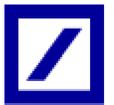
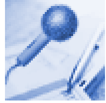


Talking point



Responding to the crisis: Did Brazil and China miss an opportunity?

August 17, 2009

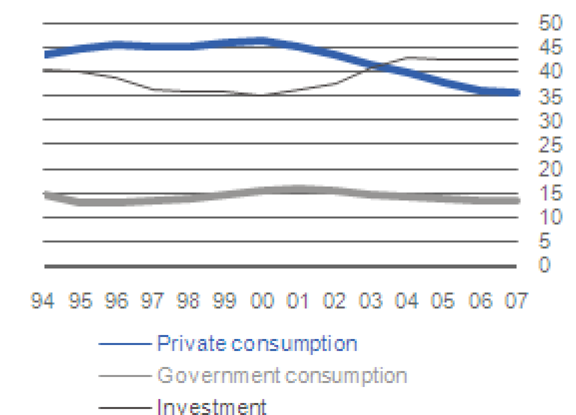
The major emerging markets have made use of their increased policy autonomy and implemented expansionary macroeconomic policies. Brazil and China make for an interesting comparison in terms of discretionary fiscal policy measures. While the Chinese measures focus on raising public investment in infrastructure, the Brazilian measures are more heavily focused on encouraging consumption. The measures seem to be working in both countries. However, from a medium-term perspective, Brazil should have raised public investment, while China should have sought to increase domestic consumption.

The major emerging markets have made use of their increased policy autonomy and implemented expansionary macroeconomic policies. Not only have they been able to support economic growth by letting automatic stabilisers absorb part of the growth shock. They have also managed to stimulate domestic demand through a mix of expansionary monetary, credit and fiscal measures. In fact, the IMF estimates that measured as a share of GDP the emerging G-20 countries introduced a larger discretionary fiscal stimulus than the advanced G-20 members.

Brazil and China make for an interesting comparison in this respect. The authorities in both countries eased monetary policy and pushed bank lending to the private sector. But while both countries introduced expansionary fiscal measures, the nature of these measures differs sharply. The Chinese measures focus on raising public investment in infrastructure, while the Brazilian measures are more heavily focused on encouraging consumption. The Chinese measures tend to be temporary in nature, while some of the Brazilian measures may turn out to be more permanent. From a short-term crisis-management point of view, the measures seem to be working in terms of buffering the downturn and contributing to a speedy economic recovery. However, from a medium-term economic perspective, Brazil should have adopted the measures China has adopted – and vice versa. Brazil should have increased public investment, while China should have boosted domestic consumption.

Chinese growth has become increasingly dependent on investment

Expenditure, % of GDP



Source: UN

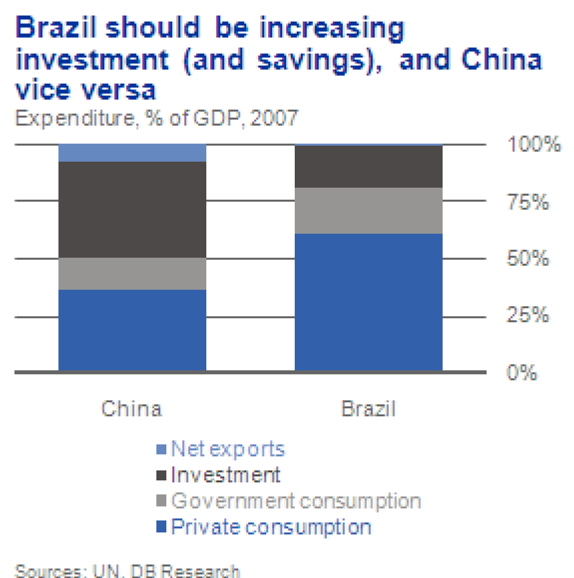
China "suffers" from an excess savings ratio amounting to more than 50% of GDP. With investment running at more than 40% of GDP, this resulted in mind-boggling current account surpluses of 10-11% of GDP in 2007-08. Such large external surpluses are unprecedented for a country of China's size. They are politically unsustainable and, from a welfare point of view, they are not in the interest of a relatively poor country like China. Why forego domestic consumption and finance consumption in wealthier countries in return for financial assets of potentially uncertain future value? As far as fiscal policy is concerned, China has two options to address this issue: it can raise domestic investment or it can reduce savings (raise consumption).

While some would argue that raising public investment further will lead to an inefficient allocation of capital, overcapacity and maybe even an investment bust, others would point out that, although Chinese investment is already massive, there still exist sufficiently profitable investment opportunities (esp. infrastructure in the less developed interior). However, the drawback of increased public investment spending is that it will absorb "excess" savings only temporarily. Furthermore, raising public investment by several percentage of GDP may be fraught with risks (e.g. quality of investment). A permanent increase in public or private consumption, on the other hand, would appear desirable in terms of rebalancing the economy from a potentially wasteful investment-intensive growth pattern to a more stable consumption-led pattern.

Low public debt, a modest fiscal deficit, large public savings and strong medium-term growth provide the Chinese authorities with considerable scope to finance measures aimed at raising domestic consumption. This is much less the case for Brazil, where a more onerous debt burden, substantial long-term expenditure commitments and a much lower growth rate limit the scope for permanent consumption-increasing fiscal measures. This difference also explains why China's discretionary measures will amount to a massive 5.8% of GDP versus a mere 1.2% of GDP in Brazil during 2009-10, according to the IMF. The Chinese government can afford to boost consumption by permanently expanding, for example, health, pension and education outlays. This would help reduce public-sector savings and it might help reduce precautionary household savings, raising both private and public consumption. The government can also address the "excess" savings of the corporate sector by taxing it more heavily. This would both reduce savings in the corporate sector and allow the government to finance further consumption measures. China thus missed an opportunity to shift towards a more balanced growth mix.

That being said, if one believes that China's capital stock remains relatively small, that there exists a sufficient number of profitable investment opportunities and that the government is competent enough to identify and implement these projects, an increase in infrastructure investment does not look like such a bad idea. Nonetheless, the fact remains that over the longer run the present investment-led growth pattern is unsustainable, economically and politically.

While China may save too much, Brazil saves too little. China may or may not invest too much, but Brazil certainly invests too little. Over the past decade and a half, Brazilian domestic investment averaged a mere 17.5% of GDP, compared with China's 40%. Savings were even lower, averaging less than 16% of GDP, compared with China's 44%. This largely explains why China grew at an average rate of 10% per year, while Brazil grew at a mere 3.3%. Brazil's fiscal stimulus should therefore have focused on raising investment, not consumption. The level of (government) consumption is already high and is one of the main causes of high interest rates and low domestic investment. Brazil's public debt position is also much less sound than China's, making (temporary) investment measures preferable to potentially more permanent consumption measures. To be sure, not all the fiscal stimulus consists of consumption-based measures, let alone permanent ones. However, further consumption-supporting measures, including minimum wage adjustments, will be introduced later this year, and let's not forget that 2010 is an election year! Over the longer term, Brazil will have to raise its savings and investment ratios if growth is to meet the government's informal growth target of 5%.



So why did Brazil and China do the opposite of what would have been preferable from a medium-term perspective? Here are some hypotheses. Brazil faces greater bureaucratic obstacles to boosting public investment, so boosting consumption is a more effective way to support domestic demand in the short term. By contrast, China faces much fewer bureaucratic obstacles and has greater experience with public investment projects, so increasing public investment (by mainly front-loading or bringing forward projects already in the pipeline) seems a more optimal policy choice. Brazilian households also have a greater propensity to consume than Chinese households, so revenue measures targeting private consumption are likely to be more effective in Brazil than in China. But be that as it may, from a longer-term perspective both Brazil and China missed an opportunity to shift towards a more sustainable and more balanced growth mix, consisting of greater investment in Brazil and greater consumption in China.

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