

UBS Investment Research

Emerging Economic Focus

Why the (Post) Communists Win

22 March 2011

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Life is tough. Three out of three people die, so shut up and deal.

— Ring Lardner

Lost the battle, won the war

Today's Focus is a bit on the lengthy side, but we really want to make one simple argument:

While the world's communists may have lost the ideological battle, their post-communist heirs appear destined to win the war of sustained market economic development.

It started with a debate on China ...

The initial motivation for writing this piece came from reading UBS Senior Economic Adviser **George Magnus'** engaging recent report entitled *Is China Tearing the Rule Book Apart? (Economic Insights, 16 March 2011)*.

George's main theme is that China cannot grow rapidly over the longer term without following the "rule book", i.e., undertaking comprehensive reforms that would create greater political accountability, an independent judiciary, better contract enforcement and the establishment of the rule of law. Otherwise, over the next decade the mainland economy runs the risk of falling into what he calls the "middle-income trap".

We have no problem with these arguments *per se*, of course. Economic and governance institutions are weaker in the EM world than in developed countries almost by definition, and China is no exception; in the report George provides a number of concrete examples where the mainland needs of structural improvement going forward.

... but it's really about the nature of the "rule book" itself

Our main question, however, is "Are we missing a key part of the picture here?" And are we defining the "rule book" correctly to gauge the potential for success?

After all, perhaps the overwhelming consensus among investors is that China's socialist background puts it at a significant disadvantage vis-à-vis other emerging countries, with "soft" legal and governance infrastructure falling ever further behind the quality of its "hard" investments in gleaming new airports, roads and ports.

In this note, however, we want to step back and think about the issue of economic development and institutional quality from another perspective. And in doing so, we end up with very different conclusions:

Three key arguments

First, it is precisely the “post-communist” bloc (defined to include countries like China and Vietnam that remain under nominal communist rule but have moved to a market-oriented economy) that actually have the *best* prospects in the EM universe of breaking the middle-income barrier and making it all the way to advanced status.

Second, this is due in part to non-institutional factors like geography – but also to the fact that China and its former socialist colleagues in Europe are well ahead of other emerging countries in one of the most critical parts of the underlying institutional equation, i.e., title reform and property rights.

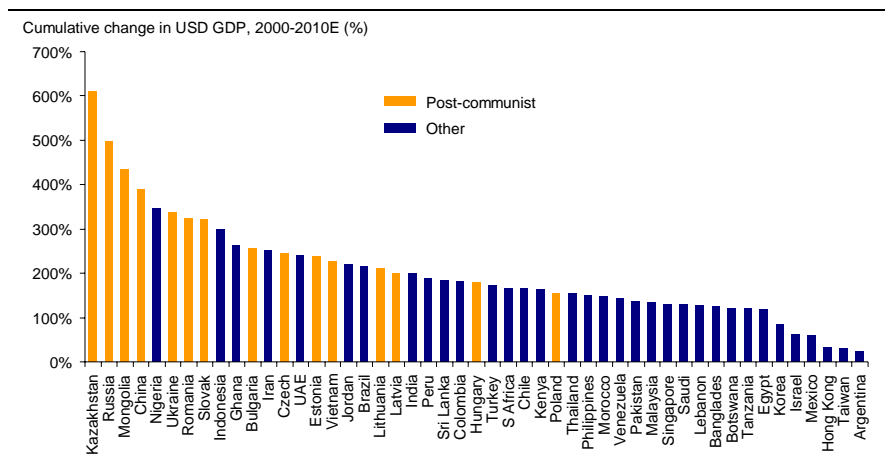
Finally, the biggest risk to sustained development, at least in the more dynamic Asian and Central/Eastern Europe parts of this universe, is arguably not the quality of legal and governance institutions (although we have more serious reservations about many former Soviet Union states here). Rather, in our view it will be the state of macro balance sheets.

The rise of the post-communists

As a lead-in to the discussion it’s useful to start with Chart 1 below, originally published a few months back in these pages, showing the cumulative growth of US dollar GDP in major emerging countries over the past decade.

If we take the top 10 or even 20 performers, the message is extremely clear: It’s not just China. If you wanted to grow rapidly you either needed to be a sizeable fuel exporter or a former communist economy (and ideally both, as in Russia, Kazakhstan and Mongolia). And as you can see from the orange bars in the chart it is really the latter group that overwhelmed the league tables.

Chart 1. Guess who grew in the last decade



Source: IMF, UBS estimates

What is it about those former Marxists?

So what is it about those ex-Marxist states that gave rise to such a boom? A natural rebound following the 1990s collapse? Probably. Excessive levels of credit and leverage creation? In many cases, almost certainly.

But there’s a good bit more to it than just that. For the whole story we need to turn to two critical factors: (i) geography and (ii) property rights.

Geography matters

In *The Frontier Book (EM Perspectives, 14 December 2010)* we took a detailed look at the growth experience of the past five decades, and among the various conclusions two stood out above all:

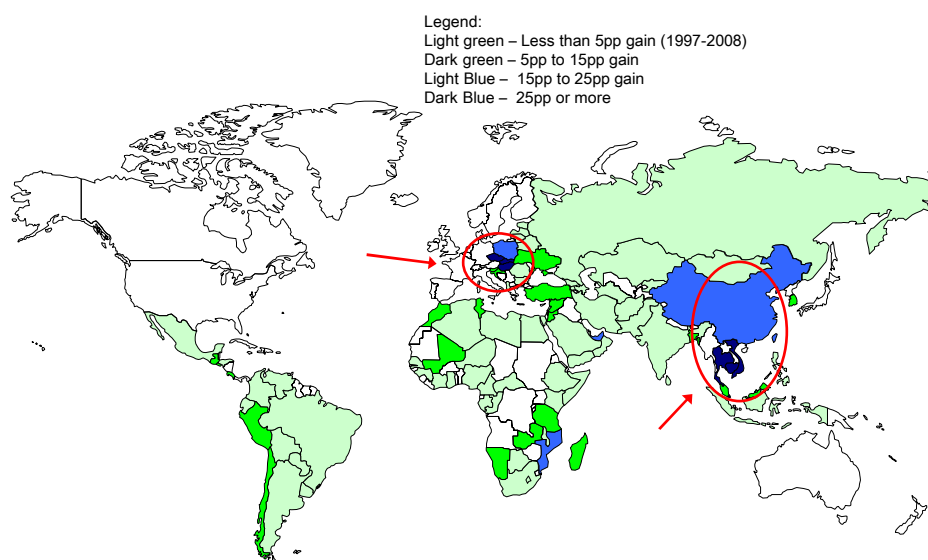
First, the only observable path to sustained development is manufacturing – and in every case this has meant a strong dependence on manufacturing exports as well.

And second, the key to manufacturing export success is geography.

When we looked at the rise of manufacturing export trade over the course of the 2000s, we noticed that in the last ten years there were essentially eight emerging countries that recorded an increase in their manufacturing export/GDP ratio of more than 15% of GDP (the medium and dark blue sections in Chart 2 below): Cambodia, China, Czech Republic, Hungary, Poland, Slovak Republic, Thailand and Vietnam.¹

The fascinating thing about this result is that, as shown in the chart, *all* of these countries sit in exactly two small locations in the world: directly to the east of traditional developed Europe, or just around the shipping lanes from the original Asian tigers.

Chart 2. Manufacturing export “heat map”



Source: UN, IMF, UBS estimates

I.e., the largest beneficiaries of the great secular expansion in global trade have been those situated closest to it, either in terms of outright proximity to markets or proximity to the sea-based production chain. Any other EM regions saw much less growth on the non-commodity trade front.

And it all goes to the socialists

The other fascinating point here, of course, is that all but one of these countries are current or former socialist states.

¹ The only other country to make it into the “blue” category was Mozambique, and this is a bit of a misnomer since in Mozambique’s case the manufacturing sector in question is aluminum, driven by nearby access to bauxite resources, i.e., in our view the economy really belongs in the commodity group rather than the manufacturing category.

In short, the post-communist bloc (or at least its Asian and Central European branches) has the lucky circumstance to be sitting on the best real estate in the world for manufacturing exports – real estate that has more or less guaranteed a massive jump-start to industrial development with a minimum of local effort.

Meanwhile, the main losers here are the CIS states of the former Soviet Union, together with most of Africa and Latin America, all of which are simply too far removed from current global trade patterns to benefit in the same degree from manufacturing relocation and outsourcing.

And manufacturing globalization is not just something that helps at an “early” stage of development; OECD economies like Japan and Korea as well as Taiwan all continue to rely heavily on overseas demand and industrial supply chains as an important driver of growth, and the same is true even for the most advanced parts of Eastern Europe such as the Czech and Slovak Republics.

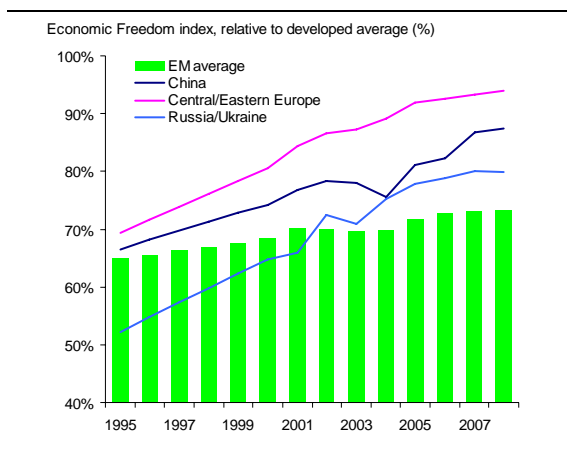
Falling behind or getting ahead?

So geography alone automatically puts not only the CE4 but also the “next wave” of Eastern European countries in the Balkans and former Yugoslavia, together with China, Vietnam and Cambodia, as heavy favorites in the race for sustained economic development.

But can they stay the course? As George argues, it isn’t enough just to get manufacturing and industrialization going; again, you need to accompany physical growth with the development of economic, political and legal institutions as enablers of sustainable development. And as a broad proxy for this kind of institutional quality he uses the Economic Freedom of the World Index, published by the Fraser Institute (please see his March 16 report for full details on the composition and calculation of the index).

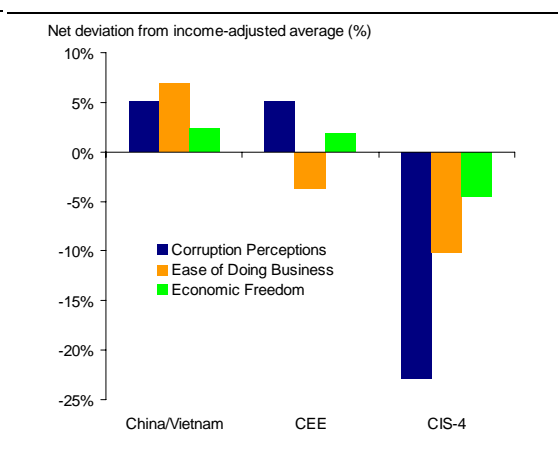
Of course his report was focused mainly on China – but let’s see what the Economic Freedom index tells us about the post-communist world as a whole. In Chart 3 below we show the summary index scores from 1995-2008 for (i) China, (ii) Central and Eastern European economies and (iii) Russia and Ukraine, measured as a ratio to the advanced-country average.² We also show the overall average for the EM universe.

Chart 3. Economic Freedom index



Source: Fraser Institute, UBS estimates

Chart 4. Relative rankings using all indices



Source: World Bank, Transparency International, Fraser Institute, UBS

² For the purposes of this report, Central and Eastern Europe includes Poland, Hungary, Czech Republic, Slovak Republic, Slovenia, Croatia, Serbia, Bulgaria, Romania, Estonia, Latvia and Lithuania.

Definitely getting ahead

What is Chart 3 telling us? In short, all three regions have massively outperformed their remaining emerging counterparts over the past 15 years, with a dramatic improvement in underlying institutional conditions and steady gains vis-à-vis the developed world as well. As of the last survey, Central and Eastern Europe polled a summary index score that was 94% of the average advanced economy; for China the ratio was 87%, and 80% in Russia and Ukraine (by contrast, the average EM country was just slightly about 70%).

This is certainly not the picture of a post-communist world falling behind in terms of institutional development. Quite the opposite; they seem to be getting well ahead.

Let's change tack for a minute and look at a different calculation. In Chart 4 above we take the latest available survey data for the three most widely cited indices of governance and institutional quality – the Economic Freedom of the World Index, the Corruptions Perceptions Index published by Transparency International and the Ease of Doing Business rankings compiled by the World Bank – and calculate index scores vis-à-vis income-adjusted peers, i.e., for each country we compare their score against the average for others in the same income bracket (for details on this calculation, please see *Corruption and Transparency, EM Daily, 9 June 2010*).

What do we see there? In Asia, China and Vietnam consistently poll above their current income level, and for the most part the same is true for Central and Eastern Europe. It isn't until we get to Russia and the CIS (the chart shows the relative average for Russia, Ukraine, Belarus and Kazakhstan) that we find rankings that fall well below income-adjusted peers.

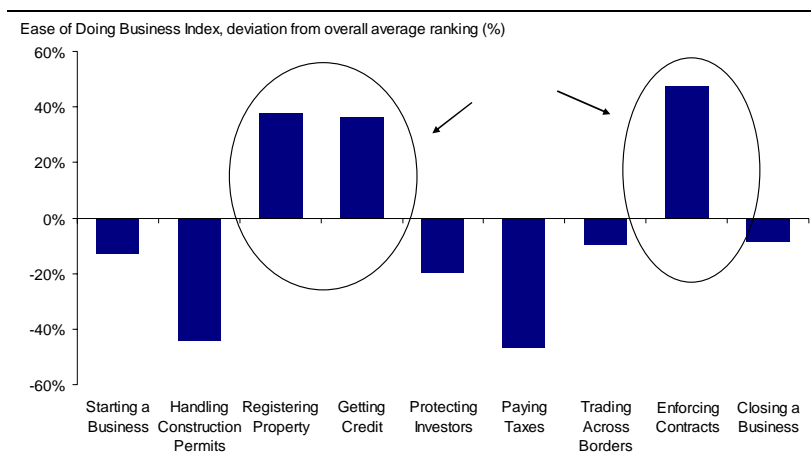
In short, the “better” parts of the post-socialist universe in China, Asia and Central and Eastern Europe are showing us both rapid institutional improvement *and* relatively consistent outperformance against the remaining EM world.

The most important chart of all

The most important point of all, however, is *where* that outperformance is coming from.

In Chart 5 we take the Ease of Doing Business survey and show the specific category rankings for all post-communist countries, measured in terms of the deviation from their summary ranking.

Chart 5. Property rights – how the post-communist world stacks up



Source: World Bank, UBS estimates

As you can see, the group does fares poorly in *procedures* such as getting permits, starting and closing businesses, paying taxes

... but stunningly well in *property rights*, i.e., registering property, enforcing contracts and getting access to credit.

And this skew holds in virtually every single country case, in Asia as well as Central Europe and the CIS. Just to use China as an example, in the latest 2010 survey it ranked 79th overall – relatively well given its low per-capita income status but still very much in the middle of the EM pack. However, it was a startling 15th in enforcing contracts, next to Singapore and above Australia, 38th in registering property (on par with Taiwan, Canada and the Netherlands) and 60th in access to credit.

Why property rights matter

Why do we focus on this aspect? Because problems with *procedures* can be more easily resolved through policy adjustments and ongoing reforms. *Property rights*, on the other hand, are entrenched in the fundamental institutional fabric of each society and are extraordinarily difficult to change – and thus constitute a vital, even overriding key to the quest for sustainable development.

To see why, we need to turn to the path-breaking work of Peruvian scholar Hernando de Soto.

De Soto and property rights

We admit to some personal bias here, but in our view de Soto's volume *The Mystery of Capital* is one of single most important contributions of the last two decades to understanding the nature of and impediments to economic development in the emerging world.

His most fundamental insight is that the vast majority of physical assets in EM (and in particular land and residential structures) is essentially “dead” capital. These assets cannot act as a significant catalyst for new investment or economic growth due to the lack of actionable property rights, in the form of clear titles or other legally binding claims, that would allow for their use as collateral for new lending or for the creation of incorporated commercial ventures – and it is precisely the use of credit and limited-liability corporate forms that define modern capitalism.

Moreover, the inherent standoff between “extra-legal” quasi-ownership and economic activity on the one hand and the formal state on the other is a constant source of potential instability, whereas every advanced country is characterized by widespread, straightforward and stable legal property ownership.

The post-communist title revolution

Which brings us to the current and former socialist bloc. The point here is simple: in virtually every country the transition from communist planning to a market system was accompanied by a “title revolution”.

For households, outright ownership of former state housing was generally passed *en masse* directly to those living in the flats or houses, either free of charge or for a nominal price. Land ownership or use rights were transferred to former owners, existing collectives or to households (most dramatically in China and Vietnam, where every farm family received an individual plot of land). And productive assets were either privatized or restructured into state-owned corporate entities.

We don't want to overstate the case, as the results are very far from perfect. Even today the state holds a sizeable swathe of the productive capital stock in China, Vietnam and the former Soviet Union (and to a significantly lesser degree in Central and Eastern Europe), particularly in capital-intensive and resource-based industries, and as we saw above the private sector is often hampered by a maze of licensing and other regulatory restrictions. Agricultural reforms have a long way to go indeed in much of the former Soviet Union, where today's joint-stock farms appear little different from their socialist collective forbearers and land transactions are heavily regulated, and in China where land use rights have yet to be remotely transferred into permanent or tradable claims at the individual level.

Also, needless to say, in a number of countries widespread corruption is a serious impediment to economic activity (and in the very worst cases the threat of lawlessness and outright arbitrary expropriation of property is the most crippling feature of all).

Despite all this, however, the crucial point lies elsewhere: as we said earlier, the real post-communist revolution was in *titles*. Property rights may not be fully respected, but in most countries the underlying infrastructure – or the “paper trail” – is broadly in place. Visit these countries today and you will generally find that the entire urban housing stock is captured in unified registers with a legal claim to each apartment or house. The same is true for land and commercial assets, where relatively unambiguous documentation exists for each parcel and firm; even if the state is still the owner, and despite often onerous restrictions that govern their use, there is normally little confusion as to who has residual claim at any given point in time.

Moreover, because most countries more or less completely threw out pre-1990s communist-era commercial and legal codes, over the past 10-15 years they were able to adopt relatively simple and straightforward legislative frameworks, however incomplete, that govern how property relations are managed.

Compare all of this with the situation detailed by de Soto in many other low- to middle-income emerging economies, where a significant share of residential and small-scale commercial assets may have no documentation or registration at all, existing in “limbo” outside of the formal legal system – or, alternatively, subject to a multitude of competing claims that effectively nullify their legal status.

The blank slate

In short, and at risk of mild exaggeration, the socialist world has transformed itself into a world of title-holders, and as we will show below these titles are already serving as actionable property rights in many areas, particularly in urban property markets. Even in economies such as those parts of the former Soviet Union where, to use George’s terminology, we have yet to fully establish rule *by* law much less rule *of* law, that latent pool still exists.

All of this was made possible by the “blank slate” provided by the end of the communist era two decades ago (and, of course, the often horrific costs borne by the preceding generation) with the accompanying once-in-a-lifetime opportunity to re-establish titles and property relationships more or less from scratch – which, again, sets this group of countries apart from the rest of the EM universe.

What about the rest of it?

So far none of this detracts in the least from the issues raised in the beginning of the report. It’s one thing to put underlying title and initial property structures in place, and quite another to follow through with the legal and governance reforms necessary to protect claims and promote continued investment and growth.

At the same time, however, in our view there is a very real sense in which getting the property fundamentals right leads directly to improvements in the rest of “soft” infrastructure. To go back to the example of China, once you have created over a billion stake-holders by privatizing the entire housing stock, giving specific land-use rights to nearly every rural farm family and pushing broad equity market participation at the retail level, with a government intent on promoting growth and stability above all else it’s fairly natural to expect that this would lead to steady progress in legal protections and governance.

And to those who argue that the lack of true multi-party democracy (in China, Vietnam and much of the former Soviet Union) is fundamentally incompatible with sustainable market-led economic growth, we would remind that the *only* examples of successful development from poverty all the way to advanced status in the post-war era were single-party states – Hong Kong, Singapore, Korea and Taiwan – and that the latter two had very repressive military regimes for much of the high-growth era in the 1960s, 1970s and 1980s.

Rather, the key to success in all these economies was once again institutional quality and especially property rights. Hong Kong and Singapore inherited commercial and title codes more or less wholesale from the Western colonial era; both Taiwan and Korea carried out fundamental land reforms very early on and had legal and commercial systems heavily influenced by earlier Japanese rule. These allowed all four economies to grow rapidly throughout the post-war era (and for Taiwan and Korea allowed for a transition to democratic rule in the late 1980s and early 1990s, after the main economic gains had already been achieved).

The proof of the pudding

Of course none of this is a guarantee that China or any of its post-communist counterparts can actually emulate these successes. Are they really keeping up? This brings us to the next section of this report, i.e., a look at the actual evidence on performance to date.

#1 – Comparative governance, legal and commercial metrics

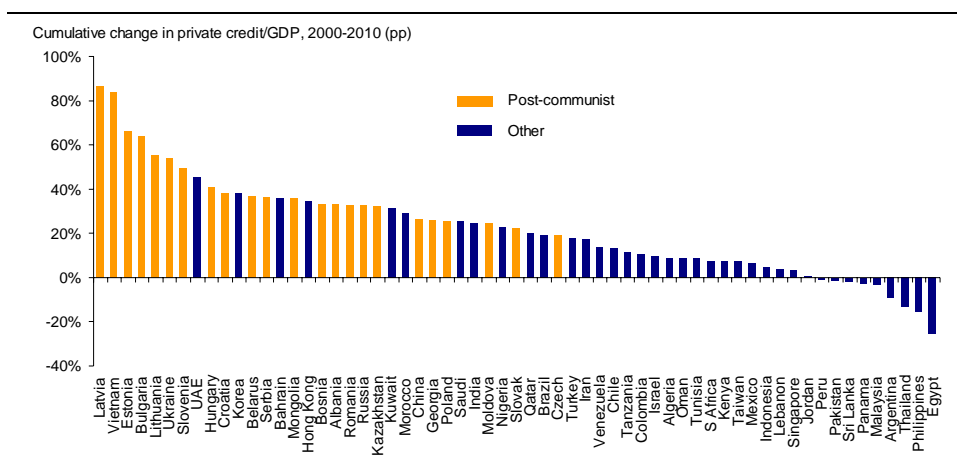
We already presented results from comprehensive global surveys on corruption perceptions, economic freedom and business conditions in Charts 3 to 5 above; just to reiterate: (i) the post-communist world shows clear superiority in areas related to property rights, such as registering property, enforcing contracts and accessing credit; (ii) as a result, the overall pace of institutional improvement has been much faster than in the remaining EM universe, and (iii) only Russia and the CIS continue to punch “below their weight” on an income-adjusted basis; Asia and Central and Eastern Europe consistently poll above.

I.e., it certainly does appear that the very nature of post-socialist ownership and title reforms has helped drive much broader progress in the quality of institutions and governance to date.

#2 – Credit penetration

For a more concrete and quantitative confirmation of this trend, turn to Chart 6 showing the cumulative change in the private credit/GDP ratio in EM countries from 2000-10.

Chart 6. Private credit penetration growth 2000-10



Source: IMF, Haver, CEIC, UBS estimates

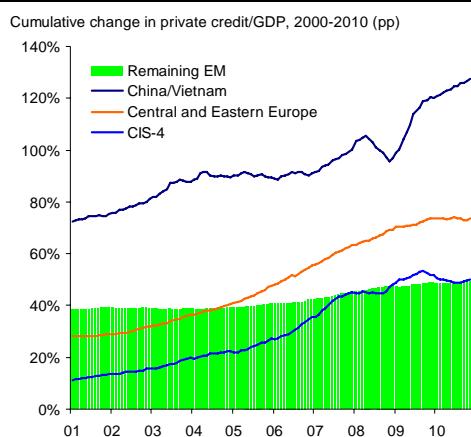
As you can see, regardless of geography, the *entire* post-communist world had a dramatic lending boom over the past decade. Among the economies we cover in this group there wasn't a single one that failed to deliver a 20-percentage point increase in private credit relative to GDP.

Meanwhile, if we exclude the former socialist bloc there are only a handful of remaining EM countries that passed this threshold ... and nearly all of those were oil and fuel exporters, buoyed up by the massive commodity boom of the 2000s.

Moreover, this clearly wasn't just about "catch-up"; as shown in Chart 7 below, credit penetration rates were already higher than the EM average in Central and Eastern Europe, and much higher in China and Vietnam. It was only Russia and the CIS that started far below the rest of the EM world and brought ratios more into line over the course of the past decade.

Where did the credit go? To many sectors, of course, but as we look across these economies the most common single thread that ties them all together was an urban real estate and housing boom (and, for many, a clear bubble).

Chart 7. Private credit trends by region



Source: IMF, CEIC, Haver, UBS estimates

At the end of the day, this massive credit expansion was not a healthy phenomenon from a macro point of view, and we will have more to say about this in the section below on balance sheet risks.

But forget about that for a moment, and think about what it means from a microeconomic perspective. As de Soto stresses, perhaps the best measure of truly functioning property rights is precisely their ability to turn underlying assets into credit. And in retrospect it should come as little surprise that this happened virtually everywhere in the former socialist economies, which had just undertaken thorough housing and property title reforms – and almost nowhere else in the emerging universe.

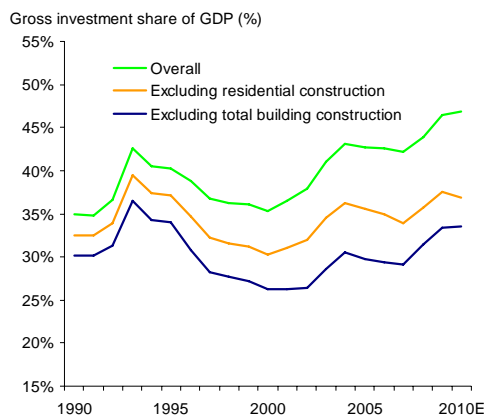
Indeed, we probably couldn't wish for a better chart to demonstrate our point.

#3 – Chinese property

Applying this point to China in particular, just last week we published our analysis showing the dominant role urban property and residential housing have played in the overall mainland growth story (see *The Most Important Sector in the Universe, UBS Macro Keys, 16 March 2011*).

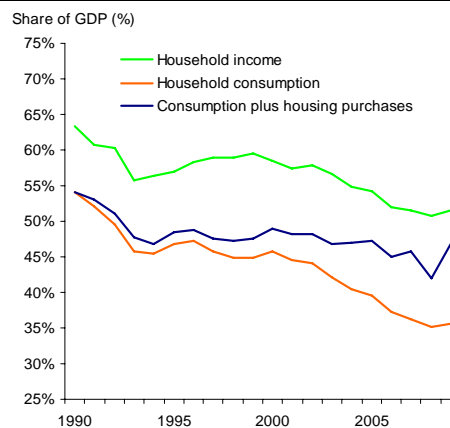
In each of the charts below, the blue line shows "adjusted" economy-wide gross investment and final household expenditure levels after accounting for real estate and housing (see the above report for full details); as you can see, property spending accounts for the lion's share of the trend increase in China's investment/GDP ratio, and likely explains most of the trend decline in household consumption as well.

Chart 8. Chinese investment by category



Source: CEIC, UBS estimates

Chart 9. Household spending by category



Source: CEIC, UBS estimates

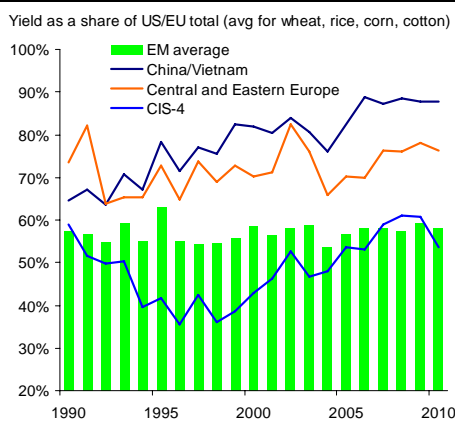
The bottom line is that tremendous resources have been diverted from other sectors and spending items in order to commit to housing – which is once again a questionable outcome from the point of view of macro sustainability but at the same time a powerful vote of confidence in the power of property-rights reforms at the micro level.

#4 – Agricultural investment and yields

It’s not just about housing, of course; most countries undertook land title and tenure reforms as well. Have these yielded similar results in agriculture?

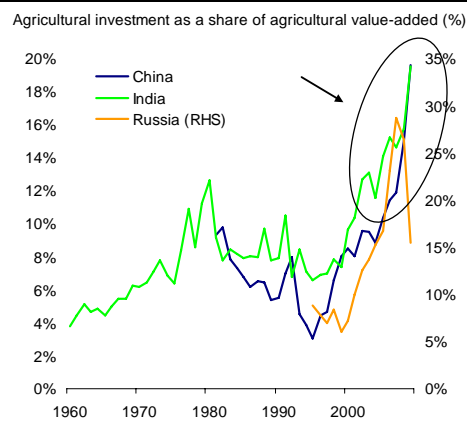
The clearest “yes” would come from China and Vietnam, where a radical approach to land reform helped generated a visible and sustained increase in grain and staple yields compared developed country levels – in sharp contrast to the relative stagnation in the emerging universe as a whole (Chart 10).³

Chart 10. Agricultural yields by region



Source: USDA, UBS estimates

Chart 11. Agricultural investment trends



Source: CEIC, Haver, UBS estimates

³ For China, Vietnam and overall EM, Chart 10 shows the average yield on wheat, corn, rice and cotton as a ratio of the average US/EU level. Due to data restrictions, for the CEE and former Soviet Union we show the average yield on wheat and corn only.

It's more difficult to give a simple answer in the remaining cases; Central and Eastern European yields were always considerably higher than the EM average but are only moderately stronger today than in the 1990s. Meanwhile, recorded yields in Russia and the CIS collapsed in the 1990s and then recovered steadily to the Soviet-era level during the 2000s, but are no higher today than those in the rest of the emerging world.

One thing we can say with greater certainty is that farmers in China and Russia wasted no time in responding to higher trend food prices in the 2000s with a sizeable jump in investment spending (Chart 11; see *A Food Glut Revisited?*, *EM Daily*, 22 February 2011 for further details). This was not just a former socialist phenomenon, of course, as we saw exactly the same trend in India, but it does at least highlight fundamental confidence in post-transition tenure reforms.

Watch balance sheets

So far, so good. Current and former socialist economies have taken a host of unprecedented underlying property reforms, reforms that have put them ahead of their remaining EM counterparts in key institutional areas. As a result, China, Vietnam and Central and Eastern Europe in particular have shown consistent and dramatic outperformance in the pace of legal and governance improvement. And the entire post-communist universe was rewarded with a credit-fueled growth boom that expanded living standards far faster than in other emerging markets in the 2000s.

There's just one problem. Those stunning 50- to 70-percentage point credit/GDP increases in the Baltics, Balkans, Ukraine, Hungary and former Yugoslav states reflected far more than just buoyant lending cycles – they were clear bubbles, with patently unsustainable residential price rises and related housing builds. As we write at the beginning of 2011, real GDP in *all* of these countries is still below end-2007 levels, and down by as much as 15% in the worst cases. Housing prices and construction have generally collapsed; banking systems are in disarray and unemployment is high; the private sector is undergoing a painful delevering and public debt is starting to mount.

These economies were not victims of poor legal protections, underdeveloped property rights and insufficient confidence to invest. Exactly the opposite, each of them was a victim of their own initial *successes* in institutional reforms, with a healthy dose of macro-prudential failure along the way. Indeed, in many ways they are far more similar to the US sub-prime crisis – another example of how rapid institutional liberalization can overwhelm macro regulation, leading to bubbles and subsequent malaise.

In general, we do expect most of Eastern Europe to get back on their feet and continue along a more sustainable development path, but only after a number of years of delevering and balance sheet repair, with all of the relevant social and political risks along the way.

Turning to Asia, Vietnam is now essentially the world record-holder in credit expansion over a 10-year period, with a rise of more than 80 percentage points as a share of GDP; in our view this boom is not remotely sustainable and highlights severe risks in overly-indebted domestic sectors of the economy. And while China did not add nearly as much leverage in the past decade, it has certainly driven residential housing and overall property construction to levels that raise real medium-term concerns at well (a point that chief China economist **Tao Wang** has written about in greater detail).

Here, again, our main concern is not that underlying soft institutional quality is not “keeping up”. Rather, it is that macro balance sheets are being overwhelmed by the pro-growth and pro-credit effects of rapid institutional reform. As a result, it is balance sheet stress above all that we want to watch.

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