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Assessing emerging markets' vulnerability to financial crisis

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Abstract

Since 2011, emerging economies have experienced a significant and largely unexpected growth slowdown. They have also faced several episodes of financial turmoil over the past two years. This paper examines the developments in 28 emerging economies since the global financial crisis and assesses their financial vulnerabilities. We analyze several factors that have contributed to the growth slowdown and the increased financial vulnerabilities: the exposure to the commodity price decline; the combination of weakening investment and rapidly rising leverage in the private sector; and increased political instability and uncertainty. Addressing these issues is critical for both short-term stability and longer-term development prospects.
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1. Introduction

For most of the past fifteen years, emerging economies were seen as the new engines of global growth. Powered by breath-taking growth in China, many countries recorded an upward shift in their growth trend in the decade before the global financial crisis. Moreover, the acceleration in growth was accompanied by enhanced financial stability after most emerging economies had responded to the crises of the 1990s by introducing macroeconomic and financial reforms. While

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the global financial crisis in 2008/09 interrupted the growth momentum, the rapid initial recovery of most emerging economies fuelled hopes of a return to strong and stable growth.

These hopes have, however, been dashed, as emerging economies experienced a significant and synchronized slowdown over the past four years. In addition, the countries have, to varying degrees, been affected by recent episodes of financial turmoil that included large capital outflows, currency depreciations and declines in domestic asset prices. These episodes have drawn comparisons to the situation prior to the Asian crisis of 1997/1998 and attempts have been made to assess the crisis vulnerabilities of individual countries.

The principal emerging market challenges discussed herein – the growth slowdown and the vulnerability to financial crises – have received considerable attention among researchers recently, particularly in the work of the IMF. However, the two issues have generally been analyzed separately, although there are important linkages between them. In this paper, we try to bridge this gap by shedding some light on three factors that have played a key role for the slowdown and the increased crisis vulnerability: the exposure to the commodity price decline; the combination of stagnating investment and rapidly rising leverage in the private sector; and increased political instability and uncertainty. We illustrate how emerging economies were impacted to different degrees by these three common factors. Based on the analysis, we discuss some policy options that could help tackle both challenges.

The remainder of the paper is structured as follows: In Section 2, we examine the synchronized growth slowdown in emerging economies. Section 3 revisits the recent financial turmoil and assesses some standard indicators for financial crisis vulnerability. In Section 4, we examine how the exposure to the commodity price decline, the combination of increasing leverage and weakening investment in the real economy, and increased political instability have contributed to both the slowdown and the financial vulnerabilities. Section 5 discusses a number of policies that appear particularly important to support future growth and financial stability in emerging economies.

2. An unexpected and broad-based slowdown in emerging economies

Since 2011, emerging economies have experienced a significant slowdown in growth that has surprised most economists and forecasters.[1] Although during the Great Recession of 2008/09 emerging economies had suffered growth collapses similar to those registered by advanced countries (Didier, Hevia, & Schmukler, 2011), the swift initial recovery from the crisis in 2010 had prompted widespread optimism about their growth prospects. Led by strong expansions in Brazil, China and India, real GDP growth in emerging economies averaged 7.8 per cent in 2010, about the same level as in the three years prior to the crisis (2005–2007).[2] This strong performance could however not be sustained and growth has slowed more sharply than expected.[3]

Fig. 1 shows that, contrary to the forecasts made by the United Nations' Department of Economic and Social Affairs, average GDP growth has declined in each of the past four years, slowing

[1] The sample used in this paper includes the following 28 emerging economies: Argentina, Brazil, Bulgaria, Chile, China, Hong Kong S.A.R., Colombia, Czech Republic, Estonia, Hungary, India, Indonesia, the Republic of Korea, Latvia, Lithuania, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Singapore, South Africa, Thailand, Turkey, Ukraine, Venezuela.

[2] Average GDP growth is calculated as a weighted average of individual country growth rates.

[3] IMF (2011), for example, projected in April 2011 emerging market growth of about 7 per cent for the period 2011–2016, warning against the risk of overheating.

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