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

Is the *B* Really Justified?

JAN KREGEL

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Preface

The term *BRIC* was first coined by Goldman Sachs and refers to the fast-growing developing economies of Brazil, Russia, India, and China—a class of middle-income emerging market economies of relatively large size that are capable of self-sustained expansion. Their combined economies could exceed the combined economies of today's richest countries by 2050. However, there are concerns about how the current financial crisis will affect the BRICs, and Goldman Sachs has questioned whether Brazil should remain within this group.

Senior Scholar Jan Kregel reviews the implications of the global crisis for developing countries, based on the factors driving global trade. He concludes that there is unlikely to be a return to the extremely positive conditions underlying the recent sharp increase in growth and external accounts. The key for developing countries is to transform from export-led to domestic demand-led growth. From this viewpoint, Brazil seems much better placed than the other BRIC countries.

When Brazil had the highest return on equities of any country in the world and the *real* became a large positive-carry currency that translated into higher incomes and growth rates, these features justified the *B* in BRIC. Its strong national development bank and greater financial stability (e.g., its derivatives market is tightly regulated), combined with an increase in the minimum wage, enabled Brazil to generate balanced growth during a global recession. However, the (indirect) impact of exchange rate appreciation and rising asset prices produced conditions that were typical of prior crises.

The factors driving global trade are all linked directly or indirectly to changes in financial regulation and competition in the United States. The evolution of the current financial crisis stems from the U.S. subprime mortgage market and derivatives. The outcome of the crisis will be a decline in returns due to rising capital requirements and a reduction in leverage. Thus, the liquidity machine based on structured investment vehicles, margin positions, and default insurance will not be part of the new financial system. Deleveraging and falling asset prices should not have any bearing on the surety of BRIC banking systems, but the high levels of liquidity have an impact on (higher) commodity prices and the BRIC equity markets.

Although 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 because of structural changes (e.g., a reduction in U.S. households' propensity to consume and the disappearance of leverage from the global financial system), Brazil's financial system has been relatively untouched by the crisis. However, says Kregel, Brazil should not return to a development strategy designed to attract external capital and build on external demand (in spite of temptations to do so in light of domestic demand recovery in China). Rather, the most obvious path is the transition to growth based on domestic income growth and consumption through diversification of markets and production. This path is particularly important in economies where large peasant or agricultural populations and associated income inequalities remain.

Kregel notes that Brazil already has a transition policy in place, along with programs that seek to augment the rate of domestic demand and growth through government-sponsored infrastructure investment projects. He suggests that these programs should be implemented in conjunction with a national job guarantee program in order to mitigate the increase in unemployment, which has been one of the major repercussions of the crisis. In addition, the domestic financial market should transform from a structure providing government financing to one providing long-term capital for domestic productive investment.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
August 2009

The Global Crisis and the Implications for Developing Countries and the BRICs

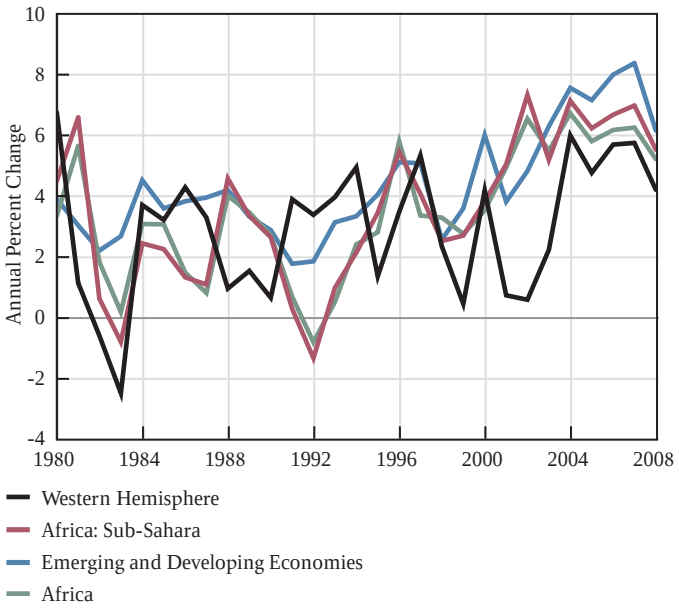
The new millennium has been characterized by exceptionally positive performance for most developing economies. Even excepting India and China, performance in Latin America and Africa has been higher and more sustained than in any period since the postwar "golden age" of late-import substitution (Figure 1). Growth rates continued to increase on a sustained basis after the turn of the century and this was accompanied by a general reduction in consumer prices (Figure 2). 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 (Figure 3). It was these surpluses that fed the increase in foreign exchange reserves that had already been observed in the recovering Asian economies, particularly China. Thus, the answer to the question of 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. One possibility is that structural adjustment policies brought about these improvements, in which case these countries should be relatively immune to the current turmoil in financial markets.

An alternative is to look at the counterpart of these improvements—the change in policy that was introduced in the United States in the 1990s, which led to the massive increase in global trade and imbalances. In simple terms, 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—many firms were forced to outsource production (either in defense or as a result of private equity investor takeovers) and take advantage of lower foreign labor costs linked to the dominance of U.S. technology. This tended to place downward pressure on U.S. wages and employment.

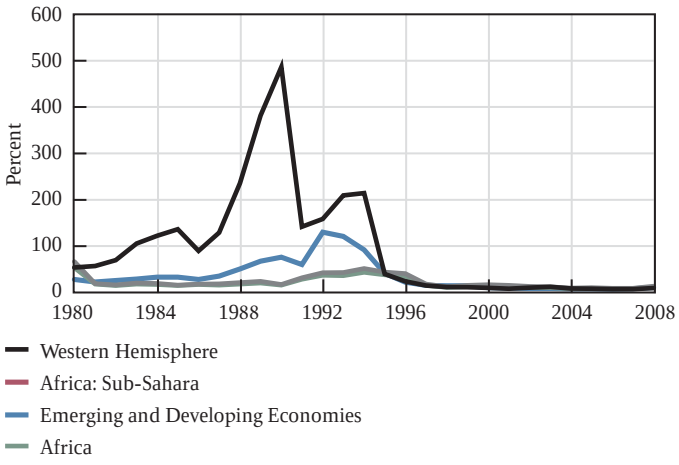
The second factor was the increase in household borrowing as a means of preserving consumption in the presence of falling real wages. This process was in place long before the advent of subprime mortgages but accelerated with the upward impetus on house prices and households' ready access to home equity (the home as ATM). This response created rising demand for the exports of developing countries that were often produced by U.S. companies operating abroad.

Figure 1 GDP Constant Prices, 1980–2008



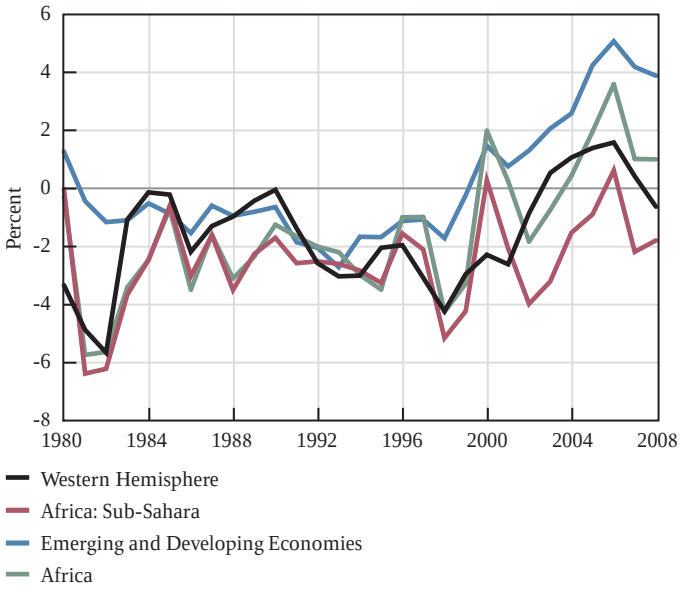
Source: International Monetary Fund (IMF), World Economic Outlook (WEO) Database, April 2009

Figure 2 Annual Rate of Consumer Price Inflation, 1980–2008



Source: IMF, WEO Database, April 2009

Figure 3 Current Account Balance as a Percent of GDP, 1980–2008



Source: IMF, WEO Database, April 2009

The third factor was the creation of the so-called "shadow banking system." In reality, the force at work was the increase in leverage that allowed large increases in international capital flows, leading to current account surpluses that supported exchange rates and increased foreign reserves in many developing countries.

And the fourth factor was the emergence of "real return" investment (return above inflation) that turned primary commodities into an asset class. Commodity investment funds helped to accelerate the increase in commodity prices that had commenced with the rapid growth of some developing countries and government support for biofuels (in response to environmental concerns and climbing petroleum prices). These commodity price increases produced similar increases in the terms of trade, which also reinforced rising incomes in developing countries.

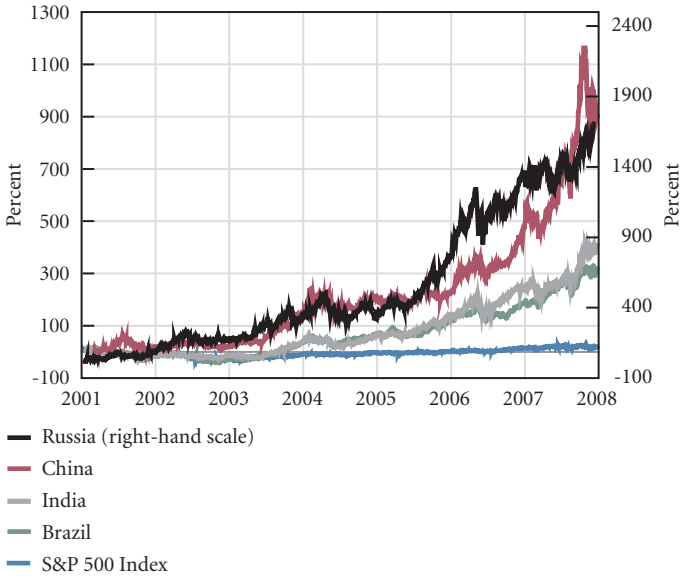
It seems clear that all of these factors were driven by the evolution of financial conditions in the United States. Thus, the evolution of developing countries in the new millennium can be characterized as a "bubble." The counterpart of the financial bubble in the U.S. economy was the extremely beneficial conditions in developing countries and in particular, Latin American emerging markets. If the crisis leads to a permanent elimination of recent 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.

It has become commonplace, however, to distinguish certain emerging market economies from developing economies in general, and to suggest that their behavior will be quite different. The term "emerging market economy" was created by sell-side investment firms and relates to a country's emergence from default and becoming once again a destination of potential investment. Its origin was in the rapid growth and industrialization of Latin American countries after the 1980s debt crisis, which was linked to the Brady bond solution; that is, finding alternative lenders to bail out the banks' syndicated loans. These lenders were institutional and other portfolio investors, and the opening of financial markets accompanied by the privatization of state assets were designed to provide alternative assets for these investors to buy, while Washington Consensus policies provided expectations of above market returns. We now know that the result of this combination produced price stability and slower growth, as well as periodic financial crises that cancelled out most of that growth. 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 also 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 and capable of more or less self-sustained expansion. At their baptism, it was predicted that they would comprise more than 10 percent of global output by 2010, but by the end of 2007, they already accounted for 15 percent of the global economy. The real interest in these countries was not income growth or even per capita income growth, but the performance of their financial markets; particularly, their equity markets. Between January 2001 and October 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 4).

The attempt to include Mexico in this group seems to have been due more to the exigencies of political discussion of governance reform at the fall 2006 Bank-Fund meetings in Singapore than to economic performance.[1] Mexico's annual growth was

Figure 4 U.S. and BRIC Equity Markets, 2001–08 (change in percent)



Sources: Yahoo! Finance; Russian Trading System Stock Exchange

good by recent standards (2.6 percent in the 2001–07 period and 3.9 percent in the 2004–07 period compared to 3.4 and 4.6 percent for Brazil). The political as distinct from the economic reason for inclusion is that Mexico differs from the original BRIC grouping by being a member of the OECD (and thus technically not a developing country) and by not being as large or as self-sufficient (i.e., it is economically dependent on the United States through NAFTA). Indeed, Mexico was included in Goldman Sachs's so-called N-11 group—the "next 11" emerging economies that were expected to catch up with the G-7 but not the BRICs.[2]

Nonetheless, the important point is that all of these numerical arrangements were formed on the wave of the exceptionally rapid recovery from the Asian financial crisis and from the dot-com equity market collapse in developed countries. In particular, Latin America did not experience any major financial crisis in the new millennium. Admittedly, the original formulations were based on a dream that could turn into a nightmare as a result of the global financial crisis and the threat of a global depression. This circumstance raises three questions: How will the BRICs and other emerging market countries be affected by the crisis? What role will they play in responding to the crisis? And, what impact will they have on the institutional changes in the international financial system?

The Impact of the Crisis

It is important to note that the original BRIC grouping was not based on economic similarities. Indeed, the four original countries could not be more different. It is tempting, however, to divide the countries into two subgroups: 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. The first subgroup has guided its exchange rate (more in China than in India), while the second subgroup has more flexible exchange rates. India and China practice development strategies based on domestic industrialization (manufacturing and services) for export, while Brazil and Russia 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 not only formally independent of the private capital market, but it largely supplants this market. It is also important to note that all countries over the last two decades have benefited directly or indirectly from the expansion of the U.S. economy at rates that were above what was once considered sustainable and compatible with price stability, and from international imbalances that were above what was once considered sustainable or supported financially with a stable dollar exchange rate.

It is also important to note that global statistical comparisons are skewed by the weight of China and, to a lesser extent, India. If China and India had matched Brazil's average growth rate over the last 10 years, the catching-up forecasts would not be so impressive. Indeed, 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 (in particular, the freezing of domestic and global liquidity in industrialized countries), followed by deleveraging and a sharp decline in lending to private productive enterprises and consumers, the analysis should start with the BRIC financial

systems. And since the liquidity crisis and the failure of financial institutions led to a U.S. recession that spread to other industrialized economies (e.g., the European Union and Japan), 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 slowdown's effects highlight the fact that exceptional growth in these countries has been due to the influence of globalization on trade and financial conditions. The performance of the BRICs must be considered in a global context, as none of these countries seem to possess the internal engine of growth required to fulfill their "dream" growth scenarios.

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 the high degree of leverage of the financial institutions in industrialized countries. In reality, the difficulty was not so much the extension of the model to low-income borrowers as it was the need for high volumes in order to profit from extremely small rate spreads. This could only be achieved through increased reliance on short-term funding and high levels of leverage, and was especially evident in the shadow banking system. Financial institutions borrowed short to invest in longer-term assets, without the benefit of either FDIC insurance (for the lenders) or access to the Fed's discount window for lender-of-last-resort funding. These institutions have become insolvent, and they, along with the leverage they provided, will not return in the immediate future.

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, which was not recognized until the crisis broke out. In future, these instruments will be under much tighter restrictions and margin requirements as well. Thus, the two basic outcomes of the financial crisis will be the decline in returns due to rising capital requirements, and the reduction in leverage. This process of deleveraging will be accompanied by 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. If the liquidity crisis was the result of reducing the leverage that caused the rise in asset prices, then it is possible to conclude that the recent decline in asset prices is due not to market valuations but to the lack of liquidity that has prevented efficient markets from providing appropriate pricing. Solving the liquidity crisis would allow prices to return to "normal," and strengthening bank balance sheets would allow banks to lend once again.

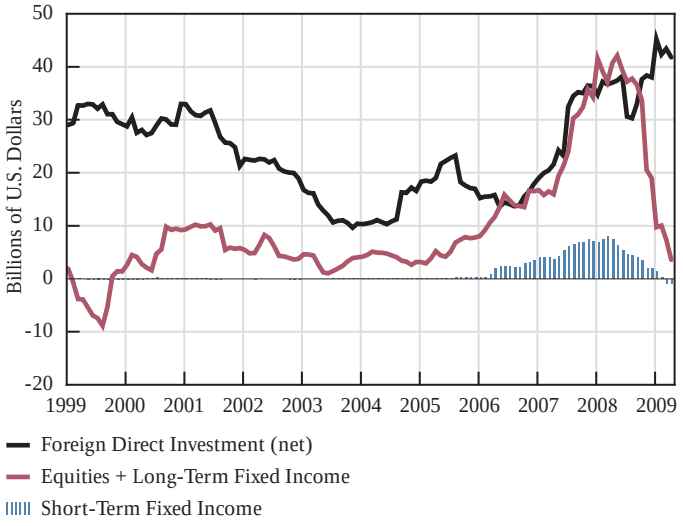
This viewpoint is expressed by Paul Reisz (2009), a product manager at PIMCO, one of the largest fixed-income asset managers in the United States:

> The deleveraging of the shadow banking system has set "pawn shop" prices on many otherwise high-quality securities. This is the result of the liquidity premium that is being demanded by buyers who have the available balance sheet to take on even the high-quality securities that deleveraging investors are forced to sell.
>
> The prices in the market are not indicative of the long-term value of many of the high-quality securities in the market. We could call this the risk premium for a shortage of balance sheet in the market, or a liquidity premium. . . . However, since the Treasury, the Fed and the FDIC (Federal Deposit Insurance Corporation) do not want securities to trade at the pawn shop bid level, they have developed programs intended to support prices, such as the Commercial Paper Funding Facility (CPFF) and the Term Asset-Backed Securities Loan Facility. . . .
>
> The government is substituting its own balance sheet for the missing balance sheet on Wall Street, with the aim of supporting prices on ABS and incrementally nudging the prices up closer to their intrinsic value.

Alternatively, if the assessment is that the liquidity currently provided by government programs will never be supplanted by private sector funding, then deleveraging will result in a permanent decline in asset prices and bank profitability. The problem with asset prices is not that the lack of liquidity is generating pawnshop prices but simply that leverage is generating unrealistically high (carnival) prices, where losses have to be borne by either the government or private financial institutions. In either case, the liquidity machine based on structured investment vehicles, margin positions, and default insurance will not be part of the new financial system.

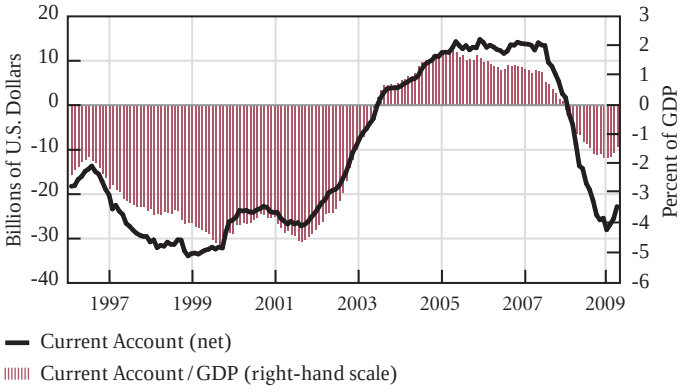
There are thus two basic impacts on the BRICs' financial systems. The first concerns intrinsic value prices. Although financial

Figure 5 Foreign Direct Investment and Company Equity in Brazil, 1999–2009 (in billions of U.S. dollars)



Source: Banco Central do Brasil

Figure 6 Brazil's Current Account Balance, 1996–2009 (in billions of U.S. dollars)



Source: Banco Central do Brasil

Figure 7 Brazilian *Real* Exchange Rate with the U.S. Dollar, 1995–2008

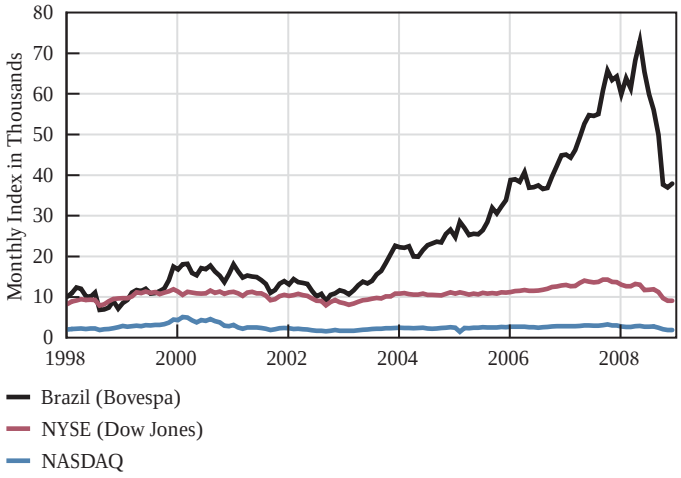
Source: Banco Central do Brasil

institutions had holdings of U.S.-issued asset-backed securities, these were not substantial (Chinese and Indian banks reported losses of less than a billion dollars). Moreover, Russia and Brazil do not appear to have made 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.

However, the high levels of liquidity have had an additional consequence for prices. In particular, it is now generally accepted that the run-up in petroleum and primary commodity prices since 2004 has been driven by proprietary speculative trading by financial institutions in developed countries, as well as by sales of "real return" investments to institutional investors as hedges against inflation. Commodity investments became an asset class and entered investment funds, but given the difficulty of storage, positions were determined by purchasing futures contracts. It is not surprising that, once deleveraging started, prices in these markets quickly collapsed.

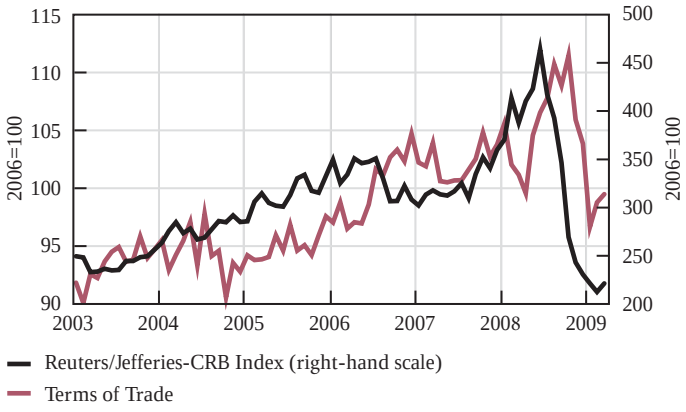
High liquidity levels, coupled with the Federal Reserve's decision to push interest rates to historic lows (in response to the collapse of the dot-com equity bubble and the political turmoil that followed 9/11), led to a secondary impact, as capital flowed to BRIC equity markets—realizing Goldman Sachs's goal to generate intermediation profits. For several years, Brazil had the highest total return on equities of any country in the world. In addition to rising petroleum prices, the shift to biofuels, and higher food and commodity prices, there were massive capital inflows that Brazil's central bank was unwilling to offset, producing 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[3] (Figure 5). The combination of these factors produced a rising current account surplus (Figure 6) in the presence of *real* exchange rate appreciation (Figure 7), ris-

Figure 8 Equity Markets in the United States and Brazil, 1998–2008



Source: Banco Central do Brasil

Figure 9 Terms of Trade and CRB Index, 2003–09

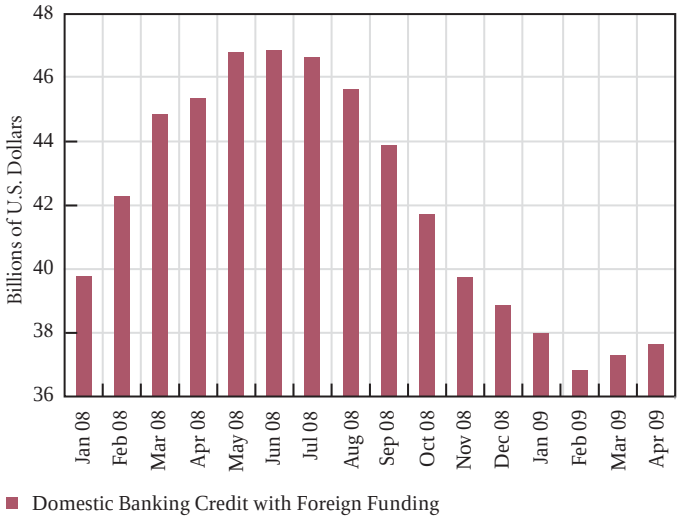


Sources: Banco Central do Brasil; Jefferies

ing asset prices (Figure 8), and improvements in the terms of trade (Figure 9) that translated into higher incomes and growth rates. It was 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. In addition, many banks that had profited from the 1999 exchange rate crisis by using derivatives to speculate against the *real* now reversed their strategy, in the belief that the trend in capital flows and

Figure 10 Brazil's Domestic Banking Credit with Foreign Funding, 2008–09 (in billions of U.S. dollars)

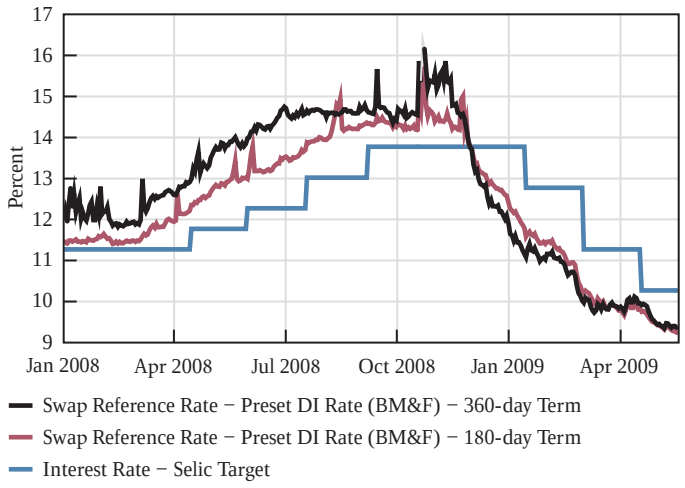


Source: Banco Central do Brasil

external balances would continue, leading to sustained strength in the currency.[4] Of course, 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 R$49–74 billion.

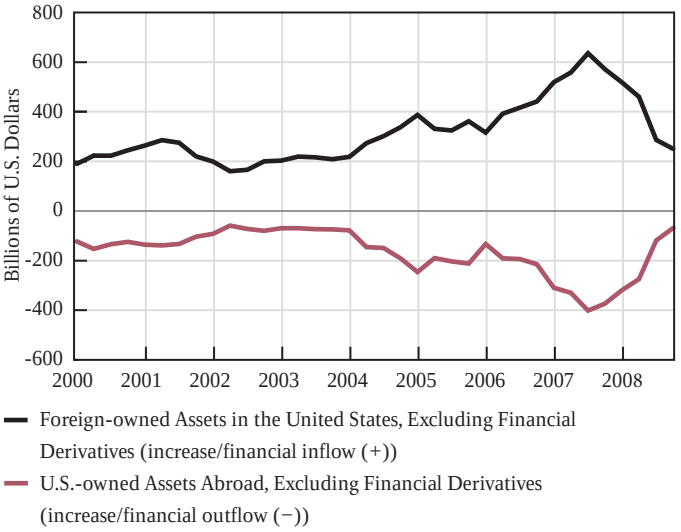
Heavy losses on currency derivatives have been reported by Sadia, a food processor; Votorantim, an industrial conglomerate; and Aracruz, one of the world's biggest pulp and paper manufacturers, among other firms. The possibility that hundreds of companies may wish to renegotiate their exposure to derivatives with issuing banks prompted the Brazilian legislature, in October 2008, to enact MP443, a provisional measure that allowed government-controlled Banco do Brasil and Caixa Econômica Federal (CEF) to acquire the capital of private financial institutions. The measure also created an investment bank under CEF to acquire capital in sectors other than the financial sector (e.g., the construction industry). It also authorized 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 10). In February 2009, Banco Itaú merged with Unibanco in order to protect itself from impending losses on derivatives contracts written to corporate clients. Moreover, Votorantim acquired Aracruz (thus meeting the latter's derivative losses), while Banco do Brasil acquired a 50 percent stake in Banco

Figure 11 Interest Rate and Swap Reference Rates, Brazil, 2008–09 (in percent)



Source: Banco Central do Brasil

Figure 12 Reversal of Financial Globalization? Repatriation of U.S. Capital (4-quarter moving average), 2000–08 (in billions of U.S. dollars)



Source: Bureau of Economc Analysis

Votorantim and a roughly 75 percent share of Banco Nossa Caixa. 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 Brazilian 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. Interest rate differentials made short dollar positions attractive. These positions were pursued largely through derivative positions for the banks' own books and to accommodate corporate clients—activities that were not sufficient to threaten the stability of the financial system because a number of preventive merger actions were undertaken to ensure a measure of stability.

One reason for Brazil's greater financial stability is undoubtedly the rigorous regulation of its derivatives market. However, the argument that this was primarily due to the prudent management of bank balance sheets seems to overstate the case. The main incentive for the development of securitized lending and the sale of securitized asset-backed securities in the industrialized financial markets was the low profitability of commercial banking relative to investment banking and the search for yield by investors facing extremely low or negative domestic rates.

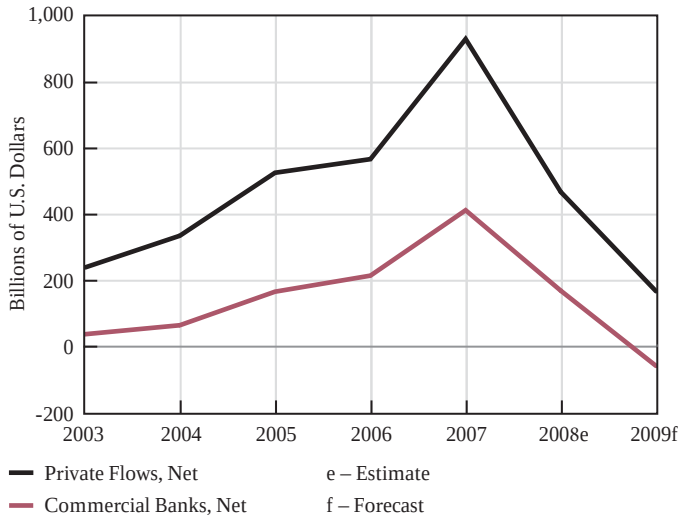
Table 1 Bank Return on Equity (in percent)

	2003	2004	2005	2006	2007	2008	Latest
Brazil	21.1	22.1	29.5	27.3	28.9	20.4	October
Russia	17.8	20.3	24.2	26.3	22.7	12.1	September
China	—	13.7	15.1	14.8	19.9	—	June
India	18.8	20.8	13.3	12.7	13.2	12.5	March
Japan	–2.7	4.1	11.3	8.5	6.1	3.0	September
United States	15.0	13.2	12.7	12.3	7.8	3.3	September

Source: IMF, Global Financial Stability Report, April 2009, Table 27

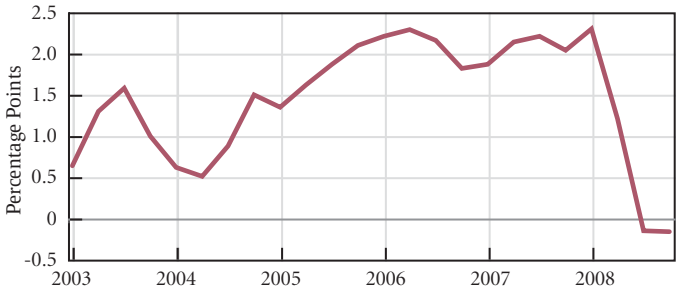
The interest rate policies of Brazil's central bank and their impact on government financing (even in surplus conditions) meant that Brazilian banks had no need to increase risks for higher yields (Figure 11). Higher returns at minimal risk were available through government securities, so there was little 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 (Table 1). In addition, these dollar-denominated structured investments were increasingly risky given the trajectory of the

Figure 13 External Financing of Emerging Market Economies, 2003–09 (in billions of U.S. dollars)



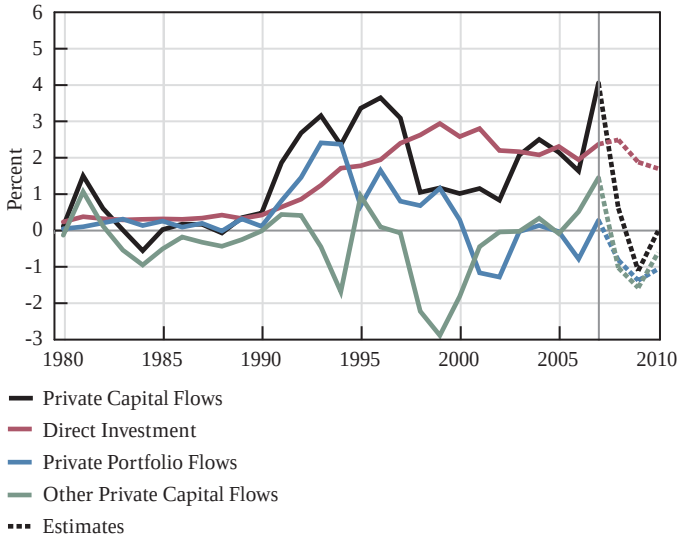
Source: The Institute of International Finance, Inc.

Figure 14 BIS Reporting Countries: Cross-border Assets as a Proportion of Total Assets, 2003–08 (annual change in percentage points)



Source: IMF, Global Financial Stability Report, April 2009

Figure 15 Emerging Market Net Private Capital Flows, 1980–2010 (in percent of GDP)



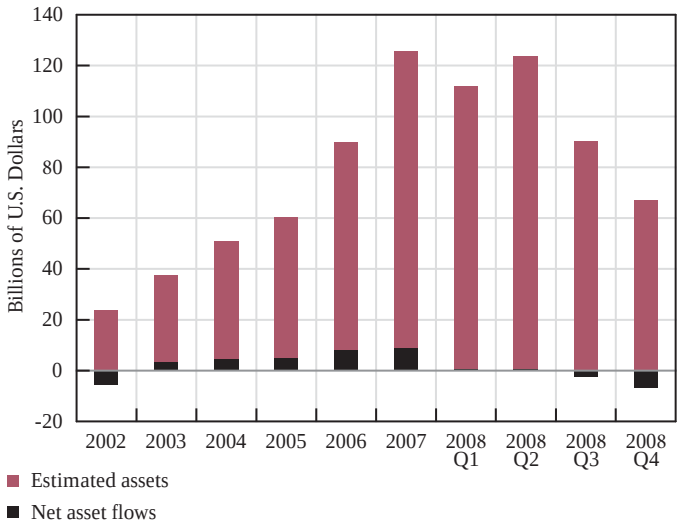
Source: IMF, WEO Database, April 2009

exchange rate. Nonetheless, banks and corporations saw little difficulty in running exchange rate risks through derivatives contracts and (inappropriate) hedging vehicles.

The creation of global liquidity was more important than the impact of U.S. financial expansion on asset prices. The improvement in Brazil's exchange rate was due largely to sharply increased foreign direct investment flows that were reinforced by short-term carry trade speculation and the attractiveness of Brazilian equities. As noted above, most of the (fatal) attraction for capital inflows was driven by the leverage created in the U.S. financial system. Even the (positive) effect on commodity prices, presumed to be a result of rising consumption in China, was in the end financed by consumer borrowing related to the U.S. housing boom.

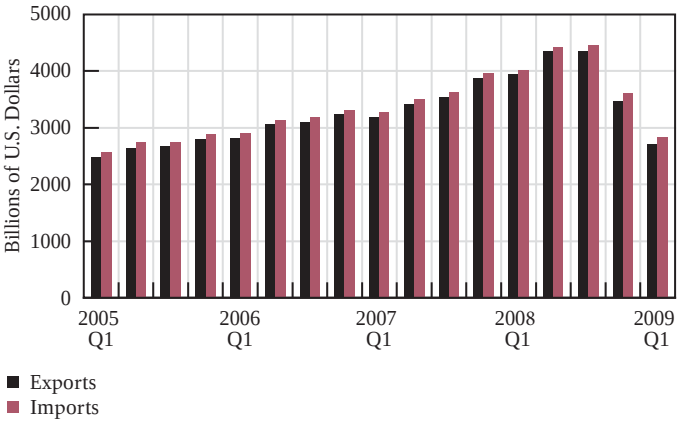
The reversal of this process through deleveraging not only let all the air out of the asset and commodity bubbles but also required U.S. financial institutions to repatriate capital to cover losses and close positions (Figures 12–16). European banks that had used cheap dollar borrowing to finance high-yield mortgage-backed assets faced a similar problem. 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 (Figures 17 and 18). 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. Thus, virtually all of Brazil's positive performance in meeting membership in the BRICs appears to be linked to a financial model and financial flows that are unlikely to be reestablished. As outlined earlier, increased leverage that was considered normal in the operation of the financial institutions of developed countries will not return, as leverage generated by derivatives will be held in check by much stronger margin requirements. This means not only

Figure 16 Emerging Market Hedge Funds: Estimated Assets and Net Asset Flows, 2002–08 (in billions of U.S. dollars)



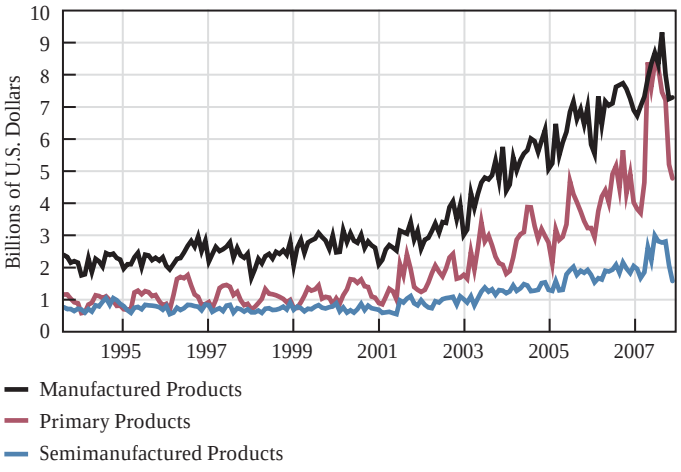
Source: IMF, Global Financial Stability Report, April 2009

Figure 17 World Exports and Imports, 2005–09 (in billions of U.S. dollars)



Source: World Trade Organization Secretariat

Figure 18 Brazilian Exports, 1994–2008 (in billions of U.S. dollars)



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

lower asset prices but also lower global demand for emerging market exports and reduced financial flows to emerging markets, including the BRICs.

The Response to the Crisis

Of the two possible responses to the crisis, one involves an attempt to restore the status quo, while the other recognizes that the status quo is not an option in light of the likely structural changes in developed financial markets. The former response requires little more than a survival policy—waiting until prices return to intrinsic values so that the U.S. government can withdraw its balance sheet support and return management of the financial system to market forces. Brazil and the other BRIC countries seem well placed to respond in this way, given that their financial systems have been relatively untouched by the crisis and have maintained high levels of foreign reserves to cover temporary external deficits caused by the decline in global trade. Indeed, mergers may have strengthened the ability of the Brazilian banking system to mitigate the crisis. Moreover, reserves of approximately $200 billion, plus Federal Reserve swap lines and IMF support, are certainly sufficient to allow recovery within six to 12 months. This timeframe fits the scenario of those who are predicting recovery by the end of the year.

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. There is a general similarity across BRIC economies, since they all depend on expanding demand by increasing global trade and maintaining global imbalances financed by global financial flows. In this context, China retains greater autonomy when com-

pared to other BRIC countries (given its size and the permanence of its foreign exchange reserve position). Indeed, if China decides to offset the decline in global demand by increasing its domestic expansion, and to follow through with its policy to diversify its reserve holdings (by increasing its stockpiles of natural resources), it may become the source of Brazil's external demand. There are signs of domestic demand recovery in China, which will drive the demand for primary materials, and there is clear evidence that China's central bank has chosen to diversify its reserve holdings by expanding into natural resources. However, it is unlikely that China can provide internal stimulus sufficient to replace U.S. demand on a global scale. Moreover, its reserve diversification process will impact commodity prices and stimulate inflation, which might influence central banks to reduce their stimulus packages and increase interest rates before the global economy begins to recover.

Because of China's possible influence on the global economy, it is tempting to return to the Brazilian development strategy of the 1990s and early this century, when policies were designed to attract external capital and build on external demand. However, if there were a change in the shape of globalization and the structure of global demand, policy based on this strategy would be a mistake. This temptation is also reinforced by the return of external capital inflows, but these inflows have been driven primarily by the U.S. investment banking sector's expectation of a return to previous growth rates and the resumption of the carry trade in emerging markets:

> Last month, the carry trade roared back, with ABN Amro's index gaining 4.6 percent, its best month since September 2003. As of today, the Dollar Index had fallen about 5.4 percent from its March 4 high.
>
> An equally weighted basket of currencies consisting of Turkish lira, Brazilian real, Hungarian forint, Indonesian rupiah, South African rand and Australian and New Zealand dollars—bought with yen, dollars and euros—earned an annualized 196 percent from March 2 to April 10. That trade produced a 41 percent annualized loss from September, when Lehman collapsed, through February.
>
> Benchmark rates in those seven economies range from 3 percent in New Zealand and Australia to Brazil's 11.25 percent. Comparable rates in the euro region, Japan and the U.S. are 1.25, 0.1 and between zero and 0.25 percent, respectively. (Cutler and Nielsen 2009)

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 an increasingly voiced opinion that it is not possible for an economy to develop on the basis of external savings.[5] Rather, all development depends on the mobilization of domestic resources and the direction of domestic policy to fully utilize domestic resources.

Thus, the most obvious path (and the continuing dilemma facing countries that have adopted a development strategy based on external demand) is the transition to growth based on domestic income growth and consumption through diversification of markets and production. Indeed, the shift from an economy dependent on exports to an economy led by domestic demand has been a highly elusive goal. Japan has never been able to achieve this goal, and has suffered from stagnant growth since 1999. This option does not apply to Brazil, since its per capita income level and (higher) population growth do not compare with Japan's. The same situation applies to the other BRIC economies. Thus, 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.

In a country known for corruption and an inefficient bureaucracy, one must question whether these programs sufficiently address the root causes of the social problems that they were intended to tackle. It also remains to be seen whether these programs will generate lasting social change beyond President Lula da Silva's time in office or the current economic boom. The

PPA was based on generating domestic demand with government support by reducing income inequality and creating demand for products produced by domestic industry. It 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. One of the major repercussions of the crisis is the increase in unemployment, compounding the long-term deficiency of employment in Brazil. 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.[6] The Brazilian program might also reduce the pressure on land redistribution, as the majority of those making up the Sem Terra ("without land") group are reportedly urban industrial workers who have given up looking for employment and are seeking farmland from which to make a subsistence living.

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, economic policy was designed to allow Brazil to benefit from U.S. demand-led and Chinese-financed growth. If that global growth structure is unlikely to be restored, then domestic policy should be made compatible with this new global structure. The most important attraction would be the ability to grow domestically without external demand and foreign financing, and within the bounds of international trade agreements. This would be possible by 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 that invests in government securities 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. While Brazil is especially well placed to implement a viable transition strategy, there will be renewed pressure on primary commodity supplies, energy prices, and environmental issues if all emerging market developing countries make the same transition successfully. Thus, domestic demand-led policies must also pay attention to food and environmental issues that have a disproportionate effect on price stability and incomes in the poorest countries.

Notes

1. "This weekend, Mexico will be included in the BRIMCS Group, comprising the six most important emerging nations in the global economy that will complement the decisions of the Group of Seven (G7) in which the United States, Germany, France, Italy, Japan, the United Kingdom and Canada participate. The six BRIMCS countries (Brazil, Russia, India, Mexico, China and South Africa) together account for nearly a third of global production and nearly 50 percent of the world´s inhabitants. . . . The extended talks will not only concern the way multilateral trade talks can be reestablished after the failure of the Doha talks but also involve multilateral coordination mechanisms for reducing global imbalances, supporting the medium/term reform of the International Monetary Fund (IMF) and restructuring the governing bodies of both the IMF and the World Bank (WB)" (http://fox.presidencia.gob.mx/en/goodnews/?contenido=27161&pagina=2).
2. The developing-country political grouping with a potentially greater impact on the global economy is the trilateral IBSA (India, Brazil, and South Africa), which aims to increase South-South cooperation. See www.ibsa-trilateral.org.
3. According to Cutler and Nielsen (2009), this position has been maintained through 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 rate 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.'"

4. Instead of using futures contracts to speculate on a depreciation after the 1998 election, banks took positions to profit from the continued strength of the currency based on forecasts that predicted a return to parity with the dollar and by writing out-of-the-money call options on the dollar, writing target-forward contracts for corporate clients, and arranging low-interest-rate dollar lending.
5. 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.
6. In this respect, an increase in the supply of jobs might reduce the pressure in the countryside, as it is reported that a large proportion of the supporters of the Sem Terra movement are unemployed urban workers who see agricultural employment as the only possibility to attain a decent living. See www.desmpregozero.org.br. For more general information on job guarantee programs employed in other economies, see www.economistsforfullemployment.org.

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About the Author

JAN KREGEL is a Levy Institute senior scholar working primarily within the Monetary Policy and Financial Structure program, and currently holds the position of Distinguished Research Professor at the Center for Full Employment and Price Stability, University of Missouri–Kansas City. He was formerly chief of the Policy Analysis and Development Branch of the United Nations Financing for Development Office and deputy secretary of the U.N. Committee of Experts on International Cooperation in Tax Matters. Before joining the U.N., Kregel was professor of economics at the Università degli Studi di Bologna, as well as professor of international economics at Johns Hopkins University's Paul Nitze School of Advanced International Studies, where he also served as associate director of its Bologna Center from 1987 to 1990. He has published extensively, contributing over 160 articles to edited volumes and scholarly journals, including the *Economic Journal*, *American Economic Review*, *Journal of Economic Literature*, *Journal of Post Keynesian Economics*, *Economie Appliquée*, *and Giornale degli Economisti*. His major works include a series of books on economic theory, among them, *Rate of Profit, Distribution and Growth: Two Views*, 1971; *The Theory of Economic Growth, 1972*; *Theory of Capital*, 1976; and *Origini e sviluppo dei mercati finanziari*, 1996. His most recent book is *International Finance and Development* (with J. A. Ocampo and S. Griffith-Jones), 2006.

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.), an elected member of the Società Italiana degli Economisti, and a distinguished member of the Asociacion Nacional de Economistas de Cuba.