Troubles Ahead in Emerging Markets

by Jeffrey E. Garten

Harvard Business Review

Reprint 97302

The opportunities in emerging markets are huge. So are the risks.

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Throughout the 1990s, financial investors, corporate strategists, and political leaders in the United States, Western Europe, and Japan have been intensifying their focus on emerging markets. Such companies as Morgan Stanley, General Electric, and Johnson & Johnson are placing enormous bets on these markets. The Clinton administration's export-promotion strategy is based on the premise that the most promising markets are not in Europe and Japan but in the so-called big emerging markets. And the U.S. approach is mirrored abroad as presidents and prime ministers from France to Japan make pilgrimages to China, India, Brazil, and elsewhere to hawk their countries' wares.

Emerging markets are indeed the new frontier. But like all frontiers, they present a mix of opportunity and risk. The question now is whether businesses and governments in the industrialized world are sober enough about the problems that lie ahead. I do not believe they are. There is considerable evidence indicating that the tides of capitalism, which rose so powerfully after the collapse of the Soviet Union, are poised to recede. This reversal may signal much more than the usual ebb and flow of political and economic progress in the developing world, and could amount to a fundamental disruption of the generally upward trajectory in so many countries.

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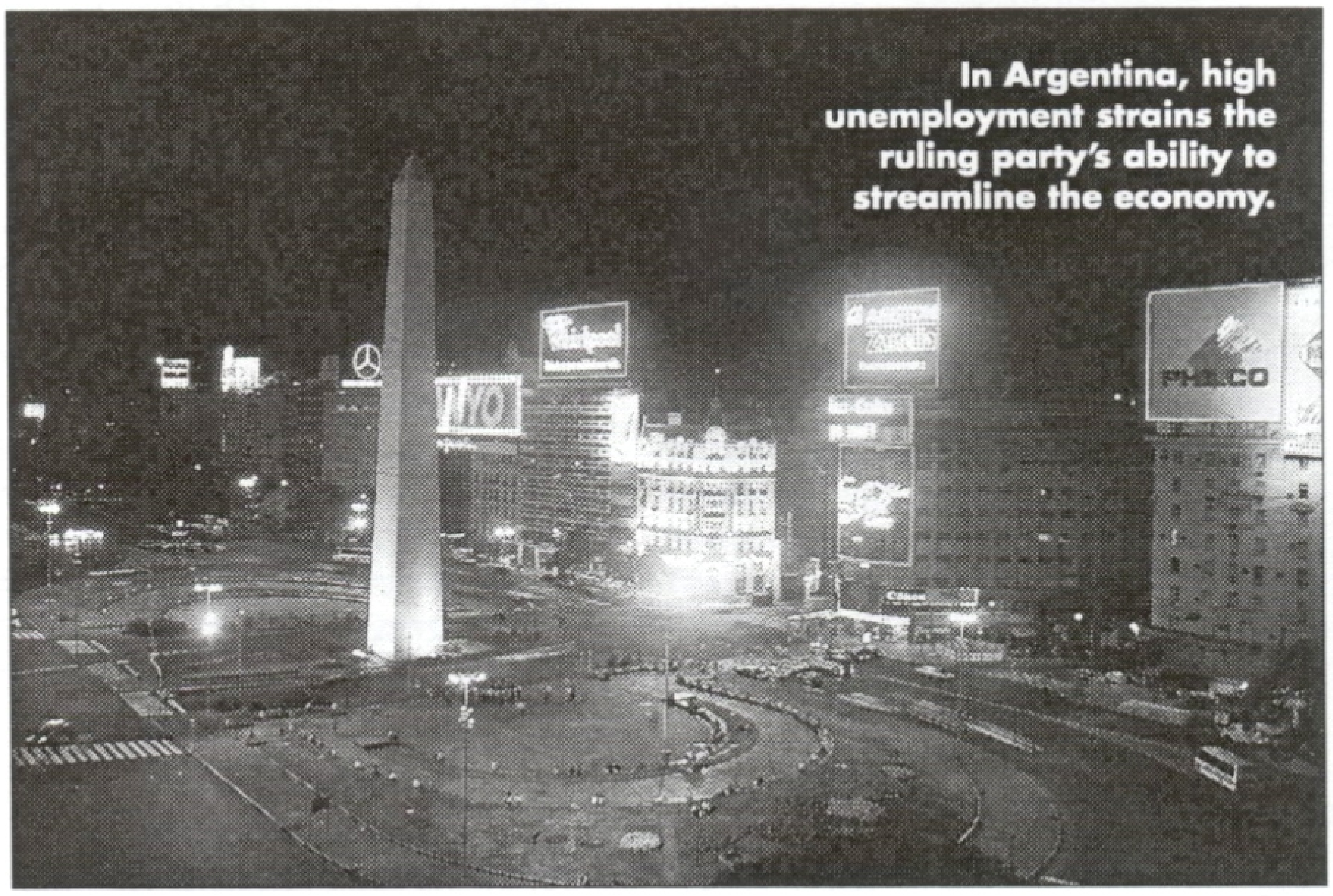


In Argentina, high unemployment strains the ruling party's ability to streamline the economy.

What can governments and businesses in the developed world do in the face of such likely turmoil? The industrial-world member-nations of the Organization for Economic Cooperation and Development (OECD) must ask whether they are pushing enough for growth and trade liberalization. Multinational companies, meanwhile, can no longer leave foreign policy to politicians and bureaucrats. They must develop capabilities that will allow them to anticipate and respond to the upcoming disruptions in emerging markets. And they must remain open to opportunities for cooperation between private and public sectors in those markets. Such cooperation can improve the economic environment and mitigate the risks of doing business in developing countries.

The Clash of Capitalism and Democracy

Emerging markets do represent undeniable commercial opportunities. In the last decade, the ten big emerging markets – Mexico, Brazil, Argentina, South Africa, Poland, Turkey, India, South Korea, the ASEAN region (Indonesia, Thailand, Malaysia, Singapore, and Vietnam), and the Chinese Economic Area

PHOTO: DAVID FRAZIER/TONY STONE IMAGES

(China, Hong Kong, and Taiwan) – have opened their markets to foreign investment and trade. The gross domestic product of the big emerging markets has been increasing two to three times faster than that of developed countries. At the same time, emerging markets have made genuine progress in reining in deficits and inflation, as well as in selling off bloated state enterprises to private investors. Of course, the measures taken have been uneven, and there is a long way to go in every case, but it is indisputable that Adam Smith's philosophy has won the day.

It should not be surprising, therefore, that long-term projections for market expansion have been optimistic. In 1995, the ten big emerging markets accounted for about 10% of the world's economic output. The U.S. Department of Commerce believes that percentage may more than double over the next two decades, as those countries boost their share of global imports from 19% to 38%. Private capital has been flowing to emerging markets in unprecedented amounts, rising 19% in 1996 to a new high of $230 billion. Enormous potential exists for further expansion: for example, whereas all emerging markets account for 40% of global production, they still represent only 15% of global stock-market value.

Any optimistic reading of the future, however, is based on a critical assumption: the economic reforms that have been so impressive in the 1990s will continue more or less along a straight line. There are good reasons to doubt that developing countries will continue to liberalize at the pace of the last few years. The threat does not lie in a repetition of the financial shocks that have hit emerging markets (such as the peso crisis that struck Mexico in the mid-1990s). Today governments and financial institutions in the OECD are reasonably well equipped to respond to such events. The worrisome problems are of a different order of magnitude – going well beyond the ups and downs of the business cycle, the usual gyrations in countries undergoing difficult transitions, or the episodic political crises that have always characterized such societies.

Something deeper is at play in the late 1990s, the collision of two forces that have not coexisted before in emerging markets: free-market capitalism and democracy. The philosophy of Adam Smith is giving rise to powerful new pressures that have enriched many, impoverished others, created enormous social changes, and unleashed new political forces. But Thomas Jefferson's part of the equation is not working so well. Democratic structures in many emerging markets are either nonexistent or too weak to ensure the modicum of economic fairness necessary to sustain democratic capitalism. As a result, emerging markets may well lose some of the progress they have made toward regulating markets and creating the rule of law that is essential to any commercial regime.

Two forces are colliding in the emerging markets of the late 1990s: free-market capitalism and democracy.

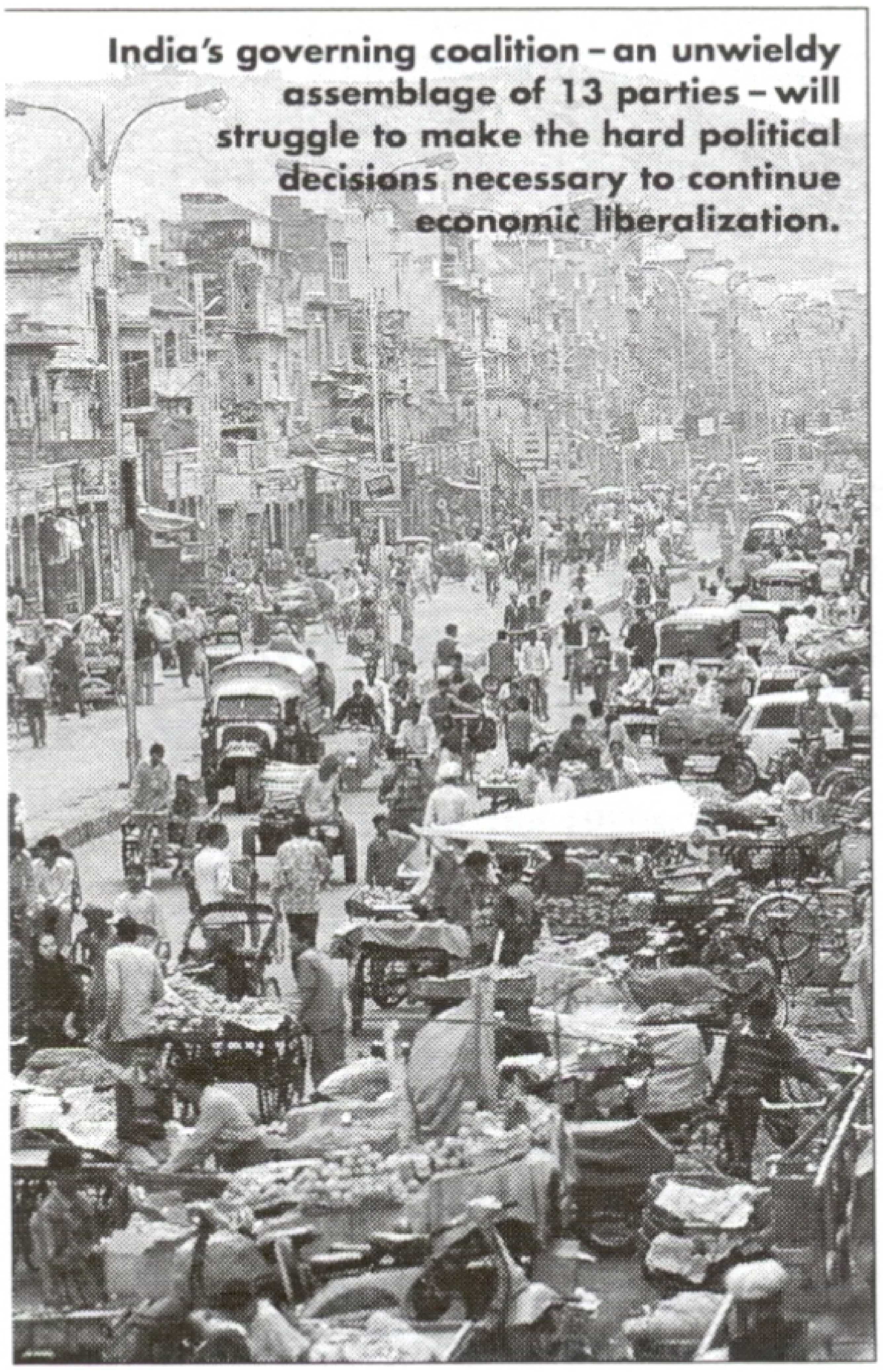
Moreover, in previous eras of crisis, the companies and governments of the industrialized world essentially wrote off emerging markets and left them to fend for themselves. Now, however, foreign investors, creditors, and governments will not be able to walk away from trouble without damaging themselves. Companies in the industrialized world depend on overseas markets for both economies of scale and increasing profits. The countries in the developed world want the jobs at home that come with expanding exports. And many pension-plan investors are banking on the high returns that can result from investing in the developing world.

Threats to Reform

A number of emerging markets already are under severe pressure. In Mexico, the path to progress has some enormous obstacles along its way. True, the economic reforms of the 1980s and 1990s were impressive, even if the government badly mismanaged its currency devaluation at the end of 1994. Today the country appears to be on the road to recovery from the peso crisis: forecasters estimate growth in the range of 4% to 5% for 1997, and the nation's export economy is flourishing. But the current-account deficit is rising again. Mexico's external debt has grown from 35% of GDP in 1992 to more than 60% in 1996. High interest rates and taxes are strangling the middle class. The banking system borders on insolvency. In the recession of the past two years, 5 million Mexicans have been added to the 22 million citizens (one-fourth of the population) who already live in extreme poverty. And the government estimates that an annual growth rate of 6% is necessary to absorb the 1 million new entrants into the labor force each year – a rate that does not appear to be attainable anytime soon.

Mexico's ability to deal with those daunting problems depends on an effective government. The country has been ruled by the iron fist of the Institutional Revolutionary Party for more than 60 years, but the party has become arthritic and corrupt. It is incapable of acting as a safety valve for the wellspring of popular discontent in Mexico, let alone as a vehicle for implementing critical new policies necessary for a rapidly changing economy. The party is in fact resisting change, having recently overturned President Ernesto Zedillo's far-reaching proposal to open and modernize Mexico's political process.

Nevertheless, political change will come – if not peacefully then violently. Already, crime, kidnapping, assassinations, and guerrilla activity are on the rise, signaling both a mounting level of dissatisfaction and the inability of the public sector to maintain order. But even if a more open and representative government emerges, it will lack the experience



India's governing coalition – an unwieldy assemblage of 13 parties – will struggle to make the hard political decisions necessary to continue economic liberalization.

and the underlying institutions – such as honest courts – to govern effectively in the short run. Initially, that government may be besieged by the accumulated demands of tens of millions of Mexican citizens who have felt disenfranchised. It also will have its hands full cleaning up the old system – getting a grip on widespread criminality and creating a rule of law that all segments of the population can respect.

In light of those pressures, future governments may put off liberalizing the economy and instead concentrate on the immediate welfare of ordinary citizens. A democratic administration could become more nationalistic and more protectionist than the existing oligarchy. It could take many years before Mexico restores its current trajectory, at least in the eyes of foreign companies and governments.

Consider also Indonesia, the largest Muslim nation and the fourth largest country in the world by population. As in Mexico, the political system there may soon be unable to cope with economic and social pressures. By any measure, Jakarta's economic performance has been strong. GDP growth has been on the order of 6% to 7% annually, nonoil exports have been growing, and billions of dollars of foreign investment have poured in. But the country is a powder keg waiting to explode. With the exception of China, no major country is more dominated by autocratic rule than Indonesia. The 75-year-old president Suharto, who has ruled since he came to power in the mid-1960s in a bloody coup, *is* the political system. The only opposition allowed is government-approved parties that support the president. Any challenge is immediately squelched – by military force if necessary.

Enormous pressures are building below the surface. When the aging president leaves the scene, they are likely to explode. It is difficult to envision a scenario that will contain those pressures when there are no existing political institutions to modulate them aside from the apparatus that Suharto now dominates. The military will want to maintain order. The Chinese minority will want to maintain its wealth. Both will be challenged by the Muslims, who constitute the overwhelming majority of the population; by the labor unions, which have been suppressed; and by the students, whose activism has been outlawed.

In a politically repressive society, change usually does not come gradually; it bursts on the scene. Some recent events are telltale signs of Indonesia's possible fate after Suharto. Last August, for example, when government pressure suppressed the voice of the leader of an opposition party, the largest riots of the past two decades ensued, followed by a brutal military crackdown. Afterward, the government began a systematic persecution of other potential "troublemakers," including the leader of the largest independent labor union. He and several labor and student leaders are currently on trial for subversion, a crime punishable by death. In early 1997, a Muslim mob burned a Chinese temple as well as Christian churches. The alleged cause was a complaint by an ethnic Chinese trader that the call to prayer from a mosque near his home was too loud. The incident highlighted the seething ethnic rivalries and resentments that will play out in the open once Suharto departs. It's difficult to see how economic progress won't suffer.

What about countries that have better track records politically? Several of the big emerging markets have practiced democracy for years, but even those nations are struggling with political pressures stemming from economic change. In India, for example, Prime Minister P.V. Narasimha Rao's measures in the early 1990s to open the economy astounded outside observers. For nearly half a century, India had been a closed economy wedded to socialism, and its sudden embrace of capitalism stimulated high levels of economic growth and trade as well as an influx of capital from abroad. But in the national elections of 1996, the Indian people jettisoned Rao's government. In its place emerged a coalition of 13 parties – an unwieldy assemblage that includes nearly every major and parochial interest group in the country, from communists to religious extremists.

Such a fractured group will struggle to make the hard political decisions that are necessary to continue economic liberalization – including massive reduction of subsidies, new infrastructure development, and labor reform. If India stands still because of political polarization – in fact, if it doesn't move ahead quickly – it faces a dire situation as popular expectations rise. India has a long way to go to overcome a host of problems such as food production that loses 30% each year to spoilage; an energy distribution system that loses 25% to leakage during delivery; crumbling roads, ports, and airports; and a primitive telecommunications sector. India is falling further behind its Asian rivals in economic reforms, a problem that may jeopardize its ability to attract foreign capital in the future.

Economic pressures also are straining South Korea's politics. No one can deny the progress that this country has made in the past several

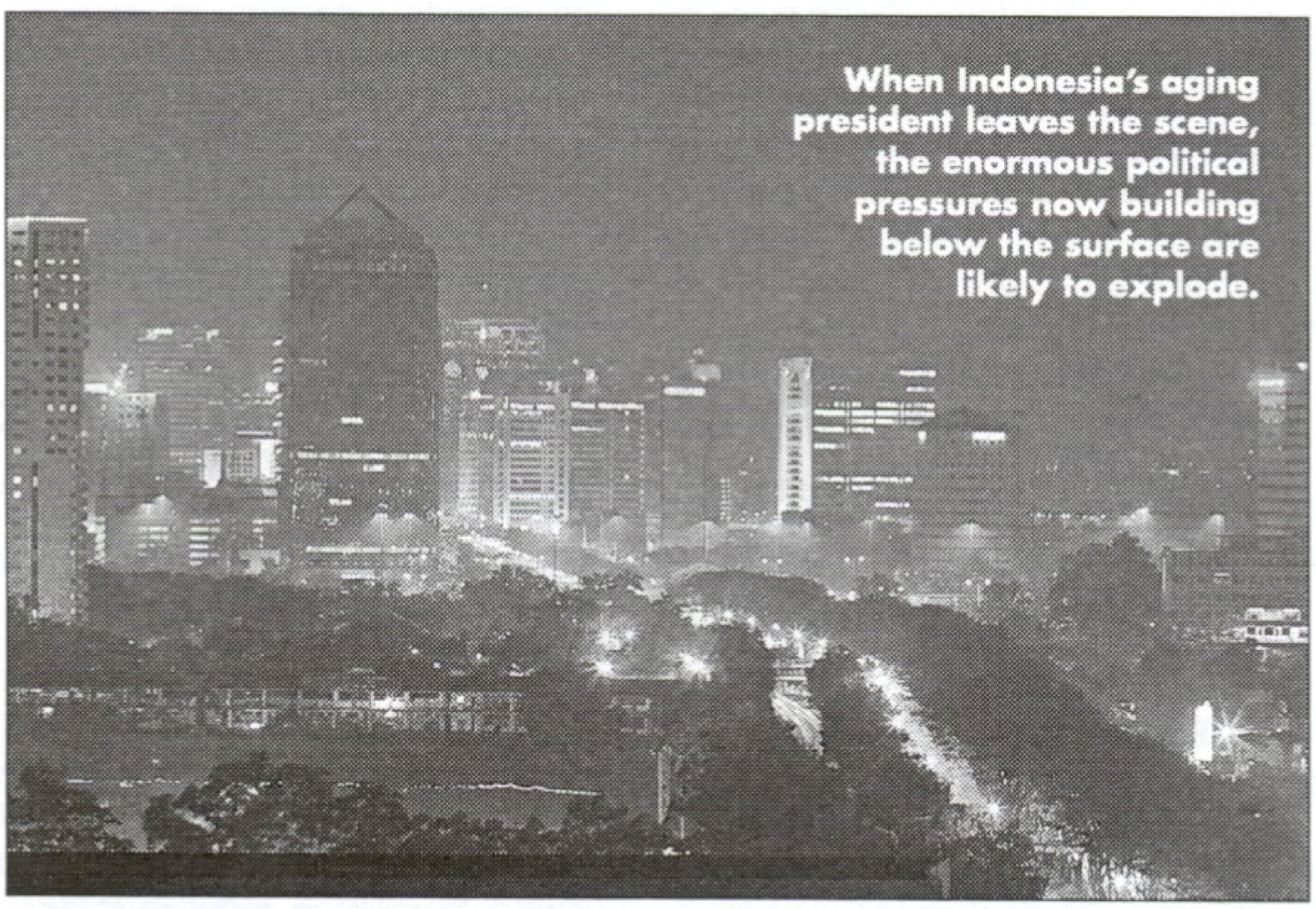
PHOTO: PAUL HARRIS/TONY STONE IMAGES

years on both economic and political fronts, but now it must move out of the ranks of emerging markets to join those that have emerged. It can no longer compete internationally with such countries as China and Brazil, where the costs of doing business are much lower. South Korea must move from a system founded on paternalism and authoritarianism to one based on democratic values, for there is no other way to unlock the initiative of the Korean people and create an economy flexible enough to cope with rapid technological change.

Many underestimate the impact of the political dimension of change.

Nowhere are these challenges more evident than in the need to reform labor laws, which derive from an era when Korea was a military dictatorship. The challenge is to balance the ability of employers to control costs with a system of free collective bargaining. With no experience walking this tightrope, the administration of Kim Young Sam has badly mishandled the task. Last December, it passed legislation making it easier to lay off workers and postponing the right of labor to unionize until the year 2000. The laws were passed in a secret closed session with no public hearings and without the involvement of the political opposition. The unsurprising results were the largest strikes in South Korea's history. Today the government and the unions are still trying to work out a viable long-term settlement.

This bruising struggle is likely to make it more difficult to enact future reforms – reforms that are needed now more than ever. The country's GDP growth is slowing, the current-account deficit is soaring, and the Seoul stock market is at its lowest point in several years. Moreover, of all the major emerging markets, South Korea is the most hostile to foreign investment. And in the wake of the prolonged strikes, workers are especially sensitive to the issue of job security – which makes measures to open up the economy politically difficult. Such measures, however, are essential if the South Korean economy is to maintain its competitive position.



When Indonesia's aging president leaves the scene, the enormous political pressures now building below the surface are likely to explode.

Other big markets are showing worrisome signs. In South Africa, President Nelson Mandela has not been able to bring about either prosperity or social justice. In fact, political wrangling within the ruling party has rendered it incapable of action, and critics fear that the nation is headed toward anarchy or permanent third-world status. In Brazil, the populist congress is resisting constitutional changes that would enable such reforms as large-scale privatization. In Argentina, unemployment has reached 17%, a level that is severely straining the ability of the ruling party – itself built around the labor movement – to streamline the economy any further. And in Turkey, economic reform has been all but taken off the table amid the election of the first Islamic government in the country's modern history.

Interpreting the Turmoil

There are several ways to account for the mounting pressures in emerging markets. One explanation is that many of the easier economic-reform measures already have been taken. A country's leaders can reduce tariffs from 300% to 50% more easily than they can reduce them from 50% to 5%; similarly, they can sell off the most viable government companies – such as the hard-currency-earning airlines – more readily than they can the money-losing steel plants. That first set of reforms can be enacted quickly: foreign and local investors respond positively, and foreign governments applaud. But the afterglow doesn't last long. Soon the domestic opposition organizes a counterattack, and those who haven't benefited from liberalization measures throw up roadblocks. Ordinary citizens, having heard about the magic of the marketplace, wonder why they can't get hot water or why the phones don't work. And top-level decision makers get worn out fighting battles over such questions.

In many emerging markets, the list of what still needs to be done is long. Market regulation is highly underdeveloped. Rigid labor laws need to be restructured. Limits on prices for energy and telecommunications discourage foreign investment. Government payrolls need to be pared down; at the same time, however, more skilled and experienced people need to be attracted to the bureaucracy. Expensive social-welfare policies need to be dismantled and re-

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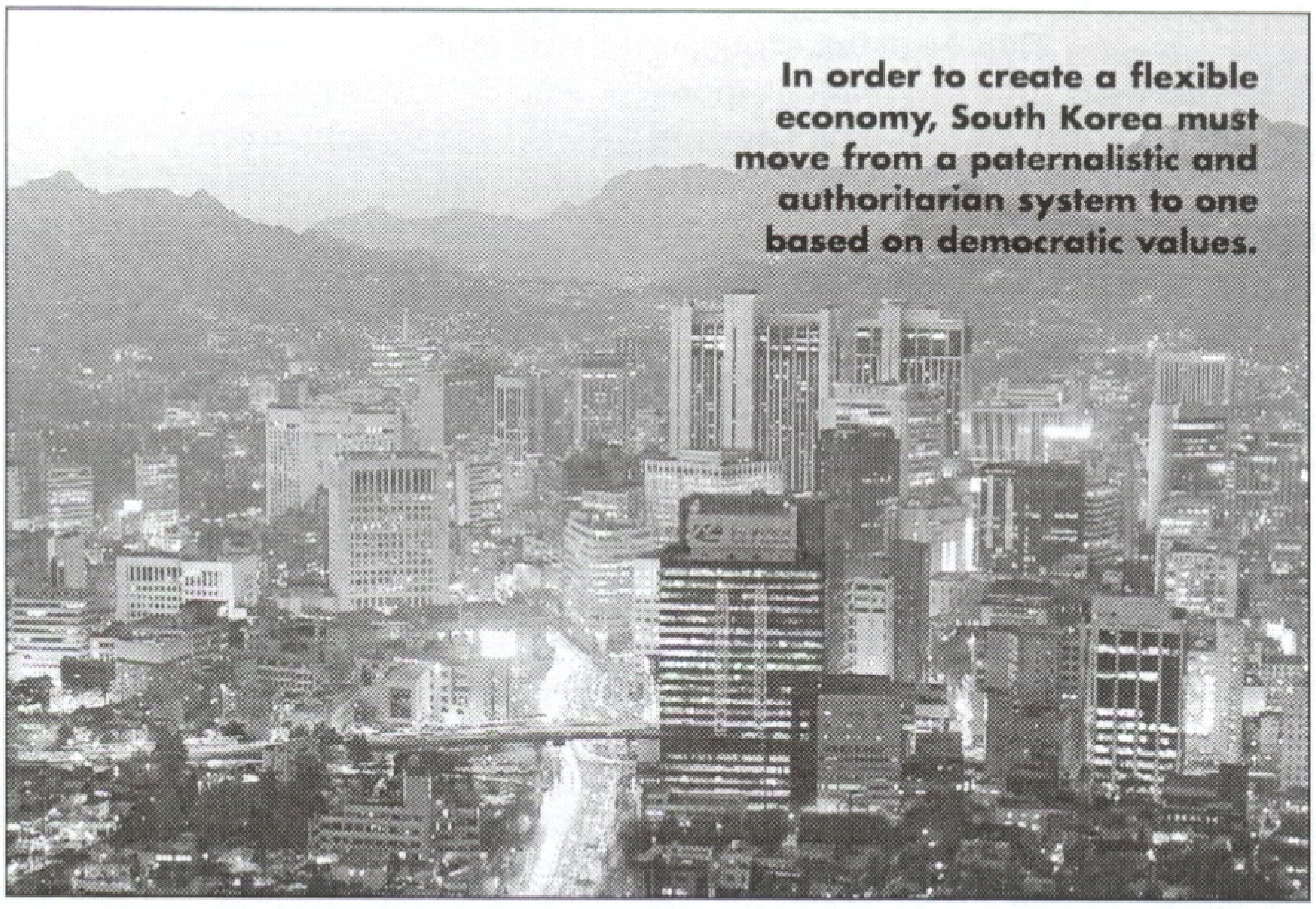
built. The massive amounts of red tape that still interfere with normal business transactions need to be slashed. And legal systems need to be strengthened.

But by far the biggest reason for anxiety about economic reforms is the political dynamics of the reforms themselves. Those who have embraced emerging markets with enthusiasm have failed to consider a number of factors: the political dimension of change, the difficulty of implementing massive transformation in a short period, and the lack of skills and institutions needed to manage democratic capitalism. In moving toward open political and economic systems simultaneously, emerging markets are on uncharted and precarious ground.



In order to create a flexible economy, South Korea must move from a paternalistic and authoritarian system to one based on democratic values.

As economic liberalization in emerging markets replaces rigid control, a new more laissez-faire, but more sophisticated, kind of economic and commercial regulation needs to be put in place. Governments need to shrink in size while managing more difficult tasks more effectively – a trick even the leaders in Washington, Bonn, and Tokyo have not yet mastered. In the absence of such a new set of political arrangements, those who held power under the old regime end up in favored positions under the new one and simply increase their dominance and privileges. In addition, the transition from a command to a market economy brings with it a hiatus of order that invites a serious increase in fraud and corruption. Leaders in emerging markets rarely have the skills and experience to make the transition smoothly.

On the political side, democracies are defined by more than just voting; they also require a complex infrastructure. Without the solid foundations of a professional civil service, a strong independent judiciary, and arm's-length regulators, the leaders of new democracies can spend all their time dealing with the pressure groups that emerge from an open economy. They cannot attend to the requirements of everyday management, let alone plan for essential long-term investments, and they are unable to deal with the popular demands critical to their legitimacy. Under those pressures, a new democracy sometimes drifts toward weak administrations and deadlock. At other times, the government moves in the opposite direction – toward the very dictatorial systems it replaced. Then comes a popular backlash, which reduces a government's ability to pursue the economic reforms that once constituted its primary mission.

These observations do not apply to every emerging market. Poland, for example, seems to have made an exemplary transition. In seven years, it has created a mature democracy, achieved the highest growth rate in Europe, and reduced the share of GDP stemming from government-owned activity from 100% to 33%. Warsaw did have special advantages: it once had a very sophisticated economy, it has a highly educated population, and it was greatly helped by sitting on Europe's doorstep. Taking another tack, China has managed to combine rigid political control with gradual economic liberalization – perhaps because its system of political control is so highly developed, and because its very size and economic potential is mesmerizing to foreign investors, who have made China the largest destination for foreign capital among emerging markets.

It would be misleading, too, to say that there are no other scenarios for Mexico, Indonesia, South Korea, and India than those described above. Political change in Mexico may come at a slow but steady pace at the municipal or state level. A more conciliatory military group may replace Suharto. South Korea may apply Asian-style discipline and determination, and persevere on the course of economic reform. India may muddle through. In the end, of course, it is not possible to predict with complete confidence the course of such profound and complex transitions.

Still, it is best now to be sober. The prevailing optimistic view of what will happen in key emerging markets underestimates the impact of variables that cannot be measured: frustration about missing out on the boom times and anxiety about the massive changes wrought by foreign investment and technology. Moreover, those who say that

In moving to open political *and* economic systems, emerging markets are on uncharted ground.

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Mexico has always had pervasive poverty or that India has always progressed slowly are underestimating both the current pace of global change, which is new, and the impact of seeing and knowing what a better life is all about, which is now more possible than ever because of modern communications. This much is sure: the risks of setbacks in many big emerging markets are escalating. Over time, democracy and free markets can reinforce each other, but the journey will be precarious. And we are entering its most dangerous phase.

Pressure on the Developed World

A slowing of economic reforms in emerging markets would be a disaster for the industrialized world on several counts.

First, powerful trade and investment ties have made the emerging markets essential to the continued economic expansion of industrialized OECD countries. For example, exports have been responsible for about one-third of U.S. economic growth in the past few years, and already the ten big emerging markets account for a greater proportion of U.S. exports than the European Union and Japan combined. Exports to the big emerging markets have been equally important for both Europe and Japan.

The ability to increase exports to emerging markets is all the more important because those markets will be selling a growing amount to industrialized countries. The enhanced competitiveness of emerging markets stems from the economic reforms they have already undertaken, as well as from low wage rates and increasing productivity. In the United States, for example, the average hourly wage in 1996 was $17.20. In South Korea, it was $7.40; in Taiwan, $5.82; in Brazil, $4.28; in China, 25 cents. And productivity in these markets will be greatly enhanced because of growing access to Western technology and supervision by foreign managers. To avoid unmanageable trade deficits and the flaring up of protectionist sentiments, the West and Japan will need to offset the likely increase of imports with their own exports. And that can happen only if emerging markets grow at a strong pace.

Second, the developed nations are counting on the growth of emerging markets to help finance pensions for their aging populations. The demographics are well known. People in the industrialized world are living longer, and there are fewer workers to support retirees. Public spending on pensions as a percentage of GDP in OECD countries is projected to soar from 8% in 1990 to more than 15% over the next 25 years. The easiest way to raise the financial returns on workers' savings is to look for a good portion of those returns in those areas where growth will be the fastest. In other words, it means looking for those returns largely in emerging markets.

Third, a slowdown in the growth of emerging markets may lead to destructive competition among governments in the developed world. Encouraged by the boom overseas, multinational companies, often backed by the financing and lobbying of their home governments, have already intensified their competition. Free and fair competition is to be welcomed, but the pressure on companies to win big contracts in emerging markets has led to bribery, violations of OECD trade-financing agreements, and escalation of political pressure by home governments on those awarding contracts. There is no sign that such competition will let up anytime soon, because the contracts in question are of the utmost national importance to countries suffering from high levels of unemployment. It is not an exaggeration to say that rivalries in this arena are becoming major wedges between countries that were allies during the Cold War. Left unchecked, these contests could create major international tensions.

Multinational companies should not be mere bystanders to change.

There also are larger dimensions to economic failures in the developing world. Borders in a number of emerging markets are contested, and civil wars in others are possible. The economic strains caused by slower growth and a reversal of reforms could exacerbate tensions in any of these hot spots. Setbacks in economic development also would hamper the countries' efforts to invest in environmental protection. And continued growth is the only way to boost the livelihood of hundreds of millions of people who are living in miserable conditions.

What Can Be Done?

There was a time, just a few decades ago, when the industrialized countries thought they could build democracies and capitalist societies by injecting massive amounts of foreign aid, making trade concessions, and providing technical advice. Following great disappointments with programs such as the U.S. government's Alliance for Progress in Latin America, ambitions about directing such transformations have been greatly deflated. In the last decade, OECD governments have either reduced aid or redirected it toward the poorest countries. The emerging markets in the meantime have entered the mainstream of the world economy, linking their fates not to other governments' largesse but to private capital, foreign direct investment, and global trade. In 1990, for example, net financial aid to emerging markets was four times the flow of private capital. By 1996, that ratio was reversed: the flow of private capital was five times that of government aid.

If aid is not the answer, what can governments in the West and Japan do? They will need to manage their economies in a way that keeps the world economy buoyant and conducive to the expansion of trade. That will take some effort. The United States, the European Union, and Japan are all growing at a much slower rate than they have historically, and fiscal contraction is every-where in vogue. Meanwhile, enthusiasm for trade liberalization seems to be waning; there is little appetite for new rounds of trade negotiations.

As for multinational companies, they should not be mere bystanders to political and economic change abroad. They can take steps to prepare for trouble. For example, they can apply higher discounts on earnings projections and diversify their activities rather than gamble on any one country or region. Managers can engage in serious contingency planning in order to cope with political and economic turmoil in emerging markets. They can improve their efforts to gather information on economic and social trends as well as on upcoming political decisions. In addition, they can work harder at collecting information about which local businesses are in the best position to survive a prolonged transitional period and might therefore make good partners. Executives can sensitize colleagues and board members to conditions in a particular country or region so that new developments do not take them by surprise and cause ill-advised knee-jerk reactions.

In Malaysia, Motorola's and Intel's training programs have enhanced the skills of local workers.

Astute human-resource management also can make a difference. For the most part, plenty of capital is available to facilitate entry into the emerging markets. What is often lacking are managers who know how to operate amid uncertainty and instability – managers who appreciate local politics and cultures and can build the relationships that not only enhance today's sales but also act as a safety valve in turbulent times. How to recruit, develop, and train managers who can operate in emerging markets is the key question. Companies should make their best effort to obtain highly adaptable men and women from the local scene. In addition, they should learn as much as possible about the mistakes that other multinational companies have made. Finally, it is essential that companies provide courses to their managers on the history and the political and economic institutions of individual developing countries.

Companies also have an opportunity, sometimes in partnership with Western governments or the World Bank, to assist emerging markets in their quest for progress. From Brazil to Thailand, countries need sophisticated technical assistance. Merrill Lynch, for example, is helping public officials in India devise sensible regulatory policy for stock markets. In China, Aetna and Procter & Gamble are helping local schools and universities train and educate leaders who understand how capitalist economies work. In Malaysia, Motorola and Intel have instituted training programs to enhance the skills of local workers. Companies that establish deep local roots and show, by dint of example rather than empty rhetoric, that their strategies are aligned with the long-term goals of the host country stand the best chance of prospering. At the same time, such companies help keep up-and-coming countries on the track of economic and political progress.

To be sure, no one can predict exactly how economies and regimes will develop. The emergence of so many capitalist economies within a few years is unprecedented and holds great opportunities – as well as equally great risks. In the 1980s, experts failed to see the rise of Japan or that of the Asian tigers. They failed to predict the collapse of Mexico, Brazil, and Argentina in the 1980s or the implosion of the Soviet Union. When it comes to the future of big emerging markets, however, enough warning signals are flashing. The penalty for not recognizing them will be severe.

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