

Welcome to tomorrow's economic giants...

The BRIC economies

Brazil, Russia, India and China are enormous countries with huge potential. Collectively they are often referred to by the acronym BRICs, created by Goldman Sachs in 2001. Whilst today the income per head in these countries may be low compared to the developed world this is changing fast. Goldman Sachs have predicted that these four economies will be amongst the top six economies in the world in by 2050. John Cleary, Chief Investment Officer of Focus Capital, says **"but it may take most of the next 50 years for these countries to evolve their political systems, infrastructure and economies to the point where they can reach their full potential"**.

Brazil

Brazil is a country with huge natural resources and is Latin America's biggest economy. It has an estimated population of around 180 million. However political uncertainty in 2003 moved Brazil bond spreads close to default levels from which they have since recovered. But Brazil still has too much public debt and a high tax burden. It will therefore need to rely on the private sector to take it further. But the environment for private investment is forbidding. Regulators and the courts cannot be relied upon to uphold contracts. Domestic interest rates remain high by international standards. Cleary says, **"the cost of capital is high and this deters all but the most profitable of investment projects"**. However greater fiscal discipline and the taming of inflation have improved Brazil's growth prospects. A current account surplus also makes the country less vulnerable to volatility in foreign investment. Brazil is working hard to overcome current weaknesses.

Russia

Although structural reforms since the 1998 Russian crisis have been significant, it remains true that modern Russia runs on oil. The Russian Ministry of Finance estimated that for every US\$1 change in the oil price there is a direct and indirect impact on the economy, of about US\$1 billion. Currently this adds to the reserves of Russia's oil stabilisation fund, essentially a financial reserve into which excess revenues are channelled, which will be available for use if and when the oil price declines. The government has agreed that when the oil price is above US\$20 per barrel, all mineral resource tax revenues from oil will go to the stabilisation fund. The stabilisation fund promises to provide a significant cushion from the vagaries in the oil price, and will help protect local budgets, the reform process and ultimately President Putin's government in the event of an oil price decline. Russians are concerned about their dependency on oil and development of the economy is encouraging them to diversify away from it. Cleary says **"Russia was one of the few countries in the world to have a working space program"**. This is an example of how its highly educated population of around 150 million people have the potential to do so much more".

India

India is the world's largest democracy with a population of around 1.1 billion people. Whilst there are many inefficiencies and layers of bureaucracy in India - the government's low level of intervention in capital markets and its decision not to regulate industries that lack tangible assets (software, biotech, media) have created room for entrepreneurs. Entrepreneurial activity is fuelled both by incumbent (often family-owned) enterprises and by new entrants. The former use cash flows from diverse existing businesses to invest in newer ventures. So India is a country where the environment has allowed the creation of many companies, some extremely entrepreneurial. In fact it is the emerging country with the most companies listed on its stockmarket, over 5000, a number that far exceeds any other emerging market. But India's meagre infrastructure could slow development. Its poor roads and insufficient water and electricity supplies, are a challenge for all businesses. Cleary said, **"The Indian government has little external debt which may have thwarted its ability to invest in such infrastructure"**.

China

China with its estimated population of 1.3 billion people and its centrally planned economy stands alone in its scale. Finding fault with China's approach to economic development is easy: cyclical overcapacity, state-influenced resource allocation, and growing social inequalities are just a few of its shortcomings. But it's hard to see how any other model could have given the economy such a powerful kick start. The Chinese government manages the development of enterprises with a view to driving economic growth. You can be a small entrepreneur in China, but if you want to be big you will have to get money from a government-affiliated source at some point. Government officials essentially have the power to decide which companies grow. So the large successful Chinese companies are the ones with government links. Cleary says, **"the question is how viable a centrally-planned economy can remain in today's competitive world"**.

Political risk is a challenge...

Cheap labour, a large and young population, and willingness to grow are the common features amongst these countries. But politics is a dominant factor in the development of most emerging markets. **"Political uncertainty can have the biggest short-term effect on emerging markets but has less influence in the long-term"** Cleary says. Income disparities and corruption are two emotive subjects which have the ability to upset the political status quo. Political instability is a big risk in emerging markets in the short-term.

Today emerging markets already account for half of world output

Today emerging and developing economies account for over half of world GDP (measured in purchasing power parity). Many economies are growing much faster than the developed world and the differential between growth rates is expected to continue well into the future, which will entail further dramatic shifts of world output. Cleary says, **"increasing contributions to world output will most likely result in huge increases in emerging market valuations. The BRIC economies will overcome their weaknesses and become the giants of tomorrow."**

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