INTERNATIONAL FORECAST

INTERNATIONAL DIRECTORATE

What is driving the Benchmark forecast for EMEs?

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International Directorate

***Main message*: Growth in EMEs has declined almost monotonically since 2010 as China has slowed and rebalanced, commodity prices have fallen, and capital inflows have tailed off. Recently, the slowdown has been driven by sharp contractions in Russia and Brazil. We expect that drag to continue such that annual growth dips further to 2.2% in 2015 Q4, before recovering gradually to 4.4% in 2018 – still below its 2001-14 average of 4.9%. This assumes commodity prices and capital flows stabilise, and that uncertainties in Russia and Brazil start to dissipate.**

Key messages:

- Fluctuations in EME growth since 2000 have been driven by several common factors including China's transition, changes in commodity prices, capital flows, and geopolitics.
- While all these factors apply to the post-2010 EME slowdown, the most recent slowing has centred on Brazil and Russia. Recent indicators suggest Russia is stabilising, but Brazil is not.
- Non-China EME growth is forecast to trough at 0.8% in Q2, and remains there until Q4 – but there is considerable uncertainty around the exact turning point. Annual growth is forecast to reach a trough of 2.2% in Q4.
- We expect a modest EME recovery during 2016, to growth of 4.4% in 2018. That is below the 2000-14 average of 4.9%, as we consider some of the slowing to be structural.
- That forecast is based on four key high-level judgements:
  - GDP in Brazil and Russia stabilises in 2016 as recent domestic political uncertainty fades, and there is no deterioration in international political tensions between Russia and the West.
  - Commodity prices stabilise.
  - Recent capital outflows may dampen investment in EMEs a little. But FDI inflows – which tend to have more impact on growth than portfolio or bank flows – will continue.
  - There is a structural slowing in EME growth relative to the past five years. China will continue to slow as it rebalances, with growth declining to 6% in 2018. Non-China EME potential output growth will be 4.0% in 2018, lower than 2001-14 average growth of 4.9%.
- We assess that risks are to the downside of the central projection. In particular, potential growth may be lower, and the cyclical downturn in Brazil and Russia may be more prolonged. We provide an alternative projection for EME growth, in which growth in non-China EMEs is 1pp lower throughout the forecast period.
- A Box (p11-12) compares and contrasts the current situation in EMEs with the Asian Crisis. While most EMEs are more resilient now, they are larger relative to the world economy, and there is less policy space in advanced economies to offset spillovers.

Introduction

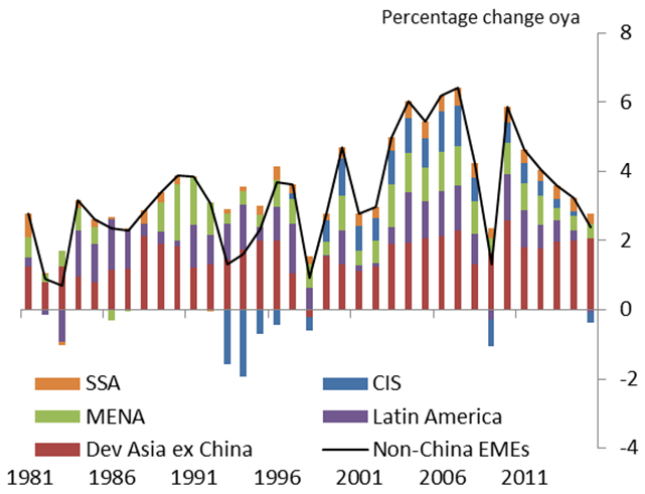
Growth in emerging market economies (EMEs) has declined almost monotonically since 2010. But even in 2015 it will contribute around 60% of global growth (at market exchange rates), given their increasing share in world GDP. Financial market volatility over the summer highlighted concerns about EME growth. How it evolves will have important consequences for the world economy. That will depend both on factors affecting trend EME growth, and on demand factors that cause fluctuations around that trend. This note examines those factors, explains what our forecast assumes, and describes an alternative scenario with more pessimistic assumptions.

How do we account for the past pattern of EME growth?

Non-China EME growth has declined since 2010

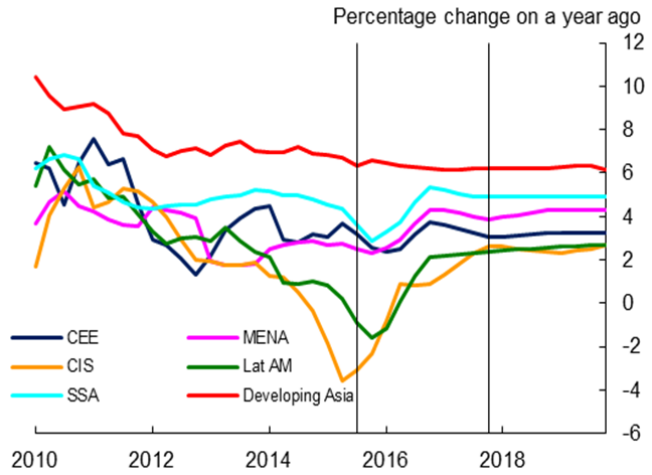
Chart 1 shows non-China EME growth since 1981. Over 1981-2000, growth was modest, averaging 2.3%, and punctuated by the 1980s Latin American Crisis, the fall of the Soviet Union and the 1990s Asian Crisis. Growth accelerated following China's accession to the WTO in 2001, as spillovers from China boosted commodity prices and world trade. Growth fell back sharply following the collapse of Lehman's in 2008, but rebounded in 2010. It has since slowed again, across most regions, but particularly in Latin America and CIS (Chart 2).

Chart 1: GDP in non-China EMEs (PPP-weighted)



Source: WEO-based estimates, with forecast for 2015

Chart 2: EME GDP by region



Source: WEO and Bank forecast

The pattern of growth since 2000 reflects several factors:

The pattern of growth since 2000 reflects several shocks – some of which have affected potential supply, some aggregate demand, and some both. These shocks include: China's transition and rebalancing; fluctuations in commodity prices (which have in part been driven by EME demand); developments in advanced economies that have affected capital flows and trade; and political developments in Brazil and Russia. We examine these in turn.

China's transition

1) China's accession to the WTO led to an increase in Chinese growth…

China's accession to the WTO in 2001 had three important consequences. First, access to world markets allowed China's exports – and trade balance – to rise sharply (Chart 3). The resulting boom in foreign demand attracted rural workers to urban areas, allowed them to take advantages of economies of scale, and thereby increasing their productivity.[1] Investment increased as a share of GDP, particularly in the export sector, resulting in capital deepening. Trade links and FDI led to

[1] EME TFP growth was unusually high during this period.

technology transfer from advanced economies, boosting TFP growth.[2] Even though this process boosted Chinese potential output, the IMF estimate that demand increased at an even faster rate, with the output gap rising to 1% in 2007, from -5% in 2001.

…higher demand for other EMEs' exports, in particular commodities…

Second, despite China's rising trade surplus with the world as a whole, China's net imports from other EMEs – particularly commodity producers, but also other EMEs producing products further down the supply chain – increased (Chart 3). That led to a big rise in commodity prices, along with disappointments in commodity supply.

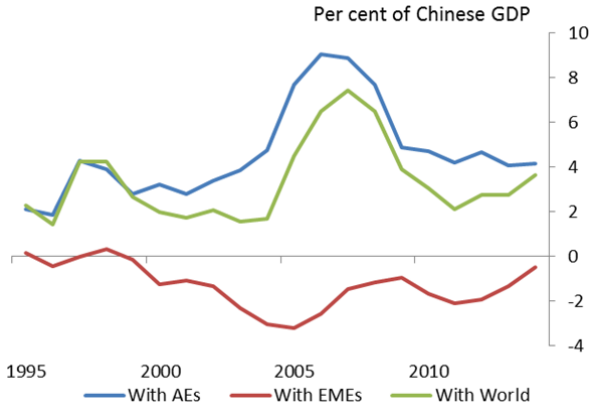
…and a 'global savings glut', which encouraged capital flows to EMEs.

Third, China's trade surplus contributed to a 'global savings glut', pushing down long-term interest rates around the world. That, in turn, contributed to a rebound in capital flows to other EMEs.

As China rebalances, these factors have started to reverse.

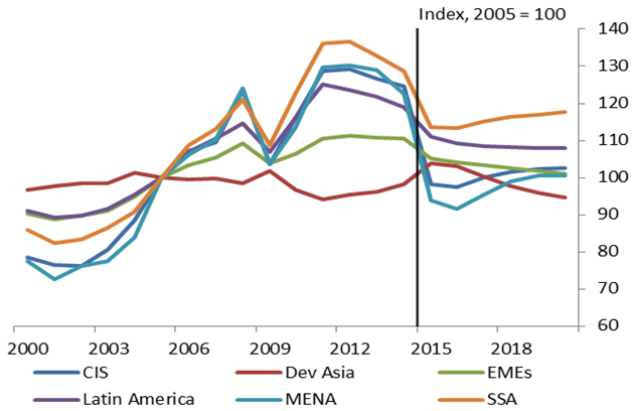
As China's economy started to rebalance towards domestic consumption, and away from investment and exports, all three factors started to reverse: China's potential and actual growth has slowed; its imports from EMEs (particularly of commodities) have slowed; and China's surplus with advanced economies has narrowed and it has started to sell reserves (although that has yet to put noticeable upward pressure on long rates, due to the emergence of excessive current account surpluses elsewhere).

Chart 3: Chinese nominal trade balances



Source: IMF Direction of Trade statistics

Chart 4: Terms of trade in EME regions: WEO forecast



Source: WEO

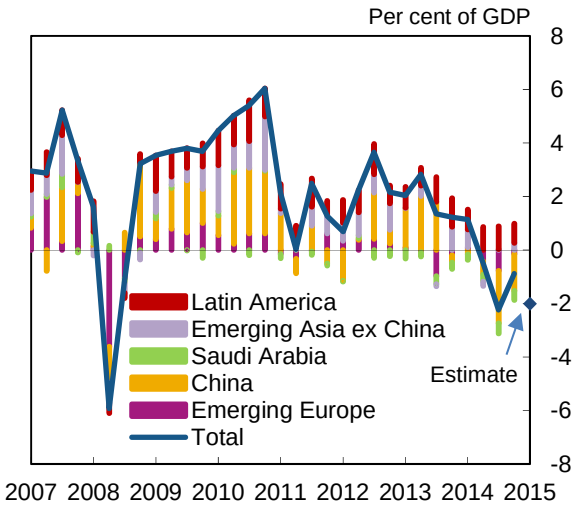
Commodity price fluctuations

2) Commodity price movements, linked to China's growth, have amplified growth cycles in EMEs.

Commodity price changes (due both to demand, particularly from China, and from supply developments) contributed to both the rise and fall of EME growth and potential growth. Commodity prices are highly correlated with EME growth. That is partly because EMEs account for around 50% of the world's demand for commodities, but also because net commodity exporting regions (Latam, MENA, CIS and SSA) account for 40% of EME GDP. Rising commodity prices cause net commodity exporters' terms of trade to improve. That in turn tends to increase profits, employment and real wages, and improves fiscal position, resulting in stronger investment and consumption. Higher investment also boosts the capital stock. The IMF estimate that commodity producers' GDP moves twice as strongly as potential output in response to a commodity price movement. The terms of trade appreciated substantially in all EME regions except Developing Asia over 2001-08, and again from 2009-11 following a brief reversal following the collapse of Lehman's. That improvement paused from 2012-14, and reversed substantially in 2015 (Chart 4). The IMF expects this to detract from growth in commodity producers over 2015-17 by around 1pp relative to 2012-14.

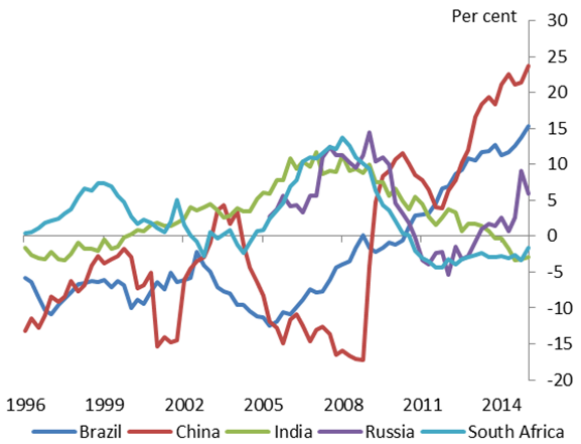
[2]For further details see 'China's changing growth pattern', by Ed Dew, Julia Giese, Jeremy Martin and Gabriele Zinna. http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110104.pdf

Chart 5: Net capital flows to non-China EMEs – with WEO forecast for 2015



Sources: IMF, IIF and Bank calculations.

Chart 6: Credit gaps in the BRICS



Source: BIS and Bank calculations. Notes: Credit-to-GDP gaps use a one-sided HP filter with a (BIS consistent) smoothing parameter of 400,000. Credit by all creditors to the domestic private non-financial sector.

Capital flows

3) Capital inflows probably boost EME growth by providing financing for investment, raising asset prices and reducing funding costs for domestic banks.

Capital flows from advanced economies and easy borrowing conditions in dollars during the Fed's QE programme also likely boosted EME growth and potential growth over the pre- and immediate post-crisis period, and may now be dragging. The link between capital inflows and GDP growth is indirect and variable. Studies suggest that FDI inflows have a positive impact on growth. Other types of flow have a less robust and stable impact[3]. Capital inflows can affect GDP by providing direct finance for investment, or by raising domestic asset prices, making it easier for firms to finance investment, and boosting the wealth of existing holders of domestic assets. They can also reduce funding costs for domestic banks, triggering an expansion of domestic credit[4] – again, leading to an expansion of investment and consumption. They can also boost potential supply growth by increasing investment and (particularly with FDI flows) facilitating the transfer of technology.

After high inflows during AE's QE, net inflows fell back sharply in 2015, particularly to China. But FDI flows, which matter more for growth, have been more stable

Over the 2001-2007, capital flows to EMEs recovered following their post-Asian crisis decline. That recovery coincided with cuts to advanced economy interest rates interest rates in wake of the dot-com bust, and later with the rise in China's current account surplus, which pushed down long rates. Following the 2008 crisis, when advanced economy interest rates were again cut and asset purchases undertaken, flows to EMEs (particularly portfolio investment) increased further. Over 2014-15 net inflows have fallen abruptly (Chart 5), particularly to China through banks,[5] but also via portfolio flows (according to the higher-frequency but less-comprehensive IIF data). But throughout this period, FDI flows – the only type of flow for which there is robust evidence for a positive impact on growth – have been remarkably stable.

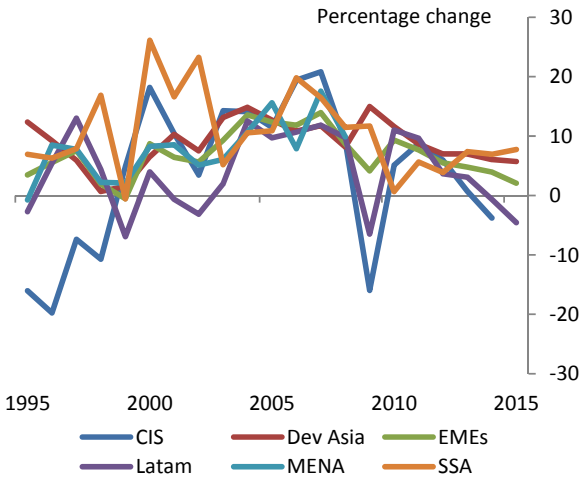
The pattern of credit gaps in large EMEs bears a loose resemblance to the pattern of capital flows to EMEs (Chart 6). Credit gaps increased in non-China EMEs during the mid-2000s. Brazil's credit gap continued to increase following the crisis, which could be related to loose global monetary

[3] Aizenman J, Jinjarak Y and Park D (2011), 'Capital Flows and Economic Growth in the Era of Financial Integration and Crisis, 1990-2010, NBER Working Paper 17502.
[4] Some studies find that non-FDI non-bond inflows have a significant positive impact on bank credit, e.g. Blanchard et al (2015) 'Are capital flows expansionary or contractionary? Theory, policy implications and some evidence', http://www.nber.org/papers/w21619.pdf
[5] The BIS attribute the Q1 outflow to the declining interest rate differential between China and the US, and an increase in currency volatility. See http://www.bis.org/publ/qtrpdf/r_qt1509u.htm

An increase in credit growth also contributed to growth in some EMs.

conditions and the resulting capital flows. But that that was not the case for South Africa, India or Russia, suggesting that capital flows were not the dominant driver of domestic credit. Likewise, investment growth in EMEs accelerated in the mid-2000s (Chart 7), perhaps partially due to the rise in capital flows and domestic credit growth – and the decline in 2015 in Latin America may partially be related to tighter credit conditions as capital flows have reversed and financial conditions have tightened.[6]

Chart 7: Investment in EMEs



Political and idiosyncratic developments

4) Most of the slowdown since 2013 has been accounted for by two countries – Russia and Brazil.

That reflects idiosyncratic domestic developments. But they were exposed by global developments, including lower commodity prices and capital outflows

Almost all of the slowdown since 2013 is accounted for by two regions: the Commonwealth of Independent States (CIS – dominated by Russia) and Latin America (Charts 1 and 2). That reflects weaker commodity prices and slowing capital inflows, but also idiosyncratic domestic factors. Vulnerabilities in individual countries have been exposed as EMEs and the world economy have slowed. In particular, Brazil and Russia, the largest economy in each region (which together account for 13% of PPP-weighted world GDP), have had a number of problems, and entered recession in 2015 and 2014 respectively. The weakness in the Russian economy reflects both weaker investment as companies face considerably tighter financial conditions (due to sanctions and sharply higher interest rates), as well as a sharp fall in consumption – the result of weaker real incomes as the depreciation of the rouble made imports considerably more expensive. In Brazil, the Petrobras scandal has led to a sharp reduction in investment. Previous fiscal overspend, coupled with tight monetary policy to bring inflation under control, mean that there is currently no policy space to support the economy (Table 1).[7] And the depreciation of the real has squeezed real incomes and worsened the balance sheets of firms borrowing in dollars.

The story for post-2001 growth

The post-2010 slowdown is a result of structural and cyclical factors

The combination of shocks from China, commodity prices, capital flows, and geopolitical events explains our view of the pattern of growth and potential growth since 2001 and the resulting pattern of the output gap (Chart 8). EME potential growth was initially boosted by China's transition, the rise in commodity prices and stronger capital inflows – but they boosted actual GDP by more, resulting in a positive output gap by 2007. Following the crisis in 2008, commodity prices and capital flows rebounded, again boosting both actual and potential growth. Over 2012-14 commodity prices stabilised and Chinese growth started to slow as it rebalanced towards domestic demand – resulting in slower actual and potential EME growth. And since 2014 political developments in Brazil and Russia have reduced demand there by more than potential supply,

[6] The IIF EME Bank Lending Survey shows conditions tightening in Latin America.
[7] For more details on Latin America

resulting in a more negative output gap.

Forecast errors suggest that we interpreted too much of the growth pickup 2000-07 as structural, and too much of the slowing post-2010 as cyclical.

The decline in potential output growth also goes some way towards explaining our forecast errors. Since 2011 we (along with other forecasters) have consistently overestimated growth (Chart 9) as potential growth has fallen, just as forecasters underestimated EME growth when potential was rising in the mid-2000s. That suggests that we tend to be slow at adjusting our expectations of potential supply growth, and tend to interpret too much of movements in output as cyclical rather than structural. If that were the case this round too, more of the recent slowing in EMEs would be structural, resulting in a more positive output gap.

Chart 8: EME actual and potential growth

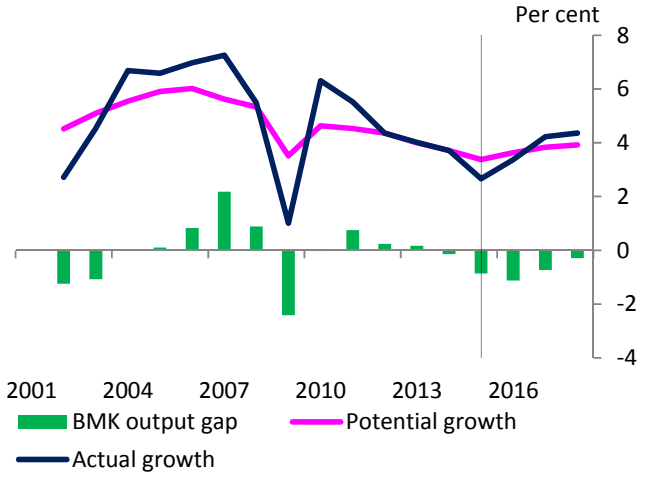
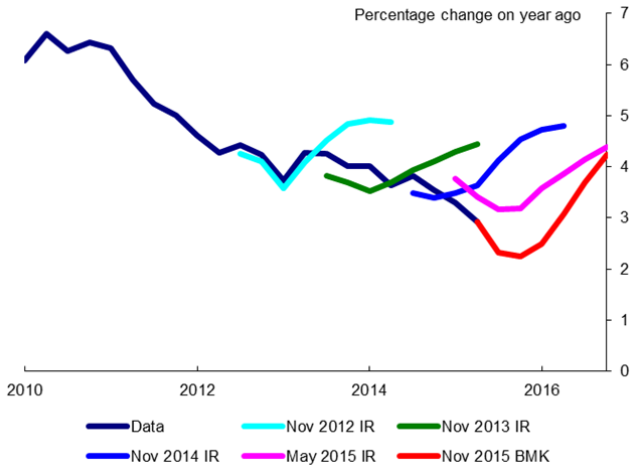


Chart 9: Recent EME growth forecasts



What are the prospects for EMEs over the forecast period?

Our forecast for non-China EME growth depends on several assumptions:

Prospects for non-China EME growth will depend on developments in Brazil and Russia, commodity prices, capital flows, China's rebalancing, and potential supply growth – as in the recent past.

Brazil and Russia

Activity in Russia is stabilising….

Most of the recent weakness in EME growth has been accounted for by Russia and Brazil. Recent indicators, including the PMIs, consumer and industrial confidence, suggest that activity is still declining in Brazil, but stabilising in Russia (Chart 10).

…but output continues to fall in Brazil, though we're past the trough in quarter-on-quarter growth.

In Brazil, we expect the steepest decline to have been in Q2, but we expect output to continue falling until the end of 2015. We expect Brazilian growth to pick up in 2016 and beyond, assuming that the political, and hence economic, situation improves as a coalition forms around necessary reforms.

We think that recent developments have affected demand more than supply (although they may have had some impact on supply), leading Brazil with a negative output gap. As uncertainty diminishes, we expect consumption and investment to rebound. There is, however, uncertainty around that. Brazil has very little policy space. Monetary policy is tight to bring high inflation under control, and previous fiscal overspend means that the focus is firmly on austerity.

In Russia, we expect the trough to have been in Q2. We expect output to stabilise this year provided relations between Russia and the West do not deteriorate. As with Brazil, recent

developments have probably affected demand more than supply, leaving Russia with a negative output gap, although they might also have a lasting impact on potential supply. Russia has some fiscal policy space, which it might use to help close the output gap if the private sector is slow to rebound (Table 1). But so far, the focus of policymakers has been on external balances (maximising reserves and a current account surplus) rather than the domestic economy.

Commodity prices

Past year's fall in commodity prices are not repeated, and as a result commodity producers' terms of trades stabilise.

The past years' fall in commodity prices is not expected to be repeated. The oil futures curve rises from $50pb in Q4 to $61 in 2018. Non-oil commodity prices are expected to be roughly flat. Chinese rebalancing mean commodity prices are likely to remain low as China is one of the largest commodity importers[8]. As long as prices do not continue to fall, commodity producers' terms of trade should stabilise (Chart 4). Once producers have adjusted to the new level of prices, investment should recover, as should confidence. Nonetheless, the lower level of investment is likely to reduce potential growth for several years, as the capital stock adjusts to a lower equilibrium level. We expect growth in commodity producers (which account for 39% of EME GDP) to rise gradually from 0.3% in 2015 to 1.5% in 2018.

Chart 10: PMIs in Russia and Brazil

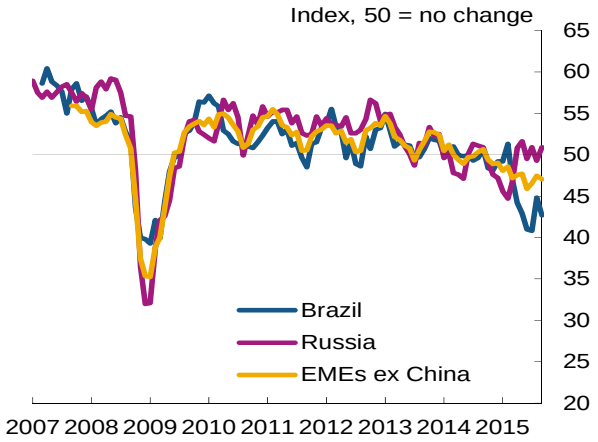
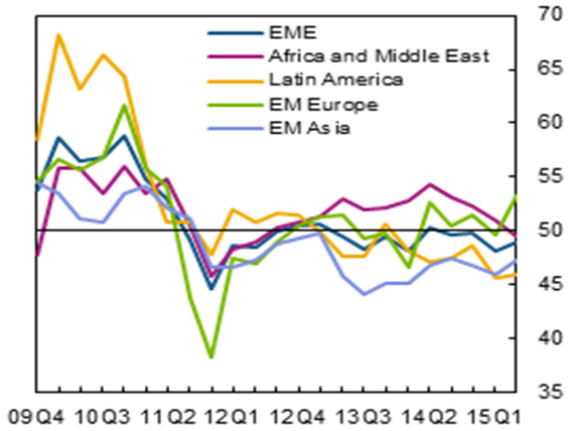
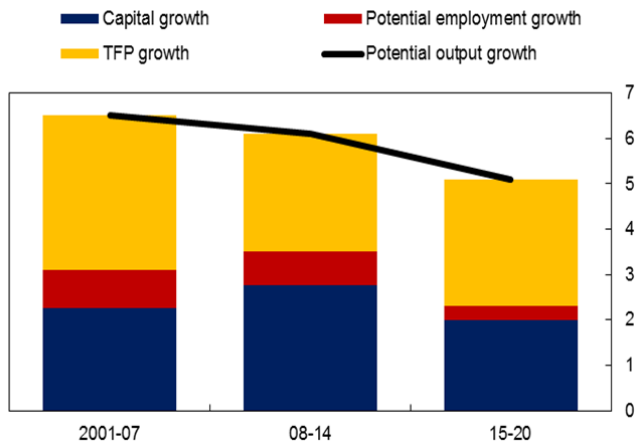


Chart 11: IIF EME credit conditions survey*



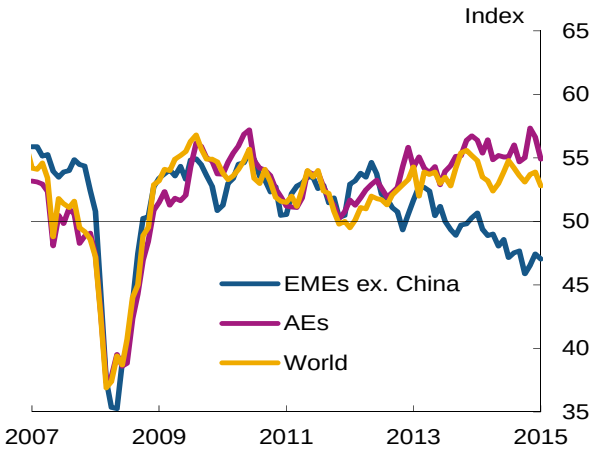
*Score under 50 indicates tightening
Source: IIF.

Chart 12: Contributions to potential output growth in EMEs – IMF estimates



Source: WEO, April 2015

Chart 13: Composite PMIs



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Similarly, we expect capital flows to stabilise…

Capital flows

Recent capital outflows have resulted in tighter financial conditions in EMEs, with bond spreads rising and equity prices falling. The IIF survey of credit conditions in EMEs shows conditions tightening, particularly in Latin America and Asia (Chart 11). That is likely to exert some downward pressure on investment, reducing both actual and potential growth relative to the immediate post-crisis period. However, as noted above, the link between non-FDI capital flows and GDP growth is not empirically strong. The forecast assumes that capital flows stabilise, such that asset prices and credit conditions do not continue to worsen.

… while Chinese growth to slow further, to 6% in 2018.

China's rebalancing

The structural slowdown in China will also contribute to slower trend growth in EMEs. As demand continues to rebalance from investment to consumption, capital deepening will slow. TFP growth is likely to slow as services account for an increasing share of output, and as China gets closer to the technological frontier. And demographic change means that labour supply growth is likely to slow. All these factors will contribute to a slowdown in potential output growth. We expect Chinese growth to slow gradually from 6.8% in 2015 to 6.0% in 2018.

Potential growth is expected to remain low.

Potential supply

We assume that potential supply in non-China EMEs will only recover slightly (Chart 8) over the forecast period. Low commodity prices and tight credit conditions will continue to weigh on investment, and therefore the capital stock. Persistent labour market slack will lead to hysteresis. And TFP growth will continue to be lower than in the exceptional 2001-07 period, in line with the IMF's estimates (Chart 12). Our estimate of potential growth in non-China EMEs in 2018 is 4.0%, below the 2001-14 average growth rate of 4.9%.

Chart 14: Non-China EME GDP growth in the November Benchmark forecast

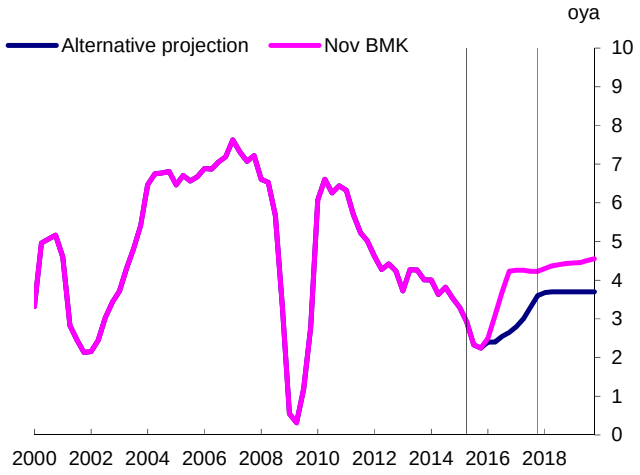
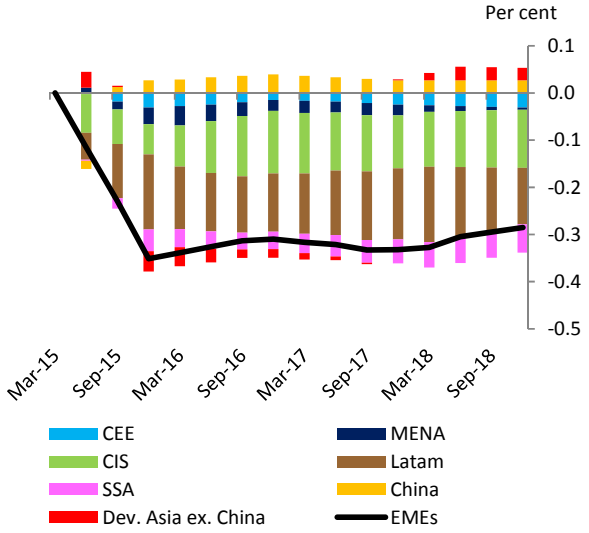


Chart 15: Contributions to world GDP level news relative to the August IR 2015



Prospects

In the near term, recent high frequency indicators for non-EMEs suggest growth rates have stopped falling. The PMIs for non-China EMEs were at 47 in 2015 Q3, unchanged from Q2 (Chart 13). Industrial production data point to a continued contraction. Equity prices (the MSCI EM index) have fallen, partly due to concerns over weaknesses in China, lower commodity prices and idiosyncratic risks in Brazil and Russia. But latest CPB world trade data showed some signs of a trade recovery in

EMEs in 2015 Q3.

The central forecast assumes non-China EME growth to have troughed at 0.8% in Q2 and Q3, followed by a gradual recovery.

The November Benchmark forecast for non-China EMEs growth in Q3 is 0.8%oqa, unchanged from Q2. That leaves annual GDP growth for non-China EMEs dipping further in late 2015, before rising to 4.4% in 2018, below its 2000-14 average of 4.9% (Chart 14).

We have revised down world growth relative to the August *IR*, particularly in the near term, reflecting developments in Russia and Brazil, stronger spillovers from a slowdown of Chinese GDP growth, and lower commodity prices. The downward revision is mainly to Latin America and the CIS (Chart 15).

Risks and alternative downside scenario

Two judgements, on which the central case is based, are particularly uncertain:

We judge that the risks around the central projection are currently to the downside. The central projection is based on a number of uncertain judgements. Two, in particular, should be highlighted.

Potential growth in EMs might be weaker…

The first judgment is on the rate of potential output growth (assumed to be around 4.0% for non-China EMEs in 2018). Potential output depends on several factors that are hard to forecast – particularly total factor productivity and investment. It is possible that the trend rate of TFP growth is lower than our current estimate, or that falling capital flows and commodity prices will affect investment to a greater extent than we anticipate. We have consistently been surprised by non-China EME GDP growth on the downside in recent years (Chart 9), mainly due to weakness in potential supply.

…and growth in Brazil and Russia could decline more persistently.

Second (and perhaps relatedly), output growth in Brazil and Russia could decline more persistently than we anticipate. That could be either because political events in Brazil and the policy focus in Russia (on external balances rather than the domestic economy) continue to suppress demand or result in lower potential output (through weak investment and hysteresis). Alternatively, a larger proportion of their current downturns could be turn out to be structural, with weaker trend TFP – together with labour market hysteresis and low investment – reducing potential output growth.

An alternative projection assumes non-China EME growth is 1pp weaker than the central projection.

We have therefore provided an alternative non-China EME projection, with a more pessimistic view of potential output, and a slower recovery from the weakness in Brazil and Russia (Chart 14). In the alternative projection, growth in non-China EMEs rises more gradually, to 3.7% in 2018, 0.7pp weaker the November Benchmark.

A more extreme alternative downside scenario would be if potential growth in EMEs slumps back to its 1981-2000 average of 2.3%. However, we view that as unlikely. Institutional quality has improved in many EMEs since that period. China and the former-Soviet dominated countries have, in practice, emerged from communism and joined the world trading system. While China's growth is likely to be slower than over the past 25 years, China's share of EME GDP is 2.6 times its 1990 share, so even at growth rates of 5-6%, its impact on EME growth will be larger. India implemented a major liberalisation programme in the 1990s that has resulted in a consistently higher growth rate. Latin America is far more politically stable. And macroeconomic management has improved, with many EMEs moving to inflation targets.

Table 1: Policy space

	PPP weight	Reserve adequacy	Fiscal policy space	Monetary policy space
Argentina	0.9			
Venezuela	0.5			
Turkey	1.4			
S Africa	0.7			
Poland	0.9			
Brazil	3.0			
Mexico	2.0			
Colombia	0.6			
Indonesia	2.5			
Russia	3.3			
India	6.8			
China	16.3			

Notes: Red indicates tight, amber medium and green lose policy space. Reserve adequacy (IMF measure) shown as red if below 100%, amber if between 100% and 150%, green if above 150%. Fiscal policy space is red if gross general government debt is > 50%, amber if 30% < debt < 50%, green if < 30%. Monetary policy space is red if inflation is above target, amber if within half a per cent (or near zero lower bound), and green below target. PPP weights in 2014.

What can the Asian Crisis tell us about EMEs today?

EMEs experienced large capital inflows during the post-crisis period. More recently, however, the expectation of the Federal Reserve raising its policy rate, the slowing Chinese economy, and low commodity prices, have led to capital outflows from EMEs. Most EMEs are less vulnerable to speculative attack than during the Asian Crisis, as they have larger foreign reserves, most do not have exchange rates pegs, and their current account deficits are smaller. But there are still downside risks as countries, such as Brazil and Indonesia, have experienced rising cumulative current account deficits as percentage of GDP over the past five years. Spillovers from EMEs could be stronger than those experienced during the Asian financial crisis as EMEs are now bigger and AE exposures to them are larger. And AEs have less room to cut policy rates to counter any negative spillovers.

The Asian financial crisis

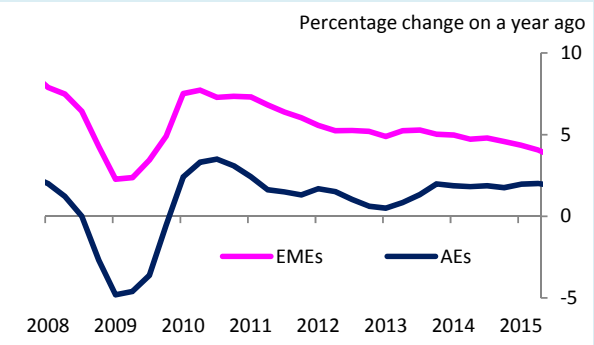
In the 1990s, loosening financial conditions in Japan and Europe, and strong growth in emerging markets, encouraged carry trades – investors borrowed from Japan and Germany to invest in EMEs, particularly in Southeast Asian countries with fixed exchange rates. This led to a large amount of capital flowing into the region, which in turn led to high credit growth, inflationary pressure and widening current account deficits. Thailand and Malaysia in particular experienced high current account deficits to GDP during the period.

During 1996 and early 1997, Thailand's growth began to slow, partly because of weaker growth in some of its trading partners and a weaker yen, which made its exports less competitive. This resulted in lower demand for baht. Thailand used its foreign reserves to maintain its peg to the US dollar. But speculative attacks intensified, and on July 2, they let the baht float. Indonesia and Taiwan devalued their currencies in subsequent months as capital flight spread across the region.

Capital inflows to emerging markets since 2010

There were large capital inflows to emerging markets during the post-2008-financial-crisis period, due to their relatively robust growth but more recently (**Chart A**) and relatively high interest rates. More recently, the expectation of the Federal Reserve raising its policy rates, slowing Chinese growth, and low commodity prices, have led to capital outflows from EMEs, particularly from those with weak macroeconomic fundamentals. That has put downward pressure on their domestic currencies. This, in turn, has tightened credit conditions for firms borrowing in foreign currency.

Chart A: EMEs vs AEs GDP growth (PPP-weighted)



However, most EMEs are now less vulnerable to speculative attack relative to the Asian-financial-crisis period. Their total-external-debts-to-GDP ratios have fallen, and their official-foreign-reserves-to-GDP ratios have risen since 1997 (**Chart B**). Moreover, most emerging markets adopt a flexible exchange rate regime. This makes them more able to adjust to shocks without major disruption. Furthermore, most EMEs have not been running such big current account deficits (**Chart C**). But some large countries, such as Brazil, Russia, Indonesia and Turkey, are still vulnerable to the attack as their foreign reserves countries have fallen, and their current account deficits as percentage of GDP have risen recently.

Chart B: EMEs' total-external-debt and official-foreign-reserves-to-GDP ratios

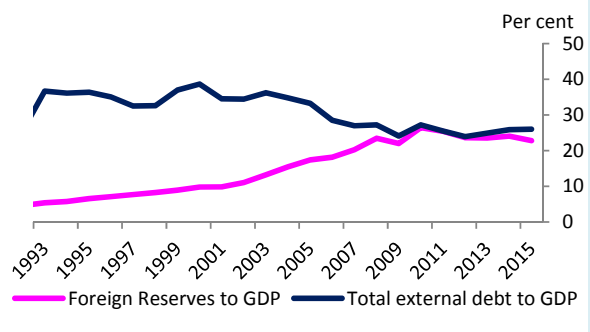
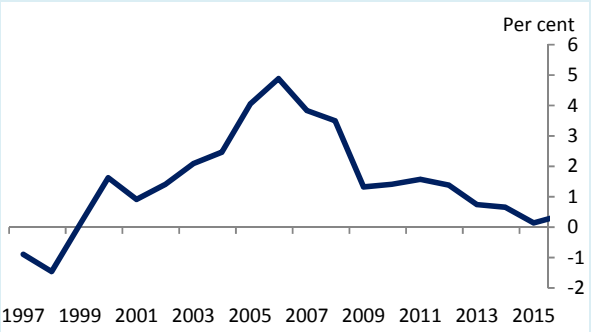


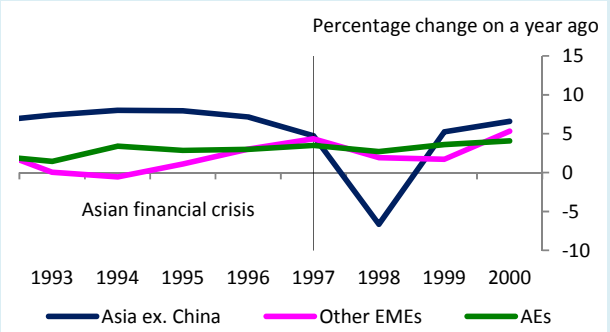
Chart C: EMEs net current account to GDP ratio



Spillovers during the Asian Financial Crisis

The Asian Financial Crisis led to a sharp slowdown and financial distress in Asia, but also spilled over to other regions (**Chart D**). It led to a slowdown of world trade and a fall in equity prices in advanced economies, particularly in Japan. Markets began to speculate against other vulnerable EMEs with fixed exchange rate regimes, particularly in Latam and Russia. In 1998-99, Russia experienced a currency crisis and defaulted on its debt – which in turn led to LTCM crisis.

Chart D: Asian Crisis countries and AEs GDP growth

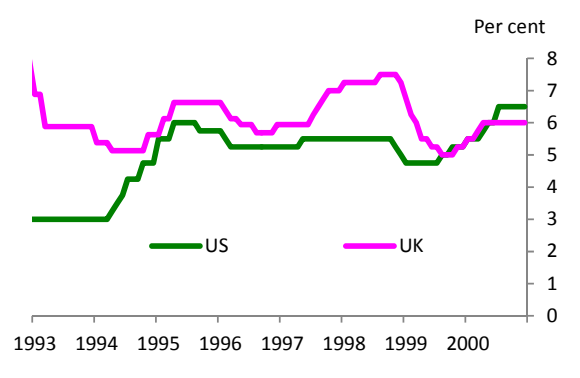


Note: countries included are 'Korea, Indonesia, Malaysia, Philippines, Singapore, Thailand, Hong Kong, and Taiwan'.

As a result, a number of advanced economies, including the UK, reduced their policy rates to counter the impact of the EME crisis. The US and UK reduced their policy rates by 0.5pp

and 2.0pp between 1998 and 1999, respectively (**Chart E**). Both the FOMC and MPC minutes mentioned the EME crisis as one of the reasons influencing their decisions. This, together with a more general loosening of financial conditions, led to a continuation of robust growth in AEs (**Chart D**). A COMPASS simulation suggests that if the UK had not lowered its policy rate during that period, its GDP would have been 0.8-1.0% lower after two years, with a peak effect on UK inflation of -0.5 to -0.7pp[1].

Chart E: Policy rates in advanced economies

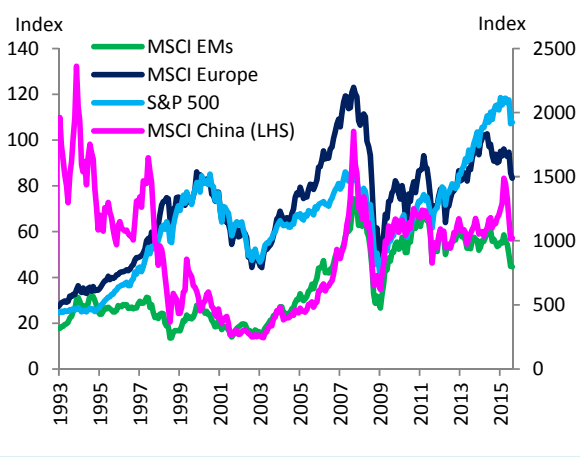


EMEs in global economy and financial system

EMEs are now bigger and more integrated with AEs than in the Asian Crisis period. The UK is also more exposed to EMEs via trade - the share of UK exports to EMEs has risen by 5pp since 1997 to 24% in 2015. Financial institutions in AEs also hold more assets issued by emerging markets. UK banks' and US banks' exposures to vulnerable EMEs are estimated to be around 240% and 40% of UK and US banks' CET1[2] capital, respectively. This implies that a slowdown of EMEs would affect AEs, including the UK, more via the trade and financial channels. Also, AEs have less room to cut policy rates than they did in the late 1990s.

The correlation between daily changes in equity prices in EMEs and AEs has remained high and roughly unchanged at 0.5[3]. This implies a high level of financial integration between AEs and EMEs (**Chart F**).

Chart F: AE and EME stock indices



[1] See 'How vulnerable is the UK to an EME downturn?' (2013) note

[2] CET1 is Common Equity Tier 1

3 The correlation is the average of the relationship between daily changes in the MSCI EMs and S&P500 and the daily changes in the MSCI EMs and MSCI Europe during 1997-1999 and 2013-present period.