Talking point

The political economy of structural reform in the BRIC

May 7, 2013

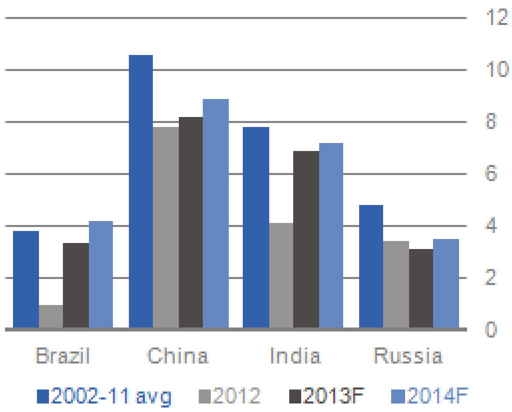
The BRIC economies, like most other economies in the world, experienced a slowdown in 2011-12. The bears are worrying that this slowdown might contain a significant structural component. These concerns seem somewhat overdone.

Sure, the last decade saw strong global economic growth against a backdrop of low interest rates, increasing global trade flows, rising capital flows to emerging markets and rising commodity prices (the latter benefitting countries like Brazil and Russia). The global growth outlook for the next few years is more modest by comparison.

China is indeed unlikely to return to double-digit annual growth rates, not least because the authorities believe that 7-8% growth is sufficient to maintain political stability. Brazil continues to experience sub-par growth. Indian and Russian economic growth has also decelerated to multi-year-ex-2008/09 lows. The IMF has just revised its 2013 growth forecast to 3.4% and 5.7% for Russia and India, respectively, and 3% for Brazil.

Slowdown appears to be largely cyclical

Real GDP, % change



Sources: IMF, DB Research

The growth potential of the BRIC economies nonetheless remains sizeable. All BRIC countries benefit from plenty of catch-up potential and scope to raise productivity via an increase in the physical and human capital stock. The first reason for optimism is that savings have not declined materially, and may even rise over the medium term. The current account positions are strong (China, Russia) or quite manageable (Brazil, India). This means that an acceleration of investment won't be much constrained by a lack of savings.

Most importantly, the BRIC countries are economically well-positioned to unlock their growth potential through structural reform. Brazil and India, for instance, have taken a number of structural measures recently (e.g. greater FDI in India, infrastructure concession sales in Brazil) Rather than solely relying on anti-cyclical demand-oriented macro policies à la 2008/09, they seem to have been spurred into pursuing structural reform aimed at enhancing productivity and international competitiveness by concerns that the current slowdown might be more structural than cyclical. Admittedly, none of these reforms qualify as big-bang reforms; but they should, at the margin, help support growth over the medium term. Encouragingly, these measures reflect the authorities' recognition that supply-side reforms are at least as necessary as demand-side policies if high growth is to be sustained over the longer term. Rising inflation in both countries has undoubtedly helped focus policy-makers' minds.

China has thus far largely refrained from taking strong anti-cyclical policy measures as well as from pushing major structural reforms. This is largely explained by the leadership transition as well as concerns about the longer-term potential negative consequences another large policy stimulus might have for existing economic imbalances. Technocratic-minded groups have put forward a blueprint for further financial sector reform and analysts expect a number of other measures to be forthcoming under the new government (e.g. social housing, infrastructure). The recent publication of a plan to raise household income shows that the authorities are aware of the need to tweak the growth model. Russia is looking at a number of reforms following last year's presidential elections; though, it remains to be seen how serious the new government is about reform. Importantly, the Russian government seeks to privatise USD 45 bn worth of public sector assets in 2013-15 and to increase infrastructure investment, especially in the Far East.

Recent Brazilian and Indian reforms may appear somewhat surprising. After all, the political-institutional backdrop for reform appears relatively unfavourable – more so in India than in Brazil. PM Singh's government has been struggling for a long time to persuade its unruly parliamentary coalition to back reforms. The opposition BJP, though in principle more inclined toward reform, has proven less accommodative of reforms than might have been expected. Aggressive reforms carry the risk of destabilising the parliamentary coalition government. This is one of the main reasons why India has not seen more extensive reforms over and above the measures alluded to above.

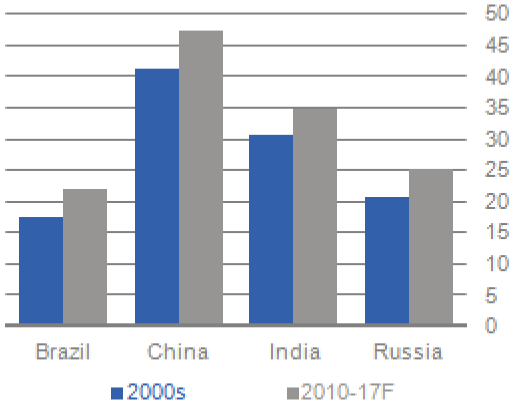
In Brazil's presidentialist political system, unlike in India, the executive does not depend on its congressional base for survival; but the president similarly needs to rally support in a highly fragmented congressional base and multi-party presidential coalitions in order to implement more wide-ranging reforms. The government has had at least one major success (e.g. public sector pension reform). It has also taken a number of other measures aimed at reviving economic growth (e.g. tax cuts, lowering of electricity tariffs). These latter measures did not require the president to spend lots of political capital or build large coalitions in congress, which perhaps explains why they were passed easily.

In institutional terms, the Chinese and Russian governments are better positioned to implement structural reform than Brazil and India, at least as far as the surmounting of legislative obstacles and societal opposition is concerned. In Russia, the presidency has not only extensive powers, but it currently also enjoys a majority in the Duma. In China, the executive rules supreme, even if it often has to contend with different technocratic and regional factions as well as well-connected vested interests, before a sufficiently large consensus on reform policies can be reached. In this respect, it is crucial that Chinese governments (or leadership groups) typically stay in power for a whole decade.

This latter fact is significant because it affects the incentives to pursue structural reform. This is critical, for the economic – and political - benefits stemming from structural reform typically materialise only over time, while the political and electoral (or legitimacy) costs typically materialise instantly. The OECD in a recent study finds that the full pay-off from structural reforms takes on average five years to materialise. This coincides almost exactly with the electoral cycle in democracies. It is easy to see why, unless a country is facing a severe crisis – like India in 1991, Russia in 1997 and Brazil in the early nineties – big-ticket reforms are rather uncommon. If they do take place, they almost inevitably take place early on in a government's term and, not infrequently, get watered down by vested interests or blocked entirely by so-called 'veto players'. Given how concentrated the costs of, and how dispersed the benefits from, reforms are (aka higher medium-term growth), vested interest find it relatively easy to mobilise against reform relative to the 'silent majority', who would benefit relatively less than vested interests.

Pessimism is likely overdone

Investment, % of GDP, average



Source: IMF

A moderate, gradual slowdown in economic growth is harder to instrumentalise in terms of mobilising political support for structural reform – as opposed to an outright economic or financial crisis. This is why the reforms in Brazil and India may look somewhat surprising – then again, the reforms that were passed are not exactly the type of high-impact, growth-accelerating reforms that are needed to raise economic growth dramatically. In purely political-institutional terms, China and, somewhat less so, Russia would appear to be far better positioned to pursue medium-term growth-enhancing reform than Brazil and India – at least once the government makes up its mind.

The long and short of it is this: if the growth decline in the BRIC economies were to prove more pronounced than we currently anticipate and reveal itself to be more structural than we believe, we would expect greater reform efforts to come through, especially in China and Russia. The relative lack of reform in China and Russia was likely due to the perception that economic growth remains broadly satisfactory. (This perception is changing fast in Russia at the moment.) It is encouraging that the Brazilian and Indian governments have taken structural measures – however modest in the eyes of critics – aimed at raising the medium-term growth potential, instead of solely relying on politically less costly demand side measures (though Brazil at least has done this, too). The current sense of pessimism pervading analysts' views of the BRIC therefore appears overdone. None of this is meant to suggest that structural reforms will be politically easy. The good news is that at least there is a, albeit varying, degree of recognition among the BRIC governments that such reforms are necessary. Once committed to reform, China and Russia will have an easier time implementing them than Brazil and India.

Markus Jaeger +1 212 250 6971

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