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Leaders Indicating: Why Markets Now Use Politics to Predict Economics
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Abstract (summary)

Market players usually focus on and respond to data related to a nation's economic prospects: measurements of GDP growth, employment, trade, and so on. But given the trying economic climate, investors have lately started to train their gaze elsewhere: on political leadership. In recent years, stock markets in countries ranging from Japan to Mexico have rallied on mere hope for political change: specifically, the rise of new leaders who seem likely to push for economic reform. When the times were good, many leaders neglected to keep pushing reforms and to invest profits wisely. As a consequence, their nations are now struggling to sustain growth. That made investors especially alert for signs that new leaders with new ideas might emerge. Another reason why politics has become so important to the markets is that the two conditions necessary for orderly leadership changes and quick economic turnarounds -- free elections and free markets -- have become increasingly ubiquitous in recent decades.

Full Text

The normal rhythm of politics tends to lead most nations' economies around in a circle, ashes to ashes. This life cycle starts with a crisis, which forces leaders to reform, which triggers an economic revival, which lulls leaders into complacency, which plunges the economy back into crisis again. Although the pattern repeats itself indefinitely, a few nations will summon the strength to reform even in good times, and others will wallow in complacency for years--a tendency that helps explain why, of the world's nearly 200 economies, only 35 have reached developed status and stayed there. The rest are still emerging, and many have been emerging forever.

Beginning in 2003, however, this cycle seemed to stop turning. The world economy entered a unique period of prosperity, driven by declining interest rates, rising trade, and surging commodity prices. These global tail winds were so strong that national leaders did not need to push fresh reforms to generate economic growth; the fruit virtually fell from the tree on its own. By the peak of the boom, in 2007, roughly 60 percent of the world's economies had hit annual growth rates of at least five percent, a record high number of economies and far above the 35 percent average of the post-World War II era. Even more unusual, only five economies contracted that

year. It seemed as if virtually every country was brimming with promise, and global investors poured hundreds of billions of dollars into emerging stock markets without bothering to distinguish one from the other, India's from Indonesia's.

Then came the financial meltdown of 2008; suddenly, the tail winds stopped blowing. By 2014, the percentage of the world's economies that were growing at five percent or faster had fallen from 60 percent to 30 percent. The threat of crisis and recession returned with a vengeance, forcing investors to become much more discerning-and in an entirely novel way. Market players usually focus on and respond to data related to a nation's economic prospects: measurements of gdp growth, employment, trade, and so on. But given the trying economic climate, investors have lately started to train their gaze elsewhere: on political leadership. In recent years, stock markets in countries ranging from Japan to Mexico have rallied on mere hope for political change: specifically, the rise of new leaders who seem likely to push for economic reform.

As political leadership has come to seem more and more important to economic growth prospects, these stock market hope rallies have grown increasingly common, especially this year, which is an unusually busy one for elections. Of the world's 110 emerging democracies, 44, including six of the largest, have held or will hold national ballots in 2014. Not all these contests have affected the markets: where there was little expectation that elections would oust entrenched rulers, as in South Africa and Turkey, the markets largely ignored the campaigning. But in countries where promising newcomers gained momentum, the markets paid close attention. In Indonesia, what analysts called a "Jokowi rally" began last December, when polls started forecasting that Joko "Jokowi" Widodo would be the next president, and the rally continued through his victory in July. India experienced something similar-a Modi rally-starting the day Narendra Modi was confirmed as the opposition candidate for prime minister last September and continuing after his victory in May.

Never before have investors so frequently named rallies after people, the way meteorologists name hurricanes. Even the developed world, where economies are more mature and politicians generally have less influence on growth prospects, has started to witness rallies named after the politicians that inspired them; when the reform-minded Matteo Renzi became prime minister of Italy in February, for example, one suddenly started hearing talk of a Renzi rally.

Meanwhile, in Latin America, investors have become so desperate for fresh faces and policies that they have rallied even on bad news for seated leaders. Argentina's markets began to rise sharply late last year after stories spread suggesting that the country's populist president, Cristina Fernández de Kirchner, was in ill health. And in Brazil, where the ruling Workers' Party is widely blamed for the country's stagflation, the stock market has risen every time a new poll has shown that President Dilma Rousseff's approval ratings are falling ahead of October's election. In São Paulo, investors are calling this a rally in support of "anyone but Dilma."

Why has politics suddenly started to exercise so much influence over financial markets? The answer starts with the breakdown of economic growth models that had come to rely too heavily on the high commodity prices, low interest rates, and other global windfalls of the last decade. When the times were good, many leaders neglected to keep pushing reforms and to invest profits wisely. As a consequence, their nations are now struggling to sustain growth. Three of the biggest commodity-exporting economies, for example-Brazil, Russia, and South Africa-have seen their gdp growth rates collapse to about one percent or less this year and their inflation rise to around six percent. That's made investors especially alert for signs that new leaders with new ideas might emerge.

Another reason why politics has become so important to the markets is that the two conditions necessary for orderly leadership changes and quick economic turnarounds-free elections and free markets-have become increasingly ubiquitous in recent decades. Since the financial crises of the 1970s began weakening autocratic regimes, the number of countries holding free elections has tripled, from around 40 to about 120. It was not until after the fall of the Berlin Wall, however, that many big developing nations took the next necessary step and began opening up their stock markets to foreign investors. And even then, these countries did not appear on the radar of global investors for another decade, because their economies' emergence was delayed by the

currency crises that swept developing nations in the 1990s. The broad explosion of hope rallies was thus not even possible until relatively recently.

MARKET LEADERS

The global markets have seen some hope rallies before, although on a smaller scale. An analysis of how stock markets have reacted to 140 national elections in 30 major democracies over the past two decades shows that investors tend to respond dramatically in conditions much like those of today: when reform-minded challengers ascend to power in the wake of financial or political crises and then actually deliver. Over the past two decades, 16 leaders have fit this profile. On average, during these leaders' first 18 months in office, the performance of the stock markets in their countries beat the emerging-market average by an astounding 40 percentage points.

Among this group, four leaders, all of whom rose to power following the currency crises of the late 1990s, are especially noteworthy because they represent the most important generation of economic reformers in the developing world in recent times: Kim Dae-jung, South Korea's president from 1998 to 2003; Vladimir Putin, who has served as Russia's leader since 2000; Luiz Inácio Lula da Silva (known as Lula), president of Brazil from 2003 to 2011; and Recep Tayyip Erdogan, Turkey's prime minister since 2003. By imposing discipline on deeply indebted economies, they brought financial respectability to once-lagging countries and helped set the stage for the boom of 2003 to 2007—the strongest and widest the emerging-market nations have ever seen.

All four managed, with stunning speed, to transform their economies into engines of growth. In South Korea, Kim used the Asian financial crisis to push through a major overhaul of the nation's banks and debtridden conglomerates, repaid an emergency loan from the International Monetary Fund in less than three years, and saw the economy rebound from a severe recession in 1998 to a growth rate of more than seven percent in the last four years of his single term. In Brazil, Lula managed to contain the government's profligate spending habits, helping keep inflation under control and setting the stage for an increase in economic growth from 1.5 percent before he took office to an average of over three percent in his first term and to an average of four percent in his second. Erdogan engineered a similarly fundamental turnaround. Weaning Turkey off the IMF loans to which it had resorted roughly every other year for four decades helped the country's GDP growth accelerate to more than seven percent in his first term before it cooled off to around three percent in his second. But perhaps the most dramatic reversal of fortune has come in Russia under Putin, who inherited an economy in 2000 that had contracted in five of the previous six years and a currency that had collapsed twice in the previous decade. Putin not only stabilized the ruble but also, with the help of higher oil prices, led Russia to an average GDP growth rate of around seven percent during his first two terms.

Such accomplishments turned all four of these reformers into market darlings. By reviving economic growth, Kim, Lula, Erdogan, and Putin also generated stock market rallies that lasted many years, but they are exceptional cases. Markets are extremely impatient and will turn on even the strongest leaders if they stop generating high growth or on the most promising newcomers if they don't produce results within their first 12 to 18 months in power. Many presidents and prime ministers have suffered this fate, including once-promising leaders such as Fernando Henrique Cardoso of Brazil, Joseph Estrada of the Philippines, and Junichiro Koizumi of Japan. All three tried but failed to deliver enough reform to revive economic growth—and the markets punished them accordingly.

HOPE SPRINGS

Just as stock markets have grown finely attuned to signs that new leaders could produce economic revivals, so, too, have they learned to read the signs of decay that usually follow, as successful leaders grow too self-satisfied to continue pushing for change. Over the last two decades, the stock markets of emerging-market countries with new leaders have typically beat the developing world's average stock market returns by about 20 percentage points during those leaders' first terms, then tracked the average closely in their second terms, and then fallen by about six percentage points below the average in their third. Such third terms are rare, but they offer at least anecdotal evidence of how markets tend to spurn aging regimes. The two recent examples are Erdogan and

Putin, former investor darlings who became complacent and allowed growth to stall in their third terms. In both Turkey and Russia, gdp growth has stumbled along at an annual pace of just over two percent in recent years.

The stage for the more recent hope rallies and the leaders who sparked them was set by the vast scale of the 2008 financial crisis and the long global slowdown that followed. In many of the countries most affected by the downturn, anxiety over the immediate impact of the financial meltdown was compounded by concerns about the fact that these nations had been falling behind for many years. Such worries made voters especially open to bold new leaders-and markets especially prone to reward them.

The first of the recent string of rallies started with the Philippines in 2010, after Benigno Aquino III won the presidency on promises to clean up the country's corrupt and debt-burdened economy. Soon, this chronic laggard became one of the world's fastest-growing economies. Next came Greece-the epicenter of the eurozone crisis-where the stock market has more than doubled since Antonis Samaras became prime minister in June 2012 and began delivering on promises of tough reforms, including cuts to public-sector wages and employment. The next month, July 2012, markets in Mexico rose sharply around the electoral victory of President Enrique Peña Nieto, who had entered office in December promising to unclog the state's monopoly-choked economy. Also in December, stocks in Japan rose just before and after the election of Prime Minister Shinzo Abe, who vowed to bring both serious stimulus and major structural reforms to that country's long-dormant economy.

Then came perhaps the most unexpected hope rally yet. In 2013, despite Pakistan's reputation as a terrorist haven, its stock market became one of the best performing in the world, based in large part on expectations that the newly elected prime minister, Nawaz Sharif, would keep his promises to increase the tax base, privatize state companies, tighten budget discipline, and push other basic economic reforms. So far, despite continuing battles with the Taliban, Sharif has delivered on his promises, and investors have rewarded him for it.

These new reformers are a much more eclectic group than their predecessors. In the 1980s, most of the star leaders, such as Ronald Reagan and Margaret Thatcher, pushed free-market reforms; in the late 1990s and early years of this century, the big struggle for Kim, Lula, Erdogan, and Putin was to establish financial stability. For the most part, however, the new generation lacks a clear theme. At a time when every nation is scrambling to carve out a competitive niche in a tough global economy, they are pursuing a mix of policies designed both to put their economies on a more solid footing (lowering national debts, balancing government budgets) and to build more competitive businesses (cutting red tape, busting monopolies). In the Philippines, Aquino has focused on distinguishing himself from his corrupt and ineffectual predecessors, from the strongman Ferdinand Marcos and his flamboyant wife, Imelda Marcos, to Estrada, a former action-movie heartthrob who proved far less dynamic once he took office. Aquino eschews visionary speeches and, when I met him in Manila in August 2012, spoke in minute detail about the city's water projects and local sardine fisheries. His honesty alone sent a strong early signal of change, and the markets have treated him as the execution-oriented technocrat that the Philippines needs.

Abe, by contrast, has promised a dramatic shakeup for Japan. He electrified markets in his first 100 days with a sweeping plan to stimulate the country's stagnant economy and raise its long-term growth potential by streamlining the bureaucracy and subjecting coddled industries to real competition. Peña Nieto, meanwhile, came to power the same month as Abe and arrived with even more drama, cutting a grand political bargain to preempt the kind of opposition that had prevented his predecessors from tackling Mexico's biggest economic problems, including the entrenched power of unions and monopolies. Within months of taking charge, Peña Nieto passed reforms that diminished the power of Mexico's mighty teachers' union and broke up the telecommunications monopoly owned by Carlos Slim, the country's richest man.

But even as Abe has pushed the easy steps to promote growth (providing cheaper credit and devaluing the currency), he has not yet undertaken the more difficult competitive reforms (making it easier for corporations to hire and fire workers and opening up Japan to more immigration). Peña Nieto, meanwhile, is continuing to take the tough steps (opening up the state-run energy sector to foreign investors, for example) but has yet to propel growth in the short term. Given such setbacks and skepticism about Abe's and Peña Nieto's long-term prospects,

market enthusiasm for both men began to wane almost exactly on cue in May, when they each reached their 18th month in power.

But neither leader should be written off just yet. As of mid-2014, Abe, Peña Nieto, and indeed all the new reformers were presiding over economies that looked strong relative to their main competitors. Despite recent signs of weakness, Japan has been one of the developed world's three fastest-growing economies over the past two years. Mexico had yet to accelerate, but along with Greece and Pakistan, it is one of the few emerging economies in which the pace of growth is expected to speed up over the next three years. The Philippines has outpaced virtually every other economy in the world since 2012. Newly confident since Modi's election, India's economy also looked poised to speed up, at least in the coming year.

It remains too early to say how many of these hope rallies will foretell long runs of strong economic growth. But the historical pattern is clear: movements in the stock market do tend to anticipate real moves in the economy. Normally, the current valuation of the stock market in any country reflects the world's best collective guess about the growth prospects of that country's economy. And such valuations are based on the sum total of economic intelligence collected by local and international investors. More recently, markets have begun to factor in the possible arrival of new leaders as harbingers of change and have often seemed more responsive to poll data and election news than to current economic statistics. Investors, meanwhile, have become politically discerning in a ruthless way, and they are likely to keep punishing complacent regimes while richly rewarding new leaders ready and able to boldly forge new paths.

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