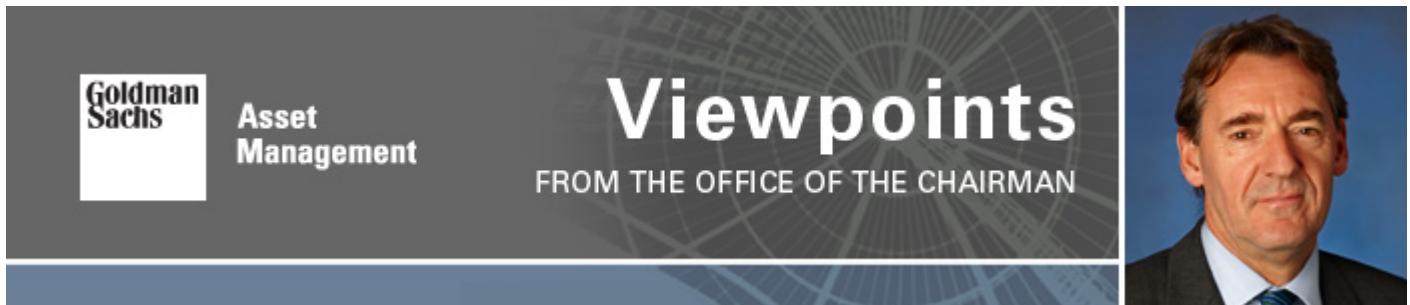


From: O'Neill, Jim [IMD]
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Subject: Some BRICs Built But More Needed



Some BRICs Built But More Still Needed.

Next Wednesday, November 30, is the tenth anniversary of when I first mentioned the BRIC acronym when I published GS Global Economics Paper No: 66, "Building Better Global Economic BRICs." As I am sure a number of readers now know, I am publishing a book to celebrate the anniversary. It is called "The Growth Map." Any proceeds accrued to me from the book will be donated to the charity SHINE, Support and Help In Education—www.shinetrust.org.uk—that I am Chair of, and helped set up with some friends back in 1999.

In this week's Viewpoints I decided to highlight some of the major observations involving the BRIC development over the past decade, as well as some key issues related to ongoing recent events.

The 2001 paper didn't create a lot of attention at the time. It was not really until after the publication in 2003 of GS Economics Paper No: 99, "Dreaming With BRICs: The Path to 2050," authored by Dominic Wilson and Roopa Purushothaman, that the theme really caught on. The fact that many large multinationals started to embrace the BRIC concept around this time and, of course, the happiness of the four BRIC countries themselves, helped give the theme such a push.

There were three essential arguments I made in the 2001 paper:

Firstly, I simply pointed out that if on a relative and absolute basis the strong growth of the four BRIC countries—Brazil, Russia, India and China—continued at the same pace, by 2010 they would become a much larger part of the world economy. In the most optimistic of the scenarios I considered, I suggested that their combined share of GDP could rise from the then 8pct to around 14pct. In the event, their share has risen to around 18-19pct. I suggested that China might get close to the size of Germany. In the event, it has sailed past Japan and has already become not far off twice the size of Germany. I suggested Brazil might get close to the size of Italy, and it actually crept above them to be the seventh largest economy last year. The collective nominal growth of the BRIC economies was close to \$10 trillion creating more than three times their 2001 size of around \$ 3 trillion.

Secondly, because of their relative shift, I argued that the BRIC countries should become more central to global economic policymaking, suggesting each of them, certainly China, should become part of the G7/G8-type groupings. Of course, while this hasn't happened quite this way, the G20 was placed at the front of global co-ordinated policymaking primarily to bring the BRIC countries into the centre. It took the global credit crisis in 2008 for this to happen, but it has, and this is probably one of the better things that have happened since. Despite many issues about the operational effectiveness of the G20, its legitimacy is greater than that of the G7/G8.

Thirdly, another key—and currently still very topical—point of the paper was my argument that since France, Germany and Italy were all now part of a monetary union with no independent monetary policy, why didn't they agree to represent themselves collectively in the G-meetings and indeed at the IMF? Amongst other things, it would demonstrate to many that their commitment to a permanent monetary union was rock solid. This is one of the BRICs that still needs to be built. In hindsight, this lack of bold vision and leadership was, and has been, symptomatic of the weaknesses in the structure of EMU, many of which, of course, escalate by the day. If EMU is to survive in the future, then the Euro zone must start to act collectively as one. Perhaps this is now where we are headed, and certainly the increasingly vocal call for a new, stronger fiscal framework from German Chancellor Merkel shows what they would like. As I will discuss more below, while there is plenty of debate about the role of true Euro-denominated bonds, more and more Euro policymakers are moving towards this ultimate goal. Merkel is now openly suggesting a revised Treaty to accommodate it, and following her joint meeting with Sarkozy and Monti last week, a specific proposal looks like it is going to be presented by

December 9. If this is where the Euro Area is ultimately headed, with a central Finance Ministry-type entity, then it should be relatively straightforward for all remaining Euro members to combine as one when it comes to their representation in the IMF and at G7-type meetings. If so, this would allow for the eventual reduction of the G20 towards something more like a G9 which is what I argued for back in 2001. The four BRIC countries would join the Euro Area, together with Japan, the US and still probably Canada and the UK. Of course, there would be questions about the legitimacy of the latter two and perhaps it might eventually be just a new G7 without them. The existing G20 could serve as a broader umbrella group but would not be as central as it currently has become.

Looking Back and Forward With the BRICs.

As I said, the BRIC economies combined have grown to around \$13 trillion and are poised to overtake the size of each of the US and the EU in coming years. Over the decade, they have created the equivalent of close to seven new United Kingdoms or at least of the 2001 size. China alone has added slightly more to world GDP than the US, around \$ 5.5 trillion probably by the end of this year.

In the decade ahead, the BRIC countries will probably create at least another one of their current self, i.e., grow by around \$12-13 trillion in nominal \$ terms, assuming that they collectively grow at somewhat softer rates. If they grow by similar degrees as the last decade, their contribution in nominal \$ could be closer to \$20 trillion. China seems likely to grow by more modest rates, perhaps in the 7-8pct range, but India could accelerate. This could be especially true if India persists with what looks like some sudden passion for policy reform. In what I would describe as the most interesting economic news of the week, on Thursday the Indian government appears to have decided to allow majority foreign ownership of their domestic retail businesses. This is obviously huge news for the world's biggest retailers given India's fabulous demographic but it is probably even more important for Indian agricultural productivity and supply chains which is why policymakers have finally decided to take this step. More of these kinds of decisions and India will possibly finally succeed in achieving China-style GDP growth rates.

Another major consequence of the BRIC story has been the desire of other large-population emerging economies to get into the "club"—something itself we recognized back in 2005 when we thought of the "Next 11" idea. Many of these countries before and after have wanted some of that BRIC "magic". These days, at GSAM, we regard four of them—Indonesia, Korea, Mexico and Turkey—as sufficiently large and important to be considered "Growth Markets" along with the BRICs. Going forward, it is quite likely that others may become this differentiated, perhaps at some stage including part of Africa and the Middle East. I discuss aspects of this in the book. I spent Friday in one of the non-BRIC Growth economies, visiting Istanbul to present my views of the world for a major client. I was literally in and out, but what a remarkably vibrant city Istanbul is these days. I cannot understand why continental European countries are not more eager to embrace this country, especially as it would seem like an obvious credible "model" for some of the dramatically changing nations in Northern Africa and the Middle East.

As it relates to the BRIC politics, Philip Stephens wrote a very interesting op-ed in Friday's Financial Times entitled "BRICs without Mortar." He points out that the four countries are not natural political bedfellows, highlighting some of their bilateral issues and many of their differences. I would agree with many of his points, but I don't think this means they are not increasingly relevant for the world and, as discussed above, they should be more and more central to optimal global economic policymaking. I never suggested that they should operate alone as a political club, and other than highlighting the inadequacies of the current G7, etc., the purpose of such a club—especially now South Africa is included—seems a bit limited. However, by the end of this decade, the BRICs and the other four Growth Markets collectively will be not far off the size of the G7. The BRICs collectively will be bigger than the US. So, from an economic perspective, the BRICs will be contributing lots of mortar.

Against this background, it seems inevitable that the current world monetary system is likely to evolve differently with, at a minimum, the role of the RMB becoming more important, and as I discuss in the book, perhaps other changes might occur.

And As for the Euro?

Away from BRIC-life, this past week, the Euro finally showed some signs of crumbling against other major currencies as the crisis amazingly seemed to deteriorate further. The specific prompt of the Euro weakness appears to have been the disappointing German bond auction on Wednesday. To many, this certainly suggests this much hyped "safe haven bid" for Bunds is simply not there, and it also suggests non-European investors might be fleeing all things European. Of course, it might not mean any of those things but in the current climate, not surprisingly; this is what many have concluded.

I attended the latest board meeting of Bruegel, a European think tank, on Wednesday. It was created at the suggestion of French and German policymakers back in 2005 with a goal of encouraging a more outward looking Europe. We had a very full agenda so had limited time to discuss specifics about current market matters, but a new paper was circulated,

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I would suggest this is broadly where many Euro thinkers now believe EMU will have to end up, assuming it can get beyond the coming days and weeks. The news of the German bond auction appeared as we were meeting, and against

this background, my own interpretation of this development was different from many others. The market has now essentially decided that any country in the Euro, even the core, carries risks. This raises the possibility—if accurate—that an option to change this perception might be to exit the Euro. Another equally likely possibility, if markets are increasingly treating all the Euro Area in a similar manner, is that Euro bonds are essentially arriving through the back door. Why not get a move on to a stronger monetary union and then set up more credible Euro bonds? Either way, it seems to me that Germany is moved towards the “end game” earlier than it might really want and by December 9 towards some stated “intent” that in the event a new Treaty would be eventually implemented, Euro bonds would be an accepted part of it. This is the essence of the Bruegel paper.

Changes in the stance of the ECB seem inevitable also, despite Sarkozy’s apparent backpedalling from criticizing them in public. Of equal, if not greater, importance were signs that the conservative Dutch policymakers are now saying that the ECB should do more. With the vicious circle of delevering escalating, where no one wants to have exposure to any European government bonds or bank equity, the ECB has an operational obligation to start behaving like the area’s central bank, not some moral policeman. One can see why they hesitate about some governments, but if we carry on down the current path, they won’t have a Euro Area to be the central bank of.

Rather oddly in the midst of all this mayhem, there were a couple of slight positive surprises data-wise. Not only did the flash Euro Area Services PMI rise, but the latest German IFO was quite a bit stronger than expected. It is quite interesting in this regard that other countries, including the UK especially, increasingly blame the Euro woes for their own growing signs of economic weakness when not all signs are so weak from even within it. This suggests that in the unlikely event that we get a surprise powerful early turn of policy from the ECB, it will be easy for markets to snap right back. Of course, on the other hand . . .

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Viewpoints are also available on our public website: www.gsam.com/jimoneill. Monthly Insights and Strategy Series are available on www.goldman360.com. If you do not have access, please contact your Goldman Sachs relationship manager.

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