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How vulnerable are emerging markets to external shocks?☆

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Abstract

This paper finds that external economic conditions have significant effects on emerging market (EM) economies, accounting for up to half of the variance in their growth rates. Stronger growth in advanced economies generates stronger EM growth, more so for those EMs with stronger trade ties with advanced economies and less so for those that are financially more open. Adverse external borrowing shocks hurt EM growth, more so for those with greater financial openness or those with limited policy space. China itself has become an important external driver of growth in other EMs. However, internal factors also matter in determining EM growth, and in the period since the global financial crisis these factors have been hampering growth for some EMs. The persistent dampening effect from internal factors in recent years suggests that trend growth could be affected as well. In sum, EMs may be entering a more challenging period of slower growth in the period ahead, reflecting both external and internal conditions.

Keywords: Growth spillovers; External conditions; Financial shocks; Structural vector autoregression

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1. Introduction

Emerging markets (EMs) grew at a rapid pace through much of the 2000s, and even staged a sharp turnaround after the global financial crisis of 2008–2009 (Fig. 1). However, growth has decelerated quite broadly since 2011. This secular deceleration in growth has in turn raised questions about whether much of EMs' previous strong performance was driven merely by supportive external conditions—cheap external credit, strong terms of trade, and solid growth in trading partners including China (Aslund, 2013; Eichengreen et al., 2011)—resulting in an inevitable slowdown as these conditions start to reverse. To shed light on this question, this paper quantifies the contribution of external conditions to EM growth since the late 1990s. It also examines the differential effects of external shocks arising due to differences in the nature of the shocks, EMs' exposures to these shocks, and their policy responses.

The literature relating EM growth to external conditions goes back at least two decades, starting with the work of Calvo, Reinhart, and Leiderman (1993) on external drivers of real exchange rates in Latin American economies. Several studies have explored the effects of growth and monetary policy shocks from the United States and/or euro area, and external financing shocks on EM growth (see Cesa-Bianchi Abbrogio, Pesaran, Rebucci, & Xu, 2011; Österholm & Zettelmeyer, 2007; Swiston & Bayoumi, 2008 for the effects on Latin America; Utlaut & van Roye, 2010 for emerging Asia; and Mackowiak, 2007, and Erten, 2012, for a diverse group of EMs or regions). Some have also highlighted the rising importance of financial over real linkages in the transmission of external shocks (Adler & Tovar, 2012; Canova, 2005; Mackowiak, 2007; Swiston and Bayoumi, 2008). More recent studies have explored the implications of the growing systemic importance of China for other EMs (see Cesa-Bianchi Abbrogio et al., 2011; Erten, 2012; Utlaut & van Roye, 2010 among others).

This paper contributes to the literature in at least four important ways. First, the analysis encompasses a broad sample of 16 EMs—accounting for three-quarters of total output in all emerging market and developing economies—and relates to a more recent period (1998–2013). Second, using Bayesian vector autoregression models, it documents both the average and country-specific effects of each external shock, and tries to provide insights on the differential effects of each key shock country by country. Third, it compares the relative importance of growth shocks

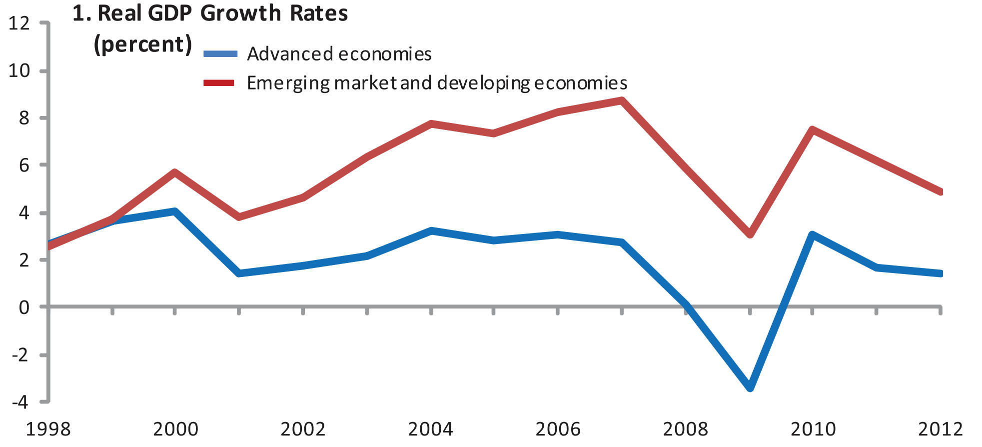

Fig. 1. Growth developments in advanced and emerging market and developing countries.