PROJETA

BRAZIL MEMO Nº 1407

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ASYMMETRIC ADJUSTMENT

- ✓ **China´s role as an anchor of world growth is showing signs of weakening. In the second quarter, its GDP grew by 7.5% - an impressive drop if compared to 2007´s 14%.**
- ✓ **Exports lost vitality and gross capital formation advanced near 8%, contrasting with last decade´s 13% average.**
- ✓ **China would have to move to a new consumption driven strategy.**
- ✓ **This new strategy, however, faces major obstacles: the risk of boosting inflation and reducing the households' high propensity to save.**
- ✓ **In reference to the emerging countries, it should be stressed that in view of the end of the super cycle, the diversification of exports has become increasingly relevant.**
- ✓
- ✓ **Brazil, in particular, will have to take a path opposite to that of China's in terms of economic strategy: reduce consumption and stimulate savings.**
- ✓ **The most needed encompassing reforms in Brazil – tax, labor and social security – compose a complex agenda. Its implementation is even more difficult when it faces an uncertain foreign scenario and a domestic climate marked by political tensions.**

In recent years, **China** worked well as an anchor of world economic growth. China is currently showing signs of **deceleration**, indicating that its role as a counterbalance to stagnating advanced economies has apparently reached its limits.

- ***Soft Landing*:**

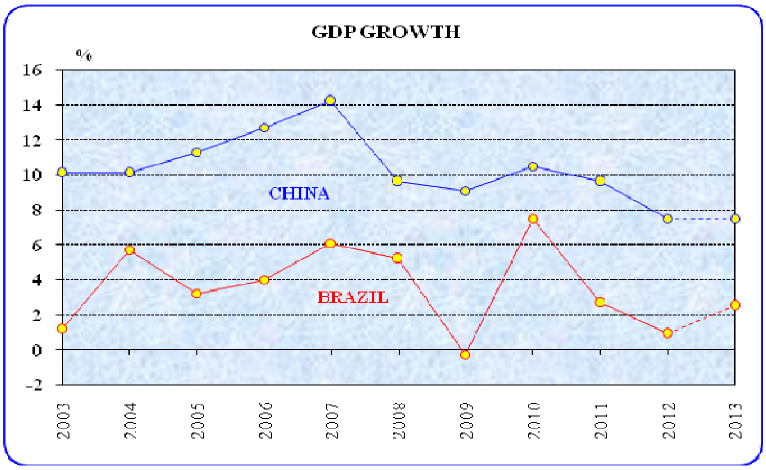
  Second quarter **GDP** grew by 7.5%, a weak performance unlike any seen since the late 1990s.

  It might appear high, particularly when compared with other emerging countries such as a Brazil. However, this is an impressive **drop**: China's growth was around 14% in 2007.

  The model implemented since the 1980s, based on **exports** and **investments**, is showing signs of exhaustion.

  Gross capital formation is growing at a more moderate pace, at around 8%, in contrast to last decade´s 13% average.

  Exports are losing momentum, having fallen in June, reflecting weak demand from advanced economies.



"The Chinese economy lost steam"

- **Reform:**

It's not easy to change growth mechanisms "while in flight". The risks of an **emergency landing** are palpable.

The government's strategy is to drive economic growth toward a lower, but sustained, level at around 6%. To reach that goal it will be necessary to increase **consumption**, which will serve as the new dynamic pole. Leveraging domestic demand through credit, without creating **speculative bubbles**, is a difficult task.

The inefficiency of the Chinese **banking system** is certainly a great obstacle. It is made up of a combination of potentially explosive state mega institutions that are vulnerable to political pressures. Moreover, the state banks exist alongside a shadow banking system which operates outside the official regulatory framework.

It is therefore not surprising that this structure is sustaining an exaggerated increase in **credit** at artificially low rates. Credit already amounts to 200% of GDP.

The timid approach toward **liberating interest rates**, restricted solely to loans, highlights the scale of this problem: to eliminate the minimum floor of 70% of the reference rate (6%) the Chinese government is focusing on the short term.

Reducing the cost of **borrowing**, mainly in the public sector, is a dangerous strategy. Although it can generate an extra boost, it does so at the expense of deepening serious macroeconomic imbalances.

- **Inflation:**

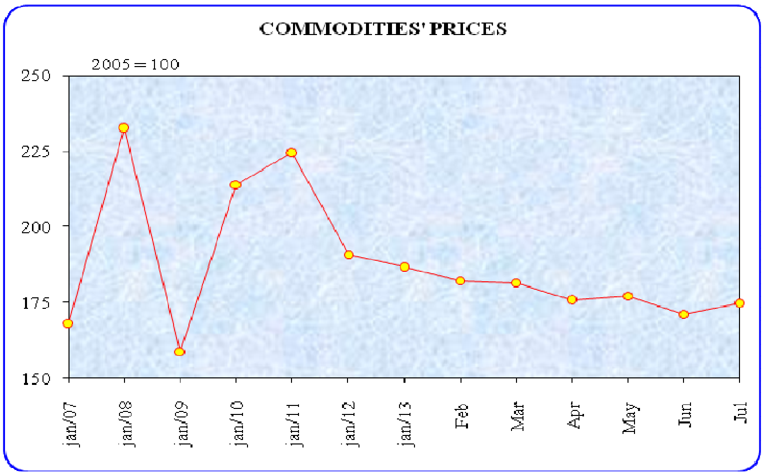
There are two additional restrictions that lie ahead. The transition from an investment to a consumption based model has to be implemented without refueling **inflationary pressures** – particularly in the sensitive foodstuff area.

At the same time, public and private **social security** systems should be improved in order to reduce the households' high propensity for saving, which is currently the only option to ensure a future retirement.

In short, China´s new dynamics suggest a **tortuous and uncertain** future. It is a disturbing element for a world economy that is already immersed in a hostile global environment.

- ***Emerging Countries*:**

  With the **super cycle** having reached its end, the diversification of exports in terms of markets and products has become even more relevant.



"Commodities tend to accommodate at a lower level"

There is a curious **asymmetry**: Brazil´s restructuring implies that the reduction of consumption is a source of growth. Consumption would be replaced by investment.

In other words, it is following a path that is **opposite** to China´s. The obstacles are well known: in the short term, higher inflation narrows the room to maneuver in terms of anti-cyclical policies.

In the mid and long term, it is necessary to make space for private investments in **infrastructure**, the precondition of which is overcoming the confidence crisis.

The enforcement of **encompassing reforms** – tax, labor and social security - is the only alternative toward improving the quality of macroeconomic management and the Brazilian economy´s productivity.

This whole agenda would already be complex within a scenario of foreign economic dormancy. With the prospect of China heading towards an emergency landing everything becomes more **pressing** and, at the same time, more complex.

As usual, Brazil **lost its timing**: deep adjustments will have to be implemented in a scenario of diminished confidence due to low industrial growth and increasing political tensions. The labor market, which shows signs of weakening, is even more worrisome with an increasing jobless rate (6% in June) and a falling pace of real gains in wages.

Brazil can no longer count on the help of Chinese **exuberance**. China´s leading role in the global economy seems to have come to an end.