Can Emerging Markets Be the World's New Locomotive?

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We're not there yet, says a leading expert.

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As storm clouds gather over the global economy, one bright spot remains in a rather dismal international economic picture. It is the continued dynamism of the major emerging market economies. Many now look towards these economies as the main hope for averting another global economic recession. Yet it remains far from clear whether these economies will be any more successful in helping to avert a renewed global economic slump this time around than they were in the aftermath of the September 2008 Lehman collapse.

There can be no gainsaying the long distance that the emerging market economies have come since the dark days of the Asian and Latin American economic crises of the late 1990s. Chastened by that traumatic experience, the systemically most important emerging market economies have improved their public finances, maintained financial stability, and reduced their external vulnerabilities. By so doing, they have put themselves in a position to more fully exploit their considerable scope for catch-up economic growth and to handily outperform the industrialized economies on a consistent basis. This has catapulted these economies into major and dynamic players on the global economic stage. Indeed, it is now estimated that the BRIC economies—Brazil, Russia, India, and China—as a group are practically as important to the global economy as the United States economy.

As impressive as the superior economic growth performance of the emerging market economies in recent years has been, even more impressive has been their relative public finance performance. Whereas extraordinarily large budget deficits are now placing the industrialized countries' public debt on a path to soon exceed 100 percent of GDP, the public debt ratios in the emerging market countries are generally in a range of 40 to 50 percent of GDP. And, with relatively small budget deficits in those countries, there is every reason to expect that their public debt ratios will remain at healthy levels. Their better public finances should

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allow these economies to gain further ground on the industrialized countries in the years to come.

On the second anniversary of the Lehman crisis, while the emerging market countries' overall economic performance continues to impress, the world economy finds itself yet again at a very troubling juncture. The U.S. economy now shows ever-increasing signs of heading for a double-dip recession as the Obama fiscal stimulus boost fades and as the inventory cycle runs its course. At the same time, as underlined by near-record-level interest rate spreads on the European periphery countries' debt, the European sovereign debt crisis remains far from being resolved. And yet once again, the Japanese economy finds itself mired in deflation.

More troubling still, as the clouds gather for what could be another perfect global economic storm, the industrialized countries' policymakers appear to be paralyzed by doubts as to what should be done to revive their flagging economies. Equally menacing, one now finds that protectionist pressures are once more on the rise as global payment imbalances resurface especially between the United States and China.

One would like to believe that in the event of a renewed synchronized slump in the industrialized economies, the newfound dynamism of the emerging market economies would help to avert a global economic recession. However, such a belief flies in the face of the emerging market economies' experience in the immediate aftermath of the Lehman economic crisis. To be sure, better emerging market fundamentals allowed those economies to weather the post-Lehman crisis better than they weathered earlier global economic downturns. However, with the notable exception of China, where massive monetary and fiscal policy stimulus supported domestic economic growth, the slowdowns in the emerging market economies following the Lehman collapse closely paralleled those in the industrialized economies.

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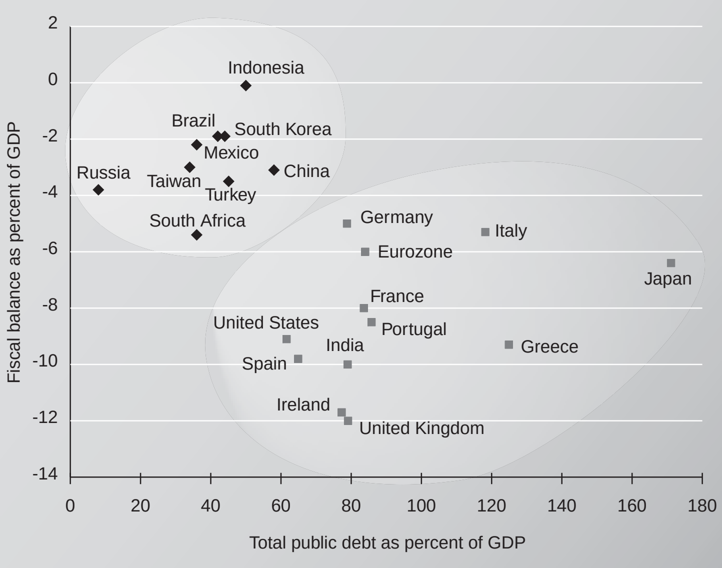
Emerging Economies, Superior Public Finances



Sources: European Economic Forecast, Spring 2010, European Commission; U.S. Congressional Budget Office; Japan Cabinet Office Projections.

If there is one thing that we should have learned from the 2008–09 global economic recession, it is how much more interconnected the global economy has become and how difficult it still is for the emerging market economies to decouple from the industrialized economies. Many of the emerging economies that have become increasingly dependent on exports to fuel economic growth found themselves particularly hard hit in 2009 by slumping industrialized country demand and by the seizing-up of international capital flows in general and of trade financing in particular. Meanwhile, the commodity-exporting emerging market economies were dealt a severe body blow by an abrupt decline in international commodity prices on the back of slumping commodity demand in the industrialized economies.

The experience with the 2008–09 global economic recession has to raise doubts as to whether the continued

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dynamism in the emerging market economies alone can help avert another global slump. A principal reason for such doubt is the likelihood that the recession in the industrialized countries will again be synchronized in nature and will embrace the United States, continental Europe, the United Kingdom, and Japan. As such, important as the emerging market economies might have become, they are simply still too small to offset a synchronized slowdown in the world's major industrialized countries.

The industrialized countries' policymakers appear to be paralyzed by doubts as to what should be done to revive their flagging economies.

A second reason for doubt is that the emerging market economies themselves are likely to be impacted by a pronounced slowdown across the world's major industrialized economies. This would be particularly the case were the sovereign debt crisis in Europe's periphery to deepen and to call into question the worth of the US$1.5 trillion in loans that the European banking system has extended to Greece, Spain, Portugal, and Ireland. Such a deepening would have the potential to heighten global risk aversion and to cause a seizing-up of capital flows to the emerging market economies in much the same way as occurred after the Lehman crisis.

The marked improvement in emerging market fundamentals over the past few years should again allow these economies to better weather any future global economic slump than they did before. It should also allow these economies to continue to handily outperform the industrialized countries over the longer haul. In time, this should allow these economies to be the real driving force of the global economy. However, it would seem that we are not quite yet at that point. ◆