Breakout To Breakdown Nation

The world was looking at China for the next emerging market crisis, but India got there first

Ruchir Sharma

A not-so-funny thing happened while the world was watching for an emerging markets crisis to erupt in China. The crisis erupted in India instead.

Contagion typically attacks weak links first, often exposing vulnerabilities hidden in plain sight. The fall of the rupee exposes India as having the emerging world's worst fiscal deficit and largest current account deficit in absolute terms.

What went wrong? For much of the past decade, India was celebrated as one of the emerging nations destined to rise indefinitely. Even after the global crisis of 2008, like China and others, it kept growth alive by spending heavily, helped by the easy money flowing out of the US.

Behind the scenes, though, the picture was deteriorating, with crony capitalism, government subsidies and inflation rising rapidly. As early as 2011, money started to flow out of emerging nations as the post-crisis stimulus began to wear off. Economic growth slowed and the flawed structures on which it was built became apparent.

The tipping point came in May, when signals that the US Federal Reserve was serious about tapering off its quantitative easing programme triggered a sharp rise in long-term interest rates in the US, drawing dollars home. The trickle of money out of emerging markets turned into a flood. In India, more dependent than ever on foreign capital, the rupee has fallen 20% since May – the largest decline of all emerging market currencies.

The reversal of global money flows has hit particularly hard those emerging markets with a high current account deficit and leadership that has been in power for nearly a decade or more and lost the will to reform. Along with India, high on this list are countries recently struck by political unrest, including Turkey, Brazil and South Africa. In these nations, the stock market is this year down 10 to 20%, and currencies another 8 to 20%.

> The good news is that a new generation of leaders is on the horizon, many serving as chief ministers in states posting strong growth with low deficits

Economic growth has now fallen to an average of 4% in emerging nations. In India, it is barely 5%, disappointing for a country with an income of only $1,500 a head, compared with the emerging market average of nearly $10,000.

This is a familiar pickle for India, which has faced a crisis early in each decade since the 1980s. Like leaders in many emerging nations, India's tend to grow complacent in good times, triggering a crisis, which forces reform, leading to a revival. What is unexpected today is that the crisis phase is unfolding under a leader credited for leading reforms after the 1991 crisis.

Economist PM who went consistently wrong on the economy?

Prime Minister Manmohan Singh, an economist, has been consistently wrong on the economy. He has assumed strong investment and savings rates would keep growth above 8%, and dismissed inflation as the natural price of prosperity and crony capitalism as a normal symptom of early-stage growth, rather than recognising it as the cancer it is that leads to a backlash against wealth creation.

India's fundamentals have deteriorated steadily since 2007. The current account deficit has exploded from $8 billion to $90 billion; it now equals 5% of GDP, twice the level academic studies suggest is sustainable. Meanwhile, many corporations have been on a borrowing binge. Since 2007, borrowing by the 10 most indebted companies has risen sixfold to $120 billion, with much of it denominated in foreign currencies.

One in four companies does not have the cash flow to cover its interest payments adequately. Total short-term external debt has risen from $80 billion to $170 billion. There is talk in New Delhi that, for the third time since the 1981 crisis, India may have to appeal to the IMF.

The situation is not yet that critical. The last time India turned to the IMF, in 1991, it had enough foreign exchange reserves to pay for less than a month's worth of imports, compared with more than five months today. It also had much heavier short-term external debts. Nonetheless, the situation is now in the hands of global forces beyond India's control.

The weak coalition government has been unable to muster a coherent response. Some tentative steps, such as recent openings to FDI, make sense but will affect the national accounts only after the crisis is decided by larger forces, such as the extent to which the Fed cuts back on quantitative easing.

The irony is profound. Indian leaders were quick to credit the boom to the country's natural strengths, rather than the incoming tide of easy money. But now they are quick to blame their troubles on the receding global tide. Voters are wondering aloud how their "breakout nation" became a "breakdown nation", seemingly overnight.

This crisis, too, shall pass, but a meaningful turnaround is not likely until the next election. The good news is that a new generation of leaders is on the horizon, many serving as chief ministers in states posting strong growth with low deficits. It will be difficult to push tough reform in coming months, ahead of the election but the new generation could play a strong national role following the election.

That would be none too soon. India has always wanted to be the 'next China' in economic terms. But beating China to the next crisis is not what Indians had in mind.

The writer is head of emerging markets and global macro at Morgan Stanley Investment Management.