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BROWN BROTHERS HARRIMAN

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Bric or Crib ?

Brazil, Russia, India and China, now collectively known as the BRICs, will hold a summit in Russia on June 16th. Besides the Goldman-Sachs invented moniker, these countries have very little in common except for the fact that they believe, to seemingly varying degrees of intensity, that they deserve greater influence in the conduct of world affairs than they currently have. And given the enormity of US power, as hard-core realists, they know any increase in their power and influence will come at the expense of America's.

The BRICs are on different sides of the terms of trade trends. Brazil and Russia benefit from higher commodity prices, while India and China prefer lower prices. All, except Russia are in the World Trade Organization. All but Brazil have nuclear weapons. While India and Brazil are democracies, China surely is not. While it may be premature to draw hard and fast conclusions about Russia, the direction does not look particularly promising.

Russia and China are permanent members of the United Nations Security Council. With their veto power there, they arguably have achieved greater political influence than in the economic sphere. Russian and Chinese influence is often sought in regional issues, like the Caucuses and North Korea. For their part, Brazil and India have quite different foreign policies. For Brazil, its immediate surroundings are considerably more peaceful than in Eastern and Central Europe, where the end of an empire has seen the birth of new states. India's foreign policy challenges are dominated by Pakistan. Security Council membership remains in the realm of aspirations.

CRIB

One of the most important reasons why the BRICs do not have the economic clout that they would like is frankly they don't deserve it. Goldman-Sachs had a story (and more) to sell with its BRICs concept, but those same letters spell a real word, CRIB. The point is that the countries, outside of China, are not among the largest.

According to Bloomberg data, at the end of last year, China was the fourth largest economy ($3.2 trillion), behind the US, Japan, and Germany. This of course takes the Chinese data at face value, and given the often large gaps between energy production and reported GDP growth, as well as the amazing consistency of the pace of growth, many often cast a suspicious eye on Chinese data.

With a GDP of $1.3 trillion in 2008, Brazil was the 10th largest economy, though it is roughly half the size of France, which is the 6th largest economy. Russia and India were neck-and-neck for 11th and 12th places with each having produced about $1.2 trillion of goods and services last year. Spain's economy is nearly 20% bigger than Russia's and India's, and it is the 8th largest economy. Together the BRICs account for a little more than 12% of the world's GDP, and China alone accounts for half of that.

The BRICs are also small in terms of the depth of the capital markets. Together, according to Bloomberg data, they account for a little more than 6% of the world equity capitalization (MSCI World Index). What equities that are truly tradable are very limited and concentrated in a few names. Often the markets lack the kind of transparency that many Western investors are familiar with, even given the financial crisis.

There are various capital controls and the BRIC's currencies are not freely convertible or tradable. The banks have managed to partially circumvent the restrictions of the domestic (on-shore) market by creating a parallel off-shore market and non-deliverable forward contracts. Rydex's CurrencyTrust ETF that tracks the ruble (XRU) was launched at the end of last year and has drawn little interest. It boasts a lowly $5 million market cap (assets under management).

Girth Not Size

Political scientists often argue that one of the characteristics of power is that it is concordant. By that they essentially mean that by having one element of power, say economic prowess, one can achieve other elements of power, such as like cultural influence. And yet during the Cold War, Russia's claim to world power relied almost exclusively on one element—its military might. Power is surely multi-dimensional, but one of the common characteristics of the BRICs are that their power is limited in breadth and depth.

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Each of the BRICs has amassed a large level of reserves. Brazil has the least at about $205 billion, just below India's $251 billion. Russia has almost as much as both of them put together with almost $410 billion. China dwarfs all of them, individually and collectively, with nearly $2 trillion in reserves. Together they account for a third of the world's currency reserves.

Yet there is no reason to consider them as a unitary whole or that they will act in concert. To the contrary, they each seem to embrace their reserves differently. India seems to regard its reserves most traditionally; an insurance against future calamities. Brazil is more willing to use reserves for domestic purposes and operates in the foreign exchange market daily. Given that Russia defaulted a decade ago, it is little wonder that its large reserves, a third of GDP, are a sign of national pride. The run-down in reserves during the last five months of 2008 was more politically embarrassing than threatening from an economic point of view.

China's massive reserves, more than a quarter of the world's reserves, are as much a sign of its successes as its failures. Reserves accumulate as a function of China's large trade surplus. Rather than increase the share of consumption in GDP, China's own figures show that it has fallen. China remains reliant on exports. Reserves accumulate as the central bank absorbs some of the hot money coming into the country so as to neutralize its effect. Reserves also accumulate as China manages its exchange rate.

IMF Bonds

The BRICs appear to be under-presented in the International Monetary Fund. As we have seen they account for about 12% of the world economy and yet have a combined quota (vote) of 9.82%. Yet the representation is not as straight-forward as that. Consider that the US accounts for a quarter of the world's economy and yet the US has a 16.77% weighted vote at the IMF.

The April G20 meeting resolved to raise more funds for the IMF. Some countries like Japan have lent the IMF money. The BRICs want to provide their funds in the form of SDR (Special Drawing Right) bonds. This dovetails nicely with their call to increase the use of the SDR.

Some esteemed money managers are reading into this a grave signal. According to Bloomberg reports, Mark Mobius, executive chairman of Templeton Asset Management, sees the desire for SDR bonds as a rebuke of US fiscal policy. Mohamed El-Erian, CEO of PIMCO, sees the purchases as evidence of accelerating rebalancing of the world economy.

But, it does not seem that it is about us as in the US, but rather about these countries trying to bolster their own prestige and gravitas by contributing to the IMF. It is a function of the wealth they have already attained (reserve accumulation), but says nothing about the challenges that lie ahead. Moreover, the moves are largely symbolic. The $10 billion worth of SDR bonds that Russia is going to procure is 2.5% of its reserves. The $50 billion China will provide is about 2.5% of its reserves as well. Russia is thus far the only BRIC to suggest it will purchase the SDR bonds with its Treasury holdings, which stood at about $138 billion at the end of March, according to US Treasury data. It does not amount to noteworthy diversification of reserves. Nor does it represent much of a diversification away from the dollar as the greenback accounts for 44% of an SDR-basket. The contribution that Japan is committed to is greater than all the BRICs combined. Although noticeably quiet on the subject, India is expected to provide $10 billion to the IMF.

Still an SDR bond market is innovative insofar as one does not exist at the moment. The IMF is expected to announce details later this month or next month. Rather than have to sell US Treasuries there has been some suggestion that the interested countries, which are likely to extend beyond the BRICs, may swap the Treasuries for the SDR bonds, minimizing any market impact. A newly formed SDR bond market will lack the breadth and depth to truly compete with the US Treasury market, though it might have some novelty appeal. The impact on the dollar will likely be marginal at best. An SDR bond market does not mean the SDR is a viable alternative to the dollar or is any closer to being the supra-sovereign reserve asset that some imagine.

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