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Government reform — the new driver of emerging markets growth?

While investors are by now quite familiar with the struggles in the emerging markets and the reform agendas of China and India, we think these issues overshadow a more interesting topic: reform initiatives elsewhere in the emerging markets that aim to develop domestic engines of growth. While not always successful, the benefits of reform are significant. Not only can they provide a powerful driver of growth, but in doing so they can also provide insulation from:

- Tightening U.S. Fed policy
- China's painful economic transition
- Falling trade and weak commodity prices

In other words, if done correctly, structural reform can act as an important buffer against the issues that have hampered EM performance over the past several years.

The government reform "sweet spot"

While investors frequently think of China and India as exponents of EM structural reform — though not always as shining examples of reform-led success — we believe investors should focus on assessing the potential effectiveness of reform agendas in those emerging markets where policymakers are bent on creating institutional change.

The economies of many of the larger EM markets remain hamstrung due to their exposure to commodities, U.S. Fed policy, and/or a lack of policies that support domestic growth. In contrast, markets such as Mexico, Indonesia, Argentina, and the Philippines are all in the process of implementing reform-led initiatives that should allow them to benefit from growth within their own borders in the near term (i.e., over the next 1–5 years), while also being somewhat protected from volatility sources elsewhere in the world. At this intersection of policy reform, policy independence, and insulation from falling commodity prices, we believe there is both near- and longer-term opportunity.

A framework for evaluating future EM growth

Identified economic growth | Economic growth potential | Headwinds to economic growth

	Active reform agenda	Beneficiary of low commodity prices	Relative policy independence from the developed markets and China
India	Yes	Yes	Yes
China	Yes	Yes	Neutral
Philippines	Yes	Yes	No
Indonesia	Yes	Neutral	No
Mexico	Yes	No	Neutral
Korea	No	Yes	No
Turkey	No	Yes	No
Brazil	No	No	No
South Africa	No	No	No

Breaking down walls with Mexico's reforms

Mexico's attractive top-down fundamentals are rare in an EM context. Unlike Brazil and South Africa, Mexico's fortunes are not tied to a transitioning China; Mexico does not contend with excessive leverage like China, Korea, and Brazil; and it doesn't have irresponsible macroeconomic policymaking like Turkey, South Africa, and Brazil.

Mexico's strong ties to the United States are a source of strength, and the country has become more resilient through reforms that reduce its exposure to oil price swings and promote more domestic-oriented growth. For example, by increasing taxes on non-energy sectors, such as beverages, and reducing taxes on the state-owned oil company, Petróleos Mexicanos (better known as Pemex), policymakers have reduced reliance on energy-related government revenues from nearly 40% at the peak to less than 20% today. Concurrently, the government has raised fiscal revenues from 8.4% of GDP in 2012 to 13.4% in 2015, which is being directed toward infrastructure spending — a key generator of domestic growth.

Overall, Mexico's energy-related reform breaks with a 75-year state monopoly, opening up the sector to private capital. It has been estimated that more than US$200 million has been spent on seismic work and that higher capital expenditures on drilling could commence in 2017. Assuming the Mexican government shrewdly negotiates its contracts with private players, the country's largely unexplored offshore reserves could prove to be a paradigm-shifting economic development. As these locations have a similar geology to the rest of the Gulf of Mexico, they could be a more attractive energy resource relative to arctic Russia or other regions beset by political instability or difficult geologies.

In addition, Mexico's reform of its telecommunications, media, and banking sectors has stimulated competition and may help ensure lower inflation. As the monopolies and oligopolies in these areas fall, we see strong potential for investment opportunity across a number of sectors.

Resetting expectations in Indonesia

A second example of how powerful reforms can alter the economic and investing climate is in Indonesia, where President Jokowi's administration is beginning to execute on much needed changes after many miscues and resetting of expectations.

Navigating difficult political waters, the Indonesian government has pushed through fiscal stimulus, and infrastructure spending has begun. A slow patch in the economy, a weaker rupiah, and lower crude oil prices have reduced the current account deficit and inflation to more manageable levels, permitting Bank Indonesia to cut interest rates. Monitoring the rebound in economic growth will be a key determinant of Jokowi's popularity and the resulting pace of reform momentum. The story is not without risks as higher crude oil prices and capital imports related to infrastructure spending will pressure the balance of payments, just as the central bank — known for its dovishness — embarks on a potentially excessive interest-rate-cutting cycle.

The key to Indonesia's reform efforts is that they are focused on making the country globally competitive. Jokowi's raft of stimulus measures includes tax holidays for key growth industries; plans to liberalize foreign investment for certain sectors, including telecom, power, and toll roads; and government guarantees for high-priority infrastructure projects, of which 30 projects representing US$63 billion — or 7% of GDP — have been earmarked for the road, rail, power, and oil and gas sectors.

Coupled with pump price decreases and lower interest rates, the monthly economic data releases since November 2015 have shown continued improvements in consumer confidence, business confidence, retail sales, cement volumes, and car sales. Also, in our conversations with global companies who care about the region, a sense of guarded optimism about the 2016 outlook generally prevails. With much needed fiscal policies finally being implemented, Indonesia is beginning to deliver, burnishing its reputation as an attractive destination for global investors.

Opportunity at the intersection of policy reform, policy independence, and commodity price insulation

While investors remain concerned regarding the structural challenges facing many EM economies — particularly China — there remain a number of countries offering compelling top-down opportunities.

We believe those countries that can successfully implement economic and market reforms, can benefit from or are less affected by falling commodity prices, and are less exposed to the risks posed by a tightening Fed will likely produce positive growth in the near term. And, because these smaller markets, such as Mexico and Indonesia, are often less closely followed than countries that make up a more significant part of the index, such as China and South Korea, they represent an important future opportunity for investors.