

Press Points for Chapter 4: *How Linkages Fuel the Fire: The Transmission of Financial Stress from Advanced to Emerging Economies*

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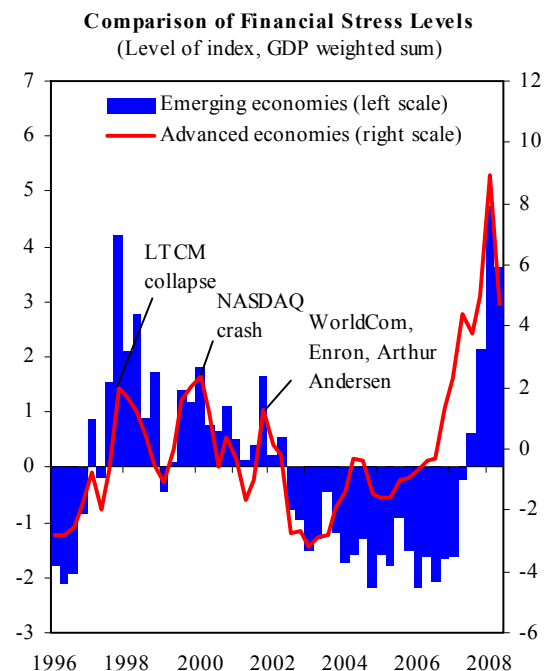
Key Points

- **Financial crises in advanced economies have passed through strongly and rapidly to emerging economies, with financial linkages a key channel of transmission.**
- **The decline in capital flows to emerging economies following a crisis may be protracted, given the solvency problems facing advanced economy banks who provide significant financing to emerging economies.**
- **A coordinated policy response by advanced and emerging economies is required, since reducing individual country vulnerabilities alone cannot insulate emerging economies from a major financial shock in advanced economies.**

Chapter 4 studies how financial stress is transmitted from advanced to emerging economies, using a new financial stress index for emerging economies. Building on a similar index introduced in the October 2008 World Economic Outlook for advanced economies, the index for emerging economies captures developments in equity markets, exchange markets, and the banking sector. It is available for 18 emerging economies on a monthly basis since 1997.

Analysis using this index reveals that, in the past, financial crises in advanced economies have passed through strongly and rapidly to emerging economies. In line with this pattern, the unprecedented spike in financial stress in advanced economies in the third quarter of 2008 had a major effect on emerging economies. In the fourth quarter, financial stress was elevated in all segments of financial systems in all emerging regions, and on average exceeded levels seen during the Asian crisis (first figure).

The extent of transmission of financial stress is related to the depth of financial linkages between advanced and emerging economies,



notably through bank lending. On average, stress in emerging economies moves almost one-for-one with stress in advanced economies, but there is significant cross-country variation. The empirical analysis of stress co-movement shows that stronger financial (i.e., banking, portfolio, and Foreign Direct Investment or FDI) linkages with advanced economies are associated with higher pass-through of financial stress. During the most recent crisis, bank lending linkages appear to have been the main driver of stress transmission.

Close bank lending ties between emerging and western Europe are important factors behind ongoing financial turbulence in emerging Europe.

Since the mid-1990s, Western European banks have dominated bank lending flows to emerging economies. By end-2007, their assets in emerging economies reached 10 percent of the GDP in advanced economies, compared to a combined 2.5 percent of GDP for Canadian, Japanese and U.S. banks. Claims on emerging Europe, measured relative to its own GDP (destination GDP), stand out as highest among emerging regions (second figure),

Historical evidence suggests that the key role played by banks in the current crisis may presage a protracted decline in capital flows to emerging economies.

Evidence from past episodes of systemic banking stress in advanced economies (the Latin American debt crisis of the early 1980s and the Japanese banking crisis of the 1990s) shows that the decline in capital flows tends to be sizeable and drawn out. Given their large exposure, emerging European economies might be heavily affected.

A coordinated policy response by advanced and emerging economies is required to prevent further escalation and spreading of financial stress. Reducing individual country vulnerabilities cannot insulate emerging economies from a major financial shock in advanced economies. The chapter finds that stronger current account and fiscal balances do little to mitigate the transmission of financial stress from advanced economies in periods of financial crisis. However, they may help dampen the impact on the real sector of emerging economies and help reestablish financial stability and foreign capital inflows once financial stress subsides.

