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Bumps in road to prosperity

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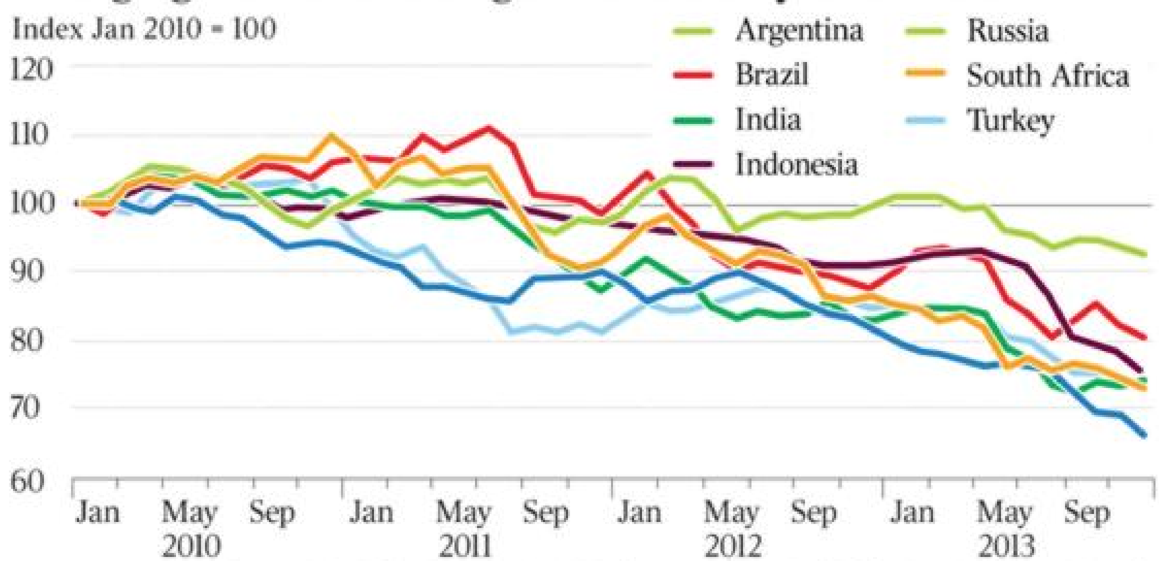
Emerging market exchange rate volatility since 2010



Source: Bank for International Settlements (Nominal Effective Exchange Rates)

Global growth and inflation

Country/Region (Trend years in brackets)	Trend GDP growth	2013 GDP growth	IMF forecast (2014-18)	Trend inflation	2013 Inflation	IMF forecast (2014-18)
United States (1980-2007)	3.0	1.6	3.2	3.7	1.2	2.0
China (2000-2012)	10.1	7.6	7.0	2.4	3.0	3.0
Euro Area (1992-2012)	1.5	-0.4	1.4	2.1	1.3	1.5
India (2000-2012)	6.9	3.8	6.3	7.0	9.0	7.3
Japan (1980-2007)	2.5	2.0	1.2	1.2	0.7	2.2
World (1980-2007)	3.0	2.3	3.4	--	--	--
Advanced (1980-2007)	2.9	1.2	2.4	2.6	1.4	2.0
Emerging (2000-2012)	6.2	4.5	5.4	6.5	6.0	5.0

Source: IMF World Economics Outlook Database

Graphic: Viki Sizgoric Source: TheAustralian

"CECILY, you will read your Political Economy in my absence", Miss Prism instructs the young

heiress in Oscar Wilde's The Importance of Being Earnest. But, the prudish governess hastens to add, "the chapter on the Fall of the Rupee you may omit. It is somewhat too sensational. Even these metallic problems have their melodramatic side."

With the rupee depreciating by 27 per cent against the US dollar since 2010, Miss Prism's dim view of India's currency gyrations seems as relevant as ever.

Yet the rupee is the image of health compared to the Turkish lira, whose value has halved since its 2008 peak, with recent selloffs driving Turkey's central bank to increase its lending rate to 12 per cent from 7.75 per cent after an emergency meeting late last Tuesday night.

Nor are India and Turkey alone in facing heightened financial market volatility. Rather, as America's federal reserve scales down its quantitative easing stimulus program, the prospect of higher yields in the US is drawing funds away from emerging markets, placing renewed pressure on the South African rand, Russia's ruble and the Brazilian real. With central banks in those countries raising interest rates to stem currency depreciation, the result could be to dampen economies that helped underpin growth in the wake of the global financial crisis.

Little wonder then that Treasurer Joe Hockey and Assistant Treasurer Arthur Sinodinos have sounded warning notes about the global economy. However, while it recognises those uncertainties, the International Monetary Fund's latest World Economic Outlook, released only weeks ago, remains relatively upbeat.

Its measured optimism is understandable. After all, the exit from QE reflects the federal reserve's assessment, which the IMF shares, that America's economy is gathering strength. And with Europe also forecast to recover, the fund expects world growth to rise from 2.9 per cent last year to 3.6 per cent this year. For the first time since the GFC, most of that growth would come from the advanced economies, whose contribution to lifting world GDP will increase, the IMF says, from some 40 per cent in 2013 to about 55 per cent this year.

That shift in the locus of expansion from the developing to the advanced economies would be a remarkably smooth transfer of the baton, given the risks the phasing down of QE poses. The policy itself was unprecedented; financial markets therefore struggle to predict the effects its withdrawal will have. With investors jittery, and central banks navigating in uncharted waters, the turmoil of recent weeks could instead persist and even spread, weakening economic growth worldwide.

Were that to happen, the IMF's projections would prove unduly rosy, as they have time and again since the GFC. Obviously, that is a matter time will test; but what is certain is that the federal reserve's actions have highlighted vulnerabilities that were masked by the wave of liquidity its stimulus program unleashed.

Those vulnerabilities help explain the geography of the latest round of financial difficulties. The countries most affected all suffer from structural obstacles that both constrain growth and make it inherently unstable.

Turkey, on which tens of thousands of Australians will converge for next year's ANZAC centenary, is a case in point.

Although per capita income has more than doubled since then prime minister Suleyman Demirel began the process of liberalising Turkey's economy in 1980, growth rates have fluctuated wildly from year to year. In fact, in seven of the past 14 years, Turkey's economy either grew faster than 8 per cent or contracted by more than 3 per cent, making Turkish economic performance twice as volatile as its emerging market peers.

The most immediate cause of that volatility is the country's dependence on capital inflows to finance the gap between low and declining domestic savings and demand that surges each time growth resumes. Moreover, despite its proximity to European markets, Turkey has struggled to attract foreign investment, forcing it to instead rely on debt to cover its financing needs.

To make matters worse, much of the lending Turkey can secure is relatively short-term, with the result that the year-on-year swings in net capital inflows have averaged nearly 3 per cent of GDP, compared to an average for its peers of about 2 per cent. Especially as liquidity flooded into world markets following the launch of QE, Turkish bond yields proved highly attractive to "hot money", placing upward pressure on the exchange rate, expanding the money supply and fueling domestic inflation, which reached 7.9 per cent at the end of last year.

But those macroeconomic developments mainly reflect underlying structural problems. If foreign direct investment into Turkey has lagged, it is because of a regulatory framework that makes it exceptionally costly to run large businesses. Turkey's labour market rules, supported by powerful trade unions, are especially draconian, with minimum wages that are among the highest for an emerging economy and a virtually complete prohibition on flexible employment contracts.

The result is that the prodigious dynamism of Turkey's entrepreneurs has flowed almost entirely into micro-firms that either evade or are exempted from regulation. In "tiger" provinces such as Anatolia's Mardin and Van, where employment outside agriculture has increased by 60 to 80 per cent since 2004, that informal sector now accounts for half or more of all non-agricultural employment.

But responsive as they are to market developments, these very small enterprises lack the scale and sophistication to durably compete in global supply chains. And their informal status limits their access to credit and their ability to recruit and retain specialist skills, while making them highly vulnerable to the demands of corrupt officials. They therefore sit below the ceiling of 50 employees, at which the most binding rules cut in, earning profits that are too low to bolster the country's savings rate.

All that is well known to Turkish policy-makers. But Prime Minister Recep Tayyip Erdogan's Justice and Development Party is entering a long electoral cycle, with local elections in spring, presidential elections soon after that and parliamentary elections in 2015, as well as a possible constitutional referendum in between. With a deepening split in the ruling Islamist coalition, needed reforms have given way to populist initiatives, including a costly expansion in the public service.

Much the same story could be told for the other emerging economies caught in the maelstrom. From India to South Africa, Brazil to Indonesia, the "sugar hit" from QE allowed tough decisions to be postponed, while accentuating domestic macroeconomic imbalances.

And the devaluations and interest rate increases now sparked by QE's withdrawal have sharpened political divisions, making it all the harder for governments to remove interventions that impede economic growth.

Moreover, as those divisions become ever more acute, even existing institutions look shaky, with the credibility of central banks seeming especially problematic.

That financial markets have reacted to those risks, perhaps transforming them into a self-fulfilling prophecy, is hardly surprising. But however great the pain that inflicts on the countries at issue, the feedback effects into the world economy seem too small to derail global expansion. Yet there are also serious uncertainties about the world economy's heavy hitters.

Nowhere are those uncertainties greater than with respect to China, which accounts for nearly 17 per cent of global GDP. The IMF expects a gradual reduction in China's growth rate, from 7.6 per cent last year to 7.3 per cent this year and to 7 per cent in the four years after that. Although those growth rates are well below the 11 per cent annual growth China achieved from 2005 to 2011, they would still be remarkable; but it is fair to question whether the IMF's forecasts are realistic.

Most immediately, there are substantial difficulties in China's largely unregulated shadow financial system, which issues roughly a third of new credit in China's debt-driven economy. Those difficulties became apparent last week as the Chinese authorities dithered over the threatened default of the $US500 million ($570m) Credit Equals Gold No 1 trust fund.

The authorities' last-minute decision to bail out the fund seems likely to aggravate already rampant moral hazard, while doing nothing to place the system on a stable basis.

At the same time, there are serious concerns about the longer-term sustainability of China's growth model, with its reliance on very high levels of investment. Taking the whole period from the start of economic reform in 1978 to 2005, 40 per cent of the growth in China's GDP came through rising multi-factor productivity (that is, to getting more output per unit of input) and 40 per cent from an increase in the capital stock, with the remainder reflecting increases in educated labour. But since 2006, more than 70 per cent of growth has come from pouring investment into the capital stock, while the contribution of productivity improvements has nearly halved.

The result is that the efficiency with which capital is being used seems to have plummeted. No doubt, China's enormous urban housing investment, which increased the average living space available to a family of three from barely 20sq m in 1978 to 81sq m in 2006, met real needs; so did a substantial share of its investment in transport infrastructure, which took the national network of high-speed roads from being virtually non-existent in 1987 to more than 75,000km today, matching the entire US interstate highway system.

Yet there has also been widespread waste, reflected in a low and declining growth dividend for each percentage of national income diverted to investment. Moreover, as the era of cheap Chinese labour comes to an end, it is only by lifting productivity that China can continue to prosper. But even returning to the trend 3.8 per cent annual multifactor productivity growth China achieved until 2006 would require politically unpalatable reforms, including loosening the state's hold on the allocation of bank credit and allowing the liquidation of the loss-making firms the state controls.

Without those reforms, China's future could involve many of Japan's woes, including a rapidly ageing population, a high debt-to-GDP ratio, a weak financial system and slow growth: but all cutting in at income levels far below those Japan has achieved. However, the politics of economic reform are no less fraught in authoritarian states than in democracies.

That is all the truer as the changes that are required could threaten the "two basic points" at the heart of Deng Xiaoping's strategy, "reform and opening up on the one hand, opposition to bourgeois liberalisation on the other". With the Communist Party's monopoly over key resources now an obstacle to economic development, which Deng defined as the party's overriding goal, China's autocracy may have run out of "win-win" options.

Nor are China's choices the only source of gnawing anxieties. Yes, the US may be this year's economic locomotive; but its labour market remains patchy, with mooted increases in minimum wages and higher labour costs from Obamacare weighing on employment growth. Troubling too are the possible effects of tighter banking regulation, which could prolong the reluctance of American banks to renew credit expansion.

And politics is also bedevilling the prospects for Europe. Even Germany is showing signs of recklessness, introducing a minimum wage and inexplicably proposing to reduce the pension age despite the huge risks population ageing poses to its fiscal sustainability. And although the collapse in Italy's economy may have bottomed out, Prime Minister Enrico Letta has done little to advance crucial labour-market reforms. As for France, it would be unduly optimistic to think Francois Hollande was rolling back the state, one first lady at a time.

Signs of asset-price bubbles, including in Canada and Britain, add to the reasons for disquiet. And so do the still extraordinarily high levels of public debt in the advanced economies, with central government debt as a share of GDP now approaching a two-century high-water mark.

Of course, even with all this, world growth may pick up, much as the IMF expects. But there are too many bumps in the road to have great confidence that growth will return to the levels needed for widespread prosperity.

Rather, that requires a willingness to tackle structural reforms that remove distortions to product, capital and labour markets, strip away unnecessary regulation, cut wasteful public spending and ease the burden of taxation.

Helping to mobilise that willingness should be the sole focus of Australia's chairmanship of the G20, not the mickey-mouse G20 agenda the Abbott government inherited from Labor.

Even so, the year ahead promises to have more than its fair share of episodes Miss Prism would find far "too sensational". But at least The Importance of Being Earnest had a happy ending. Let's hope The Importance of Sound Economic Policy has too.