BEPA MONTHLY BRIEF

Contents

Special Issue BRIC

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BEPA Bureau of European Policy Advisers

EDITORIAL *by Stefano Bertozzi*

September's BEPA Monthly is a special issue focusing entirely on the fast-growing economies of Brazil, Russia, India and China, for which an economist at Goldman Sachs coined the term "BRIC". It covers selected topics, chosen to provide readers with useful insights into these four countries, with their huge and growing populations and economic potential, which are gradually reshaping the global economic geography and politics. It also seeks to explore the foundations on which a possible EU–BRIC strategic partnership could be built in the future. The BRIC are growing increasingly aware of their international clout and have already started to concert their action in a bid to obtain more power and a greater say in the decision-making processes of certain international organisations, including the International Monetary Fund and the World Bank, and of high-level summits such as the G20. One example of this quest for a stronger voice in the international arena is the first-ever joint press release issued at the end of the G20 summit in April 2009, which made it clear that these four countries intend to have greater bearing on global affairs in the future. The first BRIC summit, held in Yekaterinburg in June 2009, should therefore be seen as a strong political signal that these countries want to have their voice heard in international summits, in particular in the G20, which is the primary forum for economic cooperation in the 21st century. Turning to the economic weight of each BRIC country, it should be stressed that the Chinese economy is greater than the economies of all the other three members put together. China therefore occupies a dominant position within this group. Equally important are the structural, long-term economic strengths of China and India, which the current economic crisis has highlighted even more, as these two countries managed to weather this "economic storm" better than other well-established economic powers.

The first article, contributed by DG RELEX, gives an interesting account of the level of cooperation within the BRIC group, while raising doubts that each country might use this forum to pursue its own hidden agenda. It also sheds light on the Yekaterinburg discussions, which

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centred, among other things, on the international financial crisis, the G20 process, climate change and food and energy security.

The second lead article, by Sven Biscop and Thomas Renard, looks at the possibility of forging a strategic partnership between the EU and the BRIC, which could be mainstreamed into a wider foreign policy framework. Careful consideration is given to the concept of multilateralism as the most effective and peaceful way of attaining the EU's specific objectives and addressing global challenges, as the increasing interdependence of the world economy prompts all international stakeholders to cooperate with each other towards commonly shared goals.

The third lead article, by Renato Flôres, while highlighting a number of unique traits of each BRIC country, covers the specific role Brazil can play, both within and outside this group. It also identifies a number of areas for future cooperation and provides an interesting reading of how BRIC can use their political and economic sway to improve global governance in G20 meetings, in negotiations within international organisations and in the strategic dialogue with the EU.

The fourth lead article, by Blanka Kalinova and Judit Vadasz, deals with Russia's dual role as a major recipient of foreign direct investment (FDI) on the one hand and as an investor in several international undertakings on the other. More specifically, it offers a convincing analysis, covering the periods before and after the global financial and economic crisis, of the primary reasons why, despite Russia's structural shortcomings, including increased State ownership and oversight, it has remained one of the most attractive destinations in the world for FDI.

The fifth lead article, by Alastair Newton and Sonal Varma, after tracing the historical importance of the courageous economic decisions taken by India since 1991, raises concerns about the sustainability of India's remarkable economic performance. It also offers a compelling analysis of how India will face future challenges, ranging from Doha Round negotiations to climate change and its role in the G20 meetings, together with an original reading of how entrenched cultural values and religious beliefs could influence India's future economic decisions.

The sixth lead article, by Daniel Daco, highlighting the impact of the world recession on China's overall macroeconomic fundamentals, offers a detailed analysis of the political and economic decisions China has taken so far to foster investment in infrastructure, to address weaknesses in the banking sector, to bolster domestic consumption, to increase export tax rebates and to contain unemployment. It also explains why the Chinese economy is not yet out of the woods, as the country's future economic performance will rely excessively on massive public investment and brave economic and social reforms.

The last lead article, by Nigel Chalk, endeavours to explain why China was able to recover faster than Western economies from the global crisis. Although fiscal discipline, restructuring of the largest banks and an expansive monetary stance have helped lift China out of the recession, Nigel Chalk makes it clear that this crisis is a golden opportunity that China must not miss to undertake more profound and ambitious reforms in areas such as social policies, domestic consumption and credit growth, financial development and corporate savings. Reforms of this kind, he concludes, will consolidate the Chinese economy and put the country on a more economically and socially sustainable growth path.

September's BEPA Monthly also features "Facts and Figures That Matter", which provides statistics on each BRIC country, along with a comparative economic analysis.

1 BRIC: Playing Together or Pursuing Their Own Interests?

*By Angel Carro Castrillo, Franz Jessen, Denis Chaibi, Hilde Hardeman and Matteo Gomirato **

At the first formal BRIC (Brazil, Russia, India, China) Summit that took place on 16 June 2009 in Yekaterinburg discussions focused on the international financial crisis, the G20 process, global financial system reform, food and energy security, climate change and the future development of the BRIC dialogue. The BRIC discussed the role of the dollar and their status as the world's dominant currency and demanded greater representation at major financial institutions. The key message though was a call for a more diversified international monetary system.

The main objective of this meeting seemed to be to pass the message for domestic and western consumption that the four BRIC countries have more in common than their size and economic potential.

Indeed, the BRIC represent a grouping of new economic powers standing for 29% of the total area of the world, 42% of the total population. The contribution to the world economy (in terms of GDP) of the BRIC account for 22%.

The four countries share a pragmatic view of the BRIC formulation and see this construction as part of their strategies to emerge or re-emerge as a global economic and political player on the international stage. While they all presumably share this goal, the relations between these four countries are of course multi-vectored and it can be argued that there are few substantive issues where all four countries have common views. Apart from Brazil, there is historical baggage that China, India and Russia bring to this organisation. Although there may be broad agreement on global and regional problems, it is far harder to agree on a common BRIC strategy let alone coordinate actions, as other fora are better suited to this exercise.

At Yekaterinburg, the Chinese President Hu Jintao made a four-point proposal for the BRIC countries in dealing with the financial crisis: committing to bring about an early recovery of the global economy; pushing for the reform of the international financial system; committing to implement the UN Millennium Development Goals; and ensuring the security of food, energy resources and public health.

Chinese experts quote IMF and investment bank Goldman Sachs (which coined the acronym "BRIC") projections that, due to the financial crisis the developing economies, will faster narrow the gap separating them from the developed world.

But China is aware of BRIC's different development models. Beijing nevertheless considers this grouping to have huge economic potential. Chinese experts emphasise that developing emerging economies share similar views on many international and regional issues and therefore cooperation between them would be an effective way to tackle the current global financial crisis.

This new economic grouping remains, however, at an embryonic stage and Chinese experts are reluctant to see it as a mini-G8.

For Russia, participation in meetings of BRIC leaders and Foreign Ministers forms part of its policy to support a multipolar approach to international relations, which has been a constant feature of Russian foreign policy since the fall of the USSR.

Russia has sought to play a leading role in bringing the BRIC countries together. It was Russia that organised the first meeting of BRIC Foreign Ministers, in Yekaterinburg, in 2008. This marked the first time the four countries had met on their own. The meeting had a relatively broad agenda, covering international issues, including the reform of the Bretton Woods institutions, and climate change, and other global challenges. Defence and security issues were not on the agenda. A press release issued at the end of the meeting placed particular emphasis on the fight against terrorism. Foreign Ministers made less progress on other international reform issues, and in particular the reform of the UN Security Council, a long-standing interest of both Brazil and India. There was also no consensus on non-proliferation, given India's decision to stay outside the Nuclear Non-Proliferation Treaty (NPT), whereas the three other countries are signatories to the NPT. There were no plans to institutionalise BRIC meetings.

* DG RELEX.

The strong focus in Yekaterinburg on the global economic crisis and the need to step up co-operation on responses to the crisis were an opportunity for BRIC countries to prepare for the Pittsburgh G20 meeting in September. South Africa's interest in joining the BRIC discussions adds weight to the argument that an expanded BRIC may end up as a G8 for economies in transition, with Russia enjoying a specific role as member of both. What is clear is that the primary focus is on economics, as the differences on fundamental principles of security, and notably non-proliferation, are too wide to bridge. During the period of the crisis, Russia's economic performance has been weaker than other BRIC countries, and it is the only one of the four to remain outside the World Trade Organisation.

It appears that Russia sees meetings of the BRIC countries as a useful element in a wider strategy of encouraging alternatives to what Moscow still sees as US dominance. The grouping is seen as a sounding board and discussion forum, rather than anything more formalized. Russia may have wished to lead the group, but its economic clout in a group that also includes China is always going to be in doubt.

As far as India is concerned, it can agree with the BRIC's agenda centred on growing economic clout. First, India finds some value in the four leaders exchanging views on the global financial and economic situation, especially outside IMF or World Bank. Second, India is happy to use this forum to use a Track-II approach and ask academics to flesh out a broader agenda for the group, in particular in the field of economic cooperation. Third, the BRIC send a signal that significant regional powers can discuss key political issues outside the G8 or the UN Security Council.

For India, the most significant difference between the BRIC members relates to the Security Council expansion — Russia and China are permanent members while Brazil and India crave for a permanent seat.

It is important to realise that each of the four BRIC countries comes with differing levels of disaffection with the global system as it exists today. And India, under the Singh leadership, is the one which is the keenest to mould into the current system, provided it gets the status that it feels entitled to: i.e. UNSC member. This is why India is not as much involved as Russia or China in the BRIC, nor in the Shanghai Cooperation Organisation (SCO – where India is an observer) for that matter. While SCO is about security and energy, the BRIC grouping is best suited to dealing with issues of global architecture that are geography-neutral. But in both cases, India plays a careful hand.

India does not want to perceive the BRIC negatively, for example as a club of countries which should be in G7/8 but which are not, but rather as a tool to enhance its influence by providing its point of view on a more like-minded environment on major global economic issues.

Though the BRIC are primarily geo-economic, and have members with varied objectives, India could consider enhancing its efforts within the group in the absence of reform of the U.N. Security Council and a serious need to shoulder global political responsibilities, in particular in the field of terrorism, nuclear issues and disarmament, energy security, global rules on the use of force and intervention.

Brazil's search for stronger south-south ties responds to the Brazilian vision of the multilateral system as disproportionately overrepresented by developed nations. The BRIC are by far the most "famous" club of emerging economies. Brazil also actively contributed to set up IBSA (India, Brazil and South Africa) in 2003. Additionally, since Lula took office Brazil has doubled the number of its embassies in Africa, a move within its strategy in a bid to forge special ties with the lusophone countries in the continent. The strategic partnership with the EU specifically addresses such geographical axis by trying to establish a triangular cooperation in several fields.

South-south cooperation is promoted by Brazil with a clear objective: countering more efficiently Northern domination of the multilateral fora (WTO, …) and UN bodies. Brazil's ambition to have a permanent seat at the UNSC is often perceived as the factor behind its dynamism on the south-south scene. More generally, the reform of the international institutions is central to understand Brazil's foreign policy.

At the 2009 Summit, which focused mainly on the financial crisis, Brazilian President Lula was very assertive in saying, once again, that the emerging countries do not hold the responsibility of starting the crisis, therefore distancing them from the source of the problems, but not from the participation in finding a lasting solution. The Brazilian government considers that the reform of international financial institutions is crucial to ensuring a stable and balanced global economy.

Brazil is hosting the next BRIC Summit. In light of what it did one year ago at the multi-Summits in Costa do Sauipe, the next BRIC Summit is expected to be another demonstration of Brazil's eagerness to take active part in "shaping the future" from a southern – pro-developing countries perspective.

2 The EU's Strategic Partnerships with the BRIC: Where's the Strategy?

*By Sven Biscop and Thomas Renard **

Introduction: An Interpolar World

"At a global level, Europe must lead a renewal of the multilateral order", states the December 2008 Report on the Implementation of the European Security Strategy – Providing Security in a Changing World, "[...] We have a unique moment to renew multilateralism, working with the United States and with our partners around the world". Multilateralism and cooperation are key principles of EU foreign policy, together with its holistic nature and its emphasis on conflict prevention.

The current global environment, marked by increasing multipolarity, ought to facilitate cooperation, for it is also characterized by increasing interdependence between the poles. Although other global actors often have different worldviews and competing objectives, all are increasingly interlinked economically, and all are confronted with the same complex global challenges. Giovanni Grevi has dubbed this condition "interpolarity": global interdependence is so great that "its mismanagement can threaten not only the prosperity, but the political stability and ultimately, in extreme cases, the very survival of the actors that belong to the system"; therefore "the ability to shape multilateral cooperation or lead collective action in addressing international challenges becomes a central feature of power".[1]

In such a context, the importance of the EU's relations with the other global actors is evident, notably with the "emerging" powers. These include Brazil, Russia, India and China, commonly known as the BRIC, as well as other States with a global scope in one or more policy areas.

The Limits of Conditionality

Arguably, what is most distinctive about the EU is what can be called the European social model: the combination of democracy, the market economy, and strong state intervention, at Member State and EU level, to ensure regulation of the economy and social security. This model, including the values on which it is based, can be conceptualized as an integral whole of public goods, to which every citizen is entitled, and which it is the responsibility of government to provide to every citizen: security or freedom from fear; economic prosperity or freedom from want; political freedom, i.e. democracy, respect for human rights, and the rule of law; and social well-being, i.e. health, education, and a clean environment.[2] An assessment of the conditions that have to be fulfilled for this model to be prosper, allows identifying the EU's vital interests, i.e. those that determine the very survival of its model: the absence of a vital military threat to the territory of the Union; open lines of communication and trade (in physical as well as in cyber space); a secure energy supply; a clean and stable environment; manageable migration flows; the maintenance of international law and universally agreed rights; and autonomy of EU decision-making.

In a world without direct enemies and in which cooperation to tackle common challenges is vital, the best way of defending EU interests in order to defend its model and values, is precisely to spread those values. Increasing the access of citizens worldwide to these same core public goods directly addresses the root causes of threats and challenges. In other words, if the fundamental objective of the EU is the preservation and strengthening of the European social model and the values on which it is based, the best way of achieving that is to promote it in the rest of the world, which moreover constitutes a positive agenda in its own right.

However, vis-à-vis other global actors, the classic EU strategy to that end, "positive conditionality", i.e. the offer of benefits in return for security cooperation and economic, social and political reforms, has great limitations. Interdependence is too great and the scale of things is too vast for the EU to have any serious leverage. On the contrary, pontificating without acting only serves to undermine EU soft power. Such global actors can only be convinced of the value of the EU model on the basis of truly shared interests and common challenges rather than enticed by the offer of the proverbial carrot.

* Prof. Dr. Sven Biscop, Director, and Thomas Renard, Research Fellow, Security & Global Governance Programme, Egmont – The Royal Institute for International Relations (Brussels).

A New Instrument: Strategic Partnerships

The EU has therefore created a new instrument to engage with other global actors: strategic partnerships. The actual strategy behind these is far from clear however.

A first and major problem is the lack of understanding of the concept of strategic partnership. It has never been defined and is consequently seen and interpreted differently by many actors within the EU, without mentioning those outside the EU. Similarly, the objectives of the strategic partnerships are ill-defined. Apart from installing various annual meetings and summits, it is not clear what the creation of a strategic partnership entails: which common objectives and especially joint actions are to be pursued in which policy areas? Who takes the lead in these partnerships on the EU side? Often it appears as if the existence of a partnership is more important than its content and its potential for the EU and for the bilateral relationship. Of course, strategic partnerships are a well-understood means to insert a new dynamic into a relationship that is deemed to be important. They also aim at providing a "comprehensive, coherent, and coordinated long-term framework"[3] to the relationship. But the role of these partnerships in the context of "effective multilateralism" remains unclear.

Another major problem relates to the countries that qualify for a strategic partnership. There are few established criteria, except that partnerships can be signed with "third countries, and international, regional or global organisations which share the principles [of democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law]" (Lisbon Treaty, Article 22) and that "the strategic partner status is specifically intended to derive from the capacity of a country to exert a significant influence on global issues".[4] At this point, not counting relations with the US, Canada and NATO, the EU has or is negotiating seven strategic partnerships with other States (Brazil, China, India, Japan, Mexico, Russia, and South Africa), and one with an international organisation (the African Union). It seems quite obvious that not each of these is equally strategic. Most of these countries undeniably exercise regional leadership or are a significant player for one specific global issue. This makes them strategic as regards one region, or one issue. But is this a sufficient condition to make them a strategic partner? Can Mexico and South Africa really be put on an identical level with China, Russia and the United States?

The danger is to overstretch the concept, on the one hand, leading to an amalgam between important relationships and strategic relationships. Such overstretch creates confusion within the EU, but also in the eyes of its partners and in the way they interpret Europe's ambitions. On the other hand, there is an equal – and tightly related – risk of diluting the symbolic but also real importance of the concept with each new partnership. "Strategic partnership" has become a very fashionable term, emptied of its real substance.

Towards a Strategic Use

A truly strategic use of the strategic partnerships, i.e. in function of EU foreign policy, must start from a thorough assessment of EU interests in the various regions of the globe and a clearer definition of its objectives towards them. At the same time, a prioritization of actions to be taken to tackle the global challenges, in function of the Union's vital interests, is in order. On many of these issues – climate, migration, energy – the EU already has elaborate policies – these must be integrated into its broader foreign policy framework.

Finally, the EU must sharpen its view on how best to organise the multilateral architecture. To be effective and legitimate, the multilateral architecture must evidently be adapted to take into account the growing importance of the "emerging" global actors. Can the EU, which clearly is over-represented, contribute to such reforms while making its own representation more effective, e.g. by compensating for the loss of European seats by speaking much more with one voice? Which are the EU's preferred multilateral forums? Which organisations are best suited to deal with which issues, which reforms must be undertaken to strengthen their effectiveness and legitimacy, and how can the EU act united within them? How does the EU assess the growing role of the G20 e.g., how ought it to be represented there, and what should be the position of the G20 vis-à-vis the UN? The EU cannot afford to dither, for things are moving fast, as the rise of the G20 demonstrates. Without proactive EU involvement, Europe will be running behind the facts.

Taken together, these regional, global and institutional interests and objectives could inform a really strategic use of the strategic partnerships. Rather than objectives in their own right, the strategic partnerships are instruments to further "effective multilateralism". The EU could identify shared interests with each of its strategic partners, in order to establish in a number of priority policy areas effective practical cooperation with those strategic partners that share EU interests in that specific domain, with the ultimate aim of institutionalizing those forms of cooperation and linking them up with the permanent multilateral institutions. Such a pragmatic approach of coalition-building and practical cooperation, on very specific issues to start with, can expand into broader areas, including with regard to values. If e.g. it is unlikely that we will see China at the forefront of democracy promotion, it has an economic interest in promoting the rule of law, if only to ensure that the mining concessions it acquires are not simultaneously offered to someone else. Such a process could allow the EU to gradually and consensually increase the minimal standards to which everyone should adhere, thus slowly but surely strengthening the recognition of the universality of our values.

Rather than asking with which State or organisation a strategic partnership should be concluded, the EU should look beyond those already in existence and involve actors in constructive cooperation in function of their power in the specific area concerned. In practice, two types of partners may eventually emerge: those with which the EU establishes cooperation in a comprehensive range of areas – probably at least Russia, China and India, if they would be inclined to such cooperation that is, and of course the US; and those with whom cooperation focuses on a more limited range of issues or regions.

For the strategic partnerships to work, the EU must speak with one voice – other global actors are only too adept at playing off one Member State against the other. "Self-divide and be ruled over" is not a strategy bound to serve European interests ... At the very least, Member States should subscribe to a rule of transparency and automatically inform the EU, at an early stage, of all important bilateral arrangements with strategic partners, so as to allow for debate in the EU institutions and de-conflicting of potentially competing interests. Ideally, on key issues, strategic partnerships could establish the EU as the unique interlocutor on a series of key issues, hence limiting the margin of manoeuvre of individual Member States.

Without strategy, the strategic partnerships will quickly become irrelevant. With a strategy, they can potentially become very effective instruments of a united European foreign policy.

ENDNOTES

[1] Giovanni Grevi, *The Interpolar World: A New Scenario*. Occasional Paper 79. Paris, EUISS, 2009, p. 24.

[2] Sven Biscop, *The European Security Strategy – A Global Agenda for Positive Power*. Aldershot, Ashgate Publishing, 2005.

[3] "Towards an EU-South Africa Strategic Partnership", COM (2006) 347, Brussels, 28 June 2006.

[4] "Towards an EU-Mexico Strategic Partnership", COM(2008) 447, Brussels, 15 July 2008.

3 Brazil, the BRIC and the International Crisis – A Short Essay

*By Renato G. Flôres Jr. **

Artificial or not, the BRIC group has been drawing attention as one more actor in the much debated world governance scenario, expected to emerge in the post-crisis decades of this century. As known, neither the BRIC, nor the G20, nor any other likely GX enjoy, up to now, an international law personality. In the absence of a treaty, or even an informally signed agreement which would give a minimal shape, in terms of objectives, rights and obligations to any of them, their importance derives from the sheer power of their members. Not having the heterogeneity of the G20, or its not always engaging connotation of "Lords of the World", which sometimes sets it apart from the smaller or less favoured countries, the BRIC can't however be considered a natural association.

Though no member, in spite of the old and powerful Russian nation, or the even older and ever more powerful Empire of the Middle, qualifies as a representative of nowadays international rulers, all are, at least, key regional players, and, what constitutes an interesting side, in different regions of the globe. This geopolitical spread, together with its conspicuous demographic weight, confers the quartet a special edge, balancing its (still) lesser economic significance.

As regards contrasts and similarities, all but Brazil are nuclear powers. Brazil and Russia are key energy suppliers and holders of considerable natural resources; China is a big demander and India stays halfway, though closer to the dependent side. Brazil stands up clearly as a world food supplier, China, again, as a major, and insatiable, demander. The Latin American giant, together with India, China and, under many dimensions, Russia, is host to serious social imbalances. Indeed, all four are far from a reasonably egalitarian society.

Ironically, the above points drive the BRIC closer to the less developed around the globe, making easier, if not the dialogue and the exchange of experiences, at least the establishment of associations, not necessarily commercial, with those countries. The diversity and remoteness among its members – used by many critics as factors of disruption, supporting forecasts of failure, triggered by the impossibility to reach a basic consensus – actually seem to count in its favour.

Brazil, in particular, with its singular position in South America, and an even more singular one in the abstract concept of Latin America, is pointed out as the member – together with China, but for different reasons – with less to gain from such association. Embedded in its much younger Latin, though highly mixed culture, miles away from the ancient, extremely rich Indian and Chinese civilizations, and also from the peculiar Russian traits, the country is viewed as a stranger in this already odd club. But, again, this can be regarded as an asset. The young nation, free from many uncomfortable remains of traditional western culture, is perhaps the ideal candidate for launching bridges among the three solid, and in some aspects frozen, cultures. The dialogue is convergent for, as exemplified, all share similar problems in their respective domestic fronts – and, though less and with subtle nuances, also in the external arena.

Will this mean, in post-crisis times, a closer association of Brazil, India and China in the WTO? Or a more co-operative behaviour between Brazil and China in both their role as investors and their attempts to become key protagonists in the nowadays African development process? Will Brazil and India share technology in services exports, building up a transcontinental platform in this area, exploiting complementary activities?

Neither of these possibilities is likely to receive a boost thanks to the shared BRIC membership. If things in these lines happen to Brazil, they are more feasible between it and Russia. India, from a Brazilian perspective, is the farthest member, and China enjoys an important and not without tensions relationship with Brazil – mostly due to its key role as a trade partner nowadays; Russia is the one with more chances to become nearly an ally. It is no stranger to the region, where fractions of the population have consistently had a sympathetic view of the country that represented the counterpoint to the US, the powerful Northern neighbour with a

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debatable performance. Commercial ties are nowadays timid, but possibilities abound as an alternative provider or exchanger of useful technologies in areas like energy generation and distribution, specific oil-related processes, nuclear and mechanical engineering and, unfortunately, weapons and armament.

However, the actual role of the BRIC, more than contributing to the mutual dynamics among its members, comes from them, as a bloc, to the outside. Their diversified character can attract main players out of the US-EU pair. One good example is Japan, an instance in which Brazil – with strong and friendly ties with Japan – can act as a smoother of its sometimes tense relations with China, and even Russia, making possible a common front. The same goes for the emerging economies of Malaysia and Indonesia, and many African countries as well.

While the G20 is lost in its own much too wide scope, and the overwhelming presence of the traditional (declining?) giants, the BRIC can, in a more flexible way, provide the ingredients to glue together different and important – actually or potentially – economies in the globe. In such event, the less menacing member, Brazil, may play the leading part. Indeed, in Africa, under the initiative of its Ministry of Foreign Relations, the country has been establishing alliances connected to other BRIC partners. IBSA – India, Brazil and South Africa is probably the most successful and well-known.

What role did these external assets play in helping Brazil sorting out the present crisis? A fairly reduced one. The successful - until now - management of the crisis has been largely due to the extremely favourable, not to say lucky, domestic macroeconomic conditions, coupled to a rigid financial sector legislation, endowed with modern and efficient prudential devices. The escalating inflation of the past had developed a worldly-known sophisticated financial sector, but also led to its rigorous streamlining, together with the creation of multiple controls, when stability was regained.

Even so, BRIC rhetoric, rather than the more pompous G20 one, has given the country a hand in gaining more international visibility and asserting itself as a safe haven during the crisis.

This unavoidably brings back the theme of global governance. In spite of a surprising display of good intentions, the G20 has progressed little in the fostering of new 'Bretton Woods - like' institutions for post-crisis times, particularly the IMF. It is outside the purpose of this essay to digress where the dynamics of present events will lead the discussions. Nevertheless, with the proviso that the United Nations still are the locus for many relevant world problems, actually outside the scope of either the G20 or the BRIC, parallel structures and evolutions, in specific issues, seem certain to take place. And here, the odds point to the latter, or similar, smaller and 'customised' groupings.

A telling example is international currencies. The recent Yekaterinburg summit provided clear signs of a movement towards a decoupling of many transactions from the dollar, even if slow and partial. This is a delicate and worrying question for China – and, for no other reason, it is, together with Brazil, the most active member in this direction. The process triggered at Yekaterinburg can gradually become a snowball. Overall moderate participation of the four in international trade and consumption patterns – in spite of the sustained growth of the Chinese shares – hides a much more important regional role which, for all four, will only increase. A diversion from the dollar, headed by them, will eventually have an impact.

Coming to the realist view of power, water, energy and natural resources are nowadays part of its dimensions; sea power also. The four enjoy an important position in this area, and, in spite of skirmishes between India and China, there is scope for joint strategic endeavours. Brazil, a country with the largest continuous coast in the world – where, thanks to its rather ancient geo-morphological structure, oil fields don't cease to pop up – is much concerned with this question. Russia and China will probably side along, in case it needs to assert in bolder ways its rights on the marine platform under its sovereign rule. Retributions, in issues certain to take place in the multiple seas of the Indian and Pacific oceans, must naturally be expected.

What is the impact of all these instances in the Brazil-EU relationship?

Though, during the last Portuguese presidency, Brazil gained special relations status with the EU, not much took place since. While, from an outside perspective, the Union continues drowned by agenda items like the approval of the Treaty of Lisbon, the Turkish dilemma and the design of effective governance schemes for the 27 members' reality - at the same time that, in the absence of clear foreign objectives, it oscillates in issues like the Middle-East drama and the finding of a less tense, normal relation with China -, it is hard to see concrete achievements in the special status partnership. The impact of the crisis, both in established as well as recent members from the East, only alienated more the Union from prospective co-operation routes. Brazil's ethanol is an instructive example.

Progressively, in a wide spectrum of questions, ranging from trade relations to the way to deal with Africa, the country has been finding more identity in its BRIC partners than in the G20 or in the 'old European friend'. A regretful situation still possible to be mended, given the cultural and economic ties between the two areas.

Summing up, Brazil stands out as a major element in the BRIC. The way the country managed to sail through the international crisis owns however little to this membership, or to its vocal performance in the last G20 meetings. Notwithstanding, the crisis helped Brazil to increase its international visibility and start assertive – if yet modest in terms of impact – movements toward being an active actor of a new order. An order where governance is likely to be shared with smaller, BRIC-like groups. In this scenario, if the European Union hesitates to transform nice speeches into clearer and more useful actions, it risks occupying a less bright position in the worldwide panorama, as seen from Brazilian eyes.

4 Russia and Cross-Border Direct Investment

*By Blanka Kalinova and Judit Vadasz **

Russia has emerged on the international investment scene as an important player only a few years ago but has built since then a solid position as foreign direct investment (FDI) destination and source. In 2008 Russia counted among the top ten FDI recipients and suppliers. In all likelihood the country will remain attractive to foreign investors in the future, but the question is to what extent the contribution of FDI has been fully exploited and is supporting Russia's economic modernisation and diversification.

Since 2005, Russia's has emerged as an active recipient and supplier of foreign direct investments …

Between 2000 and 2005, FDI inflows to Russia stagnated at a relatively low level, remained more or less in balance with FDI outflows and represented around 2% of GDP.[1] Starting from 2006, Russia has attracted a growing amount of FDI, which reached a record level of USD 73 billion in 2008 (cf. Table 1). Alongside with Russia's improving economic situation that has boosted its investment activities (the share of investment in GDP grew from less than 16% in 2000 to 21% in 2008), the share of FDI in total investment in fixed assets has also increased but still remains relatively modest (less than 5% in 2008). Given the country's natural resources endowment, it is not surprising that the primary sector and related activities, such as metallurgy, absorb the major part of FDI inflows (29 and 25% respectively in 2008). The position of Cyprus as a leading inward investor (one third of stock in 2008) corresponds to a large extent to round-tripping Russian investment, partly seeking to circumvent perceived risks to domestic investment (expropriation, regulatory restrictions) and partly taking advantage of Cyprus' tax legislation.[2]

During the last decade, Russia's position as an outward investor has also considerably evolved: its outward FDI and portfolio investment have recorded steady growth starting from 2006, but remained lower than the corresponding inflows, thus allowing Russia to remain a net importer during this period (Figure 1). Growing FDI outflows – attaining their highest level in 2008 (more than $ 53bn) – are a sign of strengthening financial position of large Russian firms and their aspiration to internationalise their activities. However, available statistics do not always permit to determine adequately the final destination of outward flows. The dominance of Cyprus, Netherlands or Virgin Islands (more than 60% of cumulated Russian outward investment in 2008) corresponds to a large extent to the activities of holding firms established by multinational enterprises in these countries to finance and manage their cross-border investment. At the same time, Russia's involvement in its partners from the Commonwealth of Independent States (CIS) is probably underestimated (4% of Russia's total FDI outflows in 2007), mainly because such investments are either realised by Russian firms through their offshore units or directly by Russian companies already present in these countries.[3]

though the current crisis marks a slowdown.

Although the world economic recession has not affected strongly Russia's economic performance for most of 2008 (GDP growth only decelerated to 5.6% compared to 8.1% in 2007), it has started hitting hard the country by the end of that year and continued to exert strong adverse impact on all segments of the Russian economy, including cross-border investment. Russia's FDI inflows and outflows dropped in the first quarter of 2009 by more than 40 percentage points and almost 20 percentage points, respectively.

International comparisons also confirm Russia's attractiveness for foreign investors …

International comparisons confirm Russia's growing participation in world cross-border investment flows. In 2008, Russia took the 6th position among the world top FDI recipients. Among other BRIC countries, it was overtaken only by China, but attracted more FDI than Brazil and India (Table 2). In absolute terms, in 2008 Russia's FDI inflows represented approximately half of those attracted by China, but almost double of that recorded by Brazil and India (Figure 2). As for FDI outflows, Russia and China have been in 2008 considerably more active investors abroad than Brazil and India. In relative terms, in 2008 Russia's recent performance was mixed compared to China's, as on the one hand the share of inward FDI stock in GDP corresponded to 13% versus China's 21%,

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on the other hand its annual FDI inflows per head amounted to $ 514, compared to $ 111 in the case of China (Table 3).

Despite the deteriorated world economic environment and Russia's difficult domestic economic situation, the country remains an attractive destination for foreign investors. According to a recent survey[4], it is considered the 5th most attractive location for FDI in 2009-2011 (after China, the United States, India and Brazil). Several factors justify this assessment: Russia's (expected) future economic growth, the size of local market and especially the access to the country's natural resource in the context of world economic recovery.

but several risks, such as large swings in capital movements, state ownership, business climate could prevent Russia to realise its FDI potential …

Notwithstanding various favourable factors, which make Russia attractive for foreign investors, there are several downside risks which can jeopardize its competitiveness in a more difficult international investment environment.

Perhaps more than other emerging economies, Russia remains vulnerable to considerable large swings in capital movements in reaction to perceived political and economic instability. For example, according to the IMF[5], positive net private capital inflows of $ 96 billion were followed in 2008 by net outflows estimated at $ 123 billion (admittedly, these in- and outflows include to a large extent portfolio flows). As an illustration of the large swings, if our understanding of the central bank's data is correct, in 2007 the stock of inward and outward investments amounted to $ 491 and 370 billion respectively, while the same figures for 2008 showed only 214 and 203 billion. The indirect impact of such large fluctuations (e.g. through changes in the exchange rate, monetary policy, etc.) could be destabilising. Other risks are related to Russia's macroeconomic situation (possible inflation pressures, exchange rate instability) and social developments (demographic decline and aging population), but there also are a number of other concerns mainly of a regulatory nature, reflecting certain weaknesses as well a number of recent policy decisions.

Although in 2000-2003 Russia has made progress in improving its business climate, in particular by reducing administrative burdens and taxation, available business surveys continue to identify the persistence of regional disparities in business conditions and regulatory uncertainty as the main obstacles affecting especially SME enterprises and exporting firms. Based on the OECD FDI regulatory restrictiveness index, which measures formal restrictions affecting only foreign investors such as limitations on foreign ownership and participation of foreigners in boards of directors, Russia's overall score in 2006 was better than those of China and India but worse than that of Brazil.[6] However, most of available surveys and indicators of Russia's business environment are unable to take adequately into account the lack of predictability and especially the effects of corruption, which remains an important problem in Russia, discouraging even foreign investors already operating in Russia from expanding their activities in the country.

Some recent developments, especially strengthening of state ownership and oversight also risk having a dissuasive effect on foreign investors …

According to the 2008 law on strategic sectors, prior authorisation is required in 42 sectors in the case foreign ownership would attain more than 50% of equity in Russian companies concerned.[7] Although national security considerations have been the main objective of the law, its large sectoral coverage raises some concerns, as it covers most of the energy sector and such other diverse sectors as fishing or handling pathogens. In addition, other restrictions – that are outside the scope of the law on strategic sectors – also could have significant potential impact, such as the prohibition of branching (not only in the financial sector), the overall quotas regulating aggregate foreign investment in the insurance sector or the discretion left to the regulatory and supervisory agencies to introduce additional restrictions.

A concomitant trend worrying foreign investors is the strengthening of state ownership and related state oversight of the economy. State ownership, which is estimated to represent currently 35% of GDP, is predominant in the energy sector (more than 80% in oil production). Political and economic rationale is to build up "national champions" and, in the case of energy sector, to enhance Russia's bargaining position vis-à-vis energy importers. These "national champions" are state-owned companies that have been designated as strategic corporations, enjoying special treatment by the state. The status of these corporations prevents their privatisation (and by definition the acquisition of majority ownership by non-residents).

The trend of strengthening state ownership has recently intensified as most anti-crisis measures target large state-owned enterprises and natural monopolies. By protecting established and not necessarily the most efficient firms from domestic and foreign competition, such developments distort the market environment and risk postponing the inevitable economic restructuring. Moreover, the unfinished business of Russia's accession to the WTO implies a lack of transparency and predictability regarding national treatment and market access commitments in areas covered by the GATS.

FDI has played an increasing role in Russia's economy …

Although additional financial resources brought by foreign investors are not negligible, their essential contribution is in intensifying competitive pressures in the Russian economy and as a result to improve its competitiveness. While some Russian sectors (e.g. food processors) are confronted with pressures from imports, large parts of the Russian industry continue to be sheltered from external competition.

and has to take a critical place in Russia's future economic strategy.

Improving the conditions for foreign investment is good for overall investment environment in Russia as the main requirements of foreign investors are very much the same as those claimed by domestic enterprises, notably sound macroeconomic environment, policy transparency and predictability, tax and administrative burdens that are conducive to business expansion. Ensuring such conditions would also reduce the temptation of capital flight from Russia and Russian round-tripping investment, which continue to be a source of the country's instability and vulnerability. Furthermore, the contribution of FDI to enhancing competitive environment in Russia will be critical for Russia's efforts to diversify and modernise its economy and improve its international competitiveness, as the lack of competition is one of the main deterrents to this process.

Recent government statements and positions seem to indicate that Russian authorities are well aware of the fact that the country's integration into the world economy implies its active participation in international cross-border flows, including as an outward investor. The project of the External Economic Strategy of the Russian Federation up to 2020, prepared by the Ministry for Economic Development, sets the goal to increase the share of Russia in the world economy from 3.2% in 2007 to 3.8% in 2015 and 4.3% in 2020. This should be essentially achieved by increasing exports of goods, especially of machine-building, and services (transportation) and by improving the geographic diversification of its trade. This strategic paper for the first time also raised the question of support of direct investment abroad.[8] It will be difficult to achieve such ambitious goals without creating sound investment conditions in Russia for domestic and foreign enterprises. In this context, Russia's firm commitment to international best practices and standards, be it in the trade area or the fight against corruption, investment policy or corporate governance, would greatly contribute to the country's creditworthiness and attractiveness.

ENDNOTES

[1] Sources: the Central Bank of Russia and the Federal State Statistics Service. Due to different sources, methodologies and presentations, the two series of data are not directly comparable and differ in terms of annual flows and cumulated stocks. This paper uses the Central Bank's data for overall flows and stocks but for geographical and structural breakdowns it refers to the Federal State Statistics Service.

[2] Including certain additional norms into Russia tax legislation could lead to a reduction of the size of tax losses and capital flight from Russia to Cyprus (cf. *Russian economy in 2008: Trends and outlook*, Institute of the Economy in Transition, Moscow 2009). However, to deal with Russia's recurrent round-tripping flows and capital flight goes beyond changes in tax legislation and requires more systemic policies, in particular improving the investment climate. The requirements for diminishing round-tripping are essentially the same that would encourage other types of FDI flows, as presented in the article.

[3] Investment transactions by offshore units are registered as Russia's outward investment to a country of the offshore centre whereas transactions by Russian companies in the CIS countries are considered as domestic investment within these countries and therefore excluded from cross-border investment statistics of Russia as well as of the partner country.

[4] *World Investment Prospects Survey 2009-2011*, UNCTAD 2009.

[5] *Russian Federation 2009 Article IV Consultations – Staff report*, Public Information Notice on the Executive Board Discussion, IMF Country report No. 09/246, Washington D.C, August 2009.

[6] OECD *Investment Policy Review of the Russian Federation: Enhancing policy transparency*, OECD 2006.

[7] OECD *Investment Policy Review of the Russian Federation: Strengthening the policy framework for investment*, OECD 2008.

[8] *Russian economy in 2008: Trends and outlook*, Institute for the Economy in Transition, Moscow 2009.

Table 1: Russia's cross-border investment 2000-2009 (USD billions)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 1Q
FDI inflow	2.7	2.7	3.5	8.0	15.4	12.9	29.7	55.1	73.1	10.0
Portfolio	9.9	0.7	3.8	2.3	4.4	0.7	9.5	16.7	26.1	3.7
Other investment	4.2	6.5	3.9	22.6	17.7	42.4	30.3	139.4	61.6	17.3
FDI outflows	3.2	2.5	3.5	9.7	13.8	12.8	23.2	45.9	52.6	12.9
Portfolio	0.4	0.01	0.8	2.2	3.8	10.7	6.2	10.0	7.9	5.8
Other investment	17.5	0.1	1.7	15.9	26.6	33.3	49.3	59.6	182.7	0.8
FDI inward stock	32.2	52.9	70.9	96.7	122.3	180.2	265.9	491.2	213.7	n. a.
Portfolio	32.1	52.3	66.9	93.4	130.8	166.3	265.8	363.0	111.4	n. a.
Other investment	119.9	110.4	113.5	147.8	164.0	201.2	238.3	389.5	420.3	n. a.
FDI outward stock	20.1	44.2	62.4	90.9	107.3	146.7	216.5	370.2	202.8	n. a.
Portfolio	1.3	1.3	2.5	4.4	7.9	17.8	12.3	27.0	24.7	n. a.
Other investment	199.4	177.3	175.8	164.6	166.7	169.7	198.9	222.0	350.1	n. a.

Source: Central Bank of Russia.

Table 2: Top 20 FDI recipient countries in 2008

2007			2008		
Countries	FDI inflows (USD mn)	Rank	Countries	FDI inflows (USD mn)	Rank
United States	327 540	1	United States	325 250	1
United Kingdom	197 770	2	China, P.R.	147 791	2
Luxemburg	188 806	3	France	120 910	3
France	159 460	4	United Kingdom	95 968	4
China P.R.	138 413	5	Luxembourg	78 244	5
Netherlands	123 609	6	Russia	73 050	6
Belgium	113 827	7	Spain	67 235	7
Canada	111 412	8	Belgium	58 656	8
Hungary	72 866	9	Hungary	48 511	9
Spain	71 498	10	Canada	45 364	10
Germany	56 500	11	India	45 100	11
Russia	55 073	12	Brazil	45 058	12
Switzerland	49 730	13	Australia	42 782	13
Australia	40 080	14	Sweden	41 908	14
Italy	40 040	15	Germany	25 000	15
Brazil	34 585	16	Japan	24 550	16
Austria	29 825	17	Switzerland	18 626	17
Mexico	27 167	18	Mexico	18 589	18
Ireland	26 085	19	Turkey	18 187	19
India	24 600	20	Chile	16 787	20

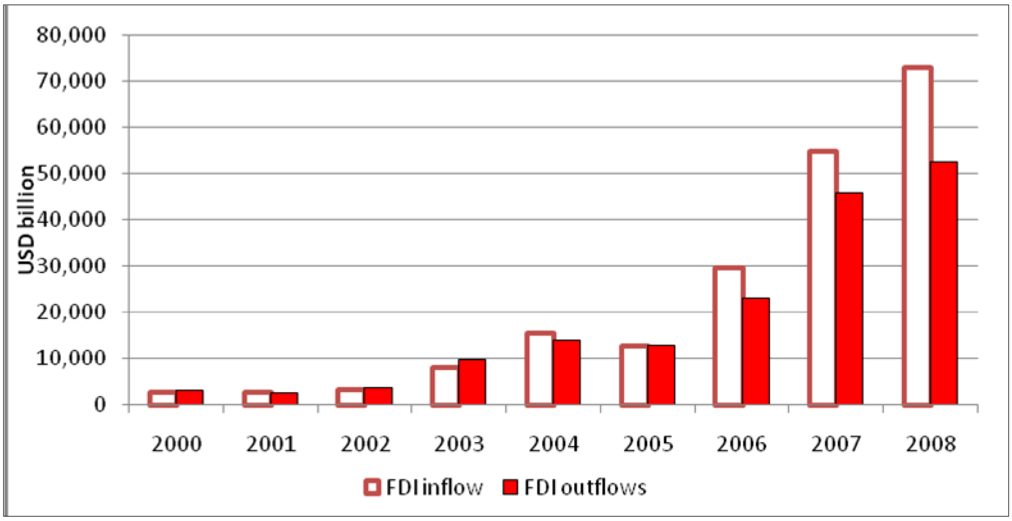
Source: IMF and Central Banks for some countries.

Table 3: The BRIC – selected FDI indicators

Indicator	Brazil 2006	Brazil 2008	China 2006	China 2008	India 2006	India 2008	Russia 2006	Russia 2008
FDI inflows (in billion USD)	18.8	45.1	78.1	147.8	19.7	45.1	29.7	73.1
FDI outflows (in billion USD)	28.2	20.5	21.2	53.5	12.8	20.5	23.2	52.6
FDI inward stock (in billion USD)	220.6	287.7	614.4	876.3	70.3	287.7	265.9	213.7
FDI outward stock (in billion USD)	114	162.2	90.6	169.4	26.8	61.8	216.5	202.8
FDI inflows per head (USD)	99.3	235	59.6	111.3	17.8	39.3	208.4	514.8
FDI inward stock per head (USD)	1165.3	1499.2	468.6	659.9	63.3	250.6	1866	1504.9
FDI stock as per cent of GDP (%)								
- Inward	20.6	18.5	23.1	20.8	7.7	24.7	26.8	13.0
- Outward	10.6	10.4	3.4	4.0	2.9	5.3	21.9	12.3
Outward/inward FDI stock ratio (%)	51.6	56.4	14.7	19.3	38.1	21.5	81.4	95.0

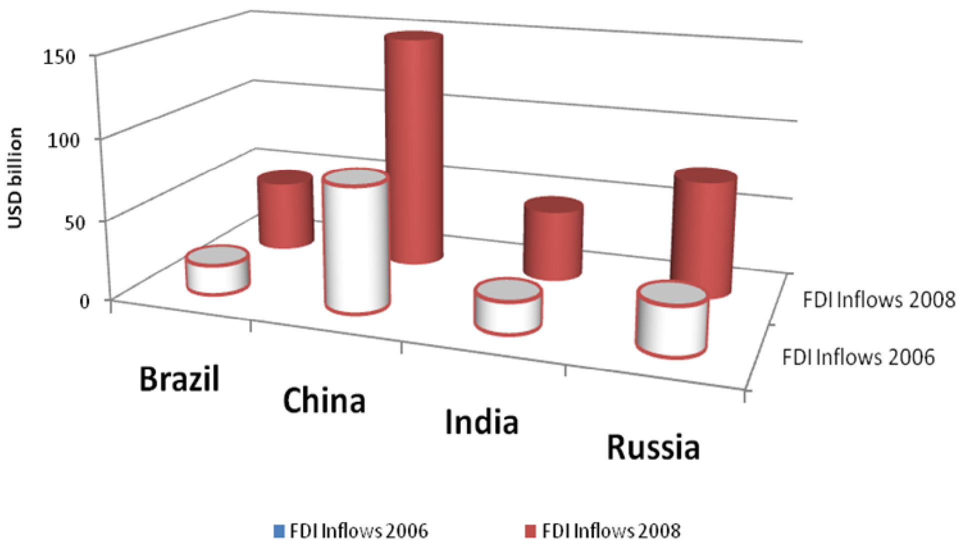
Source: IMF, World Bank and Central Banks.

Figure 1: Russia cross-border investment flows 2001-2008



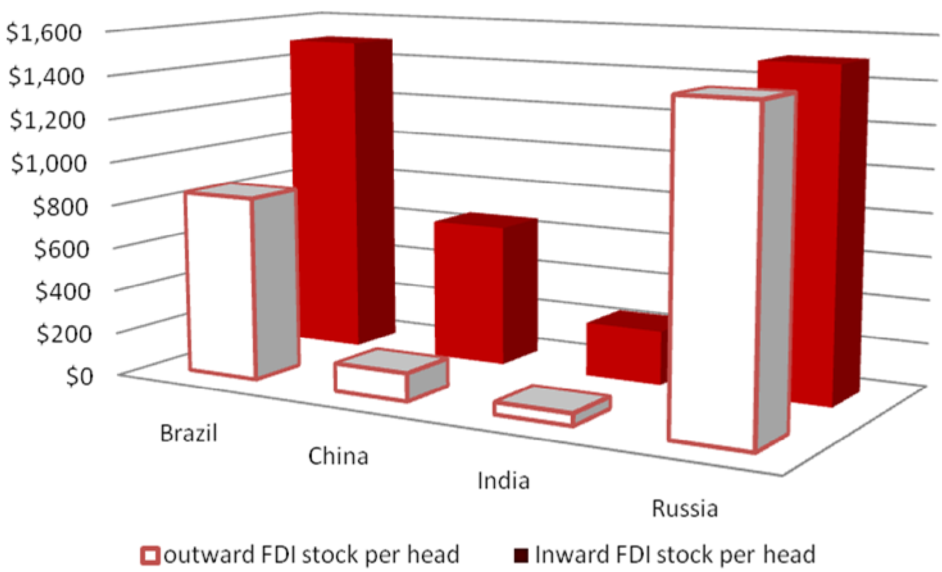
Source: Central Bank of Russia.

Figure 2: FDI inflows for the BRIC, 2006 and 2008



Source: Central Banks of the concerned countries and SAFE (China).

Figure 3: Comparison of inward and outward FDI stock per head in 2008



Source: IMF, World Bank and Central Banks.

5 Some Implications of India's Growing Economic Power

*By Alastair Newton and Sonal Varma **

"Together India and China can reshape the world."

Indian Prime Minister Manmohan Singh (2005)

India's journey towards major power status can be traced back to 1991 and then finance minister Manmohan Singh's programme of economic reforms following a balance of payments crisis. However, for the decade or so thereafter it went relatively unnoticed as world attention concentrated on China's economic rise. Nevertheless, by the start of this decade India's increasing success story was attracting attention to the point where the portmanteau word "Chindia" came into common usage, effectively "hyphenating" Asia's two emerging economic giants.[1]

Question marks still hang over the sustainability of India's (and China's) recent economic success story. But a more common sentiment is that expressed by Findlay and O'Rourke (2008):

"…the gradual rise of India and China to their natural roles as major economic and political superpowers [is] not only the best news for global human welfare in a generation, but [promises] to raise a variety of geopolitical challenges which…remain unpredictable. Indeed, history suggests that this could turn out to be the greatest geopolitical challenge facing the international system in the 21st century."[2]

What is clear is that the rapid and (to date) soft power-based rise of China and India is the major force shifting the global economic centre of gravity back closer to Asia than at any time since the early 18th century – a long-term trend accelerated by the current financial crisis. As a 2008 report by the US National Intelligence Council (NIC) put it:

"A global multipolar system is emerging with the rise of China, India, and others…. The unprecedented shift in relative wealth and economic power roughly from West to East… will continue. The United States will remain the single most powerful country but will be less dominant."[3]

So, how is India likely to project its growing economic power?

Domestic Policy Pointers …

As usual, the best place to start looking for indications of likely international projection is on the domestic front. From even the most cursory examination, it is clear that:

- Its oft-repeated 9% pa target for GDP growth notwithstanding, the priority for the present Indian government – and, in all probability, its nearer-term successors – is inclusive growth (i.e. with a major focus on poverty reduction) rather than economic growth per se;[4]
- Economic policy and related actions will, therefore, not always please India's trade and investment partners or foreign institutional investors (even though India is likely to remain an investor-favourite overall);
- Notably, India will look to protect both its farmers and traditional manufacturing base from international competition for some time to come.[5]

… International Indicators …

Internationally, there is as yet little hard evidence of India's likely direction. Notably:

- In the WTO's Doha Development Round (DDR), although India is unarguably a major player (alongside Brazil, the EU and the US), in protecting what it sees as its own interests it is no more responsible for the present impasse than others;
- Progress with proposed bilateral free trade agreements (FTAs) with the EU and, more especially, the US is slow thanks to substantive difficulties on both sides of the table;[6]
- The G20, with just two summits under its belt at the time of writing, has barely come of age yet and it is too soon to assess how a – to date largely watchful – India will play its cards there; and,
- On climate change, we should await the outcome of the December Copenhagen summit rather than judging India on its forthright stance to date.

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… And Neighbourhood "Necessities"

Indicative of where New Delhi's priorities lie absent any real progress with the DDR, following on from the successful conclusion of agreements with Singapore, Sri Lanka and Thailand, India signed two new regional FTAs in August, one with ASEAN and one with Korea.[7]

An analysis of the latter by Nomura Global Economics notes that it is expected to boost trade between India and Korea in a number of manufacturing and services sectors consistent with sustaining GDP growth in both economies; increase foreign direct investment (FDI) from Korea as its firms turn to India as a global manufacturing hub; and allow Korean construction firms to tender for infrastructure contracts in India. But it will not lead to any opening up of India's agricultural sector.[8]

Meanwhile, FTA negotiations continue with Japan and BIMSTEC, although efforts to strike agreement in SAARC have been blocked by Pakistan pending resolution of the Kashmir situation.[9]

The Philosophical "Push"

Assessing the philosophical underpinnings of Indian international policy, Sagar (2009) cites four different (if not entirely mutually exclusive) "visions", as follows:

- "Moralist" which, based in part on the Nehruvian view of the world, sees India as "an exemplar of principled action";
- "Hindu nationalist" which favours the robust promotion and defence of Hindu culture and civilisation by the Indian state;
- "Strategic" which wishes to develop India's strategic (including military) capabilities to project power; and,
- "Liberal" which aims to generate economic growth through trade and interdependence.[10]

India's economic transition owes much to the influence of the last of these visions, rooted in the – by the 1980s, increasingly apparent – failure of policy based on principles rather than pragmatism to achieve successive governments' objectives either domestically or internationally. This is especially clear in regional policy where it has long been axiomatic that, in words often attributed originally to Henry Kissinger, "India lives in a dangerous neighbourhood". India's desire to bolster economic ties with other south Asian economies through BIMSTEC and SAARC is certainly driven in significant part by a (pragmatic) desire to enhance economic growth among its neighbours and, through that growth, peace and stability across the region as a whole to mutual benefit.

The (New) China Syndrome[11]

Within south Asia, Pakistan in particular has the capacity to act as a "spoiler" in that regard. But, overall, China is now likely to have even more influence in determining which vision India follows.

As things stand, India could currently be aiming, as Sagar (2009) argues: "to create an informal coalition of Asian states sharing an interest in stability and security, thereby balancing China's influence in the region". But, if Sagar's assessment is correct, one could equally argue that it would be in India's geopolitical interests to conclude an FTA with China as speedily as possible. However, there are undeniable signs of Indian foot-dragging on that front following the completion of a joint FTA feasibility study with China in October 2008.

Underpinning this is concern to protect Indian manufacturers from an influx of products from China, which has led to a trade imbalance of $9bn in China's favour out of a total of nearly $52bn bilateral trade in 2008.[12] This triggered 17 new anti-dumping cases in the period between October 2008 and February 2009, a trend which is continuing.[13] In other words, short-term (and arguably pragmatic, at least electorally) economic and domestic political considerations appear to be getting in the way of longer-term geopolitical objectives.

If for trade domestic economic considerations are taking priority over geopolitical ones, in investment geopolitics is currently trumping domestic economic considerations, i.e. a long-standing border dispute (which could be inflamed further if medium-term projections about the impact of global warming on the Himalayan icecap prove to be accurate), coupled with concern in New Delhi over Beijing's "string of pearls" policy, is likely to dampen FDI flows between India and China to the detriment of both economies.[14]

Nevertheless, as it advances its programme of Special Economic Zones (SEZs) India stands to benefit hugely economically from a boost in investment by Chinese firms which could – and, as China's domestic labour costs continue to rise, should –

look to profit from India's large pool of low-cost labour to outsource low-skill manufacturing.[15] If the two countries can build sufficient mutual trust to overcome the political hurdles (possibly through joint investment in natural resource projects in third countries, in which tentative steps are under way), this offers a potentially major "win-win", including in relation to India's inclusive growth targets.

Wider Challenges to India's Ascendency …

As the concept of building mutual trust implies, the choices India makes are far from being entirely domestically determined. When it comes to external drivers, Sagar (2009) suggests that it is not only China which could deflect India from the liberal path; rather, "much depends on whether the existing great powers – America and China in particular – are willing to countenance [India's] rise".

Citing the US as a potential barrier to India's rise may seem odd in the light of the Bush Administration's decision to aid India's emergence as a comprehensive national power.[16] But the oft-repeated (by US officials) underlying rationale that India is America's "natural ally" may yet prove somewhat simplistic and/or short-sighted. In particular, it is worth noting that the most enthusiastic statements about India/US relations emanated largely from Washington's security and intelligence establishment in 2005 at a time when the NIC claimed that the America would "retain enormous advantages … that no state will match by 2020".[17] While that claim may, overall, still be valid it is clear from its 2008 report quoted earlier that even the NIC's view of the world is now much more nuanced than was the case four years ago. And at the heart of that shift lie the economic events of the intervening period which, as Findlay and O'Rourke (2008) highlighted, raise question marks over the US's willingness to continue to promote a pro-liberalisation global agenda.

For now (and notwithstanding Indian and US claims and counter-claims over responsibility for DDR deadlock), Washington's focus in that respect remains largely on Beijing. But this could change if India succeeds in building the low-cost manufacturing base it needs to drive inclusive growth and to provide employment for the additional 150 million people likely to join the workforce over the next decade. In those circumstances, India stands increasingly to be America's – and Europe's – *bête noire* when it comes to trade even though western trade and investment policy will have to evolve in response to growing Asian domestic markets, as reflected in the proposed India/EU and India/US FTAs.

… And India's Response

How India responds in such circumstances is of real importance to the well-being of the world economy as a whole. And that response will likely be largely determined by the extent to which the liberal vision prevails in New Delhi. As Sagar (2009) concludes:

"Should the liberal vision prevail, … India stands to become a great commercial power once again ... Its external policies will, correspondingly, be directed primarily towards ensuring access to resources and markets. … it will strongly favour the development of multilateral regimes to regulate international trade and politics, and provide orderly and fair mechanisms of conflict resolution. … A prosperous India … will more likely resemble post-war Europe than either contemporary America or China. It will have little inclination to expand geographically, and its influence will primarily be commercial and cultural."

Onus On Europe

"What can be said with moderate certainty is that the global system designed in 1945 will not survive the coming age of discontinuities. An order centred around the political, cultural and economic hegemony of the West can scarcely outlive the redistribution of global power."

Philip Stephens, Financial Times, 28 November 2008

So, the challenge facing the developed world in general – and the EU and US in particular – is the extent to which it is prepared to give India the space it needs for that liberal vision to prevail. This implies not only a need for political leadership in the West to resist protectionist pressures but also a willingness to accommodate shifts in the international political and economic system reflecting the eastward shift in the global economic centre of gravity. As Findlay and O'Rourke (2008) make clear, such institutional reform "is essential if the world is to maintain a relatively open, multilateral political and trading system".

Food for thought indeed for Europe's chancelleries as, in particular, the financial crisis-related process overseen by G20 continues.

ENDNOTES

[1] Credit for first coining the word "Chindia" usually goes to Jairam Ramesh, a key figure in India's economic reform programme in the 1990s who served as minister of state for commerce and industry from 2004 to 2009 and who is currently minister of state for environment and forests.

[2] "Power and Plenty: Trade, War, and the World Economy in the Second Millennium" by Ronald Findlay and Kevin H O'Rourke (Princeton, 2008).

[3] "Global Trends 2025: A Transformed World" (National Intelligence Council, 2008).

[4] "Inclusive growth" is defined by Madhav Singh, an Indian commentator, as "an equitable allocation of resources with benefits accruing to every section of society… the allocation of resources must be focused on the indented short and long terms benefits and economic linkages at large and not just equitable mathematically on some regional and population criteria. He also notes that it is "a utopian concept". See "The Concept of Inclusive Growth" by Madhav Singh, IndianExpress.com, 22 August 2008, available at http://blogs.expressindia.com/showblogdetails.php?contentid=352065

[5] Despite clear wins in both Delhi and Mumbai, the INC owed its unexpectedly wide margin of victory in this year's general election principally to its support in the rural areas – still home to around 70% of India's population. It is hardly surprising, therefore, that despite concerns about the fiscal deficit, the new government has already firmed up pledges to extend the National Rural Employment Guarantee Scheme (NREGS), expand low-cost housing programmes and ensure low-cost food grains for poorer families. For more detail see "India: A landmark election" (Nomura Global Economics, 18 May 2009).

[6] For more information on EU/India trade relations see http://ec.europa.eu/trade/issues/bilateral/countries/india/index_en.htm.

[7] The Association of Southeast Asian Nations (ASEAN) comprises Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

[8] "Bilateral FTAs set to deepen regional integration" by Young Sun Kwon and Sonal Varma, Nomura Global Weekly Economic Monitor, 14 August 2009.

[9] The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) comprises Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand. The South Asian Association for Regional Cooperation (SAARC) comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

[10] "State if mind: what kind of power will India become?" by Rahul Sagar, International Affairs, Volume 85, Number 4, July 2009 (Chatham House), pp 801-816.

[11] The original "China Syndrome" postulates a nuclear meltdown in which a molten reactor core in the US melts through the Earth's crust and reaches China.

[12] Total Sino-Indian bilateral trade in 2008 amounted to a remarkable increase on the $2bn total of 2001. In the intervening period, China has become India's top trading partner and India is now a "top-ten" partner of China and (until this year at least) its fastest growing one. However, one notable shift in the relationship came about in 2007 when, for the first time since this relatively recent surge began, the balance of trade swung significantly in China's favour.

[13] Of the 42 investigations launched by the Indian government in 2H08 (putting India at the top of the global anti-dumping action league table), 17 were against China. Not that trade barriers are one-sided as India is at pains to point out citing, in particular, long-standing Chinese barriers to imports of Indian fruit and vegetables. According to 7 August 2009 edition of The Hindu newspaper the bottom line consequence of the escalation in Sino-Indian trade disputes is a decline in bilateral trade of 32% y-o-y in 1H09.

[14] For a succinct account of the possible impact of climate change on the Himalayan icecap see, e.g., "Melting Asia", The Economist, 5 June 2008. For more background on the "string of pearls" see, e.g. "Fear of influence" by James Lamont and Amy Kazmin, Financial Times, 13 July 2009.

[15] For background on India's SEZs, see "India: Everything To Play For" by John Llewellyn, Robert Subbaraman, Alastair Newton and Sonal Varma (Lehman Brother, October 2007), p 51.

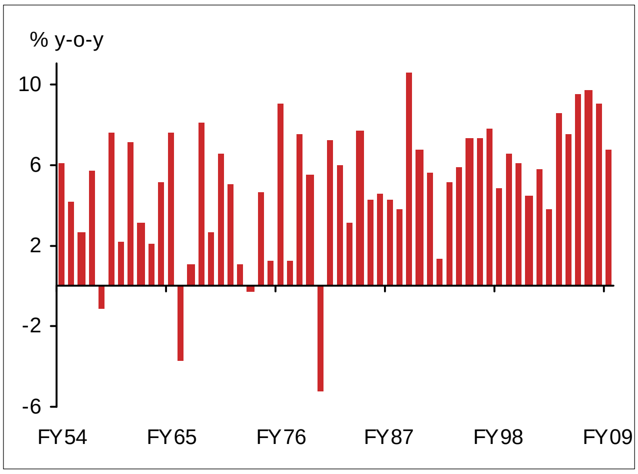
[16] See, e.g., "In Spite of the Gods: The Strange Rise of Modern India" by Edward Luce (Little, Brown, 2006) pp 281-294.

[17] "Mapping the Global Future" (National Intelligence Council, 2005).

Recommended Further Reading (in addition to references cited in the endnotes – especially nos. 2, 10 and 16)

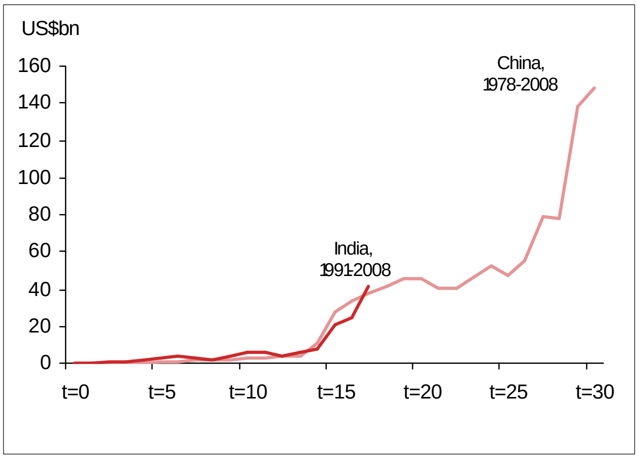
"Rivals: How The Power Struggle Between China, India And Japan Will Shape Our Next Decade" by Bill Emmott (Allen Lane, 2008).

Figure 1: India's real GDP growth rate



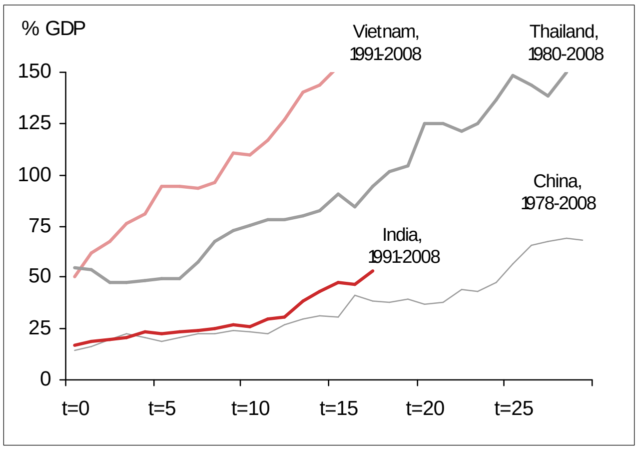
Source: CEICE and Nomura Global Economics.

Figure 2: The take-off in foreign direct investment inflows



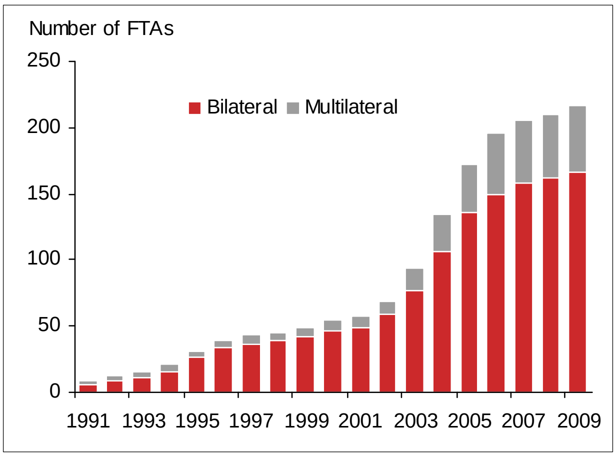
Source: CEICE and Nomura Global Economics.

Figure 3: The take-off in trade (exports plus imports)



Source: CEICE, World Bank and Nomura Global Economics.

Figure 4: Number of free trade agreements in Asia



Note: Chart includes all the status categories of FTAs: proposed, framework agreement signed, under negotiation, signed, and under implementation.

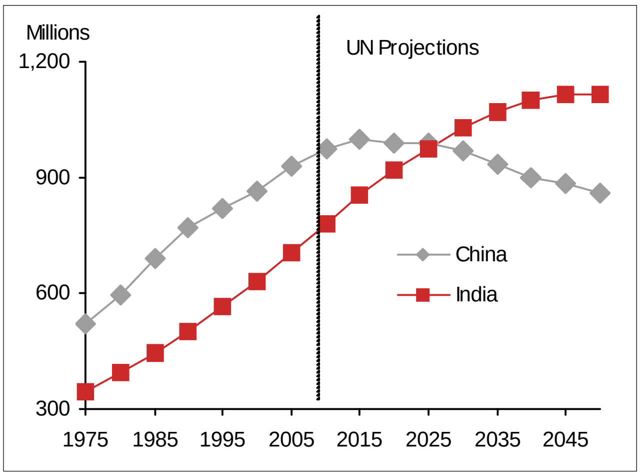
Source: ADB and Nomura Global Economics.

Figure 5: India's major export destinations

	FY06	FY07	FY08	FY09 (Apr-Feb)	FY09 (Apr-Feb)
	US$bn	US$bn	US$bn	US$bn	% total
EU	**22.4**	**25.8**	**32.2**	**34.1**	**22.3**
- France	2.1	2.1	2.5	2.6	1.7
- Germany	3.6	4.0	5.1	5.3	3.5
- Italy	2.5	3.7	3.9	3.4	2.2
- UK	5.1	5.5	6.6	5.6	3.6
US	**17.4**	**18.9**	**20.7**	**18.4**	**12.0**
Japan	**2.5**	**2.8**	**3.6**	**2.7**	**1.8**
OPEC	**15.2**	**20.7**	**26.2**	**29.6**	**19.4**
South Asia	**5.4**	**6.3**	**9.0**	**7.7**	**5.0**
Other Asian countries	**25.6**	**31.3**	**41.1**	**36.8**	**24.1**
- China	6.8	8.3	10.8	7.7	5.1
- Hong Kong	4.5	4.7	6.3	5.7	3.7
- Singapore	5.4	6.0	6.9	6.6	4.3
Africa	**5.7**	**8.9**	**12.0**	**10.3**	**6.8**
Latin America	**3.1**	**4.3**	**5.1**	**5.3**	**3.5**
Others	**5.9**	**7.4**	**9.2**	**8.0**	**5.2**
Total Exports	**103.1**	**126.3**	**159.0**	**153.0**	**100.0**

Source: RBI, Commerce Ministry and Nomura Global Economics.

Figure 6: Projections of working age (15-64) population



Source: United Nations and Nomura Global Economics.

6 China: Chronicle of a Crisis and a Sustainable (?) Rebound

*By Daniel Daco **

Although the economy is not yet on a solid footing and remains heavily reliant on public support, the speed and the strength of the Chinese recovery are impressive and commendable. In a bit more than a year, the economic situation saw sea changes: the overheating concerns of early 2008 were replaced by fears about rising unemployment, which then evaporated in the second quarter of 2009. The inevitable consequence of the stimulus package is that it makes the economy even more unbanked in its reliance on investment. Making growth more sustainable remains a challenge. In terms of relative economic and political power, the crisis has reinforced China's position and comforted China as an important global stakeholder.

Chinese policymakers started tightening macro-economic policies in late 2007 to cool down the economy. The superheated growth between 2003 and 2007 culminated in 2007 leading to bubbles in both the stock and the real estate markets. Inflation started rising mid-2007. The authorities took a wide range of tightening measures including administrative controls, increased interest rates and bank reserves requirement ratios, a quicker pace of appreciation of the RMB/USD exchange rate and tax hikes.

While the cooling-down measures gradually yielded results in early 2008, the Chinese financial sector remained immune from the Western financial meltdown. The public control of most banks and the regulated financial markets (fairly closed capital account and regulated financial products) insulated the Chinese financial market. Chinese banks had -and still have- relatively low loan-to-deposit ratios and focus on simple and traditional intermediation, which provides a large profit margin due to the differential of some 3% between the administered deposit and lending rates. They had very limited exposure to US banks, sub-prime assets and sophisticated derivatives products. Somewhat paradoxically, official institutions such as the State Administration of Foreign Exchange (SAFE), in charge of foreign reserves, and, to a lesser extent, the sovereign wealth fund, China Investment Corporation (CIC), had much greater exposure to the US financial system.

However, the summer 2008 saw China's real economy starting to feel the impact of the international crisis, mainly through the trade and confidence channels. The fact that the slowdown became apparent after the Olympic Games was a mere coincidence since, over the six years prior to the event, total Olympics spending, mainly on infrastructure, accounted only for 0.5% of total fixed asset investment.

Chinese policymakers rapidly changed the policy stance. The People's Bank of China (PBoC) injected liquidity in the inter-bank market, lowered interest rates and reserve requirement ratios, and removed the bank lending quotas. The government increased subsidies to rural areas, reintroduced export tax rebates, cut transaction fees for home sales and raised the minimum grain purchase price and subsidies. Chinese policymakers also displayed confidence, which stemmed from earlier successes, particularly the good management of the Olympic Games and the resilience of the financial system. Moreover, they knew that China could rely on its healthy fiscal position, high foreign exchange reserves, and high savings held in bank deposits.

The main concern of Chinese leaders was increased unemployment, entailing risks for social and political stability. The collapse of export orders and trade flows and the engineered slowdown in the construction sector were leading to massive layoffs of migrant workers in the coastal areas and large cities. China does not have reliable official statistics on unemployment and job creation. Estimated migrant job losses at one point reached 30 million. However, Chinese migrant workers are seen as a safety valve, ready to go wherever there is work supply and to return to their rural provinces when growth decelerates. More worrisome was higher unemployment among the 6-7 million yearly graduating students, a cohort deemed to have much more political influence.

The deterioration on the employment front mobilised the political apparatus, leading the State Council to announce early November a huge stimulus package of RMB 4 trillion. This announcement surprised by both its quickness and magnitude (EUR 400bn, about 14% of 2008 GDP). The huge package was justified by the need to maintain real GDP growth close to 8%, the

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"magic"[1] number. The timing was also linked to China's positioning at the G20 Summit mid-November.

This stimulus package has many specific features: it is heavily tilted towards infrastructure; its financing is mainly provided by banks; and it is part of a whole range of measures. The 2009-2010 stimulus package plan aims at rapidly boosting economic growth through mainly infrastructure build-up. Its real size remains unknown. Infrastructure spending accounts for 80% of the total, with the remainder being allocated to rural housing, health and environment. So far this year, banks have extended new loans for some RMB 8 tn while only RMB 1.2 tn of additional central government investment spending is budgeted for 2009 and 2010.

Deeper structural reforms might be expected from the eleven "sectoral rejuvenation plans". These plans contain short-term boosting measures, such as increased export tax rebates. But their main objective is to consolidate these sectors and move them up in the value-chain through support for R&D and technological innovation. Increased competitiveness is an objective, as well as more implicitly having three to four national champions in each economic sector. Besides the corporate tax reduction from 33% to 25% for 2009, the value-added tax (VAT) was reformed, leading to a substantial reduction of the yearly corporate tax bill.

Another objective of the policies is facilitating, in the medium term, the much needed rebalancing of growth towards domestic consumption. An ambitious health care reform was launched early 2009, aiming to provide universal basic medical services, basic medical insurance to at least 90% of the population by 2011. Social transfers were increased in the form of assistance to laid-off migrant workers, including subsistence allowances, retraining subsidies, purchasing coupons or VAT exemptions, as well as grants to graduates willing to work as teachers in rural areas. The social budget, however, looks pale when compared to infrastructure spending: in the first seven months of 2009, total fiscal expenditure increased by 23.5% yoy to reach RMB 3,4 tn, exceeding at this stage the yearly target of 22%. Government expenditure on social security and employment rose slightly less than total expenditures, namely by 22.3% yoy over the same period.

In July 2008, the PBoC re-pegged fully the currency at around 6.81 RMB/USD. Although a RMB appreciation could help rebalancing the economy towards consumption by increasing household disposable income and by reducing the prices of energy and commodities imports, the authorities were - and remain - convinced that the RMB needs to be firmly anchored to the USD in a context of high economic uncertainties.

2009Q2 data confirmed that China was the first major economy to emerge from the crisis though, as rightly pointed out by Premier Wen, the economy is not yet on a solid footing and remains heavily reliant on public support. In 09Q2, the annualised GDP growth reached some 15%. This provides comfort that the 2009 target of 8% real GDP growth is within sight. The rebound is driven by fixed asset investment (mostly state), supported by private consumption that remained rather resilient throughout the crisis. The unemployment situation, though unclear, remains worrisome. There are no inflationary pressures since both CPI and PPI are continuing to fall. Trade flows are slowly recovering from a much lower base.

The impressive and successful credit expansion has nevertheless many flaws. Firstly, it is not very efficient: growth stimulation required new loans amounting to more than half of China's GDP. Secondly, as corollary, bank financing is creating asset price bubbles in both the stock and the real estate markets. Thirdly, the very fast credit expansion does not allow banks to exert due diligence and risks leading to increased non-performing loans. In the meantime, the higher lending volume with guaranteed interest rate spread increases banks' profits. Fourthly, some hasty and wasteful projects with little productivity gains have been approved. Fifthly, job creation remains subdued because state-owned enterprises (SOEs) receive most of the loans, also financing this way their operational needs. Regulators have so far failed to ensure higher lending to SMEs that are better at job creation. Finally, loans are targeting investment infrastructure, with no impact on growth rebalancing.

Interesting specificities

Aggressive fiscal and monetary policies have managed to engineer a rebound but the inevitable consequence of the stimulus package is that the economy has become even more dependent on investment and more "unbalanced".

Public investment could further increase the excessive capacities in some sectors, which could result in large inventories and, possibly, risks of dumping. The State Council has recently acknowledged this risk by urging measures to limit capacity build-up in six sectors.

Short-term unemployment concerns make policymakers more timid in launching deeper structural reforms, such as the liberalisation of the services sector, in particular financial ones, which would in the medium term increase productivity, promote job creation and ensure sustainable domestic-led growth. These reforms will eventually take place but, as an aftermath of the crisis, probably at a more gradual pace.

Somewhat surprisingly, despite its low official public debt, China seems keen to respect its self-imposed constraint of a 2009 fiscal deficit of less than 3% of GDP.

China is emerging from the crisis relatively stronger. Foreign exchange reserves have increased further to almost USD 2.2 tn end of June. Chinese companies and banks (if non-performing loans are limited) could be expected to become rather fast large international investors/stakeholders.

State interventionism has further increased because (i) credit is essentially allocated to SOEs; (ii) in each sector, 3-4 SOEs benefit from a "national champion" policy; and (iii) the state has repurchased shares of SOEs and state-owned banks.

Changing the economic investment-led model, which generates trade surpluses, will be very gradual at best: reducing household precautionary saving through the building-up of a social safety net requires time. The crisis has also reinforced the already strong vested interests of some SOEs that are benefitting from subsidies in terms of low costs of input, capital and low taxation.

China as global stake holder

The financial crisis has made China even more courted on the international scene and has forced China to take a more active stance, particularly in the G20, perceived in Beijing as, possibly, the best forum. The relations between Chinese and US economic policymakers have improved because China has remained invested in US assets. In Pittsburgh, China's position will be a continuation of the London position taking: Ensure that all G20 countries fully implement their London commitments in order to restore confidence in financial markets and in the world economy. China will argue that it is premature to consider “exit strategies” and express a strong willingness to cooperate on economic and financial issues.

- Request further forceful actions by industrialised countries, seen as responsible for the crisis, to restore the good functioning of the international financial system. China is not very interested in the financial regulation debate and remains unenthusiastic about an increased role of multilateral institutions in the surveillance and supervision of national economic policies;
- Re-affirm a strong commitment against increased protectionism in both trade and investment. However, China's deeds are not always aligned to its plea. China reversed some earlier decisions and reinstated export tax rebates and, under the stimulus package, national preference in public tenders was promoted;
- Hold the banner in the defence of developing countries' interests, including through additional support from IFIs and MDB;
- Accelerate the pace of reform of the governance of the IFIs (more weight to developing and emerging countries) and increased even-handedness of IMF surveillance;
- On climate change issues, China will resist anything that goes beyond the Copenhagen Agreement and the “principle of common but differentiated responsibilities”. China will argue that it is premature to enter into a detailed discussion of financing modalities;
- Initiate a reflexion on the current USD-centred international monetary system which allows the US to enjoy the exorbitant privilege of issuing the international reserve currency and "dictating" monetary conditions. This has allowed excessively accommodative US monetary policy, which did lead to excessive consumption and risk taking, and hence was the major cause of the crisis. The result of excessive US consumption, namely the US trade surplus and its counterpart in terms of Chinese trade surplus, is ignored by Chinese policymakers, probably because by acknowledging a responsibility in the crisis, China fears to be asked to share more of the adjustment burden.

ENDNOTES

[1] 8% is the estimated GDP growth rate necessary to ensure the absorption of the yearly 10 million net new non-farm labour supply.

7 China: The Policy Challenges of Economic Recovery

*By Nigel Chalk **

China's economy has proven resilient in the current global crisis

Over the past decade or more, China's economy has grown at extraordinary rates, lowering poverty and significantly increasing the living standards of the Chinese people. While hard hit by the global crisis, China's economy has shown a remarkable ability to adapt to the changing global circumstances and to emerge from the global economic downturn both earlier and faster than industrial economies. This resilience has been due to multiple factors but three in particular are worth highlighting:

- First, China has maintained a long track record of fiscal discipline which has driven down public debt and afforded the government significant fiscal room for manoeuvre.
- Second, far-sighted efforts to restructure and reform the largest banks—and the fact that the financial system had little exposure to the financial products at the epicentre of the global crisis—has meant that the credit channel for monetary policy was fully operational allowing monetary policy to be quickly transmitted to the real economy. Similarly, corporate balance sheets were also healthy and many corporations were well placed to expand investment once credit became available.
- Third, the rapid and determined monetary, fiscal and structural policy response of the government has been instrumental in insulating the Chinese economy from the worst of the global downturn.

However, this is not a time for complacency

The pace and timing of the global recovery is still uncertain. Further, it is becoming increasingly clear that consumption growth in developed economies—and the consumer financing needed to sustain it—will be well below the pace that was seen in the early part of this decade. Consequently, it will be much harder in the coming years for global demand to absorb increased production capacity from China. However, there is a silver lining. The current crisis represents a historic opportunity for China to accelerate the pace of reform, reduce its dependence on exports and high levels of investment, and ensure that strong growth and a steady improvement in living standards are sustained for years to come. There is already evidence of that increased reform momentum is indeed taking hold.

There are multiple policy challenges facing China

Consumption. The most immediate, and perhaps most important, policy goal is to catalyze private consumption in China. Household consumption growth already has a healthy momentum behind it and the government is well-placed to capitalize upon that impetus. Over the shorter term, fiscal measures should be deployed targeted at increasing household consumption. Much has already been achieved including introducing consumption subsidies, lowering consumption taxes on certain consumer durables, and increasing basic pension benefits to raise household disposable income. However, still more can be achieved through measure that increase the resources available to those income groups with the highest propensity to consume. Consideration should be given to the introduction of supplementary fiscal measures that are directly aimed at bolstering private consumption. Such policies could include a temporary lowering of taxes on labour income, particularly on social insurance contributions, additional reductions in consumption taxes, greater co-financing of health care costs, further expansion of the scope of consumption subsidies, or direct income transfers to both the poor and the recently unemployed.

Social policies. Such fiscal policies should certainly help bolster household consumption in the short run. However, to ensure that this dynamism in private consumption is sustained over a longer horizon the government should simultaneously press ahead with substantive reforms to lessen the motivations behind high precautionary savings. These reforms will have a longer gestation period before they are able to translate into changes in consumption behaviour and, as such, it is important to move ahead quickly in three broad areas:

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- Healthcare. The government's recent, wide-ranging reform of health care is a critical step forward and should be implemented expeditiously and in a manner that convincingly reduces the risk that households face from potential future health care costs including, for example, by offering catastrophic health care insurance.
- Pensions. Improvements in the pension system will be essential. The intention to expand pension coverage for rural migrant workers and increase the portability of pensions go a long way in the right direction. However, the rapid aging of the population highlights the urgency of resolving the current shortcomings of the pension system including incomplete pension coverage and an underfunded public system.
- Education. Finally, the decision to fully finance compulsory education for both rural and urban areas will help reduce the need to save for future schooling costs but there is still scope for improvements. China could further extend the number of years of publicly financed education, develop vocational schools, and improve the overall quality of education, particularly in rural areas.

Credit growth. Since late 2008, the bulk of macroeconomic stimulus has been delivered in the form of infrastructure spending and a rapid growth in bank credit used to finance investment projects. Consideration should now be given to adapting the structure of that stimulus. While the recent monetary loosening has been an effective countercyclical tool and has given significant support to the weakening economy, the rapid expansion of credit does have its downsides. These could emerge in the form of an increase in fiscal liabilities from lending to infrastructure projects, particularly at the subnational level. Alternately, such rapid credit growth could create the conditions for a further build up of excess capacity, particularly in certain tradable industries. Finally, whenever substantial liquidity is present, there are always concerns of unintentionally precipitating a run up in asset prices, particularly in real estate and equity markets. Given these potential risks, and once there are clear signs that the economic recovery is firmly established, the authorities should begin the process of gradually unwinding the recent credit expansion. As this monetary stimulus is unwound greater reliance should be placed on those fiscal policies geared toward boosting consumption in providing support to the economy.

Financial development. While the thrust of the effort to lower precautionary savings will need to come through improvements in safety nets and social programs, steps to develop financial markets and products can play a complementary role. Expanding the coverage of commercial insurance products—such as term life insurance, commercial health insurance, pensions and annuities—would lessen the need for self-insurance and help raise consumption. At the same time, developing domestic capital markets—including corporate bond markets, mutual funds, and equity markets—would broaden the range of alternatives for household savings. Given that bank deposits have historically paid low real rates of return, a more diversified set of savings vehicles would raise household capital income, which has historically been quite low, thus helping to boost consumption.

Lowering corporate savings. Corporate savings in China are high. Many firms benefit from an oligopolistic position in local markets and have access to cheap capital from retained earnings and from banks. Tackling high levels of corporate saving is a complex undertaking that will require deep-rooted structural changes, including through the removal of obstacles to competition. As a first step, the recent efforts to ensure dividends are paid from publicly owned corporations to the government will help. It will be important to ensure the size of these dividend transfers is increased over time and that the resulting revenue is used to fund a broad range of government spending needs, particularly on social outlays. Further developing market alternatives for businesses to finance their operations—such as new markets to provide equity financing for smaller corporations and improvements to corporate debt markets—may also reduce the incentives for corporate savings.

Realigning relative prices. Finally, I would highlight three key areas where relative prices provide undesirable incentives that are relevant at the macro level:

- First, China has extraordinarily high levels of investment, much of which has found its way into a range of industries oriented toward external demand. The capital-intensity of production is particularly striking, given China's enormous labour force. A principal driver has been a relatively low real cost of capital. Over time, the cost of capital should rise. Key in that effort will be the liberalization of interest rates, particularly on bank deposits. The current ceiling on deposit rates provides banks with a low cost of funds which allows them to lend these funds at relatively low real rates, predominantly to larger, well-established companies. Gradually phasing out the limits on deposit rates would raise the cost of capital, lessen the motivation for excessive investment, and increase the labour intensity of production. Further, liberalizing deposit rates will encourage greater competition within the banking system and improve the efficiency of financial intermediation. Finally, given that the bulk of household savings are held in the form of bank deposits, raising deposit rates would increase household income and support higher levels of consumption.

- Second, efforts should be intensified to raise the costs of other factors of production, such as energy, water and land. This would support the government's intentions to improve energy efficiency and protect the environment as well as dissuade overinvestment in highly capital and energy intensive means of production.
- Third, a stronger currency would facilitate higher household consumption, by lowering the cost of consumer goods and other tradables, increasing the purchasing power of households, and raising the labour share of income. At the same time, a stronger renminbi would provide clear incentives to reorient investment toward those sectors that service the domestic market rather than toward capital formation in tradable industries.

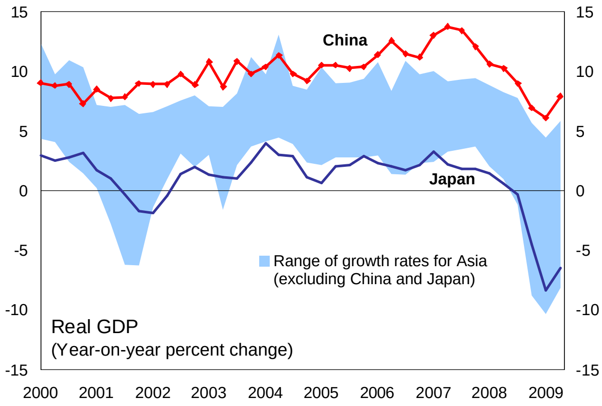
The road ahead

The agenda for China is long and complex and will certainly be a multi-year undertaking. It will be important to move ahead on all areas simultaneously since one policy lever alone will be insufficient to precipitate the deep-rooted structural changes that are needed to reorient the Chinese economy in a post-crisis global environment.

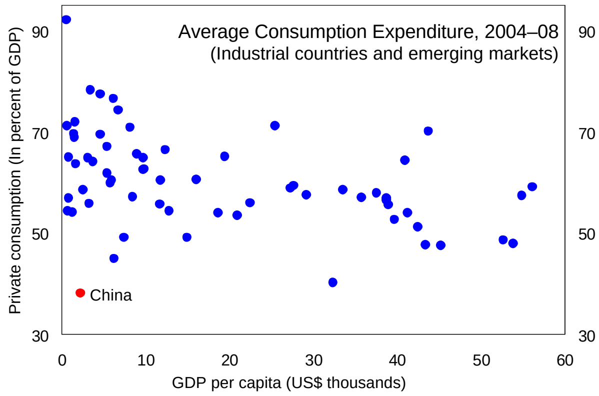
Encouraging progress is already being made in many areas. The government has made clear its objective to reduce China's reliance on external demand and to stimulate domestic consumption in the coming years. Health care reform is moving forward and the government is steadily broadening pension coverage for rural residents.

Steadfastly addressing the various policy areas outlined above will make China an even more important global force for growth in the coming years. This will benefit China—raising both employment and household welfare—and also will provide positive spillovers for the wider global community.

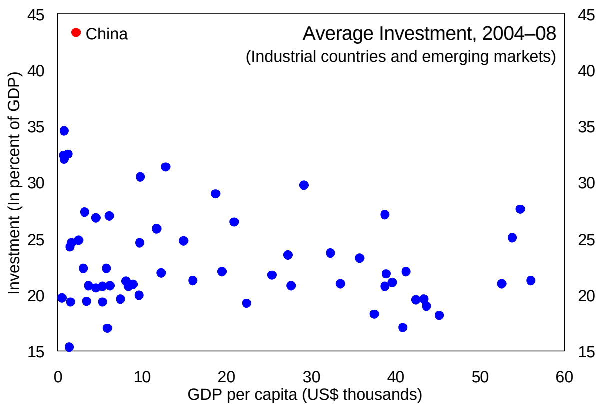
Graph 1: China's economy, like others in Asia, was hit hard by the global downturn, largely through trade channels



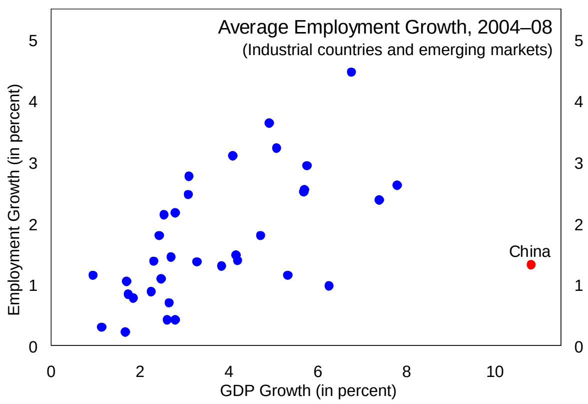
Graph 2: China' s low level of private consumption stands out from an international perspective



Graph 3: China's investment is high by international standards ...



Graph 4: ... and China's high growth has not been very job-intensive



Source graphs 1-4: IMF Staff Estimates.

8 Facts and Figures That Matter

By Alina-Stefania Ujupan

The global giants in the battle for leading the world

On the 19th of June 2009, Brazil, Russia, India and China (also known as the BRIC) held their first summit in Yekaterinburg. The leaders of the four countries pleaded in a common declaration for a multi-polarised world, reflecting their will to become better involved in world governance. Moreover, they announced their intention to reduce their dollar assets and increase the use of domestic currencies in international trade. China, Brazil and Russia are to trade a part of their foreign currency reserves in dollars for IMF bonds issued in special drawing rights (SDR). Although not receiving the attention of a G2 or a G8 summit, the BRIC summit was the potential beginning of an institutional framework of cooperation between the four emerging economies and puts pressure on the domination of the industrialised economies at the world scale. This note explores the leadership potential of the BRIC in the current system of global governance.

Despite lower income levels than industrialised economies (Fig. 1), the BRIC are impressive in terms of their size and economic potential. They have 42% of the world population and cover 29% of the land area of the globe (Table 1). Currently the BRIC supply 22% of the world output, while only a decade ago they supplied 16% (Fig. 2). The size of their economy and of their markets has acted as cushion in the current financial crisis, rendering the four countries less dependent on exports and making them the drivers of economic recovery[1]. Their long-term economic ascension (Fig. 3), which is amplified by the current financial crisis, is challenging the current economic and political global order.

The BRIC are a heterogeneous group. Russia and Brazil are commodity exporters, while China and India are huge consumers (Fig. 4); all four however being inescapable players partners of any serious attempt to reduce CO2 emissions and tackle climate change in the future (Fig. 5). Their positioning either on the supply or the demand commodity curves may favour economic integration among the four, as with economic development more resources will be traded in the future.

The four economies, although certainly affected by the global crisis, have followed somewhat an idiosyncratic cycle compared to most industrialised economies[2]. Being developing economies in a rapid catching-up process, the BRIC have experienced, even in times of crisis, growth rates that are higher than those of industrialised economies. Nonetheless, the BRIC's capacity to integrate further and participate in global governance is yet to be tested.

The post-crisis growth perspectives for each of the four states are not necessarily likely to follow similar directions. Nouriel Roubini[3] has drawn attention to the economic risks that may impede the BRIC from a smooth recovery: Brazil's outlook strongly depends on the timely development of 'credible macroeconomic policy-making and sound banking system'. India's pick-up may be constrained by slow reforms. Russia has been most severely hit by the crisis, facing a 9.5% q/q contraction in Q1 2009. Structural vulnerabilities such as weak productivity, underinvestment in infrastructure, demographics are barriers that are difficult to overcome. China, on the other hand, has responded to the crisis with significant government stimulus, boosting growth, however risking the development of asset bubbles and non-performing loans in the long run.

Although united by a common interest – to have greater influence in global governance by increasing their clout in international institutions – the BRIC's policy views and motivations do not always follow a common line. Of the four, China could be the least interested in having the BRIC coalition and has consequently the greatest veto power. China stands on its own both economically and politically: the Chinese economy is greater than the economies of all the other three members put together (Table 1) and has political recognition as a world power through the G2 summit[4]. In addition, India's involvement in the BRIC may weaken should it become a permanent member of the UN Security Council. The remaining two members, Brazil and Russia[5], are the ones that need the BRIC grouping the most. The four countries do not share similar views on climate change or trade. Some bilateral relations are still biased by former border conflicts (as it is the case with India and China) and some countries lack the necessary institutions, as well as the full acknowledgement of democracy and human rights protection. These shortcomings may weaken the BRIC's influence at the world level.

Overall, the four global giants' claim for more influence and leadership in global governance is justified by their size and economic clout. Nonetheless, their capacity to evolve into an integrated economic block with leadership potential at the world level is impeded by differences in policy views and economic profiles. It is therefore less likely that one will see concerted policy lines on behalf of the BRIC with regards to major issues of global governance such as trade, climate change, or finance.

ENDNOTES

[1] http://www.imf.org/external/pubs/ft/survey/so/2009/rea072209a.htm

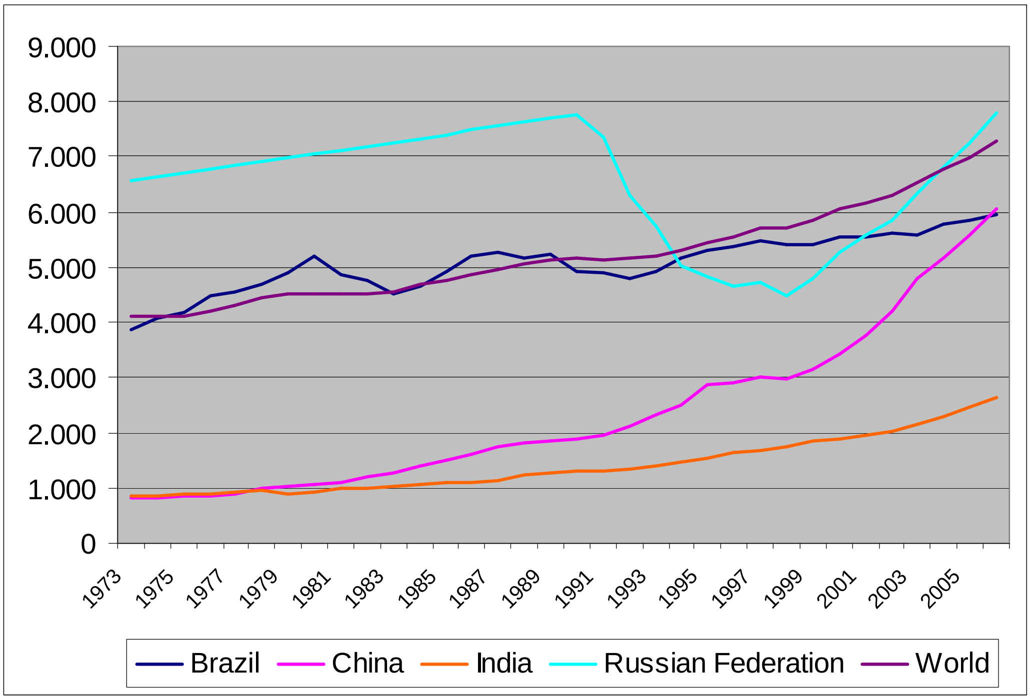
[2] 'Not just straw men' The Economist, June 20th 2009

[3] 'The Brics: An Analysis', Nouriel Roubini, The Forbers. Com, 18th June 2009.

[4] Reuters: Analysis – Does more than ambition cement the BRICs?: http://in.reuters.com/articlePrint?articleId=INIndia-40229220090610

[5] Although Russia is part of the G8, its visibility among the 8 is much less than that of China in the G2.

Figure 1: Evolution of GDP/cap in the BRIC as opposed to the world average (1990 International Geart-Khamis dollars)



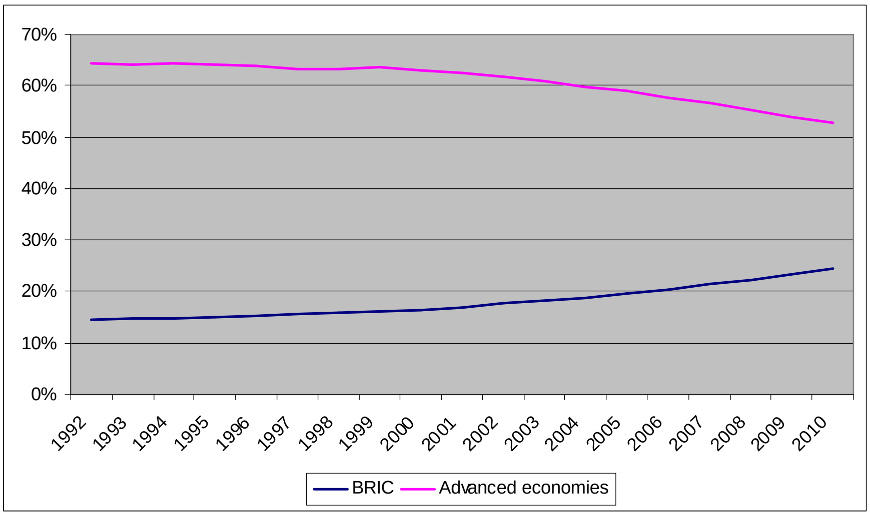
Source: The Maddison Database.

Table 1: The BRIC in the World

2007	Brazil	China	India	Russia	BRIC	World
Population, total (millions)	191,6	1.318,3	1.124,8	142,1	42%	6.610,3
Surface area (sq. km) (thousands)	8.514,9	9.598,1	3.287,3	17.098,2	29%	133.945,8
GDP (Current International Dollar; Bn.)	1.845,4	7.105,4	2.999,7	2.095,4	22%	65.490,3
Life expectancy at birth, total (years)	72	73	65	68		69
Population growth (annual %)	1,2	0,6	1,3	-0,3		1,2

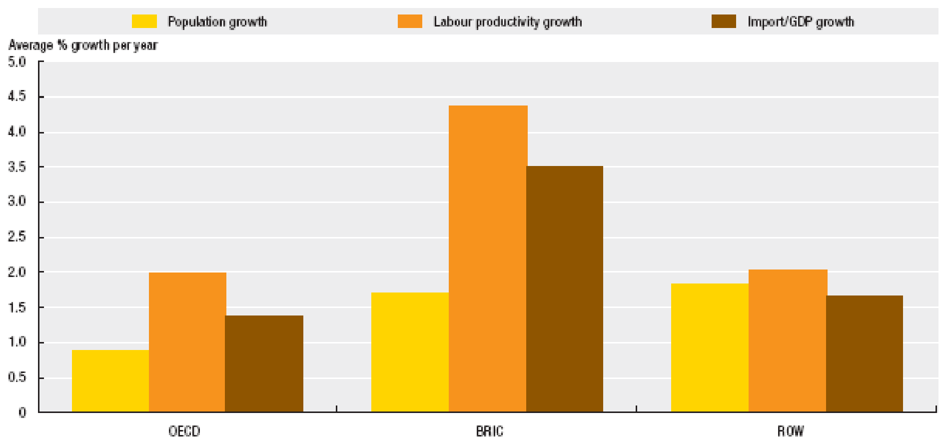
Source: World Bank; IMF.

Figure 2: Evolution of shares in the world output (GDP based on PPPs; current international dollar)



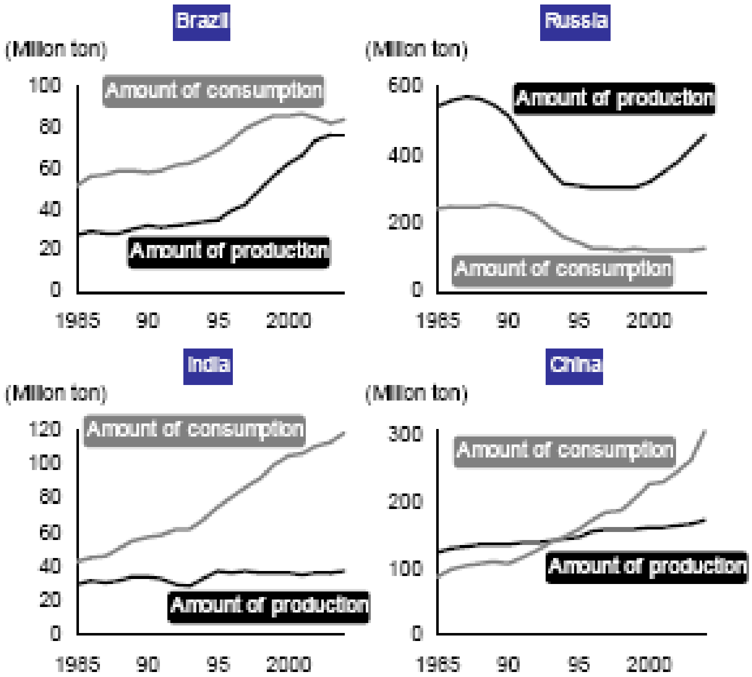
Source: IMF, WEO Database, April 2009.

Figure 3: Growth trends (average % per year) 1980-2001



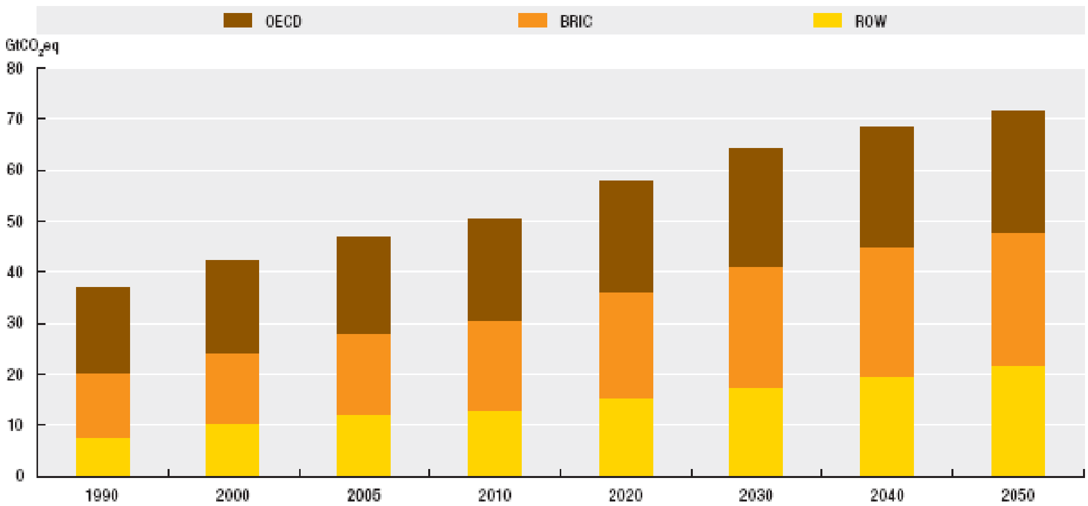
Source: OECD Environmental Outlook 2008.

Figure 4: Crude Oil Consumption and Production



Source: Mizuho Research Institute, 2006, "Comparative Analysis of the BRICs".

Figure 5: Baseline GHG emissions by region (1990-2050)



Source: OECD Environmental Outlook 2008.