



May 2009

Long term outlook of BRICs remain positive

Despite global recession continue, we believe that the longer-term outlook for BRICs remain positive due to their relatively strong fundamental characteristics and faster growth potential than their developed counterparts. BRICs are well positioned for a rebound once the world economy stabilizes. With reference to World Bank and Goldman Sachs' report "BRICs and BEYOND", this article discusses the economic outlook of these four countries and the ways they can sustain their long-term economic growth.

India

India's GDP (in USD terms) will likely surpass that of the US before 2050, making it the world's second-largest economy. Since 2003, there has been a structural increase in India's potential growth to nearly 8% from 5%-6% in the previous two decades. Productivity growth has been the key driver behind the jump in GDP growth, contributing nearly half of overall growth since 2003, compared with a contribution of roughly one-quarter in the 1980s and 1990s. We believe that the productivity growth is likely to be sustained for the coming decades.

India's urbanization rate is 29% in 2008, which is still very low compared with 86% for Brazil, 73% for Russia and 43% for China. Rural-urban migration in India has the potential to accelerate to higher levels as, judging by the experiences of other countries, the pace of migration tends to accelerate after a critical level of 25%-30% urbanization is reached, and due to faster economic growth. Urbanization is spurred by both push and pull factors. Deteriorating agricultural productivity, caste barriers and unemployment in villages push rural inhabitants out, while better opportunities in cities, very high growth in the construction industry and demonstration effects from other migrants pull rural workers into urban centers. It is expected that 140mn rural dwellers will move to urban areas by 2020 and 700mn people will have moved to urban areas by 2050.

In India, agriculture employs close to 60% of the labor force. But labor is nearly 4 times more productive in industry and 6 times more productive in services than in agriculture, where there is a surplus of labor. Given that the movement from agriculture to other sectors is still in its initial phase, we expect the gains to increase and continue for several decades. India also needs investments in agriculture to boost productivity, especially in rural connectivity, storage, etc., to improve the yield of remaining agricultural land.

Increased financial intermediation improves resource allocation by effectively channeling savings into investment and raising productivity. India's financial sector is still relatively small compared with the size of its economy, as well as with those of its East Asian neighbors. Assuming that policies to open up the financial sector remain on track, we expect financial deepening to continue and to contribute to increases in productivity in the medium term. Besides, India is the fastest-growing market for mobile phones, with average growth rates of over 80% every year since 2000. India's technology spending is still low and there remains substantial scope for catch-up and productivity gains.

Obviously, India's growth transition is unlikely to be smooth or devoid of shocks. India will need to alleviate supply-side constraints to doing business. It currently takes about 35 days to start a business, 270 days to obtain various licenses and permits, 62 days to register a property, and a shocking 10 years to close a business. It is also extremely difficult to lay off workers in India, and on average it costs more than one year's wage. Environmental degradation is another critical risk to India's long-term growth potential. With increased urbanization, industrial development and a burgeoning need for energy, India will be a large contributor to global warming. Climate change can cause erratic monsoons, with grave implications for rural incomes and overall growth. India will need to put in place policies that are increasingly environmentally friendly.

Temporary fiscal stimulus such as enhanced public spending, increases in public sector wages and tax cuts are expected to prop up economic activity, but it is imperative that the government deficit should be brought down in the medium term to a manageable level so as to assure long-term debt sustainability. Similar to China, the saving rate in India is high. The inadequacy of India's social security system is a major reason. Only around 10% of India's

population is covered by a retirement-benefit scheme and the health insurance coverage is also low. As a result, the government would like to channel household savings into the country's debt, equity and infrastructure-finance markets. This would stabilize the financial markets and reduce the government's future social security burden. The completion of structural reforms and substantial investment in infrastructure are the main requirements to help the economy maintain its longer-run growth trajectory. The creation of new Special Economic Zones (SEZs) will attract private-sector as well as foreign investment, thus helping to develop much-needed infrastructure, generate employment and facilitate urbanization.

In absolute terms, India will remain a low-income country for several decades, with per capita incomes well below its BRIC peers. But if it can fulfill its growth potential, it can become a motor for the world economy and a key contributor to generating spending growth.

China

China's unrivalled economic growth over the past quarter-century has surpassed all records and created a new standard in the history of economic development. Economic reforms since 1978, state-owned enterprises (SOE) restructuring in the late 1990s, entrance into WTO in 2001 and the modest appreciation of Chinese Yuan since July 2005 are unambiguously positive for the economy. The average growth in real GDP in the past 10 years is 10.53%. By 2030, the size of the Chinese economy (in nominal USD terms) is expected to surpass the US to become the world's largest economy.

China has benefited from strong raw labor growth from the late 1970s until now, but the future demographic outlook suggests that the growth of the labor force will slow and ultimately decline after 2030. Although it is still considered a developing country by many standards, China has the fastest ageing trend among the BRICs. China's average population growth from 1950 to 1978 was 2.01% per year. Since then, population growth has slowed substantially. From 1979 to 2004, growth averaged 1.16% per year. By 2008, the population growth rate had fallen to about 0.63%, which is higher than Russia (0.47%), but substantially lower than India (1.58%) and Brazil (0.98%). Two main forces drive these changes: 1) increased longevity, which is raising the number of elderly, and 2) the one-child policy, which has slowed the growth rate of young adults in the population. The implication for workforce growth is immediate and significant. When more workers reach retirement age and growth of the young adult population slows, the dependent per-worker ratio will increase and the demographic bonus will end.

A change in the one-child policy would help sustain China's population growth in the long run and improve its demographic structure. In our view, a gradual and conditional easing of the this policy beginning in 2010 would significantly boost the total population by 2050. The government is reported to be considering a gradual lifting of the one-child policy from as early as 2010. Ultimately, birth rates are likely to stabilize at a level that is higher than in most developed countries, but lower than that in most developing countries. China's population is ageing, but its economy should continue to grow rapidly with the help of a better-educated labor force and rapid urbanization. The gains from human capital development and intensive urbanization will help buffer the slowing labor force growth.

The global economic crisis is bound to contain China's growth in 2009 and 2010, especially via weaker exports, market based investment and employment. However, China's growth is still to be higher than in most other countries: it has huge amount of foreign exchange reserve and does not rely on external financing; its banks are largely unscathed by the international financial turmoil; and the government has space and willingness to implement forceful fiscal and monetary policy stimulus. The subdued prospects for the exports increase the importance of boosting domestic demand and domestic consumption, therefore, instead of the traditional, largely investment-oriented fiscal stimulus, more consumption-oriented fiscal stimulus are expected to be implemented. The draft of China's first Social Insurance Law was released in late 2008 for public consultation and may be introduced later. It is one of the steps taken to improve the social safety net which can help reducing the saving rate and boost the consumption. The Communist Party of China issued a landmark policy document on Oct 12, 2008 to allow farmers to lease their contracted farmland or transfer their land-use right to boost the scale of operation for farm production and provide funds for them to start new businesses. The new land policy, together with the Property Law passed in March 2007, can over time generating higher incomes for China's farmers.

We believe that China's GDP growth has likely bottomed and China's stimulus efforts are producing results, but economic recovery takes time. The inefficiency of the banking and financial markets is currently a drag on economic growth, but in future, the financial sector will make a large contribution to growth due to deregulation and increased competition.

Russia

Russia is the largest country in the world and contains the largest reserves of mineral resources of any country in the world. It is especially rich in mineral fuels. The country may hold as much as one-half of the world's potential coal reserves and may hold larger reserves of petroleum than any other nation. Although minerals are abundant, many are in remote areas with extreme climate conditions, which make them expensive to extract. Not only could it become the largest economy in Europe before the middle of this century, but alone among the BRICs, Russia has a real chance of catching up with living standards of the current G7.

After the economic crisis in 1998, Russia's economy rebounded with surprising speed. The depreciated Ruble restored the competitiveness of many tradable sectors, while depressed imports caused the current account surplus to surge to 13% of GDP in 1999 and 18% in 2000, allowing the central bank to start accumulating reserves. Former President Putin introduced structural reforms to address many of the economic rigidities left over from Soviet days. Between 2000 and 2003, the government adopted a new tax code; a modern labor code; a land code that legalized the purchase and sale of both urban and agricultural land; and a reduction of red tape and harassing inspections of small businesses. The government also launched an electricity, sector restructuring, and less successful pension and judicial reforms. Besides, the ongoing increases in oil prices from 2003 to 2007 have caused the current account and fiscal surpluses to expand.

However, a narrow industrial base and dependence on the oil and gas sector make Russia more vulnerable to the current global recession. Sharp fall in crude oil prices, collapsing global demand, rising unemployment and depreciating Ruble have hurt both investment and consumption growth in Russia. The current crisis is now likely to be longer than the 1998 crisis, although the negative growth in economy is not expected to be as severe as last time. Russia's 1998 crisis was a classic public sector and currency crisis that resolved itself in a debt default, deep currency devaluation, and a steep, export-led recovery from an extremely low base. By contrast, 2008 was a private sector crisis incited by excessive borrowing by the private sector. Investment and net exports recovery will be much more gradual relative to 1998 - 99. However, Russia's large fiscal and reserve buffers provide important cushion to the economy. Its early fiscal policy response has been larger than that of many other G-20 countries.

We think that the Russia government will accelerate structural reforms that increase productivity and competitiveness so as to fasten economic recovery and maintain long-term growth: continuing to modernize the banking system, ensuring support for small and medium enterprises, improving governance and transparency and improving the investment transparency and climate. We are also bullish on oil prices, which should reflect the marginal costs of production.

Brazil

Thanks to sizeable FX reserves, a solid public-sector debt position and a fundamentally sound banking system, Brazil's short and medium-term growth outlook has improved relative to many other emerging and developed markets. Since 2003, Brazil's government had been in the process of implementing a stabilization program, with a view to achieving macroeconomic stability. Inflation has fallen, the external accounts are less vulnerable to external shocks and international reserves jumped.

However, the average real GDP growth between 2002 and 2008 is 3.93% only, which is much lower than other BRICs. We think Brazil falls short relative to the other BRICs in the following areas:

Brazil's investment and savings ratios are extremely low when compared with those in China and India. The savings ratio and the investment ratio have fallen considerably since the 1980s and recovering modestly since 2003 and the recovery came almost entirely from the private sector. Besides, Brazil has broadened its trade platform since the late 1990s. But with its trade share amounting to just under 25% of GDP, the country is far more closed than China and Russia.

Besides, average labor productivity has declined since the 1980s but has recovered somewhat since the Real plan in 1994. This is in part because Brazil is inefficient at spending on education and because its labor laws are outdated. Brazil spends almost twice as much (4.1% of GDP a year) on education as China, but if we proxy education by the average number of years of secondary education, Brazil ranks below China and Russia.

Brazil has made important progress in developing its political institutions, due to a great extent to its remarkable stability. Brazil's overall legal framework and judicial system compare reasonably well with its BRICs peers, but the complex multi-party political system is a large obstacle to rapid implementation of structural reforms. We believe that they should be modernized and made more efficient, so as to better suit the needs of an open and free-market-oriented economy.

As the global financial crisis intensified, Brazil's industrial production tumbled in credit sensitive sectors, such as the motor industry and other consumer durable, whereas domestic sectors that rely less on credit contracted only modestly. The central bank responded to the rapidly deteriorating credit outlook through a number of liquidity-enhancing measures: compulsory reserve requirements for banks were eased, export credit lines were created using receivables as collateral, and capital were injected into the National Development Bank and other government owned banks. Monetary policy began to be relaxed and there is ample room for additional monetary easing and we expect the Central Bank will continue to reduce the interest rate. Government support for social housing and infrastructure development, together with a scheduled rise in compensation for civil servants is expected. Ongoing policy easing, coupled with improvement in credit conditions, will hopefully buttress the recovery towards year-end and in 2010.

Important Notice:

The information contained within this document is for the information of prospective clients and existing clients of Arcadia Financial Services (Asia) Ltd (here after AFS) and/or Arcadia Asset Management (Asia) Ltd (here after AAM). The information is not intended to be a recommendation, offer or solicitation to buy products, securities or services. Products and securities described within this document are not applicable to all persons of all nationality, residence or domicile. Persons interested in making any investment or purchasing any products or securities described within this document should inform themselves as to the legal requirements in their country of nationality, residence or domicile.

Investment in securities carries risks. Past performance is not necessarily a guide to future investment performance. If there is any doubt, you should seek advice from your financial consultant before contemplating any investment.

The information contained within this document is believed to be correct and was obtained from sources believed to be reliable, but accuracy, timeliness or completeness cannot be guaranteed. AFS and AAM cannot be held responsible for any errors or omissions contained within this document or for any consequences arising from the use of this document or the information contained within it.

If you want to receive Arcadia Market Commentary or you have any comments to us, please send to us by email: servicing@arcadia-asia.com or contact us at below at no obligation. Information sent to us will be treated strictly confidential.

**Arcadia Financial Services (Asia) Ltd
Arcadia Asset Management (Asia) Ltd
Room 1404 &06, Leighton Centre, 77 Leighton Road, Causeway Bay, Hong Kong
Tel: (852) 2114 8488 Fax: (852) 2111 0777**