

Economics in Brief



No. 68, 18th February 2015

Without addressing structural weaknesses, Emerging Markets will struggle to make progress

Author: Dr Martin Raschen, Phone +49 (0) 69 7431-2434, research@kfw.de

The Emerging Markets (EM)ⁱ have the favourable global economic climate and market economy reforms to thank for their enduring economic growth since the 1990s. The economic weaknesses observed recently in many EMs do not cast doubt over these successes but do point towards a number of reforms still to be pushed through. The following overview is by no means exhaustive and of course not all aspects apply to every EM.

Inadequate infrastructure

Without efficient systems for transport, energy, ICT, water/waste water, waste, etc., an economy based on the division of labour cannot function properly. This is one of the key problems facing the EMs. The expansion of infrastructure has not kept pace with the economic boom and services are often of poor quality. In India for example, a good 20 % of generated electricity is lost within the transmission and distribution system, while frequent power cuts force companies to maintain costly stand-by capacities. In Brazil, only 14 % of roads are paved, while rail transport is under-developed. Traffic jams are a permanent problem in all large EM urban areas. The competitiveness of companies is significantly hampered by infrastructure deficits.

Fiscal policy, price distortions

The state is responsible for a large part of the infrastructure referred to here. Public budgets for construction and maintenance are regularly insufficient. Looking at the revenue side of the equation, this is often due to inadequate tax administration. Only 3 % of India's population pays income tax for instance. In terms of spending, budget implementation is weak but the scope for investment is also too narrow as the state

frequently spends a lot of money on expensive subsidies. For instance, until recently Indonesia spent 20% of its national revenue on questionable fuel price subsidies that favoured the middle and upper classes with cars. Electricity prices are distorted by subsidies in many places too.

Bureaucratic jungle, legal uncertainty, corruption

Companies complain about cumbersome public administration, complicated legal rules, lengthy court procedures and widespread corruption. This means that many EMs have low rankings in governance indicators, which shows that the high self-imposed demands are not always met.

Weaknesses in the finance sector

While there have been many reforms in the financial sector (such as after the Asian crisis in 1997), many EMs still have an Achilles' heel. In some cases the state still dominates the banking sector and/or exerts significant influence on business policy, regulations are weak and non-performing loans are in fact higher than official statistics suggest (in China for example).

Education, labour market

Primary education is now largely assured but there are still gaps with respect to vocational education. In many places there is a lack of labour with secondary education qualifications (Turkey, South Africa) or skills to meet current demands. Labour markets are often rigid.

Strong social disparities, democratic deficits

Some regions (MENA, South Africa) are hindered in their development by social

tensions, youth unemployment and crime. China and Russia are not democracies and freedom of speech is limited. Such problems are not just alarming from a general policy perspective; they also detract from the economic appeal of the given location. Deficits in democracy serve to fuel corruption.

Implementing structural reforms is not easy

The structural weaknesses and the need for political action are largely accepted, even within the EMs themselves. The crux of the problem is implementing reforms. Particularly high hurdles to negotiate come in the form of three political/economic aspects:

- (1) Structural reforms take longer to prepare and their impacts only emerge in the long term – which is a problem not least because of the shorter election periods.
- (2) Political stability is quite commonly lacking, even in EMs that have free elections: politics is a domain reserved for a small group of the population with clear personal interest.
- (3) The acceptance of reforms is complicated, not just by the weak political and economic understanding of large parts of the population but also because reforms entail losers too.

The acceptance of reforms and social cohesion could and should, where possible, be enhanced by means of targeted compensation measures. ■

ⁱ There is no clear-cut definition and unambiguous statistical classification of emerging markets. However, this is not an issue for the purposes of this paper.