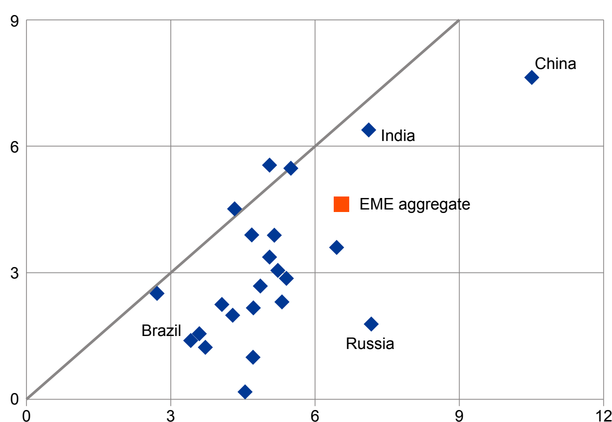
Box 1
Why has growth in emerging market economies slowed?

Growth in emerging market economies (EMEs) has slowed since 2010. Aggregate annual EME GDP growth is expected to fall from over 7% in 2010 to around 4% this year – well below the pace of expansion in the early 2000s. The slowdown has been broad-based: growth in 21 of the 23 largest EMEs has been lower, on average, in the past three years than before the global financial crisis. In some countries, growth has slowed substantially (see chart). EMEs play an important role in driving the global economy and as partners for euro area trade. A stronger emerging market slowdown would therefore weigh on global and euro area growth. This box discusses the factors behind the slowdown in economic growth in EMEs. These factors include the combination of a structural growth moderation in some of the larger countries and cyclical factors such as spillovers from weaknesses in advanced economies, changing external financing conditions and domestic policy tightening.

Chart
GDP growth in emerging market economies

(annual percentage changes)

x-axis: average GDP growth, 2000-07
y-axis: average GDP growth, 2012-14



Source: Haver Analytics.
Notes: The sample includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hong Kong, Hungary, India, Indonesia, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Taiwan, Thailand, Turkey and Venezuela. The EME aggregate is a GDP-weighted average of these countries.

One component of the recent slowdown has been structural. Potential growth in EMEs was on a rising trend prior to the global financial crisis – driven by strong capital accumulation and productivity gains, as well as favourable demographic trends – but has since slowed.

The factors underlying the trends in potential output growth differ across countries. In China, capital accumulation has moderated after years of strong investment, a result of which has been some excess capacity and resource misallocation, weighing on productivity. At the same time, the working-age population has been in decline since 2011. The Chinese authorities have emphasised the need to rebalance the economy to ensure long-term growth sustainability. In Russia, unfavourable demographic trends are also weighing on potential growth. In addition, lower energy prices and international sanctions have reinforced long-standing obstacles to higher investment and growth, such as infrastructure bottlenecks and a poor business climate, which have led to capital outflows over many years. In Brazil, potential growth has deteriorated as lower commodity prices have hit key exports. Moreover, low productivity has been reinforced by regulations on infrastructure investment and limited structural reforms. In India, by contrast, potential growth has been more resilient as the new government has taken measures to support activity, for example

by accelerating public infrastructure investment, adopting an inflation-targeting framework, removing price-distorting subsidies and initiating policies to improve the business climate.[1] Demographic trends also remain supportive of higher growth.

Cyclical factors, including weakness in the external environment, have also been responsible for slowing EME growth. Growth in advanced economies has been sluggish in the wake of the global financial crisis. Together with moderating growth in China, this has contributed to growth in global trade that has been below historical norms since 2011,[2] dampening economic activity in EMEs as a consequence. More recently, some commodity-exporting EMEs have suffered a considerable deterioration in their terms of trade as a result of falling prices of raw materials, with particularly sharp declines in the prices of energy products and industrial metals. By contrast, commodity-importing EMEs have benefited from lower energy prices.

Domestic policy tightening has also weighed on growth in some countries. In the immediate aftermath of the global financial crisis, EMEs benefited from domestic policy support. Led by a strong expansion of investment spending in China, fiscal policies were expansionary. Monetary policies were also accommodative, and low real interest rates supported rapid credit growth in several EMEs. More recently, however, some central banks have raised interest rates in the light of rising inflationary pressure following the depreciation of their currencies. Similarly, fiscal policies have tightened in some EMEs as the authorities have sought to rebuild buffers that were eroded after the crisis.

By contrast, the external financing environment has remained supportive of growth in EMEs. Global funding conditions for EMEs have been generally favourable since the global financial crisis as central banks in advanced economies have pursued accommodative policies, keeping interest rates low and engaging in large-scale asset purchases. As a result, capital flows to EMEs have remained buoyant in the post-crisis period, with the exception of periods of higher risk aversion during the euro area sovereign debt crisis and in 2013 following speculation about the monetary policy intentions of the Federal Reserve System.

However, prospective monetary tightening in the United States is likely to affect the global financing environment and may pose risks for the economic outlook in EMEs. In the past, episodes of US financial tightening and US dollar appreciation have typically been associated with a rise in financial turbulence in EMEs. Compared with the situation in previous crises, however, most EMEs now have stronger macroeconomic frameworks and more flexible exchange rate regimes. However, speculation during 2013 about US monetary policy normalisation led to a sharp sell-off in EME assets. Exchange rates weakened rapidly in some countries, particularly those with external fragilities such as large current account deficits or a strong reliance on external funding. One risk is that rising external debt, especially increased US dollar liabilities, could leave some EMEs vulnerable to a sustained deterioration in global funding conditions.

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1 See the box entitled “The rise to prominence of India’s economy”, *Economic Bulletin*, Issue 4, ECB, June 2015.

2 See the article entitled “Understanding the weakness in world trade”, *Economic Bulletin*, Issue 3, ECB, April 2015.

Overall, EME growth is expected to remain more moderate than before the global financial crisis and risks remain on the downside. Less accommodative domestic and global financing conditions suggest that growth in EMEs will continue at the more subdued pace of recent years. Potential growth has also slowed, despite some promising reform efforts in several EMEs. Looking ahead, one risk is that these cyclical and structural headwinds to economic activity may have an even larger effect than currently anticipated. EMEs play a significant role in the global economy – in purchasing power parity terms they account for 60% of global GDP and since 2000 they have contributed on average three-quarters of global growth. A stronger emerging market slowdown would therefore act as a large drag on global and euro area growth (see Box 5).