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Slowdown threatens the developing world

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Indians at the Bombay Stock Exchange in Mumbai. The rupee sank to a historic low this week. Source: AP

WITH the fifth anniversary of the collapse of Lehman Brothers looming, financial markets are again in turmoil. Paradoxically, the jitters come not from the risk of crisis in the US but from fears that a strengthening economy will lead the Federal Reserve to scale back on "quantitative easing" and eventually increase interest rates.

That prospect has triggered a flight of investors from emerging markets back into US assets. The exodus sent India's rupee to historic lows this week; the Indonesian rupiah and the Brazilian real have depreciated by nearly 15 per cent; and share prices in those countries have taken a battering, with Latin American stocks approaching their lowest level since 2009. The disarray in emerging markets is likelier to weaken the global recovery than to abort it. But it highlights deeper issues that have far-reaching implications for Australia.

That is not to suggest the problems were unexpected. It was obvious that the dramatic loosening of monetary policy in the advanced economies that followed the global financial crisis would send shock waves through the developing world. After all, the Fed's decision to lower its short-term interest rate to 1 per cent in 2003 had wreaked havoc as "hot money" flowed into larger emerging markets, such as Brazil, with naturally higher interest rates and floating exchange rates.

While those flows subsided as the Fed started to increase rates in 2005, they resumed four years later, once the GFC induced the Fed to drive US short-term rates to zero. They then accelerated as successive rounds of quantitative easing, in which the Fed bought US bonds and other American securities, reduced yields on those securities and encouraged cashed-up sellers to shift their portfolios to higher-earning investments overseas. And no destination was more attractive than the rapidly growing developing countries, most of which (with the notable exception of China) had removed controls on capital movements.

Scaling back quantitative easing was therefore likely to cause a "giant sucking sound": but unlike Ross Perot's colourful prediction, which anticipated a rush of American jobs south as a result of the North American Free Trade Agreement, it would be a tsunami of liquidity heading north.

Not all emerging markets are equally affected. Some, such as South Korea, are virtually unscathed; many others, including India, Brazil and Indonesia, are reeling. The hard-hit share a key feature: they have all turned their back on economic reform, succumbing to the new populism that gathered pace after the GFC.

That they would do so is easy to understand. Domestic imbalances, culminating in repeated currency crises, had forced painful reforms in the late 1980s and 90s, often imposed as part of international bailouts; the good times of the past decade might have been a reward for those efforts, but they also encouraged a sense that enough had been done.

Moreover, strong growth boosted tax revenues and, with foreign investors queuing up to finance any deficits, fiscal constraints seemed less binding than they had for years.

Domestic politics had changed too. Combined with a wave of democratisations in the developing world, gains in educational levels and the increasingly rapid spread of information through the internet and through ubiquitous mobile phones galvanised electorates, increased voter turnout and made political contests more tightly fought.

Tocqueville effects added to that mix. Writing 50 years after the French Revolution, French aristocrat Alexis de Tocqueville noted that it was prosperity, not misery, from which the revolution had sprung. With rising wellbeing, aspirations had grown even more rapidly than achievements. At the same time, the fact some problems had been dealt with but not others made those remaining all the more galling. And economic progress, not matched by improvements in social status, created an incongruence that was especially frustrating.

The resulting revolution of rising expectations, born from a flammable mix of greater wellbeing, the fear of falling back to where one had been and a desire to have a greater say, created opportunities populist politicians were well placed to exploit.

Brazil is a case in point. After years of accelerating rises in prices, the inflation rate reached 3000 per cent in 1990; the country was gripped by despair as it circled between hyper-inflation and failed efforts at stabilisation.

But a process of reform, precipitated by a currency crisis in January 1999, finally succeeded in bringing monetary and fiscal policy under control.

By 2007, Brazil's economy was expanding at more than 6 per cent annually off the back of a resource boom, foreign debt had been reduced significantly and the government could borrow at longer maturities and lower costs.

But with economic growth lifting tax revenues from 29 per cent of GDP in 1999 to 35 per cent last year, leftist former president Luiz Inacio Lula da Silva and his hand-picked successor Dilma Rousseff had plenty of scope to increase spending. And spend they did, not only on poverty alleviation but on an ever-growing range of subsidies, including for petrol and transport, distributed through an ever-rising number of public agencies, multiplying the opportunities for cronyism and corruption.

Spending on much-needed infrastructure, on the other hand, fell behind, with many roads scarcely usable, electricity supplies unreliable and the country's largest airport strained to the point of paralysis. And progress on structural reform came to a halt, with restrictive labour laws made even harsher.

The result has been rising inflation as well as mounting budget and current account deficits. Those deficits have been financed through short-term foreign debt, magnifying the country's vulnerability to changes in investor confidence. With an election due next year, Rouseff is expected to further increase public spending in a bid to reduce unemployment and offset increases in oil prices. Little wonder markets have panicked.

The Indian story is strikingly similar. Although India did not experience the Latin American cycle of hyper-inflation and economic meltdown, per capita incomes increased by barely 1 per cent annually from independence to the early 80s. Pervasive restrictions on international trade and investment, coupled with the dead hand of the "licence Raj" (in which official permission was required for virtually all private initiatives), crippled previously successful export industries such as the tea plantations of Assam and West Bengal.

Growing fiscal deficits, trade deficits and foreign debt turned into a major crisis in 1990, aggravated by rising oil prices and the disruption of remittances from the Persian Gulf. After teetering on the brink of default, an ambitious structural adjustment program launched in 1991 finally opened up India's economy.

The results were impressive, with the growth rate of per capita income doubling from 3 per cent in the 1980s to 6 per cent in the decade to 2011. The GFC, and a surge of foreign funds seeking higher yields than those available in the advanced economies, gave that growth added impetus.

But many growth blockers have remained in place, including restrictive labour laws and constraints on foreign investment. To all that is added the burden of an extraordinarily inefficient public sector, in which wages are set without regard to budget constraints and in which corruption is endemic. And that corruption extends to the political system, with one-third of members of the Indian lower house, the Lok Sabha, facing criminal charges.

But rather than pressing ahead with change, the United Progressive Alliance government of one-time reformer Manmohan Singh has relied on ever-expanding subsidies to cushion price hikes and win votes.

Nearly 1.7 per cent of India's GDP (about four times the central government spending on public health) now goes on subsidies for petroleum and fertilisers, the Public Distribution System provides rice and wheat to up to 75 per cent of rural households and the National Rural Employment Guarantee Act gives all applicants a legally enforceable right to a job at regulated wages and conditions.

And only this week the government secured a substantial extension to food subsidies and began the process of enacting a land acquisition bill that India's television news described as "a mega vote-getter in the 2014 national elections" but that could increase the cost of purchasing agricultural properties for industrial and commercial use by 40-60 per cent.

As in Brazil, the fruits of populism have been stubbornly high inflation and growing budget and current account deficits, financed through short-term foreign loans at rising interest rates. Again, as with Brazil, it is easy to understand why the prospect of liquidity drying up has spooked investors.

Nor are India and Brazil alone. Indonesia is in the same boat. After the departure in May 2010 of former finance minister Sri Mulyani Indrawati and the demotion of trade minister Mari Elka Pangestu to the tourism portfolio, economic policies have taken a populist turn, underwritten by budget and current-account deficits financed through short-term foreign borrowing. With the situation clearly unsustainable, yields on Indonesian 10-year bonds have leapt from 5.2 per cent five months ago to 8.4 per cent this month, while shares have lost about a quarter of their value.

None of that is likely to derail the world economy; however large their population, these economies are simply not big enough to cause serious global harm. And the International Monetary Fund, assisted by major central banks, is well placed to shield them from falling apart and limit wider contagion. But that hardly means the costs will be trivial.

Rather, currency crises generate enormous dislocations: companies go bankrupt, unemployment increases rapidly, people lose their life savings, and the share of the population in poverty typically rises by 10-15 percentage points. Moreover, research shows that even after 25 years, or one generation, a country that has experienced a currency crisis will still have per capita incomes 18 per cent lower than one that did not.

Populism therefore exacts an extremely high price from those it was claimed to benefit and who gave it their enthusiastic support. But however misguided they may have been, it would be wrong to blame voters in those countries alone. For the allure of populism would have been weaker, and the scope to implement populist policies smaller, had the advanced countries not implemented monetary policies that flooded the emerging markets with cash.

Yet it has not only been the advanced countries' reckless monetary expansion that has contributed to populism's recrudescence in substantial parts of the developing world. Crucial too has been the advanced countries' retreat from the principles of economic liberalism and the practice of economic reform. When Kevin Rudd, in his 2009 Quarterly Essay, hailed the death of the "Washington consensus", which (in his words) advocated that "government activity be constrained, and ultimately replaced, by market forces", he was merely parroting a new conventional wisdom: a wisdom that accommodated, when it did not actively endorse, the populist policies whose consequences are being played out.

Given the countries affected, those consequences will reshape our region's political and economic landscape. And they highlight the uncertainties a new government will face: uncertainties that make it all the more important to "fireproof" our economy by restoring fiscal sustainability and increasing flexibility in product and labour markets. There is nowhere better to start than by eschewing the market-distorting interventions at which Labor, like its counterparts in India and Brazil, excelled.

Ecclesiastes tells us there is a time for planting and one for uprooting. But politics rarely concedes the luxury of time. Nor is it kind to those who refuse to learn from experience. No wonder the time of Rudd and his acolytes is fast slipping from their grasp; as the Coalition contemplates its time approaching, it needs to heed the harsh lessons of populism's false promise.