Emerging Markets Face a Treacherous Transition; China Is Last Man Standing

By Viktor Shvets
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Emerging markets have too much of one factor of production (i.e., cheap labor) and too little of another (i.e., intellectual capital, intangibles, and technology).

In more conventional times, less-developed economies started with the abundant factor (usually labor or basic resources) and used it to attract the scarce one. This optimization was the essence of mass migration from overcrowded Europe to the New World in the 19th to early 20th centuries as Europe’s excess labor transferred to the sparsely populated New World, which had no shortage of land or resources but lacked sufficient labor, technology, and capital. Likewise, in the past four decades, China has exploited its ample labor resources by encouraging foreign capital and technology, and the same process was at work in Japan from the 1950s to the 1970s and in Korea from the 1970s to the 1990s.

As the traditional King’s Road for development (i.e., globalization, trade, and manufacturing) sunsets, the magnitude of challenges facing EMs is immense. The EM ex China labor force is expected to grow by more than 500 million people by 2030 and by about 1 billion people by 2040 (see figure 1). The problem is particularly acute in sub-Saharan Africa. In the next few decades, EMs need to generate more than 45 million jobs per annum. But in a world where labor’s role is diminishing, this is a huge challenge. Unless there is a way to utilize these young cohorts, growing cities within less-developed nations are likely to become sources of squalor and disease rather than centers of productivity. At the same time, EMs have virtually no intellectual capital and benefit from only limited R&D, and their ability to tackle deeply seated domestic inefficiencies is highly questionable. In essence, most EMs simply have no tools to compete and prosper in the modern information age.

China, however, is very different. It has aging demographics, and therefore it is not compelled to create millions of jobs. It also has a much deeper pool of intellectual and intangible capital than the entire EM universe combined; its R&D budget exceeds 20 percent of the world’s total. China is building an impressive array of intellectual assets, boasts a deep domestic market, benefits from strong monetary sovereignty, and has ample capacity to pursue localized fiscal and modern monetary theory (MMT) policies. China’s challenge is how to progress in a deglobalizing and balkanizing world while moving from mere innovation and application of past discoveries to inventiveness. It is also not clear how it would manage the significant rift between West and Sinosphere. These are complex issues, but they pale in

Unfortunately, we do not live in conventional times. Today, the value of labor inputs is declining, and the importance of labor arbitrage is diminishing even in highly labor-intensive industries as the role of robotics and automation continues on a steep upward trajectory. At the same time, research and development (R&D) as well as intellectual and intangible assets are gaining momentum while capital is becoming virtually free for developed and some of the better-positioned emerging markets (EMs), but it is getting harder to come by for the rest.
comparison with the challenges facing the rest of EM universe.

**EMERGING MARKETS EX CHINA: A BLEAK OUTLOOK**

In the past two centuries, less-developed economies grew by using abundant and cheap labor resources and basic commodities to attract foreign capital, technology, and know-how. Success also required a conducive global trade and capital environment.

It was globalization of the 1850s–1910s, underwritten by British capital and industry, as well as the British navy, that offered an opportunity for the United States and Germany—emerging markets of that era. Levels of globalization in 1913 were not surpassed until the 1990s. The next major globalization phase started in the 1970s, significantly accelerated in 1980s–1990s, and peaked just before the Global Financial Crisis in 2008. This period, underwritten by U.S. consumption, provided a necessary boost for Japan, Korea, Taiwan, and of course China, and in a different way, Israel and to some extent countries such as Thailand and Malaysia.

The King’s Road for development traditionally has relied on leveraging global manufacturing and trade flows. Alas, globalization has now gone into reverse, with a rising trend toward protectionism and nativism, with nations employing both direct (tariffs) and indirect (non-tariff) protectionary measures. Globalization’s proponents are being overwhelmed by those arguing in favor of local interests. At the same time, declining importance of labor arbitrage, rising use of automation and robotics, and secular changes in how we manufacture and distribute products are starting to shut down manufacturing routes. Increasingly, EM labor might no longer be needed, even at labor costs of $1 or $2 per hour. This has become known as a “premature de-industrialization,” with EMs losing manufacturing at income levels far below the levels where developed economies experienced manufacturing loss. As Daron Acemoglu highlighted, trade and manufacturing also have traditionally played a fundamental role in creating democratic politics. Hence, the diminishing role of manufacturing, trade, and organized labor would not only make it more difficult for poorer nations to develop, but it also would encourage more restrictive and undemocratic political and social orders, potentially leading to chronic conflicts.

Dani Rodrik conceptualized the inevitability of regular rollbacks in globalization and trade as the “political trilemma of the world economy”: One cannot have nation-states, local politics, and globalization simultaneously and in full; we need to choose two out of three and, given that neither nations nor local politics are likely to disappear, globalization must at some stage go into reverse. This is because globalization creates winners and losers, and winners never compensate losers within an acceptable political time frame. Losers also heavily concentrate in certain geographies, occupations, and racial groups, further aggravating the Maslovian disappointment, fueling social and political backlash.

However, Rodrik considered his hypothesis largely in isolation from the prevailing technological, financial, and demographic environment. In our view, these three factors make this thesis even stronger, potentially mortally wounding globalization and providing a further boost to the balkanization of global trade, the creation of well-defined spheres of influence, an accelerated atrophy of supply and value chains, and the shutdown of the most prospective developmental opportunities for emerging and developing economies.

**EM EX CHINA: NARROW DEVELOPMENTAL CORRIDORS**

The declining ability to leverage global demand through globalization, trade, and manufacturing means that only a few avenues remain for EMs to accelerate per capita gross domestic product (GDP) growth rates, namely the following:

**Size matters.** As the ability to leverage global demand erodes, the size of the domestic market becomes incredibly important. Size really does matter, and it is an advantage for China, India, and to some extent Brazil, but it likely will become a disadvantage for most other smaller emerging economies such as Malaysia, Philippines, or Thailand. As manufacturing and trade changes, the larger domestic markets will command a premium. This is a reverse of the preceding globalization trend when smaller, nimbler, and more efficient countries could successfully and profitably leverage global demand.

**Policy flexibility.** In the absence of global growth and with limitations on the benefits of labor arbitrage, EMs must focus on growing domestic economy by stimulating local cycles to drive growth and to clear bottlenecks. However, most EMs have limited capacity to embark on aggressive developmental projects, because few have true monetary sovereignty (i.e., ability to issue, use, and borrow mostly in one’s own currency) and almost none have institutions of state to moderate inefficiencies, corruption, and waste. In some EMs, strong public sector responses are more likely to create another Zimbabwe or Venezuela than a Korea or Taiwan.

**Productivity in non-tradable sectors.** The key difference between countries such as Australia and Indonesia is found not in their respective tradable goods but rather in the efficiency of their non-tradable sectors (i.e., retail and wholesale trade, construction, utilities, financial institutions, domestic manufacturing, etc.). Alas, these sectors are wrought with corruption, nepotism, and monopolistic rents. Almost no EM can confront vested interests, and even fewer are able to maintain meaningful structural reform momentum. For most local elites, external trade is just the cherry on the cake, with the bulk of their monopolistic rents coming mostly from domestic assets. This is the primary reason why in the past six
decades there were so few graduations into the developed economies league. Most EMs today have relative income versus the United States that is lower than it was in 1960, and others are stuck in the “middle income trap,” without promise of any further progression.

**Intellectual and intangible capital.** EMs should embrace the future of new materials and digital technology because intangibles (i.e., IT, technology, software, digital and social capital) will continue to eat tangible assets (i.e., factories, machinery, roads, labor, etc.). Unfortunately, most EMs ex China have almost no intellectual capital. Building intangibles is a long-term project that requires careful nurturing over decades. The new economy foundations for most EMs are almost non-existent. If we examine the most obvious starting point of R&D spending, on a nominal basis, EMs ex China are currently spending around US$130 billion per annum, representing only 7 percent of the world’s total and merely 0.6–0.7 percent of their GDP (versus levels closer to 2–3 percent for most developed economies) (see figure 2). These regions also have only 3 percent of global patents, even though they are home to 66 percent of the world’s population.

The daunting challenges described above are gravely compounded by sigificant demographic changes that are accelerating across the EM universe at warp speed.

**EMs EX CHINA: MALTHUSIAN DEMOGRAPHICS**

In an industrial age, demographics and urbanization can become productivity and wealth enhancers. When people are the primary productivity drivers, larger younger cohorts, if accompanied by improvements in human capital (e.g., elimination of illiteracy, etc.) and core infrastructure, lead to a growing and more productive labor force while urbanization creates productivity and innovation clusters. Younger demographics and improved human capital also minimize the cost of caring for the elderly and support the tax base.

In a modern information age world, however, where humans are no longer the key productivity drivers—where the need for labor inputs diminishes and a growing proportion of gains accrue to intangible assets—the rapid growth in the size of younger cohorts becomes a recipe for dissatisfaction, violence, and immigration pressures. Meanwhile, urbanization, rather than yielding innovation, likely will be associated with poverty and disease.

This is a typical Malthusian trap. This is what we describe as the age of “diminishing returns on humans and conventional capital but rising returns on digital capital.”

Thus, in the information age, rapidly growing younger cohorts likely would lead to lower per capita income, less economic growth, and more violence. On the other hand, an aging population might not excessively strain budgetary and fiscal systems, because technology and greater fiscal flexibility change this dynamic. Having fewer people, particularly young people, might become a positive demographic trend.

This is where most EMs ex China will experience the greatest challenge. According to the United Nations’ database, the labor force in EMs ex China is likely to grow by almost 1 billion people over 20 years; by 2040, about 72 percent of the global labor force will be in the less- and least-developed economies ex China. This massive growth in the labor force is fueled by the collapse in infant mortality rates while fertility remains high due to sticky social conventions about how many children per family any given society regards as appropriate.

What would this surging cohort do in a world where neither manufacturing nor trade offers opportunities, and where most countries likely would remain stuck in a quagmire of corruption and inefficiency? There are no easy or simple answers. It could lead to uncontrolled migratory flows that might become increasingly destabilizing to wealthier nations. It could result in violent upheavals or another pandemic emerging from less-developed EMs. Arguably, the best answer would be initiation of a new and aggressive Marshall Plan.

**CHINA: IN A CLASS OF ITS OWN, BUT IS IT INVESTABLE?**

China, however, is in a class of its own. In the past three decades, China has emerged as the world’s largest manufacturing and trading economy, as well as the key driver of global saving rates, commodity prices, etc. No facet of global economics or politics has not been touched by the rise of China. But how well...
is China positioned for a world where neither manufacturing nor merchandise trade will be among the key success drivers?

Growing deglobalization, technological disintermediation, political backlash against globalization among developed economies, and geopolitical pressures might suggest that China is transiting from being the greatest beneficiary of globalization to becoming its most significant loser. But we disagree with this argument, for the following four reasons:

**China has a large domestic market.** The information age will favor countries with significant local markets, and no other EM even approaches China’s US$5 trillion–$6 trillion in domestic consumption. A significant part of that consumption is driven by external demand, but in the past decade, China’s market has become much more localized. The only EM that comes anywhere close to China’s domestic potential is India, which today is only about one-fifth the size of China’s market.

**China has limited fiscal and MMT restrictions.** The information age requires a much greater reliance on local fiscal and monetary pulses, and China’s “dual circulation” economy is becoming the most viable developmental path for any emerging nation. China is the only EM that has been practicing a version of MMT (particularly in the case of urban redevelopments) while liberally mixing fiscal and monetary levers. Although a sizable portion of investors perpetually worry about a looming debt bomb or Minsky moment, we do not believe they apply to China’s circumstances. China is the only major EM that satisfies all preconditions of MMT-style policies. Therefore, it is much better positioned than most other less-developed nations to transform from a globalized to a more localized economy.

**China faces no demographic curse.** China has the right demographics for the information age. Its cohort of under 15-year-olds peaked about 40 years ago at around 370 million (or 35–40 percent of China’s population at the time). Today, it stands at 255 million and is expected to drop to about 200 million by 2040. China benefited as its working-age cohort grew during the 1980s and into the 2000s, but the labor force has already peaked in 2015 at just more than 1 billion, and it should drop to about 890 million by 2040. Correspondingly, China is now experiencing a significant rise in older age cohorts. Although most commentators view this in a negative light, we believe that increasingly productivity is derived not from labor or tangible assets but from intangibles, new materials, and intellectual capital. At the same time, today, most developed and some emerging economies (such as China) have a much greater degree of fiscal and funding flexibility, thus significantly blunting what otherwise could have been seen as a serious growth drain. As a result, China, unlike say India or most other developing economies, is not compelled to continuously generate a high number of jobs while avoiding an equivalent productivity penalty.

**China is building its intellectual and intangible assets.** China is the only major developing economy that is succeeding in building a broad range of intellectual and intangible assets. China is already responsible for 17 percent of global R&D (or US$300 billion and close to a 25-percent share in terms of purchasing power parity). It also employs more than 20 percent of global researchers and has become the leading publisher of cross-referenced scientific publications. Various studies also have highlighted that China’s stock of intangible assets could be as high as 10–15 percent of China’s GDP. As a result, the new economy (i.e., IT, technology, media, biotech, social, etc.) now accounts for more than 50 percent of capitalization of MSCI China, and these sectors are responsible for the highest return on equity and the greatest profits. This compares to a new economy share of only 5–7 percent in equity indexes of other EMs such as ASEAN (Association of South East Asian nations) or Latin American countries (see figure 3).

However, it will be far from smooth sailing, because China is also facing a number of complex challenges.

Most of China’s R&D, including its patents, comprise small or incremental improvements rather than brand—new breakthroughs. In other words, China is better at innovation than inventiveness, and it depends heavily on the bank of Western intellectual breakthroughs. This explains China’s limited exports of intellectual services (whether royalties or license fees) as well as its large net trade deficit in these areas (close to

**Figure 3** INDEX WEIGHT OF NEW ECONOMY SECTORS

Source: Factset, MSCI, Macquarie Research
US$30 billion per annum). It also corresponds with China’s lack of Nobel Prizes in science, with only one award in the past 30 years. China’s contribution to the key intellectual and scientific underpinnings of the modern information age remains minuscule, explaining the brutal effectiveness of the Trump administration trade restrictions.

Although one could argue that this is a natural progression, from being a contributor of labor to more sophisticated industries and then to inventiveness, the information age is rapidly rewiring every aspect of our lives, and it impacts production and distribution as well as social, personal, and political interactions. Economists have a problem dealing with such a wide and imprecise field, preferring to focus on the quantifiable contribution of capital and labor in a conventional production function. But today, politics and technology dominate economics. In our view, this explains growing geopolitical and trade tensions, as two largely incompatible economic and political systems collide.

It is important to remember the extent to which China’s system is different. China has no independent central bank; its commercial banks are not truly commercial, and its private sector is not really private. In China, the state is completely dominant and although the role of the state and public sectors is also rising in the West, it is nowhere near the depth and comprehensiveness of the state, party, and private sector relationship in China. Hence, there are growing and inevitable tensions, particularly between the broadly defined Anglosphere and Sinosphere, which aggravate the deglobalization trend and have the capacity to retard evolution of the information age industries in China. All these challenges are occurring at least a decade too early for China, and it is not clear how it will navigate these complexities.

The atrophy of supply chains and their segmentation into Sino-centric versus global chains also will create consistent headwinds for the factory of the world. The only feasible response is for China to create its own sphere of influence while emphasizing its domestic economy. This is the essence of its recently announced “dual circulation” economic agenda. To overcome resultant cost and scale disadvantages, China will need to invest even more aggressively in robotics and automation. China also must redefine and strengthen its welfare and social policies while massively expanding its current modest basic income guarantee schemes. All that needs to be done within the system that has limited tolerance for dissent and opposition.

These are complex challenges. However, in our view, China has the toolkit to manage this transition, as long as geopolitical tensions are kept under control. China has a very large domestic market and is creating its sphere of influence (i.e., Russia, Turkey, Iran, parts of South and Southeast Asia, Africa). The Sinosphere might be responsible for as much as 25 percent of the global economy. China also has monetary sovereignty and extensive experience mixing fiscal and monetary policies, and it remains highly competitive across a range of industries including many labor-intensive and low value-added segments. Finally, China is growing an impressive information age footprint.

We therefore maintain that, although the EM investment universe no longer has a meaningful reason to exist (because the core premise of faster growth and convergence has largely disappeared), China is very different. In our view, the EM equities investment horizon already has shrunk to China and Northeast Asia, a bit of India, and perhaps a few themes in Brazil. The rest are essentially cyclical proxies with no meaningful secular themes, and even if investors were to find the right corporate stories there, they will probably suffer from a long-term currency depreciation. This explains why China has remained our consistently largest overweight and why we have invariably been short most other EMs, investing in them only as short-term trading when these markets are significantly undervalued.

Our only concern is that geopolitical issues, environmental, social, and governance (ESG) considerations, and broader societal demands may make China increasingly uninvestable for some global investors, particularly those in the Anglosphere. We believe that globally we are moving away from the baby boomer’s world of “freedom, choice, and efficiency” and toward much greater emphasis on “equality and fairness,” where “bad will be simply bad” at any price. In this new world, excessive share buybacks or exuberant chief executive officer compensation will be penalized, as will not paying taxes, polluting the environment, engaging in uncontrolled surveillance, or running labor camps. So, it is possible that a number of China’s stocks and sectors might be blacklisted not just by the U.S. State Department but by ESG, societal norms, and trustees of investment groups.

Although most investors argue that one cannot ignore the world’s second-largest economy and least-correlated market, we disagree. China can be ignored, and China itself might eventually view this as the best “dual circulation” outcome. Barring this somewhat extreme but plausible scenario, we remain comfortable arguing that China is the best and arguably the only viable EM market, and we continue to recommend keeping investments focused on the information and new materials age sectors rather than state-driven cyclical themes.

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ENDNOTES

1. See Acemoglu and Robinson (2006a, b).
3. "Maslowian disappointment" is a perceived inability to progress along the hierarchy of human needs and desires.
4. “Malthusian trap”: In its original form it described a situation when population growth outpaces agricultural production, causing poverty and ultimately depopulation.
5. China’s “dual circulation economy” is the core economic policy concept that has emerged during trade wars in 2020. It implies an equal weight be dedicated by the state to domestic economic activities (internal circulation) and to China’s economic links with the outside world (external circulation). It is a strong signal suggesting that China wants to reduce its external vulnerabilities and strengthen self-reliance and the role of local demand.
6. A "Minsky moment" is a tipping point that leads to a market collapse after a prolonged period of unsustainable speculation and excessive debt creation.

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