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# Do not count on EMs coming to the rescue in a double dip

By John Plender

Will the emerging markets keep the global economy afloat if the developed world is hit by a double dip? Since the financial crisis, the shift in economic power from the developed to the developing world has been palpable. Such is the dynamism of the larger emerging market economies that many people appear to think that they could indeed come to the rescue. Yet this optimism is sadly misplaced.

That is not to say the dynamism is illusory. The story of the recovery from the recent recession is a remarkable one. While the developed world has been struggling to return to pre-crisis output levels, the International Monetary Fund estimated earlier this year that the output of developing Asia and Latin America was 7 per cent and 2 per cent above 1997-2006 trends respectively.

The emerging markets are expected to account for 38 per cent of global output by 2016 compared with just 25 per cent in 2007. We also know that the developing world's productivity growth will outstrip the developed world beyond 2016 as high levels of public sector debt in the west crowd out private investment.

In a paper for last week's central bank talkfest at Jackson Hole, Eswar Prasad of Cornell University highlighted the extraordinary turnround in the emerging markets' financial position.

Their external liabilities are no longer dominated by foreign currency debt. Since the Asian crisis of 1997-98, they have sensibly shifted the mix towards more stable flows such as foreign direct investment and portfolio equity which now account for more than 60 per cent of their total external liabilities.

By 2008 some 85 per cent of emerging market international bond issues were denominated in local currency. And external assets are increasingly concentrated in foreign exchange reserves amounting to $6,400bn, of which China owns roughly half.

Yet as Mr Prasad points out, the risk in emerging market balance sheets has shifted to the asset side. Official reserves are vulnerable to capital losses and currency fluctuations – India lost more than a fifth of the value of its reserves in just six months during the crisis – and countries with open capital accounts have seen disruptive capital inflows that have exposed the weaknesses of domestic policy and institutions. Even so, the devastating balance sheet effects that brought many countries to their knees during the Asian crisis are unlikely to be repeated.

This combination of high potential growth rates and reduced vulnerability to crises does not mean that the emerging markets will be invulnerable to recession in the west, or be in a position to offer any kind of antidote. For contributing substantially to global economic growth is not the same as imparting a demand boost to the world economy. In fact the emerging markets as a group are in surplus overall on the current account, which means they are a drag on global growth rather than a spur.

There is, admittedly, some potential good news here in that the recent fall in oil and commodity prices will reduce the surpluses of producing countries. Yet there is an offset in that the reduced import bills of China and other big consumers of energy and raw materials will tend to increase their current account surpluses.

Moreover, trends in the two biggest emerging market economies are not encouraging. The IMF's projection for China's current account surplus is of a rise from 5.7 per cent of gross domestic product in 2011 to 7.8 per cent of GDP in 2016. For India it projects a decline in the current account deficit from 3.7 per cent to 1.6 per cent over the same period, which is equally unhelpful.

Of course it is possible that China could resort to another fiscal pump priming exercise in response to recession. Yet it will do so from a position of lesser fiscal strength than last time, a point that applies to most other countries too. Moreover, the Chinese predilection for investment-led remedies for deficient demand means that most of the external benefit will accrue to energy and commodity producers. There will be little succour for the unemployed in the US and Europe unless China shifts the balance of its economy towards stimulating domestic demand. At the risk of repetition, there is little sign that the political will exists in Beijing to make such a change.

This underlines the fact that, while huge strides have been made in the emerging markets to reduce balance sheet vulnerability and restore economic growth, the global imbalances that played such a large part in creating the financial crisis are still with us. It is hard to escape the conclusion that expectations of the emerging markets have been pitched too high, while prospects for the debt-sodden developed world will remain mediocre for some time.

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