A Wall in the BRICS

- All major Western central banks now share a common narrative
- China's chronic current account surplus is a limit to the extension of the BRICS political project to the whole of the Global South

The Federal Reserve, the ECB and the Bank of England are now sharing a common narrative. They all consider themselves at or close to their policy rate peak, although they all maintain a hiking bias. Steering markets away from pricing cuts too early is going to be their main communication problem – which we think will force them to maintain a hawkish rhetoric. Still, while we would agree with the notion that delivering or not "one last hike" is no game changer, optically it probably does not help the ECB, given its past policy errors in 2008 and 2011, that it was the one hiking in September while it is in the Euro area that the signs of recession are probably the clearest now.

As the curtain is falling on the tightening phase of monetary policy, we can take a break from focusing on central banks and explore some of the other trends shaping the macro debate at the moment. We attempt this week to "connect the dots" between China's efforts are reviving domestic consumption and the BRICS summit last August which, beyond the extension to new members, sent another signal of the "clubification" of the world economy.

Our point is that China's difficulty to deal with its chronic excess savings will increasingly be a limit to the extension of the BRICS' project to the whole of the Global South, irrespective of the already wide political fault lines across members. If China continues to post a large, structural current account surplus, at a time when the West is increasingly tempted to reduce its reliance on Chinese supply, then the natural counterpart of China's excess saving will be a growing bilateral trade surplus vis-à-vis the rest of the Global South. There are exceptions, some emerging countries such as Brazil are posting bilateral surpluses vis-à-vis China but many of them find themselves in the uncomfortable position of being reliant on imports from China while remaining dependent on the West for their exports (e.g., Vietnam). China is increasingly recycling its surpluses as FDIs in the Global South – which can elicit some resistance. The US is a hegemon with a chronic current account deficit. This is probably not a coincidence.

Who can comfortably be on the other side of the Chinese surplus?

The August batch of data for China brought some measure of relief in the short-run – inflation was back into marginally positive territory (0.1%yoy), industrial production rebounded somewhat, and exports declined less (still a hefty -8%yoy though) - while the drip of stimulus measures has continued. When taking all the recent decisions made by Beijing in the real estate space together, they ultimately amount to a near-complete U-turn on the crackdown engineered by the three "red lines" last year. Yet, the key signal in our view was not the loosening of the rules on mortgage access – although this should help cushion the correction in construction – but rather the cut in the interest rate levied on *existing* mortgages, since this will liberate some much-needed household disposable income worth roughly 1% of consumption. Habitual readers of Macrocast will be familiar with our view that the last thing China needs right now is another dollop of state-supported physical investment but more consumer spending instead.

Yet, even if such boost to disposable income is a step in the right direction, it will not address what remains a key impediment to the transformation of the Chinese economy: a stubbornly high personal savings ratio (c.40%). **The persistence of such "savings glut" in the household sector is not offset by enough investment in the rest of the economy: China continues to yield a current account surplus** (2.1% of GDP last year, c.USD 400bn). A persistent current account surplus comes with two challenges. First, Beijing must convince the rest of the world to continue to buy more Chinese products than China buys from the rest of world. Second, China must find the right investment opportunities overseas to recycle its surpluses.

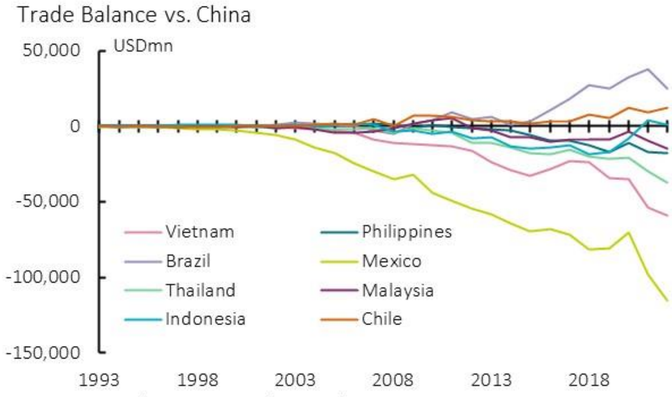
In principle, if there is enough demand in the rest of the world and its products remain competitive, there is no limit to China continuing to export more than it imports, as long as free trade is allowed to proceed unfettered of course. There is even a self-reinforcing mechanism at play: rationed consumption in China helps keeping domestic inflation low, which supports further improvement in China's competitiveness. The recent gains on this front, compounded by the weak exchange rates, are spectacular, even if they do not materialise in more export volumes. But **politics can get in the way, and there is little doubt that the global Zeitgeist is not particularly pro-free trade.** That the United States (US) gets into one of its regular phases of protectionism is not necessarily surprising – from this point of view Joe Biden is merely falling back to the Democrats' historical approach, closing the pro-free trade shift under Clinton 40 years ago – but even the European Union (EU), normally much more dedicated to free trade, is clearly tempted.

The arrival of China-made electric cars on the European market has just been met with an official investigation for dumping by the Commission, while the potential proceeds of the border tax, even if it comes with a limited scope for now, are in our opinion too tempting for cash-strapped governments for the rate not to be raised in the future. Since the carbon intensity of Chinese products is likely to remain high – Beijing's net zero pledge targets 2060, 10 years later than the EU – they should be among the most penalized ones.

While we had our doubts about the speed at which developed economies could change their supply lines, the re-emergence earlier this year of Mexico as the biggest exporter of manufactured goods to the US after 20 years of Chinese dominance suggests that international trade can be quite flexible.

If the "Western club" continues to get less open to Chinese producers, they will need to find substitute markets, and other emerging countries are natural targets, even more so dynamically that their potential growth remains significantly above that of their more mature counterparts. This will only displace the problem though**. Beijing needs to be sure it will not face a similar backlash in these countries in the years ahead**. Many of them are already facing a significant and growing trade deficits vis-à-vis China (see Exhibit 1).

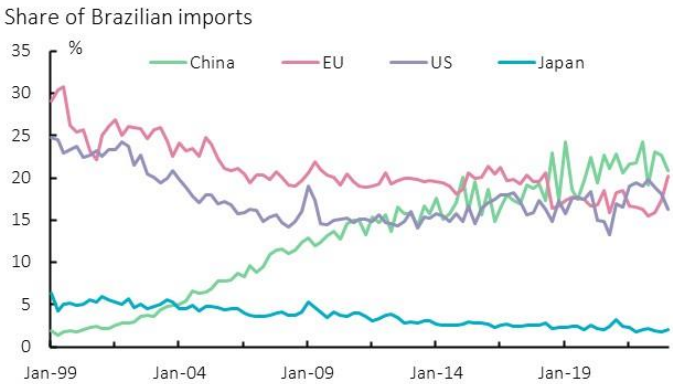
Exhibit 1 – Most EMs don’t do better than DMs on trade with China



Source: IMF and AXA IM Research, September 2023

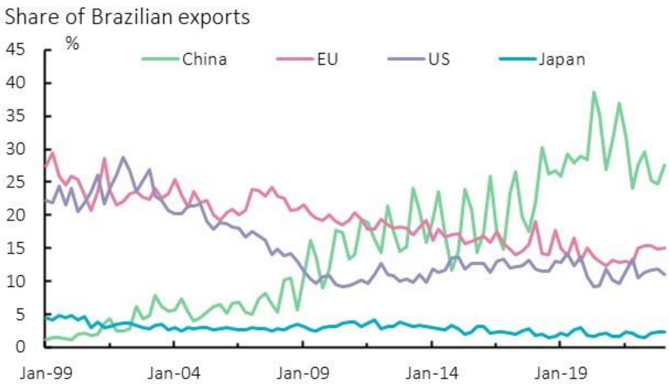
There are exceptions though. **Brazil and Chile enjoy a significant and growing bilateral trade surplus vis-à-vis China.** True, they constitute textbook “unequal trade” cases – a concept which has long been very popular in Latin America when it was directed at the relationship with the US – since these countries export mainly low-value added products to China – food and raw material - and import manufactured goods. But overall, they are still “winners”. In Exhibits 2 and 3 we focus on Brazil. What is striking there is how similar their export and import geographical structure is: a rise in the share of China in Brazil’s imports has been matched on the export side. **Given the diminishing role Western demand plays for Brazil, this makes this country less amenable to pressure from the US to reduce their reliance on Chinese products, and politically sympathetic to Beijing’s views on global trade and the international monetary system**.

Exhibit 2 – Brazil is increasingly reliant on Chinese supply



Source: IMF and AXA IM Research, September 2023

Exhibit 3 – But this is matched on the export side

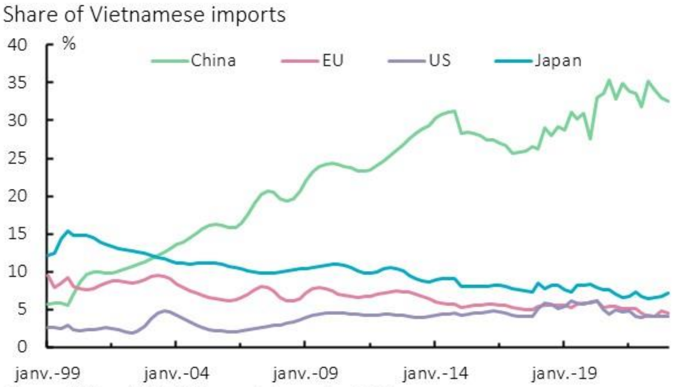


Source: IMF and AXA IM Research, September 2023

In a recent piece for the US Peace Institute, Pr. Urdinez showed how **even under the very vocal stance taken by the Brazilian government under Jair Bolsonaro at the federal level, the country’s reliance on China actually intensified**. The return to power of Lula Da Silva – explicitly supportive of a “non-aligned” foreign policy – has removed the rhetorical “anti-Chinese” stance, but even beyond his party - which does not command a parliamentary majority – a sympathetic view of Beijing is pervasive. At the state and municipal levels, authorities across the political spectrum contracted with Chinese suppliers during the pandemic, ignoring the choices made at the federal level. Even if the Brazilian President made every effort at the recent BRICS summit to stay as far away as possible from the *political* dimension of the club, his efforts at intensifying the economic and financial links – e.g., by pushing for a common currency across the BRICS to stop using the US dollar in bilateral trade - are at least at first glance aligned with the transformation of Brazil’s trade structure.

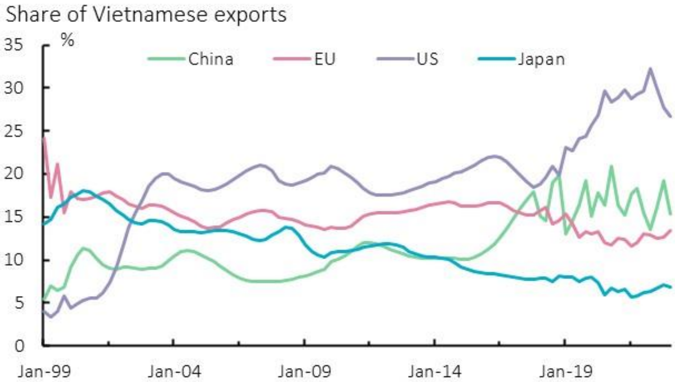
Many actors of the "Global South" are however in a very different situation from Brazil, with some key countries finding themselves in the potentially uncomfortable position of being very reliant on China for their supply, without equivalent traction on the demand side, for which they remain dependent on western clients. In Exhibit 4 and 5 we look at the example of Vietnam. Chinese products now account for about a third of the country's imports, higher than the cumulated share of Japanese, American and European products. This is however unmatched on the export side: the three players in the "old North" absorb more than 50% of Vietnamese exports, more than twice the share of China.

Exhibit 4 – Vietnam dependent on China for its supply…



Source: IMF and AXA IM Research, September 2023

Exhibit 5 – …But reliant on the West for its exports



Source: IMF and AXA IM Research, September 2023

To some extent, **we could see Vietnam as an "indirect base" for Chinese exporters**, the country "transforming" inputs sourced from China to then ship them to the US. This was the point made by Laura Alfaro in her paper presented at the Jackson Hole conference in August: the US decoupling from China is superficial because China's market share continues to rise – and is massive – in the countries which the US now wants to use as substitute suppliers. **The same applies to Mexico,** where the share of China in imports has risen to 20% from 15% since 2010. We note however that the tougher thresholds on the "rules of origin" for products benefitting from free trade under North American Free Trade Agreement (NAFTA) have been made tougher during the last renegotiation under the previous US administration, which puts a limit to how much transformation of Chinese products can be implemented in Mexico.

This is still a headache for Vietnam. At first glance, the country could completely ignore its huge bilateral trade deficit vis-à-vis China (c.60bn USD a year) if this were the price to pay to enjoy an aggregate trade surplus (which is the case, USD13bn last year). Yet, if the "clubification" of the world economy intensifies, the West could be increasingly tempted to extend protectionist measures to producers which rely too much on Chinese inputs. In any case, even without considering the fractious history of the Sino Vietnamese relationship, such reliance on western demand should incentivise Hanoi to maintain decent political relationship with the US and the EU and avoid getting "sucked in" a North/South confrontation led by China. Vietnam participated to the BRICS summit in August but refrained from joining. A few days later, Joe Biden was welcome in Hanoi, and the US and Vietnam signed a "Comprehensive Strategic Partnership."

Some stakeholders in the Global South are getting concerned about their reliance on China either as a source of supply or as the main destination of their exports. Supply security is an issue for the South as much as for the North, and fears around the possibility of military confrontation in the South China sea are particularly acute for neighbouring countries. The evolution of the Philippines' attitude towards China over the last few years has been quite symptomatic from this point of view, from open sympathy to explicitly expressing concerns over the geopolitical situation. Symmetrically, especially as Chinese demand is going through a soft patch, we expect quite a few governments in Emerging Market (EM) countries to question the wisdom of having such a large and rising share of their exports dependent on a single market.

Meanwhile, **China's rejection of the centrality of the US currency and financial markets is inconsistent with the continuation of using US assets as the instrument of choice in which to invest its excess saving**. We have already documented in Macrocast how the share of China in foreign holdings of US federal bonds has been diminishing steadily over the last

10 years, while investors from the “global West” have become, again, the majority holders. This is the result of a conscious choice by the Chinese government, but we think it also reflects the changing nature of China’s foreign assets: in 2005, official reserves stood for two third of the total, while last year direct investment overseas (FDIs) had nearly caught up (see Exhibit 6). **These FDIs when directed to other members of the “Global South” can of course complement and strengthen the intensification of the trade links. Yet, they can also trigger resistance in the host countries**, potentially concerned with the risks for their “economic sovereignty”, another popular theme these days.

Exhibit 6 – China’s FDIs levelling up with reserve assets

Source: SAFE and AXA IM Research, September 2023

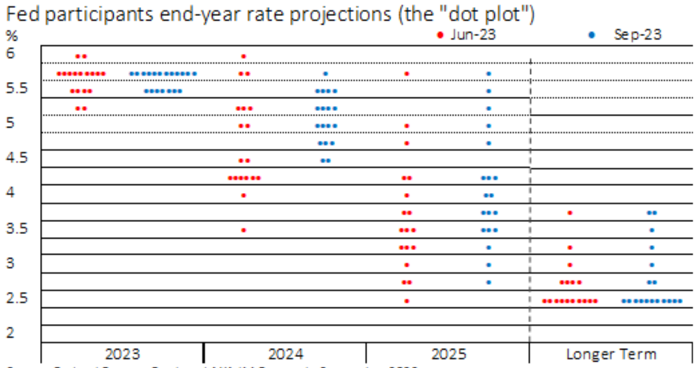
We do not want to “bat away” the significance of the BRICS summit last month, but our point is **that beyond the political lines of fracture between the key members – such as the traditional distrust between China and India - the economic sources of disagreement within the emerging “club” abound**, and that turning the “global south” as the natural source of external economic traction for China as a substitute to growing resistance in the West is not as straightforward as it seems. There remains a key difference – in the realm of international economics – between the two competing hegemons: the US is a structural current account deficit country, which offers its allies massive trade opportunities as well as a liquid and well-regulated market to invest their own surpluses. As long as China remains a current account surplus country operating with a financial system which is not fully liberalized, what it can offer to its allies in trade and investment solutions will remain limited. Reducing China’s savings rate may not just be what the doctor prescribes to deal with the country’s current soft patch. It is also probably what would be needed to fulfil Beijing’s geopolitical goals.

Curtain falling on the central banking festival?

Although it is largely uncoordinated – each central bank coming to its own conclusions independently amid quite different macroeconomic conditions – the Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England are now sharing a common narrative, irrespective of whether they delivered a hike in September. They all consider themselves at or close to their policy rate peak, although they all maintain a hiking bias, and are all reasonably confident the cumulative tightening will eventually “do the trick” and bring inflation back to target in a timely manner. Steering markets away from pricing too early cuts is going to be their main communication problem in the months ahead – which we think will force them to maintain hawkish rhetorics, without having to ultimately act on them.

The Fed delivered a master class last week in our opinion in how to confirm they are probably “done” while keeping the market on its toes and ensuring overall financial conditions remain restrictive enough to steer inflation towards target. As we expected, the “dot plot” came out on the hawkish side, with the Federal Open Market Committee (FOMC) keeping at an underwhelming majority of 12-7 “one last hike” by the end of the year. With the upward revision of the 2024-2025 trajectory for the Fed Funds – signalling 50bps of cuts “only” next year and leaving the rate at the end of 2025 50bps above the level indicated in June (see Exhibit 7) - the FOMC took another step in weaning the market off hoping – as it has been constantly doing in this policy cycle – for a quick turnaround in the Fed stance. **We were however surprised that the FOMC's "median member" did not revise up the longer-term level for the Fed Funds**, which would have further anchored the bond market's recent repricing. We find it even in contradiction with the overall message of the forecasts.

Exhibit 7 – Higher for longer – but not forever



Source: Federal Reserve Bank and AXA IM Research, September 2023

Indeed, the Fed has revised up its projections for GDP growth (by 1.1pp for 2023 and 0.4pp for next year) and is now expecting the unemployment rate to exceed 4% only marginally (to 4.1% over the next 2 years instead of 4.5%), while keeping the trajectory of a gradual return to 2% inflation unchanged. If the economy "can take" a high level of policy rate for longer without crumbling into recession, there is in our book a strong suspicion that the equilibrium rate has moved up. Powell in the Q&A made a distinction between the neutral rate and the longer-run rate of the dot plot, stating that the former may have moved up without taking the latter up. He did not elaborate on why such a wedge would be even possible. Technically, we suspect this might be because the neutral rate could be higher today owing to *transient* factors, before reverting to its "old value" further down the road, but this would call for a long debate. Of course, individual FOMC members' forecasts are collected independently, and it is sometimes futile to seek too much consistency across the aggregate results.

Still, in general Jay Powell managed to defuse some of the hawkish signals from the dot plot during the press conference by distancing himself from the forecasts (his point on *"forecasters being a humble lot with much to be humble about"* has not been lost to the profession…). **He downplayed the significance of the "last hike" for 2023 and listed enough downside risks to the growth trajectory to build up what ultimately is in our view a cautious message**. As we wrote last week, our own belief in the absence of further hikes hinges on a very mediocre end of year for the US economy and the Fed is clearly in no mood to discard this possibility, possibly extending further into 2024. We found it striking that Powell explicitly refused to call the "soft landing" a baseline – although it is what would best describe the Fed's own forecasts.

The latest news from Washington DC are raising **the risk of a government shutdown starting at the end of this week. While the market has become increasingly insensitive to what has unfortunately become a recurrent feature of US policymaking, the impact on the real economy is not always trivial**. An often-quoted note by the non-partisan Congressional Budget Office estimated the impact of the 45 days-long partial shutdown between December 2018 and January 2019 at 0.1% of GDP in Q4 2018 and 0.2% in Q1 2019, but this a computation in non-annualized terms. When annualizing – to scale it up to how GDP growth is usually presented in the US – the impact looks much more significant (0.4% in Q4 2018 and 0.8% in Q1 2019). True, Morgan Stanley Research recently reminded its readers that historically, shutdowns have not coincided with GDP contractions, and in any case at this stage it is impossible to know if the shutdown will be as long as the previous one, but there might still be an unfortunate combination at play this time.

On top of the shutdown, and beyond the impact of the strike in the car industry, GDP should be further dragged down by the adverse effect of the resumption of student loans' repayments, effective on 1 October after three years of suspension. Moody's Analytics came out with an estimate of 0.2% for the impact on annualized GDP in Q4, assuming some drawdown on the savings effort. Again, taken in isolation, none of these shocks would really matter. It is their concentration over one quarter which could prove problematic. A side-issue of the shutdown though is that the main federal statistical institutes will not be able to produce their usual data which could make the Fed's next decision even more difficult. Given where monetary conditions already are, this would be another reason to be prudent and refrain from exiting the current pause.

Down the road **the issue is whether all this would prove to be a mere "pothole" to borrow Goldman Sachs' qualifier, or the beginning of a proper slowdown**. Indeed, as we have been repeating for some time now there is no guarantee the resilience of the US economy to the tightening can be sustained indefinitely. In such configuration, **it is perfectly understandable that the Fed chose not to take risks and hit peak rates in July already**.

The same cautious approach has won the day at last week's meeting of the Bank of England (BoE)'s Monetary Policy Committee. We thought that the still strong gains in pay would convince them to err on the side of "one last hike" but in fact a small majority (5 against 4) chose to keep the base rate unchanged. The unexpectedly steep deceleration in inflation in August – although still massively above the Bank's target – probably was a key ingredient in the discussion. We think the BoE has also hit its tightening peak.

All this – especially if one adds to the mix the Bank of Japan (BoJ)'s decision to keep policy and forward guidance unchanged - makes the ECB's September hike stand out. Again, there is no major sense of divergence on substance across the three major western central banks - the "high for longer" is a strong consensus – but **optically it probably does not help the ECB, given its past policy errors in 2008 and 2011, to be the "one hiking" while it is in the Euro area that the signs of recession are probably the clearest now.**

Now, it seems relatively clear the "upward phase" of the monetary cycle is closing, with a quantum of tightening which very few – and certainly not your humble servant – expected at its beginning. Still, as much as we would relish focusing less on monetary policy in the months ahead – we sense that fiscal issues are going to take precedence – the communication hurdles, in navigating the long "plateau" central banks now see ahead, are likely to continue to make every single meeting "interesting."

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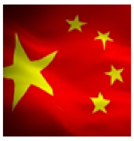
Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left FFR at 5.50%. Projections see one more hike, but Powell stressed data dependent. Higher outlook for 2024 & 25 sent 10y yields to 16-yr high • Philly Fed survey (Sep) fell sharply to -13.5 from +12 • Existing home sales (Sep) -0.7%mom, but housing starts -11.3% - likely reflecting extreme heat • Jobless claims fell to 201k, lowest since Jan.	• PCE inflation (Aug) expected to rise on gasoline, core to ease • Personal spending (Aug) softer, despite gas, from strong July. Saving rate to rise from low 3.5% • Chicago PMI (Sep) markets expect modest reversal • Conf Bd consumer conf (Sep) expected weaker on rising gas prices, in line with Michigan survey
	• EMU headline final August HICP print was revised down 0.1pp to 5.2%yoy, core unrevised at 5.3%yoy • EMU "flash" PMI composite output index inched up 0.4 points to 47.1 in September. French PMI was particularly weak while INSEE survey was unchanged from August	• German IFO and EC business/consumer survey (Sep) • French 2024 draft budget and Italian NADEF • EMU M3 data for August • Flash HICPs (Sep). We forecast EMU headline and core inflation to edge down by 0.5pp to 4.7% and 4.8%yoy respectively
	• BoE surprised in close 5-4 vote to hold rates at 5.25%. We see as peak, but risk of further hikes • CPI (Aug) eased to 6.8% rise in oil countered by fall in airfares and hotels. Core eased to 6.2% from 6.8% • Retails sales (Aug) rose 0.4%mom following weak July	• Nationwide house prices (Sep) likely to show continual gradual declines • GDP (Q2, 2nd est) no change expected from initial 0.2%qoq • BoE HH lending data (Aug)
	• BoJ remained on hold. Made no change to forward guidance around easing as many had been expecting following Ueda's hawkish comments • CPI inflation (Aug) headline eased to 3.2% from 3.3% and core (ex fresh food and energy) stable at 4.3%	• Tokyo CPI (Sep) • Labour market data (Aug) • Industrial output (Aug, prelim) • Retail sales (Aug)
	• LPRs (Sep) unchanged at 3.45% (1Y) and 4.2% (5Y)	• Wed (27 Sep): Industrial profit (Aug) • Fri (30 Sep): NBS PMI mauf and non-mauf (Sep)
	• CB: Indonesia (5.75%), Philippines (6.25%), South Africa (8.25%) & Taiwan (1.875%) stood on hold. Brazil cut 50bps to 12.75% • The monthly economic activity index slowed in Brazil (0.7%yoy) & Colombia (1.2%yoy) • Aug inflation (yoy%) remained unchanged in Malaysia & it edged up in South Africa	• CB: Czechia (7.0%), Colombia (13.25%), Hungary (13.0%), Mexico (11.25%) & Thailand (2.50%) to stay on hold • Aug ind production: Russia, Singapore &Thailand • Inflation in Singapore (Aug) & Poland (Sep) • Q2 current account figures across EM • Aug Unemployment data: Colombia, Brazil & Mexico

Upcoming events		
	US:	Tue: Case-Shiller HPI (Jul), FHFA HPI (Jul), Consumer confidence (Sep), New home sales (Aug); Thu: Core PCE price index (Q2), GDP (Q2), Weekly jobless claims (23 Sep); Fri: PCE price index (Aug), Goods trade balance (Aug), Personal income & spending (Aug), Wholesale inventories (Aug), Chicago PMI (Sep), Michigan consumer sentiment (Sep)
	Euro Area:	Mon: Ge IFO business climate index (Sep); Wed: EA M3 supply (Aug), Fr Consumer confidence (Sep); Thu: EA business confidence (Sep), Ge CPI (Sep), Ge, Sp HICP (Sep), It Business confidence (Sep); Fri: EA CPI (Sep), Ge Unemp (Sep), Fr Consumer spending (Aug), Fr, It HICP (Sep)
	UK:	Mon: CBI Trades survey (Sep); Fri: GDP (Q2), Private consumption (Q2), Business investment (Q2), Current account (Q2), Consumer credit (Aug), Mortgage lending (Aug), Mortgage approvals (Aug), M4 supply (Aug), Nationwide HPI (Sep)
	Japan:	Wed: Leading index (Jul); Fri: Unemp (Aug), Industrial production (Aug), Consumer confidence (Sep), Housing starts (Aug)
	China:	Wed: Industrial profits (Aug); Sat: Manf PMI (Sep), Non-manf PMI (Sep), Caixin manf & services PMI (Sep)

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