Tales from the Emerging World

Elections 2014: How Fragile are the "Fragile Five"?

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Every time there is a new threat to the health of global markets, such as fresh buzz about the end of quantitative easing, analysts rush to check the pulse of the "Fragile Five." These countries have one important thing in common—high and rising current account deficits that make them more dependent on foreign capital flows. But we have never believed in lumping markets into one faceless group. Though these countries still have five of the hardest-hit EM currencies this year, a more comprehensive look suggests they are on very different paths. Stocks in South Africa and India have proven relatively invulnerable to currency weakness. And while the current account deficit is starting to correct in India and Brazil, it is stuck in place in Indonesia, and still at more than 5 percent of GDP in Turkey and South Africa—a level that in the past has precipitated currency crises.[1]

The decisive factor this coming year is politics. By sheer coincidence, all five countries elect new national leaders in 2014, with dramatically different implications for reform. We always look for the rise of new leaders with a pragmatic understanding of economic reform and a mass base to push it through. Right now, only the frontrunner in Indonesia has both, but India looks ready to gamble on an aggressive reformer, while Turkey and Brazil could muddle through under chastened incumbents. Among the five, the prospects for reform look particularly fragile in South Africa. Here's how we see these stories playing out.

South Africa

The prospects are worst in the nation that most needs an overhaul. Nearly a quarter century after toppling apartheid, the African National Congress (ANC) is still in power with the same allies, the unions and the communist party, forming an entrenched elite hostile to any significant market reforms. This paralysis is most likely to change under breakaway factions of the ANC, because South African parties need roots in the liberation struggle to have political credibility. Lately, more factions are breaking away, but they have neither the momentum to win in 2014 nor the will for pro-growth reform.

[1] Source: IMF. Data as of October 2013.

The ANC vote is expected to fall about ten points from its 2009 total, to 56 percent, but hopes for internal party reform have been undermined by the near invisibility in recent months of the leading ANC moderate, Cyril Ramaphosa. The main challenger remains the Democratic Alliance, a center-right party that pushes practical improvement in public services but (despite efforts to recruit young black leaders) is still seen as too white to win a majority. The other moderate reform party, Agang, was launched in February by a former apartheid activist, Mamphela Ramphele, but she lacks star power and her party polls in single digits.

So do the ANC breakaway parties. In 2008, party rebels formed COPE, but they have been paralyzed by infighting ever since. The momentum is gathering behind charismatic firebrand Julius Malema and his new "movement," the Economic Freedom Fighters, a jab at the failure of ANC freedom fighters to deliver economic results. But Malema wants to nationalize mines and expropriate white farms, so his challenge from the far left could make the ANC even less likely to push market reform.

Turkey

Turkey's prospects look less bleak, in part because it does not need a wholesale overhaul. It needs to restore the relative normalcy that prevailed before May, when protests erupted against Prime Minister Recep Tayyip Erdogan and he escalated attacks on his opponents. Erdogan has been jailing critics, blaming foreigners for Turkey's troubles and punishing opposition business figures by canceling their privatization projects or investigating their tax returns—all of which clouds the environment for investment and innovation.

There is no viable opposition party. Erdogan won 49 percent of the vote in 2009, and his AK party still polls around 42 percent.[2] He cannot serve again as prime minister but is likely to win the presidency, although without the new powers he has tried but failed to secure for that office. Next April, local elections could strengthen the hand of AK party moderates, led by the man most likely to become the new prime minister, Abdullah Gul.

The AK moderates have already signaled their opposition to Erdogan's heavy-handed tactics, and their rise could restore confidence. The wildcard is Erdogan, who is experiencing the diminishing returns of power. Even strong leaders become less effective reformers over time and Erdogan, who brought normalcy to Turkey a decade ago, now seems unlikely to retire without a fight.

Brazil

Once seen as a less charismatic reflection of her predecessor, Luiz Inácio Lula da Silva, President Dilma Rousseff has proven less inclined to leave policy to technocrats, more prone to meddle. The markets, which came to embrace Lula despite his radical past, now root for ADB: Anyone But Dilma.

When two powerful politicians, Marina Silva and Eduardo Campos, joined forces last month to mount a challenge, the markets cheered, albeit briefly. Rousseff has seen her support fall by more than ten points since 2010, when she took 56 percent of the vote, but she still enjoys a big lead.[3] If this seems surprising when the economy is growing at a rate of just two percent, the likely explanation is that unemployment is still low at around five percent.[4]

[2] Source: Various polls. Data as of November 2013.

[3] Source: Folha. Data as of October 2013.

[4] Source: IBGE. Data as of October 2013.

Display 1: **2014 Election Guide: The Potential Impact on Reforms**

COUNTRY	ELECTION	TIMING	FRONTRUNNER	LEAD IN LATEST POLL	LIKELY REFORM IMPACT
S. Africa	Parliamentary	April	Jacob Zuma African National Congress	29 points	Negative
Turkey	Presidential	Aug	Recep Tayyip Erdogan AK Party	19 points	Mixed
Brazil	Presidential	Oct	Dilma Rousseff Workers Party	24 points	Mixed
India	Parliamentary	May	Narendra Modi BJP	13 points*	Who knows?
Indonesia	Presidential	July	Joko Widodo PDI-P	27 points	Positive

Source: Eurasia Group, Bank of America Merrill Lynch. Data as of November 2013.

* For India, based on the format of its national polls, the lead is measured as a projected share of parliamentary seats, not of total votes.

Brazil can muddle through under Rousseff. The summer chaos raised the pressure on her to restore growth and quit meddling. She has stopped pushing banks to loan and companies to spend, while reaching out for more private investment in new infrastructure projects. The market should also beware what it cheers for. It likes Campos and Silva because their rhetoric has been moderate; but he represents a socialist party, she a green party, and they might prove NBD: No Better than Dilma.

India

India's muddled outlook is mirrored in the emerging legacy of Manmohan Singh, who may be remembered as the nation's best finance minister and its worst prime minister. The landmark opening of India that Singh engineered as finance minister in the 1990s has been largely overshadowed by growing corruption and incompetence during his ten year tenure as prime minister. As his weak coalition government continues to waffle in the face of slowing growth and rising inflation, polls show that Indian voters are looking to new faces—even a strongman—to put things right.

Political momentum has been shifting to regional parties with strong leaders, and in recent months to the opposition BJP and its prime ministerial candidate, Narendra Modi, the dynamic but domineering provincial leader who has been able to position his state of Gujarat as the "China of India." This sets up an intriguing gamble: democratic India may bet its future on an authoritarian personality. Our research shows that, on average, authoritarian and democratic regimes tend to produce similar GDP growth records, but authoritarian regimes are much more likely to produce extreme results. For every success like China, there is a disaster like Cuba.

Indonesia

The brightest prospects shine on Indonesia where, unlike EM peers like Erdogan, President Susilo Bambang Yudhoyono (SBY) plans to retire gracefully. That's a relief, because in his second term reform has stalled and his popularity has fallen.

The frontrunner to replace SBY is former bamboo-seller Joko "Jokowi" Widodo, who would break the mold of an office heretofore occupied by political princelings and former generals.

Jokowi entered politics in 2005 as mayor of Solo, a crowded city in central Java, where street vendors and squatters were blocking commerce, and Islamic extremists were recruiting angry youths. Jokowi cut deals to move the squatters and peddlers to new homes. He created job-training programs and new public transit links, particularly in neighborhoods targeted by extremists. He persuaded developers to restore a historic fortress as a tourist site, rather than bulldoze it for a mall, and brought minority Christians and Chinese into his administration. In 2012, Jokowi easily won election as governor of Jakarta, where he continued to build on his reputation as a local statesman.

Jokowi is seen as the kind of leader who can unite this ethnically and linguistically splintered nation behind practical reform, like building out the spotty road network. He has yet to declare his candidacy, but leads the polls by 27 points.[5] If his accomplishments to date seem small bore, consider how President Benigno Aquino III has transformed the Philippines, also by focusing on execution, not windy vision statements. That is what Indonesia needs.

The final score: the prospects for post-election reform look worst in South Africa, best in Indonesia, muddled in Turkey and Brazil and unpredictable in India. Add in the fact that the current account deficits are already moving in different directions, and it is clear these five are not equally fragile.

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[5] Source: Various polls. Data as of November 2013.

[6] Source: Assets under management as of September 30, 2013. Morgan Stanley Investment Management is the asset management division of Morgan Stanley. Assets are managed by teams representing different Morgan Stanley Investment Management legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Singapore and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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