

What has gone wrong with Brazil, India and China?

EDITION 27 – 16 AUGUST 2012

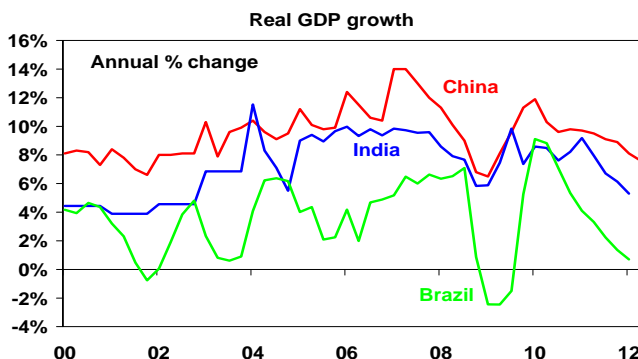


Key points

- > Brazil, India and China have slowed sharply on the back of weakness in advanced countries, the lagged effect of past monetary tightening and structural constraints.
- > While their long term growth potential has been reduced a bit, emerging countries still offer better long term growth prospects than Europe, the US and Japan given a lack of major debt problems & lots of catch up potential. Given very low valuations, emerging market shares continue to offer value & growth for long term investors.

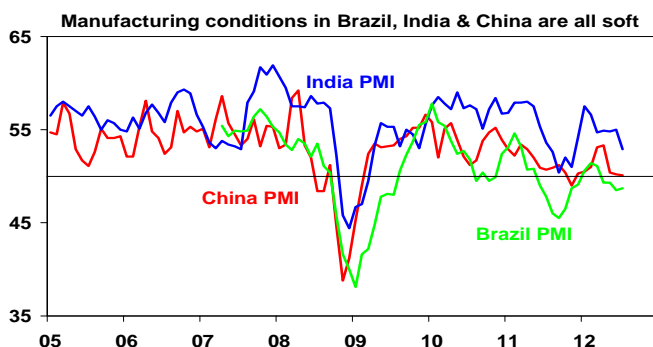
Introduction

For years we have had a two speed global economy composed of constrained advanced countries offset by strong growth in the emerging world. The emerging world now accounts for more than 50% of world GDP and it was hoped it would keep the world growing at a reasonable rate. Over the past year though it has become readily apparent that even emerging countries, led by Brazil, India and China are struggling, with all seeing a sharp slowing in growth.



Source: Thomson Reuters, AMP Capital

This slowing is also evident in business conditions indicators.



Source: Bloomberg, AMP Capital

So what's gone wrong and how big a threat is this to global growth and investment markets?¹

¹ This note has benefitted significantly from research undertaken by my colleague David Roberts.

Common factors

The slowdown in the emerging world and specifically Brazil, India and China (BICs) has a number of common factors:

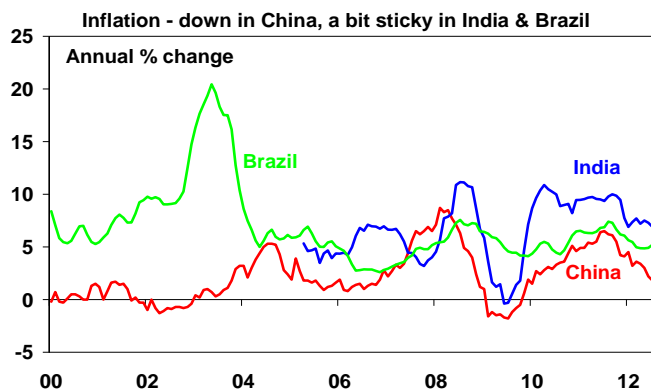
- A big part of it is the growth slowdown in advanced countries driven by recession in Europe and more modest growth in the US. Apart from dampening business confidence this has directly affected exports, particularly in China and Brazil where 20% or more of exports go to the European Union. This has adversely affected export demand resulting in a slump in exports to just 1% year on year growth in China and 10% growth in Brazil from a 20% plus pace a year ago.
- A lagged response to policy tightening to slow growth. The BICs and most emerging countries saw a strong rebound in growth coming out of the GFC. This along with the post GFC rebound in commodity prices resulted in rising inflation which in turn led to policy tightening in order to bring economic growth back to a more manageable level. As a result interest rates were moved higher in all three countries and fiscal policy was tightened. Currency appreciation also added to the tightening in China, and particularly in Brazil as the Real surged in value.
- Structural change has also played a role, as a combination of the need to aim for more balanced growth (China) and a lack of further economic reforms and imbalances has highlighted that potential growth in these countries is somewhat below what had been achieved in the years before 2008.

In terms of the latter the issues vary from country to country and range from mild in the case of China to significant in the case of India.

China – can boost growth, but reluctant

For some time China has been seeking to focus on quality growth as the 10.5% pa growth rate of the 2006-2010 period resulted in various imbalances, particularly in terms of a mild pick up in inflation and excessive reliance on exports and more investment, and social tensions. As a result it has lowered its growth rate for the current five year plan to 7% and its growth target for this year to 7.5%. While investors may be disappointed at the lack of an aggressive 2008 stimulus program the authorities in China are clearly wary of going down such a path again given the risk of overheating the economy once more. In the meantime there is no sign of a hard landing. Growth has slowed but not collapsed. Real retail sales growth remains solid. Property market indicators have slowed but not collapsed. Growth in bank lending and money supply appears to have bottomed. And inflation has fallen to just 1.8% - see the next chart - suggesting plenty of room to stimulate the economy, Premier Wen Jiabao has acknowledged. With feed prices rising partly in response to the US drought inflation is probably at or close to bottoming but non-food inflation is likely to remain low given spare capacity in the economy so the US drought is unlikely to significantly impact the Chinese economic outlook. The most likely scenario remains one of continued gradual stimulus

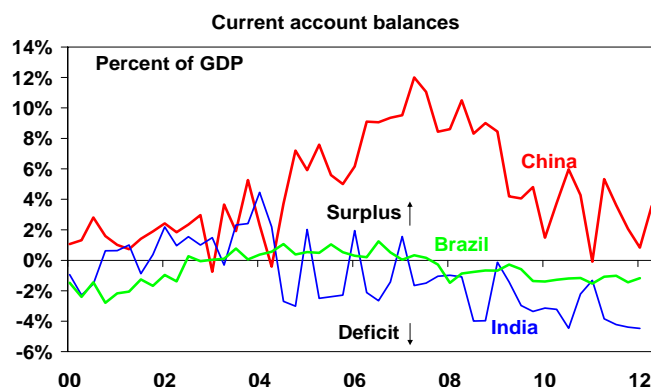
with two more rate cuts and reserve ratio reductions each this year. But in the absence of much weaker growth don't expect a dramatic stimulus. The Chinese authorities seem quite content to see growth around 7-8% pa.



Source: Thomson Reuters, AMP Capital

India – wants to boost, but constrained

India is more problematic. While there was talk a few years ago that it was becoming the next China and that its potential growth rate may be around 8% pa, it is clear that this is not the case. To maintain decent economic growth India needs radical economic reforms to cut subsidies, reduce regulation and red tape, reform its tax system and boost infrastructure spending. But in recent years reform has ground to a halt, erratic government policy has scared foreign investors and the government sector has been running a 9% of GDP budget deficit, such that ratings agencies are threatening to remove India's investment grade credit rating. The combination of these factors has meant a worsening current account deficit (next chart) and hence reliance on foreign capital at the same time that a lack of competition and investment has led to a chronic inflation problem (previous chart). These factors suggest that India's sustainable medium term growth rate is closer to 6% than 8%.



Source: Thomson Reuters, AMP Capital

And while India's inflation rate has slowed it is still too high to allow an aggressive reduction in interest rates from the Reserve Bank of India. Growth looks likely to be around 4 to 5% over the year ahead rising to 6% through next year thanks to rate cuts & the recent 20% plunge in the currency.

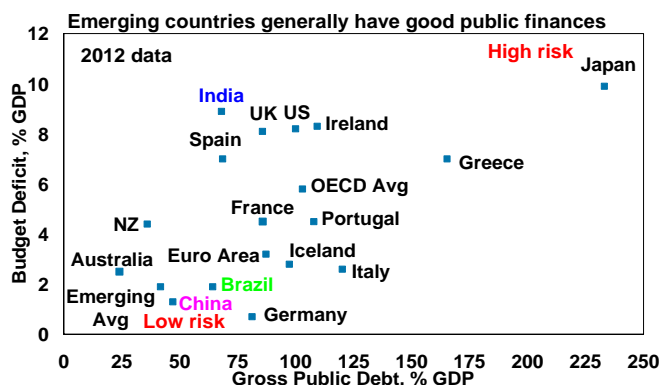
Brazil – in between

Brazilian economic growth has decelerated dramatically since 2010 thanks to a combination of earlier monetary tightening and strength in the Real and a fall in export prices. While Brazil's budget deficit at 2% of GDP, current account deficit and inflation rate are much lower than those in India they all warn that its potential growth rate is much less than the 6% pa pace it saw before the GFC, probably around 4%.

Brazil has also slacked off on the economic reform front and underinvested in infrastructure in recent years. After growing around 1.5% this year, growth should pick up next year to around 4% thanks to lower interest rates and a 25% fall in the Real over the last year. A just announced stimulus program focussed on infrastructure will also help.

No disaster

However, while growth in Brazil, India and China and more broadly the emerging world has disappointed and longer term sustainable growth rates have come down a bit, the underlying fundamental picture is far stronger than in the US, Europe and Japan. Firstly, public finances are far stronger than is the case with Europe, the US and Japan so the need for fiscal austerity is not a constraint on growth and there remains room for further fiscal stimulus if need be. India is an exception on this front though given its budget deficit problems, although it should be noted that when economic and population growth are strong it is much easier to sustain public debt at around 68% of GDP as is the case in India.



Source: IMF, AMP Capital

Second, official interest rates remain relatively high (at 6.5% in China and 8% in Brazil and India) in contrast to official interest rates of zero in advanced countries suggesting there is plenty of scope for further monetary easing if need be.

Finally, the emerging world still has plenty of catch-up potential. India's per capita GDP at around \$3700 on a purchasing power parity basis is still below the \$5000 level at which the mass purchase of TVs, washing machines and cookers occurs. China at \$8400 is still below the level where mobile phones, cameras and cable TV become common. And Brazil at \$11,800 is well below the \$22,000 level at which the mass ownership of cars occurs. They are all a long way from the \$40,000 per capita GDP experienced in Australia. This means that while they may not be growing as strongly as thought a few years ago the growth potential in the BICs and the emerging world generally is still very high.

Conclusion

While growth in the emerging world, led by Brazil, India and China, has slowed it should still come in around 5% this year and slightly more next year. This is actually in line with what I have been assuming, which in turn underpins a 3% expectation for global growth this year. While the uncertainty about growth in the BICs may linger for a few months - weighing on share markets, commodity prices and resources stocks - price to earnings multiples of around 9.5 times and long term real growth potential around 5-6% pa suggest there is plenty of value for long term investors.

Dr Shane Oliver

Head of Investment Strategy and Chief Economist
AMP Capital

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