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Economic Insights

U.S. Economy: An Emerging "Fear Factor"?

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Investors appear to be worried that the U.S. economy is increasingly vulnerable to disruptions in emerging economies. They shouldn't be.

A recent *Barron's* article[1] elicited a fearful response from a large number of financial advisors. Quoting a noted New York-based think tank, the piece noted how emerging economies continue to grow as a share of the global economy, verging on 40%. It then went on to argue that their increased importance makes the U.S. economy more vulnerable than it once was to foreign influences and that, if these emerging economies were to collapse or just suffer tough times, this economy would come under considerable strain, forcing the Federal Reserve to hold short-term interest rates lower for longer than many now expect.

It is understandable how such a narrative can generate fear, but on closer inspection, it really says very little about likely future events. It is, of course, irrefutable that the United States is vulnerable to problems in the rest of the world. This country's economy is big, but still barely 30% of the world's gross domestic product (GDP), smaller than the European Union (EU), even after all its troubles of recent years, and clearly smaller than the emerging economies as a group. If these or any other significant part of the globe were to suffer a major setback, the U.S. economy would inevitably suffer ill effects, and the Fed would have to trim its monetary policy accordingly. There was only ever a brief period, in the late 1940s and 1950s, when the U.S. economy was such a big part of the world that it seemed almost immune to foreign influences. The question then is not whether the United States would suffer *if* the emerging economies fell as a group. The answer to that question is clearly, yes. The relevant question is, are these emerging economies *likely* to suffer in sufficient numbers?

Perhaps the article and the think tank see greater danger because each assumes that emerging economies are more prone to setbacks than developed economies and so their rise acts as a kind of threat that did not previously exist. Though it is hard to see anywhere more vulnerable these days than the EU, emerging economies are indeed known for volatility. It would, however, be a mistake to simply run with such a supposition. For one, emerging economies have become increasingly differentiated over time, moving less and less in tandem with each other than they once did, either in economic or in market terms. If half of them had troubles, and the other half resisted, it would be harder to see a terrible impact on the United States. What is more, their rising size and significance speaks to greater levels of development and presumably relative stability. Indeed, measures of volatility in these economies in the last 40 years have fallen by a fifth.[2] Meanwhile, their rise diversifies the foreign influences on the United States and so could create more stability even if they were not individually more stable, which clearly they are becoming.

Meanwhile, patterns of trade may make the emerging economies less of a threat than they seem or than are other, more developed markets. According to the U.S. Department of Commerce, this country has much less balanced trade with emerging than with developed economies. The data, admittedly, are far from comprehensive, but just using key trading partners, it is apparent that the United States, by a far greater margin than with other trading partners, buys much more from emerging economies than it sells them. Since fluctuations in demand almost always create economic cycles, it would seem then that the rise of emerging economies makes the world more vulnerable to the United States than this country is to the emerging economies. To be sure, secondary and tertiary influences should qualify such a blanket statement, but it does suggest that there is less to fear in this respect from the rise of emerging economies certainly than is suggested in this article.

[1]Randall Forsyth, "A Scary New World Order," *Barron's*, May 3, 2014.
[2]Data from FactSet.

Risks to consider: Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. The growth potential offered by emerging markets remains accompanied by heightened risks when compared to developed markets, including risks related to market and currency volatility, adverse social and political developments, and the relatively small size and lesser liquidity of these markets.

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