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Are emerging markets still built on the BRICS?

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- Since the early 2000s, the BRICS countries (Brazil, Russia, India, China, and, later, South Africa) have been among the fastest-growing economies in the world. In 2001, these five nations comprised about 9% of global gross domestic product (GDP). By 2016, that percentage was approximately 25% of GDP, and the five countries accounted for 41.4% of the world's population.
- But many of the BRICS' ambitious goals have gone unrealized thus far. In fact, many observers assert that what divides the BRICS (geography, disparate interests, and internal rivalries) has proven much more pervasive than what unites them.
- Perhaps it would be most useful for investors to consider the BRICS not as an economic bloc but as a group of five major developing economies with certain common interests.

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The term *BRICS* is commonly used to refer to the most prominent emerging market countries. There was—and is—a presumption that there is something relevant about grouping them together for investors. By contrast, we argue that the term was never intended to be more than a useful acronym. In fact, what distinguishes the BRICS countries from one another is much greater than their common characteristics.

BRICS emerged from a 2001 report titled "Building Better Global Economic BRICs" by Jim O'Neill of Goldman Sachs Asset Management. At first, the reference was synonymous with the four largest emerging markets. It was meant to convey a new era in which the countries were experiencing new challenges and new opportunities in the world economy. Indeed, O'Neill suggested that in the coming years, these rapidly emerging nations would be the strategic pillars of a renewed international system. The more wide-eyed optimists among the BRICS advocates speculated that these large emerging market nations would represent all developing countries and would promote a more legitimate, representative, and fair international order.

But in 2001, this BRICS idea was just an acronym in a research report. Soon after the report's release, the financial press picked up on the idea, and the term took on a life of its own. The nations met formally in Russia at the inaugural BRICS summit in 2009. South Africa officially joined in 2011. What was once just a useful tool to describe first four and then five of the most important emerging market nations had morphed into a forum for expressing common interests and concerns.

Since the early 2000s, the BRICS (and other large emerging market countries, including Malaysia, Mexico, and Indonesia) have been among the fastest-growing economies in the world. In 2001, the five BRICS nations comprised about 9% of global GDP. By 2016, that percentage was approximately 25% of GDP, and the five countries accounted for 41.4 percent of the world's population. Varying levels of prosperity and influence on the world stage have accompanied this rapid growth. Advocates for the BRICS assert that these countries share certain common interests and could thrive with increased cooperation on trade, investment, and political goals. Despite their rapid growth this century, it should be noted that between 2010 and 2015, the BRICS and the other prominent emerging market countries have demonstrated slowing growth, as shown in **Figure 1**.

The BRICS countries are among the largest on their continents and could best represent the priorities of their regions. The symbolism of these five nations' finding common purpose is an inspiring thing. Further, there has been an understanding by BRICS proponents that these large economies, if working together, could pose a meaningful challenge to the United States' and Europe's dominance over international affairs. The BRICS, especially China and Russia, could demand and expect to receive a "place at the table" regarding economic and political decision-making.

But many of the BRICS countries' ambitious goals have gone unrealized thus far. In fact, many observers assert that what divides the BRICS (geography, disparate interests, and internal rivalries) has proven much more

Notes on risk

Investments are subject to market risk, including the possible loss of the money you invest. Past performance is no guarantee of future returns. Investments in stocks issued by non-U.S. companies are subject to risks including country/regional risk, which is the chance that political upheaval, financial troubles, or natural disasters will adversely affect the value of securities issued by companies in foreign countries or regions; and currency risk, which is the chance that the value of a foreign investment, measured in U.S. dollars, will decrease because of unfavorable changes in currency exchange rates. Stocks of companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets.

Funds that concentrate on a relatively narrow market sector face the risk of higher share-price volatility. Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Diversification does not ensure a profit or protect against a loss in a declining market.

Figure 1. Growth in the BRICS and other prominent emerging market countries has slowed, with some faring worse than others

Real GDP annual growth	Brazil	Russian Federation	India	China	South Africa	Indonesia	Malaysia	Mexico
1997	3.39%	1.38%	4.05%	9.20%	2.65%	4.70%	7.33%	6.96%
2010	7.57%	4.50%	10.26%	10.60%	3.04%	6.38%	7.53%	5.11%
2015	–3.03%	–3.83%	7.26%	6.81%	1.40%	4.66%	4.70%	2.31%

Weak Strong

Note: Based on 2015 data.
Sources: Vanguard, based on data from International Monetary Fund (IMF) and Moody's Analytics.

pervasive than what unites them. Further, their common influence, particularly within the United Nations and other international bodies, has proven limited. It is one thing to identify five regional economic powerhouses. It is another to presume that they could easily form a meaningful multilateral bloc. Critics charge that the notion of a common BRICS purpose seems contrived, as each nation is so different economically and politically. Thus far, there is not much of a collective identity and only the beginning of an institutional apparatus. There is no strategic BRICS agenda that would include their concrete goals. In fact, the countries share no coherent foreign policy objectives and interests.

Indeed, with one exception, it is hard to find tangible evidence that the promise of BRICS unity on international issues has produced much of substance. The exception is the serious conversation about New Development Bank (NDB) BRICS, which was launched in Shanghai in July 2015 to provide an alternative to the U.S.- and European-dominated World Bank and International Monetary Fund. The NDB's mandate is to efficiently channel savings into infrastructure and sustainable development. From China's perspective, the NDB provides an alternative to western-dominated development institutions. For Russia, which is hampered by western-imposed sanctions, the NDB is a way to exert lost influence on the world stage. If the bank is successful, the argument goes, then emerging markets worldwide would benefit, and that is all to the good. But the NDB, with an initial capitalization of $100 billion, is still in its infancy.

We would also note that although the term *BRICS* was useful to describe the largest emerging markets in 2001, it might not be as relevant today. Why should such emerging market powerhouses as Indonesia (the fourth most populous nation in the world), Turkey, South Korea, Mexico, and possibly Saudi Arabia be excluded? From an investment perspective, these countries are active issuers in the international debt capital markets. This is one reason investors focus on them, as they do the BRICS. All of these countries have gained much influence globally in the last 15 years. Drawing the line between the five BRICS and these other prominent emerging market nations is now less meaningful.

One motive for the creation of a BRICS alliance was the idea that only a unified grouping of the largest emerging market countries could counterbalance the perceived hegemony of the United States and, to a lesser degree, Europe. But in the real world, one might acknowledge that each of the BRICS has a varying relationship with the United States. For example, Russia's trading and investment relationship with the United States and Europe is modest, and its economic and strategic interests clearly compete with the west's. But China's economy is co-dependent with that of the United States and Europe. Its strategic interests differ from those of the United States, but China and the west also complement each other in many ways. Also, India, Brazil, and South Africa often disagree with the United States on selected economic interests. But overall, their economic, political, and strategic priorities are usually aligned with those of their western counterparts.

Until 2014, the BRICS countries were among the fastest growing countries in the world. They demonstrated adequate fiscal prudence (as shown in **Figure 2**) and reasonably solid monetary policy, such that they were considered investment grade with at least two of the three most prominent credit rating agencies (Moody's, Standard and Poor's, and Fitch Ratings). But as of May 2016, Russia remains split-rated (partly investment grade and partly junk-rated) and declining. Brazil is now junk-rated with all three of the credit rating agencies. South Africa will remain investment grade with all of the agencies for now, but it is also a deteriorating credit due to its sub-par political and macroeconomic management.

As of 2016, the BRICS countries are facing domestic challenges that may distract their policy-makers from notions of emerging market unity. Brazil is in the midst of the worst political scandal in modern Latin American history, the "Lava Jato" (Car Wash) Affair. Numerous public sector officials in the federal government and the government-owned Petrobras national petroleum company have been implicated. As a consequence, the process of impeaching Brazilian President Dilma Rousseff has begun.

Russia is dealing with crippling international sanctions, a GDP that has fallen 3.7% in the first quarter of 2016, and plummeting oil prices. South Africa's mining sector is in disarray, the credibility of its Finance Ministry is in serious question, and the government's policy proposals appear more arbitrary each day.

In India, Prime Minister Narendra Modi has proposed the most wide-ranging set of economic reform proposals in the nation's modern history, but their implementation is proving problematic. China President Xi Jinping's

Figure 2. BRICS' and other major emerging markets' economic and fiscal fundamentals are mixed

	Brazil	Russian Federation	India	China	South Africa	Indonesia	Malaysia	Mexico
International debt/GDP (%)	8.50%	8.91%	1.43%	0.69%	10.38%	8.28%	13.95%	18.03%
Foreign-exchange reserves/ GDP (%)	19.68%	25.88%	15.32%	29.38%	13.12%	11.83%	29.98%	14.93%
Fiscal surplus/ deficit as % of GDP	–7.67%	–5.68%	–7.20%	–1.92%	–4.07%	–2.33%	–3.51%	–4.00%

Weak Strong

Notes: Foreign-exchange reserves, GDP data, and fiscal balance as of end of 2015; international debt as of second-quarter 2015 (latest value reported).

Sources: Vanguard, based on data from Bank for International Settlements; IMF databases (International Financial Statistics, Fiscal Monitor, and World Economic Outlook); and Moody's Analytics.

proposed numerous economic and political reforms are proceeding; however, implementation of these reforms will take years in some cases. But China's economic growth continues to slow, and private sector debt is increasing rapidly. For quite some time, the government has been constrained by a burgeoning credit bubble in an economy that is growing at its slowest pace in 25 years. To those who suggest that political freedom and economic growth should be correlated, the evidence, as noted in **Figure 3**, is not conclusive.

In short, the five BRICS countries are at middling stages of development, with all of the accompanying stresses. All of the BRICS are experiencing demographic challenges. All are witnessing slowing economic growth and rapidly increasing economic inequality. All need far more private sector investment. All require more respect for property rights and the rule of law. The commodity producers are seeing plummeting prices for oil, copper, and other commodities, and world trade is not nearly as robust as it was in 2010. Perhaps most important in 2016, all of the BRICS have growing public and private sector debt burdens, forcing higher borrowing costs.

If there was a hope in 2001 that the BRICS would eventually demonstrate a measure of cohesion based on common interests, it has not yet occurred in a serious way. The countries quarrel among themselves as much as they take issue with more developed market countries. Perhaps it would be most useful for investors to consider the BRICS as something less than an economic bloc and instead as a group of five major developing economies with certain common interests. Beyond the notion that they pose an alternative to western-dominated institutions, the BRICS have growing needs for trade and investment, for new and effective development assistance strategies, and for political reform opportunities. The BRICS are not a uniform bloc but are instead an ever-evolving and powerful group of voices on the international stage.

Reference

O'Neill, Jim, 2001. *Building Better Global Economics BRICs*. Global Economics Paper No. 66. New York: Goldman Sachs.

Figure 3. There is no strong correlation between political freedom and economic growth

	Brazil	Russian Federation	India	China	South Africa	Indonesia	Malaysia	Mexico
Freedom in the World status, 2016	Free	Not Free	Free	Not Free	Free	Partially Free	Partially Free	Partially Free

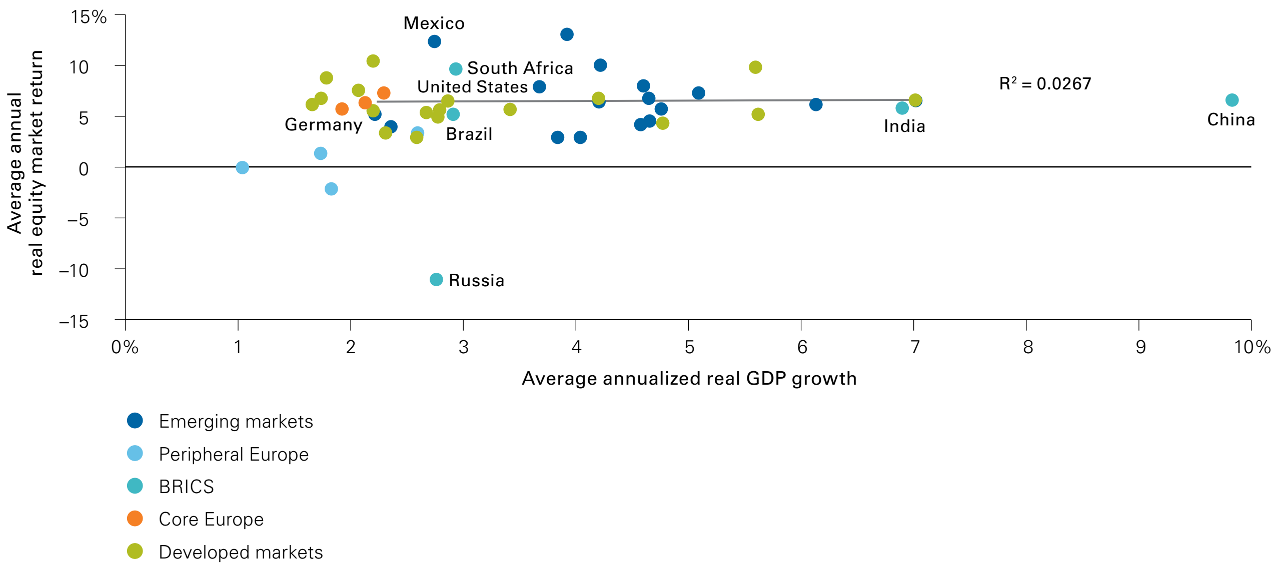
Source: Vanguard, based on data from Freedom House.

Appendix. No correlation between economic growth and real equity returns

Forming an investment case based on the BRICS' economic fundamentals would not have yielded fruitful results. Previous Vanguard research has shown that there is virtually no correlation between economic growth and real equity returns; holding the BRICS as a group offers no advantage relative to the broad class of emerging markets.

Figure A-1. Allure of high-growth economies does not usually lead to high-return performance

Real GDP growth and real stock returns 1970–2015



Notes: Figures display each country's average annualized real GDP growth rate and average annualized real stock return. We include all members of the FTSE All World Index (except the United Arab Emirates, for a lack of return history). The period covered begins in 1970, with the starting point for each country depending on the availability of both returns and GDP data. (Most developed markets have data from 1970 onward, and most emerging markets have data from 1988 onward.) Real growth rates are computed using data from the IMF's World Economic Outlook database. (For data prior to 1980, we use the April 2004 database; otherwise, we use the April 2013 database.) Return data are based on MSCI country indexes spliced with FTSE indexes once the latter are available. Both growth and return data are in real local terms, with the index returns deflated using the GDP deflator from the IMF databases.

Sources: Vanguard, based on data from the IMF, MSCI, and FTSE.

Figure A-2. Relative strengths and weaknesses of the BRICS

	Brazil	Russian Federation	India	China	South Africa
Strengths	• Abundant natural resources. • Large population.	• Military superpower. • Well-educated labor force. • Nuclear power.	• Ambitious reform agenda. • Largest democracy in the world.	• Positive momentum in adopting structural reforms. • Economic power.	• Abundant natural resources. • Most economically developed large nation in Africa.
Weaknesses	• Currently engulfed in political scandal. • Weak educational institutions.	• Lack of industrial diversification. • Too much dependence on petroleum reserves.	• Slow progress in adopting reform. • Weak infrastructure. • Unpredictable corruption.	• Mixed results in passing structural reforms. • Nondemocratic character of leadership. • Growing private sector debt obligations.	• Deteriorating fiscal and economic situation. • Weak political management.

Source: Vanguard.

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