EMERGING MARKETS REFORMS
The history of reforms in Emerging Markets

Historically, economic and political reforms in Emerging Markets (EM) have come in waves. Previous waves of reforms were the product of the crises of the 1990s, which started with India opening up large parts of its economy to foreign investment, continued with financial reform in Latin America after the Tequila Crisis in Mexico, accelerated with significant fiscal and monetary reform in Asia after the Asian Crisis, and culminated in key reforms in China that allowed it to join the World Trade Organisation (WTO) in 2001. These reforms led to unprecedented economic growth in EM, which significantly outperformed Developed Markets (DM) throughout the 2000s. Now, after several years of economic slowdown in EM, increasing pressure from the emergent middle-class is forcing governments to pass a new wave of reforms in order to boost growth, jobs, and opportunities for their populations.

For investors, understanding the history of economic and political reforms in EM is critical given the importance of reform for the future performance of the asset class. To understand why this is the case, it is important to take a step back and remind ourselves of the fundamental rationale for investing in EM. The long-term investment case for EM is simple: as economies transition from undeveloped to developed, the structural changes in the economy that this requires unleash economic growth which, combined with higher levels of governance, should translate into attractive investment returns. Developed economies are characterised as having transparent and flexible markets for goods, services, capital and labour, where prices are primarily determined by supply and demand, and where the rule of law means that contracts are enforceable at a reasonable cost. As developing economies move closer to this economic model, overall productivity per capita will improve as capital and labour are redirected to the more productive parts of that particular economy. It is this productivity growth that will be the ultimate source of long-term, sustainable improvement in the living standards of the world’s poor and that will drive long-term, sustainable returns for investors.

Exhibit 1: Long-term EM/DM relative performance and EM/DM economic growth

Source: FactSet, Datastream, Bloomberg, Goldman Sachs Global Investment Research, Dec 2016
The importance of economic & political reforms

According to the IMF, emerging economic growth slowed from 7.4% in 2010 to 4.1% in 2016, although it is expected to show improvement in 2017 (Exhibit 2). The general hangover from government stimulus-driven credit growth after the global financial crisis of 2008, particularly in China, as well as the fall in global commodity prices, has weighed on economic growth for a number of major EM countries. This slowdown has underlined the importance of economic and political reforms in order to promote sustainable, productivity-driven economic growth. Brazil offers a clear warning to governments and investors of the human and economic costs of not implementing political and economic reforms before a crisis hits.

Exhibit 2: Advanced vs. Emerging Economies Real GDP Growth

Source: IMF World Economic Outlook. April 2017
Key areas of reform for Emerging Markets

The growing middle-income class has been the key driver of consumption and growth in the last decade. Now EM countries need to avoid the so-called ‘middle-income trap’. In the early stages of development, strong growth can be achieved by shifting labour out of low-productivity agriculture into labour-intensive manufacturing.

To ensure that growth does not stall, it is important that countries are able to adapt to the changes in demand which result from the move away from traditional manufacturing and natural resources to a service-based economy. Research has shown that countries that struggle to move beyond the ‘middle-income’ economy do so because they do not have a flexible growth model which can keep pace with the changing environment.

This analysis leads to an emphasis on policy reforms focused on improving institutions and increasing the efficiency of markets, so-called ‘second generation’ reforms, in order to avoid the middle-income trap. In this respect, assessments by the Organisation for Economic Co-operation & Development (OECD) and others show that progress in recent years has been slow. In our view, the three key areas where EM countries need long-term structural reforms are infrastructure, the labour markets, and financial markets.

Underinvestment in infrastructure

Many EM countries need large-scale investment into infrastructure, particularly transportation infrastructure, in order to improve economic growth. Poor transportation links, for example, will create serious problems for any export business and having a weak urban infrastructure (poor housing, education, sanitation and access to utilities) will impede the development of a skilled workforce. China has spent around USD10tn over the last 10 years on infrastructure and this level of public investment has accelerated its economic development and reduced trade friction in the economy considerably. Due to China’s example, the pressure is building on the governments of other EM countries to follow suit,

Unfortunately, not all EM countries have access to this kind of money. Many of them are already burdened by large public sector wage bills and social welfare spending and therefore have less money available for large infrastructure projects (Exhibit 3).

Exhibit 3: Overall infrastructure score - major EM countries vs. select DM countries

Low labour market efficiency

Labour market inefficiency is a key area where long-term reform is necessary. Indicators published by the OECD suggest that employment protection legislation remains strict in many EM countries and, as such, this regulation deters those who attempt to develop a more formal economy. It becomes harder to achieve economies of scale or redeploy workers. In addition, according to data from the World Economic Forum, wage flexibility continues to remain below that of the U.S. and has declined since the financial crisis of 2008 (Exhibit 4.)

Exhibit 4: Labour market efficiency score - major EM countries vs. select DM countries


Low financial services development

Financial sector reform is an integral part of encouraging growth. In the last few years there has been a perceptible improvement in financial services in EM countries. Debt and equity capital markets have continued to grow as a percentage of GDP across the EM universe, however growth in equity market capitalisation slowed sharply in many EM countries during the financial crisis of 2008, and in some EM countries this has not recovered. It is important that access to financial services becomes more readily available as this will have the positive effects of encouraging individuals to save money and supporting the development of small businesses. According to the Institute of International Finance, measured by bank branches per 100,000 people, some larger EM countries are closer to US levels, in part reflecting greater reliance on banks. Many EM countries are still well behind on this score however and the overall level of financial development varies widely across EM countries (Exhibit 5.)

Exhibit 5: Financial services development score - major EM countries vs. select DM countries

Most Recent EM reforms

In line with our overall thesis, namely that we are witnessing another wave of political and economic reforms in EM countries, below is an outline of the reforms announced or implemented recently in key EM countries that we believe will improve the productivity, and thus competitiveness, of their respective economies.

China

In an effort to counter the country’s recent slowdown in economic growth, China’s main economic liberalisation reforms are centred on its 13th 5-year plan (2016-2020). In this plan, key reforms encompass new policies in the areas of manufacturing, urbanisation, infrastructure investments, privatisation, efficient capital allocation mechanisms and trade reforms.

China’s ‘Made in China 2025’ initiative will target an upgrade of 10 major “high value-add” manufacturing-related industries through government investment of USD1.3bn in industry-specific infrastructure over the 10 year period. The development of these industries is expected to help China increase the quality of its products while remaining competitive globally.

In the next few years, the government aims to invest in urbanisation and infrastructure. This will bring nearly 250 million people to the cities, to create a market of USD6tn relating to new settlements and employment opportunities. Over the last 10 years, China has spent approximately USD10.8tn in infrastructure alone which is expected to increase further.

The government plans to boost trade by initiating reforms to promote global collaboration. The “One Belt, One Road” initiative involves the construction of regional transport networks and international economic co-operation corridors along the routes, in order to reduce trade frictions and costs. The initiative is expected to cost USD1.2tn. In addition, the government has established 13 Free Trade Agreements (FTAs) and is currently negotiating 16 more, which would help China curb slowing economic growth by opening up key markets and industries.

Financial reform and Renminbi internationalisation is also on the agenda. China is planning to accelerate reforms in the financial system to establish a transparent and more liberal capital market, overhaul the issuance and trading of stocks and bonds, and to expand the banking system to provide more credit to the rural sector. Other planned financial reforms include the promotion and regulation of internet financing, boosting the development of new financing vehicles such as peer-to-peer and crowd funding, and piloting the trading of insurance assets.

Deposit rate liberalisation has freed up interest rates on bank deposits, which is expected to improve the economy in the long run. According to the Wall Street Journal, China’s officials announced that the decision will lead to efficient capital allocation, allow small businesses to access capital cheaply, and make the banks appraise risks more prudently.

South Korea

The political unrest in South Korea, fuelled by the impeachment of its President, Park Guen-hye, along with an economic slowdown caused by a fall in exports, rising household debt and youth unemployment, paints a picture of an economy in a challenging state. Despite the recent political upheaval, however, some progress has been made.

South Korea has made a concerted effort with Chaebol and dividend reform. Chaebol is the Korean term for a large business conglomerate characterised by a complex structure, often involving cross-holdings of group companies, and a tendency to hoard cash on the balance sheet. To combat this reluctance to distribute cash to shareholders, the government introduced the “Corporate Accumulated Earnings Tax” in late 2014. This measure was designed to penalise companies that did not distribute or reinvest at least 60% of net profits. Parliament is expected to continue to implement legislation designed to tighten laws for chaebols. These laws will make it more difficult for chaebols to engage in collusion, maintain nepotistic control of operations, excessively compensate executives, and exert undue political influence.
India

India is taking steps to continue its growth momentum. The major reforms centre on boosting domestic consumption, reducing the untaxed “black economy” and making it easier to do business. On 8th November 2016, Prime Minister Modi announced the withdrawal of the two highest-denomination bank notes (the INR500 and INR1000). The move was aimed at reducing “black money” in the financial system and expanding the tax base. In India, more than 90% of daily transactions are performed using cash. The surprise move has taken a toll on economic growth in the short term. The temporary disruption, due to a shortage of cash to complete transactions coupled with time spent queuing in banks, has affected general productivity. By early December 2016, however, 82% of the demonetised notes had been deposited into bank accounts and thus declared to the authorities.

The new sales tax, called The Goods and Services Tax in India, was passed into law in August 2016 and came into effect in July 2017. It replaced 17 current indirect tax levies and vastly simplified the sales tax system for cross-state transactions. The introduction of a new Goods and Services Tax (GST) means that tax rates are expected to be around 14-16%, while existing rates are 10% on services and 20% on goods. Moreover, with the implementation of GST, full input of tax credits will be granted on capital goods which could reduce the cost of capital goods by 12-14%. With the new tax system, prices of goods and services are likely to fall, leading to increased consumption.

The Indian cabinet has approved the Seventh Central Pay Commission’s recommendations for a pay rise of 14.27% to all central government employees. This would increase the minimum monthly pay to INR18,000 which is more than twice the current INR7,000. The pay rise, and the resulting higher disposable income, should result in an increase in domestic consumption.

There are plans to bring undeclared income back into the system through a tax evasion amnesty scheme whereby the individual making the declaration would have to pay 50% in taxes and surcharges. Moreover they would be required to put one quarter of the total sum in a non-interest-bearing deposit account for four years.

In November 2015, the government relaxed the FDI rules relating to foreign investment in the construction sector. Foreign investment is now permitted in projects with a minimum built-up area of 20,000 square metres, and the minimum required investment has been reduced to USD5m.

India has attempted to attract foreign investment in its rail network and now investors will be allowed full ownership of new services in suburban areas, high speed tracks, and connections to ports, mines and power installations.

Brazil

Brazil's reforms have been centred on a change in government and a shift away from 13 years of profligate leftist regimes to a focus on reform aims to return the economy to growth after 2 years of recession.

In December 2016, Brazilian senators passed a 20-year public spending real-term limit. This new expenditure rule will limit real increases in expenditure and reduce the rigidity of the budgeting process, with the exception of pensions and benefits which account for almost half of central government spending. The expected long-term impact of this policy is to allow stronger monetary easing in the future, giving rise to substantial investment.

In an overhaul of Brazil’s overly-generous pension system, a minimum retirement age of 65 would be imposed with a requirement to make contributions into the system for at least 25 years. The current system has different rules for men and women, and for public and private sector workers, and has an average retirement age of 54. In addition social security expenditure has risen to 40% of the government's primary budget.

South Africa

South Africa faced unemployment and income inequality that were among the highest in the world and reforms have been proposed which aim to boost jobs. The government prioritised spending on public infrastructure in order to fix bottlenecks and support small and medium-sized enterprises which are more labour intensive and therefore hire a relatively high proportion of low-skilled workers. Despite these measures, South Africa continues to face significant challenges with low growth amid a China economic slowdown, weak commodity prices, and political uncertainty. This has prompted the International Monetary Fund (IMF) to call for further reforms.

The government has promised to commit substantial public funds to build the infrastructure required to facilitate economic growth. In a bid to encourage investment and create jobs, government spending over the next three years will be directed to housing, public transport and roads and to increasing the supply of utilities.
Easing regulation on labour-intensive sectors is also crucial as the government aims to reduce the high level of unemployment. There is a focus on identifying and removing regulatory constraints in sectors that are less energy-intensive and more labour-intensive such as tourism, the ocean economy, agriculture, and agro-processing.

To attract more foreign direct investment, the government is introducing long-term multiple-entry visas for frequent travellers, and a business visa waiver for travellers from Brazil, Russia, India and China (BRIC) and a number of other countries. Furthermore, exchange controls over non-residents have been removed and proceeds from the sale of assets can be freely remitted; cross-border transaction thresholds have been amended to reduce both red tape and the bias between resident and non-resident individuals.

The government plans to prioritise spending on supporting small & medium-sized enterprises (SMEs) through various programmes including the launch of a ZAR1bn SME fund, The National Gazelles programme (which aims to support 200 SMEs), and the proposed creation of an SME public-private venture capital fund.

**Russia**

Russia, which is currently struggling due to the low oil prices, plans to support its economy through reforms expected to help new businesses, oil companies and investments. President Vladimir Putin has recommended a programme of major economic reforms after the 2018 polls.

In order to improve Russia’s low ranking related to ‘ease of doing business’, planned business reforms include the improvement of tariff regulation in order to attract investments, and making paying taxes less costly for companies by excluding movable property from the corporate property tax base (though it also raised the wage ceiling used in calculating social contributions). This has also made it much easier to start a business. The number of days required to open a corporate bank account has been reduced; transferring property has been made easier by reducing the time required for property registration; and access to credit has been improved as a result of a new law on secured transactions that has established centralised collateral.

Russia’s Finance and Energy Ministries have reached a provisional agreement on new tax reforms for the oil industry. The proposals would see a switch from a fixed Mineral Extraction Tax (MET), where a company is taxed based on the amount of oil, gas, or other mineral extracted, to an Excess Profits Tax (EPT). EPT will be applied at 50%, but extra duties paid in addition to MET will be scrapped. The new system is expected to bring about major benefits; mature oil fields are expected to save upwards of USD605m while newer oil fields are expected to gain by trading customs exemptions for EPT.

**Mexico**

Mexico’s reforms have been focused on increasing competition in its domestic market in order to improve efficiency and encourage direct foreign investment. It has introduced reforms which will enable the denationalisation of the energy sector, improve competition in the telecoms sector and to tackle corruption.

In 2014, Mexico decided to open its doors for private companies to invest in its oil and gas sector. This ended the seven-decade monopoly held by the state-owned petroleum company, Pemex. This will likely attract investment into the sector and reverse years of decline in production. After a lacklustre start to the bidding process, a number of bidding rounds exceeded expectations. In December 2016 the National Hydrocarbons Commission awarded four blocks in the oil-rich Perdido Basin to companies including Total SA, CNOOC Ltd, Chevron Corp. and Exxon Mobil Corp.

Also in 2014, reforms were made in the telecom sector to improve competition by eliminating monopolistic practices, enhancing the fundamental rights to freedom of speech and information access, and increasing the coverage of telecommunication and broadband services to its population. In 2016 the Mexico’s Secretariat of Communications and Transport (SCT) noted that around USD13.5bn had been invested in the telecom sector since these reforms, and another USD7.0bn worth of investment is expected through the upcoming nationwide shared broadband network.

In a bid to reduce corruption, Mexico passed an anti-corruption reform that required the amendment of 14 constitutional articles, the drafting of two new general laws, and the reform of five more. A National Anti-Corruption System has been established under the regulation of a citizen board (citizens actively participating in the system) and it will have the capacity to investigate corruption and prosecute if necessary.

**Indonesia**

A volatile currency and declining commodity prices have led President Widodo to announce measures to overhaul 89 regulations in order to reduce costs and impediments to corporate investment. These reforms centred primarily on increasing trade, opening up the economy for private investments, SME
growth, reducing taxes and regulatory burdens and increasing competitiveness.

The government has introduced 12 economic policy packages to help stimulate growth. The key goals of these packages are to increase privatisation, spend more on infrastructure, open up trade by signing partnerships and make Indonesia more business friendly, especially for SMEs.

A key reform that was implemented was Indonesia's tax amnesty programme. All unpaid taxes of citizens and investors alike could be settled at a lower rate under the plan. Since the amnesty began in July 2016, the Finance ministry has collected IDR97.2tn (USD7.5bn), or 59% of a targeted IDR165tn. Funds raised from taxation are expected to be used to fund future infrastructure spending in Indonesia.

There has also been a proposed lowering of the final income tax rate for REITs. In March 2016, the government cut the rate for transferring assets into REITs from 5% to 0.5% to allow Indonesia to become more competitive compared to its neighbours.

Trade has been a critical focus area for policy reforms and under the new government restrictions have been lifted in order to expand the sectors available to foreign investors. The government also plans to complete negotiations on the Indonesia-European Union Comprehensive Economic Partnership Agreement (IE-CEPA) by 2019.

The World Bank’s Board of Executive Directors approved the first Indonesia Logistics Reform Development Policy Loan to enhance logistics and strengthen connectivity. The USD400m World Bank loan will enable the government to alleviate bottlenecks in the country's supply chains, such as long dwelling times in ports and lengthy procedures for trade clearances. Currently, Indonesia's logistic costs account for 25% of manufacturing sales, compared to 15% in Thailand and 13% in Malaysia.

It is likely that SMEs will benefit from new reforms as implementation of soft loans for SMEs, and reduced energy tariffs for labour-intensive industries, will continue to boost competitiveness. Free leasehold certificates have been issued in 34 zones in an effort to boost economic activity.
The goal of economic and political reforms is to improve the relative competitiveness of a country’s economy in order to support long-term economic growth and human development. In our opinion, we are witnessing a new wave of reforms in EM after years of slowing economic growth in a number of major EM countries. We believe that the continuing programme of reforms highlighted above should result in an improved competitive position for EM as a whole and result in improving economic growth. It is important, however, to note that there is a lag of a few years before the economic benefits of an improved competitive position can be felt. It takes time for reforms to change the behaviour of workers, consumers, managers and owners.

Exhibit 6 plots the simple average over time of the World Economic Forum – Global Competitiveness Index rankings of the largest 15 EM countries, the countries that make up more than 80% of the MSCI EM Index. The average ranking fell during the period 2007-2008 (inception of the index) to 2010-2011, but has since improved with a current average global ranking of 40.6. This suggests that major EM countries are already benefiting from the reforms implemented in the last few years and this gives us more confidence that aggregate EM real GDP growth should continue to improve. Another interesting observation is that the improvement of this average ranking has been at the expense of a number of DM countries where we are yet to witness any significant reforms, despite sub-par growth since the global financial crisis in 2008.
Emerging Markets Reforms

From an investment perspective, the most attractive countries are those that have a low, but improving, competitive position relative to global peers. Fundamental reforms in these countries have tended to have a more positive impact on economic growth.

Exhibit 7 plots the World Economic Forum – Global Competitiveness Index rankings of the same largest 15 EM countries and how their global rankings have changed in the last five years. With the exception of Brazil, EM countries that are below average have improved their global ranking, whereas higher ranked countries have lost ground slightly. This intuitively fits with our thesis that EM reforms tend to be cyclical because reforms are more likely to be pursued when a country’s competitiveness has fallen and its economy has started to suffer as a result.

Previously we have written about how Brazil provides a good example of the negative consequences of failing to implement progressive reforms, and Exhibit 7 shows that Brazil’s competitive position has fallen significantly in the last five years. Recently, however, we have seen the impeachment of President Rousseff and the appointment of President Temer on a pro-reform platform. It will be interesting to see how Brazil’s competitive position changes although the full effects of the new President’s reforms will take time to become apparent. The Philippines, Mexico, Russia and India stand out as countries that have a relatively low competitive position but have seen a material improvement in the last five years. We have written previously about our positive investment view on the Philippines, Mexico and India, given the reform agendas of their respective governments, and despite Russia’s significant improvement in the rankings, poor corporate governance remains a key impediment to investment. Indonesia has only experienced a slight improvement in its competitive ranking during this period however we are now seeing an acceleration of reforms under President Widodo and would expect to see its ranking improve in the next few years.
Conclusion

There has been continuing momentum regarding political and economic reforms in a number of major EM countries. Given the importance of China to the asset class, we were pleased to see a number of key reform announcements in 2016 and believe that continued economic (if not political) reform is critical for the stabilisation of its economy after the rapid slowdown in the last three years. We also continue to have a positive view on the Philippines, Mexico and India as we are already seeing a material improvement in their global competitiveness rankings as a result of their reform agendas. We are hopeful that we will see an improvement in Indonesia’s global competitiveness as a result of the pick-up in reforms we witnessed in 2016 after a slow start for the new government.

We are doubtful of material progress with reform in South Africa and Turkey given the continuing dominance of the ANC and President Erdogan respectively. We are unlikely to see a significant improvement in the competitiveness of South Korea, Malaysia and Taiwan as they already enjoy high rankings however we remain hopeful for an improvement in corporate governance in South Korea under President Moon’s new administration.

The number - and nature - of economic and political reforms outlined in this report is unprecedented in the history of EM. Unlike the reforms of the 1990s, this current wave has not been in response to severe economic crises, but instead driven by the demands of an emerging middle-class as their economies slowed. The virtuous circle of economic development means that as people become wealthier, better educated and more connected to the world, they become more demanding of their political class which, in turn, drives further reform. We believe this bodes well for long-term investors in EM equities.
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