

Emerging Markets in Retreat*

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Whatever happened to emerging markets? For a while it looked like they had secure and buoyant futures, regardless of the travails of advanced economies. Global investor interest focussed on varied countries grouped by acronyms like BRICS and MINTs that sometimes even led to institutional tie-ups. There was much trumpeting of their advantages, like the demographic bulges producing young populations, without considering how that could lead to disaster if employment did not increase in tandem. Few asked about the nature of the growth, or whether it could last. The euphoria spread, leading to large private capital inflows that pushed up asset prices in these countries.

That already seems like a long time ago, as investor opinion has done yet another volte face. The positive excitement was exaggerated, but the reaction to the inevitable slowdown in these markets has been extreme. Investors who were slow to read the tea leaves have now taken fright. In just 13 months, capital outflows from these countries have crossed \$1 trillion. Stock markets have tanked across countries as distant and diverse as Malaysia, India, South Africa and Brazil; currencies have depreciated; bond issues are slowing down, with fewer takers.

For a change, this is not being driven by policy in the developed world (unlike the “taper tantrum” unleashed in mid 2013 by former US Fed Chairman Ben Bernanke when he simply announced the possibility of reducing the massive liquidity stimulus that was being provided in the US). The current skittishness in emerging markets is the fallout of what is happening in China. This is hugely important, not just because of China’s now major role in global trade, but because it signifies the end of a particular growth strategy that many other countries were trying to emulate.

Everyone knows about recent travails of China’s economy: the [falling real estate](#) prices that put paid to the construction boom and the bursting of the [stock market](#) bubble that was then ham-handedly controlled through various official measures. But these current difficulties are the outcome of earlier economic strategies that were widely celebrated when the going was good.

From the early 1990s, China adopted an export-led strategy that delivered continuously increasing shares of the world market, fed by relatively low wages and very high rates of investment that enabled massive increases in infrastructure. This was very successful over two decades, albeit accompanied by big increases in inequality and even bigger environmental problems. But the strategy received a shock with the global crisis in 2008-09, when exports were hit.

Much is made of how China, India and other large emerging markets showed that they were “decoupled” by continuing to grow quite well despite that crisis. But in reality it was simply that China (and much of developing Asia) shifted to a different engine of growth without abandoning the focus on exports. The Chinese authorities could have generated more domestic demand by stimulating consumption through rising wage shares of national income, but this would have threatened the export-driven model. Instead, they put their faith in even more accumulation to keep growth rates buoyant.

So the “recovery package” in China essentially encouraged more investment, which was already nearly half of GDP. Provincial governments and public sector enterprises were encouraged to borrow heavily and invest in infrastructure, construction and more production capacity. To utilise the excess capacity, a real estate and construction boom was instigated, fed by lending from public sector banks as well as “shadow banking” activities

winked at by regulators. Total debt in China increased four times between 2007 and 2014, and the debt-GDP ratio nearly doubled to more than 280 per cent.

We now know that these debt-driven bubbles end in tears. The property bubble began to subside in early 2014 and real estate prices have been stagnant or falling ever since. Chinese investors then shifted to the stock market, which began to sizzle – once again actively encouraged by the Chinese government. Stock market indices more than doubled in a year, reaching a peak in early June 2015. For some stocks, the price-equity values crossed 200. This was clearly crazy, but the correction was untidy. Stocks are now trading 40 per cent lower than the peak, but only because the Chinese government has pulled out all stops (and lots of money) in intervention to control further falls.

All this comes in the midst of an overall slowdown in China's economy. Exports fell by around 8 per cent in the year to July. Manufacturing output is falling and jobs are being shed. Construction activity has almost halted, especially in the proliferating "ghost towns" dotted around the country. Stimulus measures like interest rate cuts don't seem to be working. So the recent [devaluation of the RenMinBi](#) – which has been dressed up as a "market-friendly" measure – is clearly intended to help revive the economy.

But it will not really help. Demand from the advanced countries – still the driver of Chinese exports and indirectly of exports of other developing countries – will stay sluggish. Meanwhile, China's slowdown infects other emerging markets across the world, as its imports fall even faster than its exports and its currency moves translate into capital outflows in other countries.

The pain is being felt by commodity producers and intermediate manufacturers from Brazil to Nigeria to Thailand, with the worst impacts in Asia where China was the hub of an export-oriented production network. Many of these economies are experiencing collapses of their own property and financial asset bubbles, with negative effects on domestic demand. The febrile behaviour of global finance is making things worse.

So this is not the end of the emerging markets, but it is – or should be – the end of this growth model. Relying only on net export growth or debt-driven bubbles to deliver rapid growth cannot work for very long. And when the game is finally up, there can be severe political fallout as well. For developing countries to truly "emerge", a more inclusive strategy is essential.

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