Emerging markets: While the sun shone

By Jonathan Wheatley and FT reporters

Only a few developing nations used their boom years to enact crucial structural reforms. This failure to pursue change has worried investors.

In December 1994 Fernando Henrique Cardoso, president-elect of Brazil, made a speech before the country’s Senate. He held up a paper on which he had listed his priorities. It was a blueprint for profound reform of Brazil’s fiscal system and of its “economic order”, cutting across public spending, labour law, the judiciary and politics.

Two decades later, despite a commodities boom and the rise of a new consumer class in the developing world, it is striking how little of Mr Cardoso’s work has been done.

Brazil is not alone. Investors are increasingly questioning whether many leading emerging markets have undertaken vital structural reforms during their years of high growth.

Such doubts about the resilience of developing markets raise hackles from Brasília to Bangkok. Governments across the emerging world argue that they are much less exposed to external shocks than they were in the 1990s, when tremors that began in Mexico, Thailand and Russia sent waves of financial destruction around the globe. To an extent, their claims are justified. Many emerging economies have reduced their dependence on foreign currency debt, cleaned up their public finances and built big foreign reserves.

Mehmet Simsek, Turkey’s finance minister, says sweeping changes have been made. “Many emerging markets have significantly improved their balance sheets, whether you are talking about public finances or other macro- fundamentals,” he says. Floating foreign exchange rates and better regulated banking, for example, are now almost universal, he says.

But such changes, as Mr Simsek recognises, were “first-generation” reforms – the kind of measures that can be implemented by technocrats at finance ministries and central banks. Just as that work was being done, Chinese demand, the commodities supercycle and the age of irrational exuberance sent a flood of new wealth into the emerging world. The financial crisis of 2008-09 kept the money flowing via quantitative easing. The imperative for reform ebbled.

Now the world has changed again. Chinese growth has slowed. The commodities supercycle is over. The end of quantitative easing was...
deferred by the US Federal Reserve in September but it is coming, nevertheless. The failure to reform is again a worry.

“Maybe the second and third-generation reforms were shelved,” says Mr Simsek. “Let’s say emerging markets were not aggressive enough against this relatively easy backdrop.”

One problem is that, today, there is little room for finance ministries and central banks to come to the rescue. “There is nothing they can do now that is easy,” says Gaurav Mallik of State Street Global Advisors, an asset manager. “It is all difficult stuff now.”

He cites India, where the government is battling with politically charged land and labour reforms. “Look at the maelstrom that happens every time a new policy is tried,” he says, pointing to U-turns in New Delhi’s efforts to allow foreign investment into the retail industry.

In Brazil, the failure to reform is notable because the road ahead had been so clearly mapped out. Mr Cardoso was no slouch. As finance minister, he beat runaway inflation. As president, he did much to lay the foundations of later prosperity. In a country addicted to irresponsible state largesse, he enshrined fiscal responsibility in law. He also advanced privatisations in core areas such as energy, utilities and telecommunications.

But his reforms lost momentum. The government still spends too much and badly. A bewildering tax system and bureaucracy remain heavy burdens on business, as is a labour code inspired by Benito Mussolini’s Italy.

Luiz Inácio Lula da Silva, who succeeded Mr Cardoso, kept his pillars of stability in place and helped extend their benefits to the poor through a generous social security safety net and by encouraging access to cheaper credit. But the Cardoso agenda was partly reversed, as the government clawed back state control over the oil sector at a heavy cost and extended state influence elsewhere.

Not all emerging governments have gone backwards. Some, such as Chile and Poland (and others in central Europe) have neared developed-world income levels and now face the challenge of escaping the middle-income trap. Others have yet to come close.

As he spoke in 1994, Mr Cardoso was perhaps at the height of his popularity, having been swept to power on the inflation-busting Plano Real. As he told the senators, the plan had been “only the first step of the changes and a bridge towards the structural reforms that we lost the opportunity to launch this year”.

He had no idea the opportunity would be lost for so long.

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Chile: a beacon of stability and progress

Chile is often held up as an example of Latin American success, writes Benedict Mander. Its gleaming macroeconomic fundamentals and solid institutions give it a fighting chance of entering the select club of developed countries. It was a pioneer in pensions reform and almost all of the economy has been privatised apart from Codelco, the copper miner; its profits are stashed in a sovereign wealth fund that can be dipped into during lean times. Chile’s labour laws are considered more liberal than those of many European countries.

Although poverty has fallen from 40 per cent during the Pinochet dictatorship to 15 per cent today, inequality remains among the highest in the region and is Chile’s most serious challenge.

With Chinese demand for copper slowing, some fear that lower export revenues will restrict economic growth and the ability of Michelle Bachelet, who is expected to return to power in next month’s elections, to implement reforms needed to promote equality and keep a lid on social unrest.

Nevertheless, Chile’s stability is in marked contrast with crisis-ridden Argentina across the border. Argentina suffered a crushing debt default in 2001-02, which was a culmination of poorly implemented market reforms during the 1990s.

Even today, Argentina has to pay double-digit interest rates, while Chile’s borrowing costs are similar to those of France.

Companies in Argentina are struggling against strict economic controls, while Chilean businesses are expanding around the world.

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Poland: state policies have led to a booming private sector

Poland has been a star performer among central European post-communist countries, partly because its starting position was so dismal, writes Jan Cienski. When the communists slunk off the stage in 1989, the country was a hyperinflationary mess. Reforms launched under Leszek Balcerowicz, the then finance minister, ended support for state-owned businesses, opened the country to foreign investors and made the zloty convertible.

Communist-era debts were paid, inflation conquered, spending brought under control and the conditions created for a flourishing private sector. Poland’s labour market, for example, is among the most flexible in Europe. This was not achieved without cost and the economy fell into deep recession. But by 1992 it was growing again and Poland has been the only European country not to fall into recession over the past two decades. Its gross domestic product per capita this year will reach 62 per cent of the level of the eurozone, up from below 30 per cent in 1992.

Some reforms have stalled, though. Privatisation is incomplete; bureaucracy is rife and the tax system is complex. Poland’s initial enthusiasm for reform has waned. Donald Tusk’s government pushed through one significant change: raising the retirement age to 67. But it is rolling back earlier pension reforms, saying they are hurting public finances.

Much effort has been concentrated on guiding the country through the financial crisis – something that Mr Tusk and Jacek Rostowski, his finance minister, have done relatively successfully.

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Turkey: Political tension puts investment at risk

For many observers, Turkey is a case apart, writes Daniel Dombey. Recep Tayyip Erdogan, the prime minister, has dominated the country for a decade. His sheer force of will has established the supremacy of democracy in a country previously in the shadow of the military. The economy has also been transformed. In the late 1990s inflation exceeded 90 per cent; it is now in single figures. In 2002, 86 per cent of tax revenues went to interest payments compared with 16 per cent today.

But the extent of Mr Erdogan’s power is controversial and this year mass protests erupted against his rule. His government clashed with Turkey’s biggest company, Koc Holding; business leaders warn privately that the atmosphere of tension risks scaring away foreign direct investment.

Growth has slowed. The savings rate has fallen by more than in any other G20 country; reliance on foreign capital has left Turkey dependent on portfolio funds to finance more than 80 per cent of its current account deficit, which at about 6 per cent of gross domestic product is the largest of the big emerging markets.

Not enough Turks are working and those that do often lack skills. Just 28 per cent of women participate in the labour force. Despite improvements in education, a quarter of all 15-year-olds are functionally illiterate.

Given such challenges, many wonder if a country in which one man wields so much power is likely to make the changes that would lead to continued success.

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India: Bureacracy still bedevils investors

In May, when the US Federal Reserve warned of an approaching end to its quantitative easing programme, the Indian rupee was the hardest hit of the big emerging market currencies, writes Victor Mallet. One fundamental problem is that, while the country has
There are formidable bureaucratic obstacles to building and running factories in India. Foreign and domestic investors complain bitterly of needing several years to acquire expensive land for factories and projects. And they are so appalled by burdensome labour laws and low productivity that they typically try to employ as few people as possible and mechanise where they can.

The result is a weak manufacturing sector, substantial industrial imports that contribute to the current account deficit and high unemployment.

The other big problem is one of implementation. Since returning to the job in 2012, Palaniappan Chidambaram, the finance minister, has wooed India’s investors by announcing a series of liberalising reforms. They include the opening of more sectors to greater foreign investment, the clearing of bureaucratic obstacles to infrastructure projects, the part-privatisation of state companies and cuts in diesel subsidies.

However, progress on the ground has been painfully slow, largely because the left-leaning Congress party that heads the coalition is ambivalent about such reforms. It wants to win over voters in next year’s election by increasing subsidies rather than cutting them, and by distancing itself from big business.

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**Indonesia: Little progress made on structural reforms**

Until recently, Indonesia was a darling of emerging-market investors, writes Ben Bland. Once it recovered from the turmoil that followed the fall of its dictatorship in 1998, it enjoyed a decade-long boom that made it one of the world’s hottest markets.

But that hype has been blown away during the past year, with falling prices for Indonesia’s commodities exposing a widening current account deficit. Growth, consumption and investment are all slowing.

Like other emerging markets, Indonesia has reduced its foreign debt, cleaned up its banking sector and sharpened its financial regulation. It has also made progress in tackling poverty, set up an independent body to tackle corruption and resolved most of its ethnic conflicts.

Average incomes rose sharply in the good times but so did inequality. The receding tide of optimism has revealed that scant progress was made on structural reform.

Indonesia badly needs judicial, tax and labour reform; a big reduction in red tape; infrastructure development; an overhaul of ailing health and education systems; and more systemic efforts to reduce the most egregious forms of corruption.

And the prospects? President Susilo Bambang Yudhoyono will step down next year after reaching the legal two-term limit, meaning southeast Asia’s biggest economy will get its first new government in 10 years. But with power still captured by a tight-knit political and economic elite, hopes for radical change are slender.