government debt as a percentage of its economic output has been declining steadily and quite substantially. It is not so much that Indian Governments have been that much more prudent, but that India's GDP growth rate has accelerated more in the recent years, pushing down the debt to GDP ratio. It still leaves India in a better position to handle the present tough times, and any future crisis.

Amongst the Asian economies, and as a percentage of its GDP, India has one of the lower debt levels, particularly as compared to China, whose debt ratio has climbed recently to above 280%, because of the need for emergency stimulation required to stabilize its banking, real estate and recently crashing stock markets.



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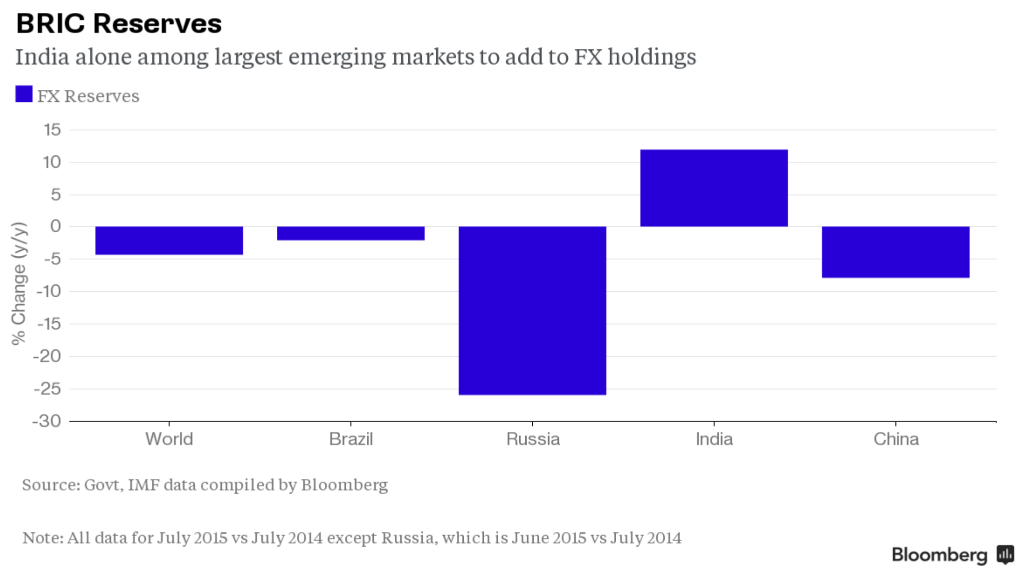
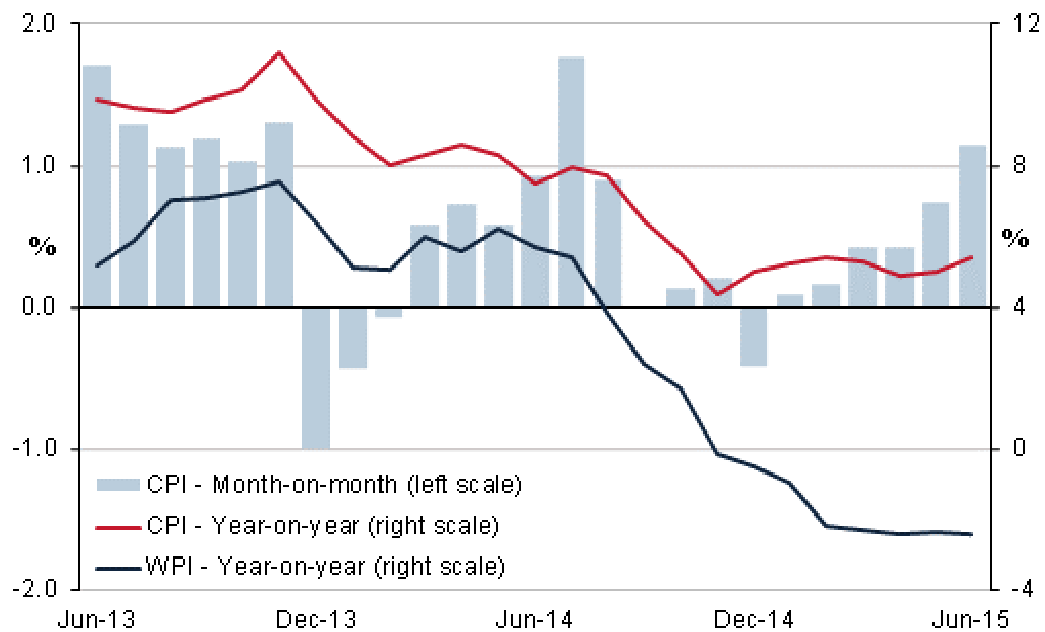
Not having excessive debt, and no particular crisis except stabilizing the Rupee, India alone has been able to continue to add to its Foreign Exchange Reserves.



Inflation, at above 10% had been India's Central Bank's major challenge in the recent years. But the Reserve Bank of India has managed to steadily reduce India's inflation rate to more manageable and less harmful levels. In 2015, the average inflation rate is estimated to be in the range of 5.75%, rising towards the latter part of the year, due to higher food prices. The dramatic drop in commodities, particularly the price of oil, has helped India tremendously as it is a large net importer of energy (*oil, natural gas and coal*) which is its biggest external bill.



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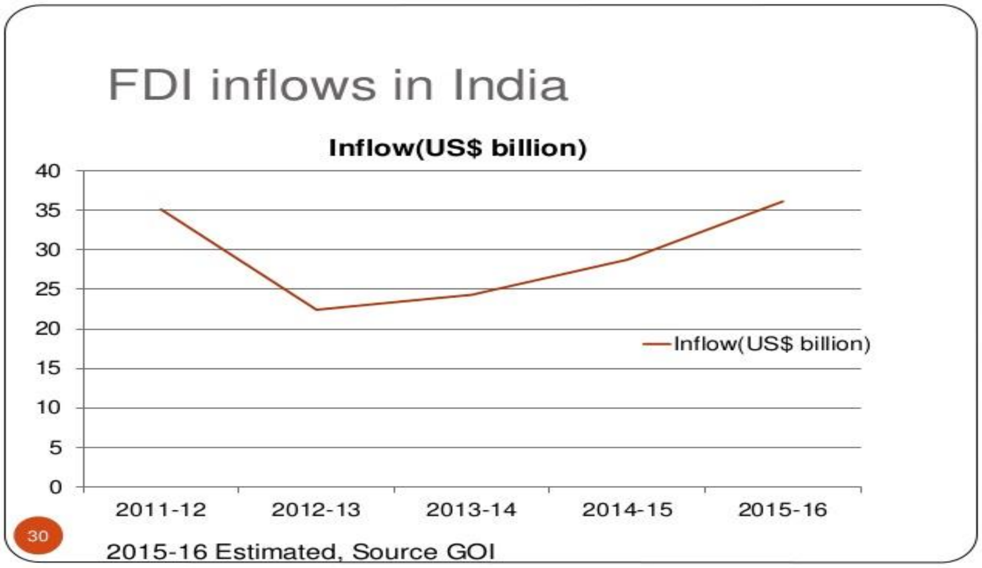
Since Prime Minister Modi's election, June 2013, Foreign Direct Investment into India has climbed steadily, as investors continue to bet on the slow but continuing economic improvement in India. On the large corporate side, for the biggest private and public sector companies, debt and deteriorating business conditions are causing problems, but the small and medium businesses, a large segment, are still very vibrant and good investments.



Source: shareslide.net

India, on the whole, is experiencing the headwinds of the global slowdown. The rising U.S. Dollar (*USD*) and the depreciation in the Rupee have caused USD denominated debt to become a serious problem for the large Indian companies that had binged on cheap credit in the recent years. Many of those companies have been forced to liquidate assets to pay down the heavy debt loads and have thus gone into consolidation mode, curtailing new investments and business expansion.

Additionally, the Government's inability to push through the required reforms in areas such as labour laws, land acquisition for infrastructure projects, public sector inefficiencies in utilities, transportation, health services and education are hampering India's development to become a true economic giant.

The terrible state of affairs in the infrastructure sector, particularly power, is resulting in increasing difficulties in servicing of loan payments, which in turn is adding significantly to the non-performing-loan (*NPL*) portfolios within Indian Banks holding infrastructure financing. The pro-active Reserve Bank of India Governor Raghuram Rajan has taken steps to force Indian Banks to collect on the non performing loans and to bring them under control to reduce the exposure to the banking sector. So far, he has tamed the inflation rate and stabilized the currency. This has allowed India to grow without a particular problem area getting too much out of hand.

Global Economies 2015 – Once More Off-the-Cliff, Dear Friends…IV – BRICs

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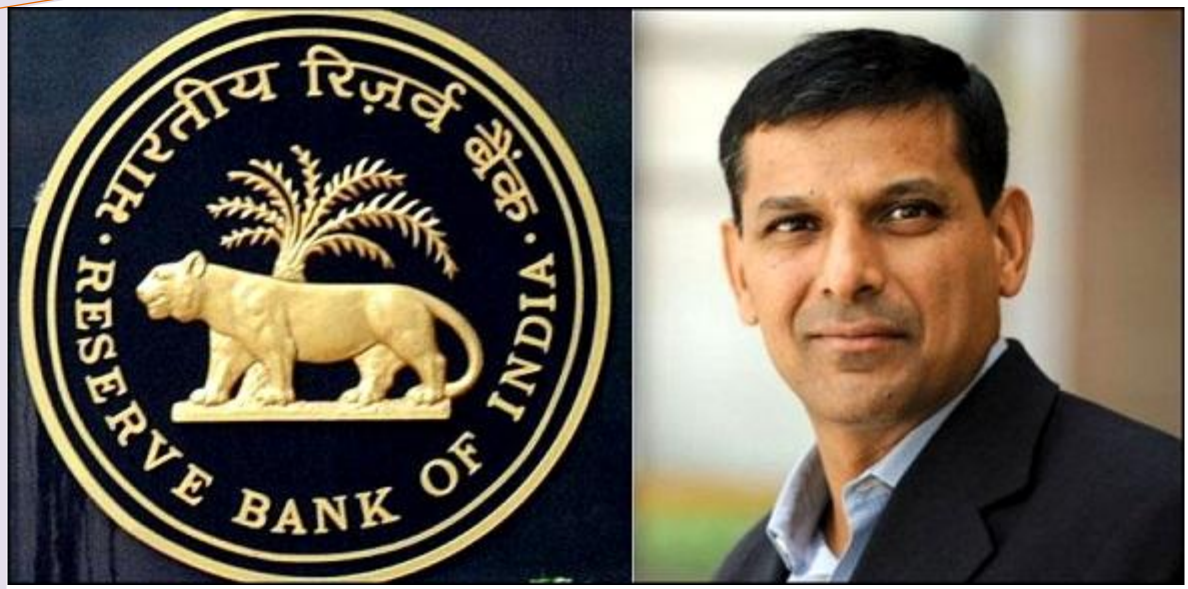

Source: banking. mercenie.com

And that has been India's accomplishment to date, when most of the other major economies in the World are struggling with a crisis or two, India is by and large, crisis free and only dealing with age old problems of corruption, an inefficient public sector, relatively poor governance, resulting in poor infrastructure and services. Having said that, in our view, at the moment, India is in much better shape than its BRIC peers, and therefore somewhat less susceptible to external risks building in the global financial and economic system. We think India will maintain a 4% to 6% growth rate, continue to have fairly strong internal consumption which should allow it to ride out external storms, and its governance and business climate should keep improving, slowly…

To be continued…