

Box 1

REPERCUSSIONS OF THE RECENT FINANCIAL MARKET TENSIONS IN EMERGING MARKET ECONOMIES

Financial market tensions in emerging market economies (EMEs) have increased again in early 2014, heightening concerns about the risks to the economic prospects of EMEs and the wider global recovery. Compared with last year's episodes, the recent turmoil has been less intense and has not been as widespread, with only a small subset of countries affected (see Chart A). From a longer-term perspective, the turmoil is likely to reinforce the broader trend of slowing growth observed in EMEs over the past four years, which partly reflects a structural slowdown in some of the larger EMEs. This box examines the broader economic developments in EMEs and the possible repercussions of the recent financial market tensions.

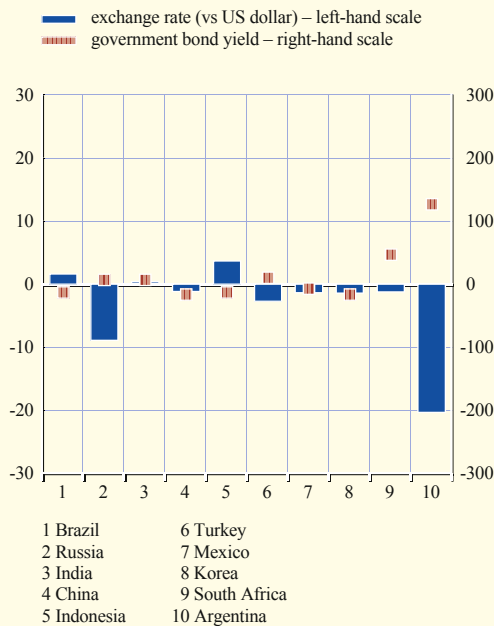
The role of structural and cyclical factors in the growth slowdown in emerging market economies

Aggregate GDP growth for EMEs has slowed sharply over recent years, from 7.6% in 2010 to 4.7% in 2012. This is well below the growth performance in the years prior to the financial crisis, when aggregate emerging market growth averaged around 6% between 2000 and 2007 (see Chart B). This slowdown has been observed across most emerging market economies and has exceeded that witnessed in advanced economies.



Chart A Recent government bond yield and currency developments in selected emerging market economies

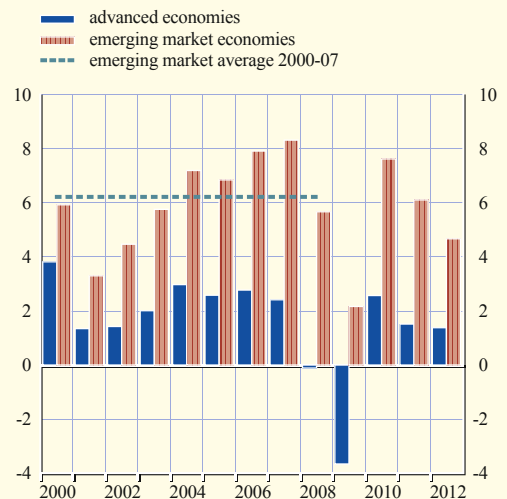
(basis points; percentage changes)



Sources: Haver, Bloomberg and ECB staff calculations.
Notes: Change between 1 January and 26 February 2014. For Argentina, the EMBI sovereign spread was considered.

Chart B Real GDP growth

(annual percentage changes)



Source: ECB staff calculations.
Notes: Advanced economies are the euro area, Australia, Canada, Denmark, Iceland, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. The group of emerging economies consists of around 150 countries.

One component of the recent deceleration has been a moderation in potential growth. Most analysts now foresee moderate growth in the coming years – long-term forecasts (five years ahead) by Consensus Economics have been revised downwards for many of the larger EMEs. Growth in China has declined particularly strongly since 2012, as limits to its growth model – characterised by strong reliance on capital accumulation and migration of labour from rural to urban manufacturing sectors – are becoming apparent.¹ In the coming years potential growth in China is likely to follow a downward path, owing to a decline in the working age population and a gradual rebalancing of demand away from capital expenditure towards household spending. In many EMEs, inadequate physical infrastructure and a poor business climate, combined – in some countries – with waning momentum in structural reforms, have also contributed to a decline in growth potential.

However, the bulk of the slowdown is attributable to cyclical factors. EMEs have suffered from weak demand in advanced economies, which account for half of EMEs' exports on average. Many have also been affected by the moderation in China's growth. Related to this, lower demand for commodities has meant that commodity-exporting countries are no longer benefiting from sharply increasing prices.

¹ See the box entitled "Factors underlying China's growth performance and prospects", *Monthly Bulletin*, ECB, December 2013.

At the same time, for much of the period since 2010, EMEs have benefited from a number of offsetting factors, most notably loose global and domestic financial conditions. Monetary accommodation in advanced economies has lowered global interest rates and boosted capital flows towards EMEs. Domestic policies, such as expansionary fiscal policy measures, have also tended to reinforce growth in the immediate aftermath of the global financial crisis. With low real interest rates prevailing in many EMEs during this period, financial conditions in these economies have been rather loose and credit has grown very rapidly in some countries.

Rising external and domestic fragilities in some emerging market economies

The factors that helped to sustain growth following the global downturn in 2008-09 have also led to rising imbalances in some

EMEs, most notably deteriorating current account balances (South Africa, Indonesia, India and Turkey), persistent fiscal deficits (Argentina and India) and overextended financial sectors following periods of very high credit growth (Brazil, Indonesia and Turkey).

Since May 2013 financial markets appear to have paid more attention to such fragilities. Most countries with large current account deficits have been affected by financial market tensions (see Chart C). The currencies of these countries have depreciated by up to 25% in effective terms, on average, since May 2013. Other factors such as domestic and political uncertainty (e.g. in Argentina and Turkey) also appear to have contributed to increasing market concerns about the outlook.

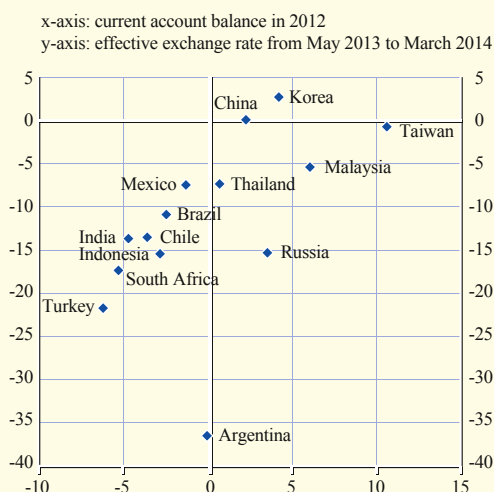
Risks and repercussions

The global implications of ongoing tensions are likely to be limited, as long as the turmoil does not intensify and remains confined to a small number of countries. To date, the limited contagion observed across emerging market currencies suggests that the recent sell-off in financial markets has been driven mostly by idiosyncratic country issues.

At the same time, there is a risk that the slowdown in growth in EMEs observed in recent years might be a reflection of deeper and more structural problems across a wider set of EMEs. Accordingly, against the backdrop of the recent increased fragilities in some EMEs, there remains a tail risk that localised problems could spread, triggering a more generalised capital flight from EMEs. In such a tail risk scenario, an ensuing broader emerging market slowdown could act as a drag on global growth.

Chart C Exchange rate developments and current account balances in selected emerging market economies

(percentage of GDP; percentage changes)



Sources: Haver and ECB staff calculations.

Note: Exchange rates are measured using the nominal effective exchange rates vis-à-vis a group of 39 trading partners.