PRESS POINTS FOR CHAPTER 4: *ON THE RECEIVING END? EXTERNAL CONDITIONS AND EMERGING MARKET GROWTH BEFORE, DURING, AND AFTER THE GLOBAL FINANCIAL CRISIS*
World Economic Outlook, Spring 2014

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Key Points

Emerging markets are being challenged by an external environment that is less supportive of growth than during the precrisis period. Moreover, internal factors are also pulling growth lower in recent years in many countries. Policymakers must better understand these internal factors to ensure growth resilience regardless of the external backdrop.

External factors—external demand and financing conditions and terms of trade—explain nearly half the variance in emerging market growth.

- A 1 percentage point rise in U.S growth raises emerging market (EM) growth by 0.3 percentage points on impact. The cumulative effect stays positive beyond two years, despite the associated rise in U.S. rates.
- A 100 basis point rise in EM sovereign bond (EMBI) yield shaves ¼ percentage point off their growth.
- Within EMs, a 1 percentage point rise in China's growth immediately boosts growth in other EMs by 0.1 percentage points. The positive effect rises over time as EM terms of trade further improve.

External factors accounted for half or more of the cyclical fluctuations in EM growth during the past 15 years, but with differences over time and among countries.

- These factors dominated in determining the decline in EM growth in the early 2000s and in 2008-09, reflecting the drag from reduced external demand during the two advanced-economy recessions.
- In contrast, internal factors were more dominant in strong EM growth uptake in 2006-07, although external factors also helped as commodity prices were strong and EMBI yield low.
- During the past two years, internal factors in some EMs have persistently held growth below the level expected given current external conditions.

In contrast to the favorable external environment that existed before the crisis, during the next few years EMs will need to navigate through conditions that will be less conducive to growth.

- On the one hand, EM growth will be supported by higher growth in advanced economies.
- On the other hand, the expected slowdown in China and somewhat tighter external financing conditions will weigh on EM growth.

Nearly half the variance in emerging market (EM) growth is explained by external factors, including advanced economy (AE) growth, external financing conditions as indicated by EM sovereign bond (EMBI) yields, and EM terms of trade growth. However, not all EMs are alike, and external factors play a less important role in relatively large or less-open economies such as China and India. Over the past 15 years, China's growth in fact has become a significant contributor for growth in other EMs.

EM growth is boosted by a rise in AEs growth despite the associated higher global interest rates. A 1 percentage point increase in U.S growth raises EM growth by 0.3 percentage points on impact. The cumulative effect remains positive even after two years. The U.S. growth increase raises the U.S. 10-year Treasury bond rate by 25 basis points after one year and by 65 basis points after two years.

Tighter external financing conditions that are unrelated to a recovery in AEs hurt EM growth. A 100 basis point rise in the composite EMBI yield reduces EM growth by ¼ percentage point on impact. The negative effects linger beyond one to two years. A higher risk premium on the U.S. corporate bonds also has adverse effects on EM growth.

Within EMs, China's growth stimulates growth in other EMs. A 1 percentage point rise in the former boosts the latter by 0.1 percentage points on impact. The effect rises over time, as EMs get a boost to their terms of trade.

A rise in EM terms of trade that are unrelated to external demand has a small positive effect on EMs' growth, and this lasts about a year. The relatively limited effect reflects the fact that these terms-of-trade changes may be driven by supply shocks.

During the past 15 years, external conditions have often driven cyclical fluctuations in EM growth, although there have been differences over time and among countries.

- As shown in Figure 1, external factors have frequently contributed more than internal factors in explaining deviations in EM growth from the estimated averages during 1998-2013. In particular, the sharp decline in EM growth during the global financial crisis and during the recession in AEs in the early 2000s was largely explained by external factors.

- In contrast, internal factors dominated in explaining the upswing in EM growth before the Great Recession, although the external environment also helped. Indeed, the likely effect of most external factors was to boost EM growth in the mid-2000s, given reasonably strong AE growth, beneficial EM terms of trade, and easy EM financing conditions.

- China's growth has also greatly influenced growth in other EMs. The strong stimulus-driven rebound in China's growth during the Great Recession provided a buffer for growth in other EMs. The situation has reversed more recently with the deceleration of China's growth.

Looking ahead, EMs may have to deal with an environment that is less conducive to growth.

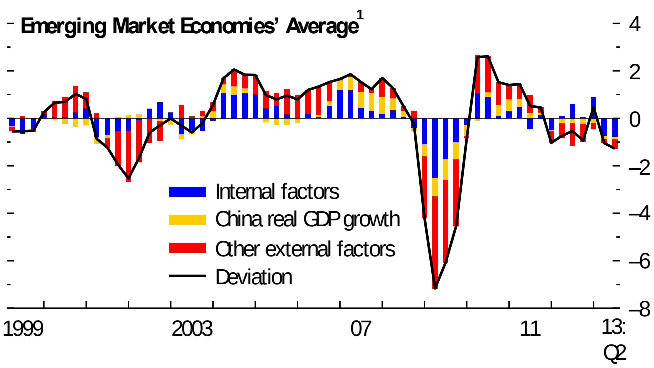
- In contrast to the run-up to the global financial crisis, not all external factors will support EM growth in the future. Whereas AE growth should pick up momentum, EM's external financing conditions and terms of trade will be less supportive. Moreover, China will transition into a more sustainable but lower pace of growth, and this will temporarily weigh on other EMs.

- Also, for many key EMs besides China, internal factors have been pulling growth below the level expected given current external conditions (Figure 2). The persistence of these factors suggests that trend growth is likely to be affected as well.

Policymakers must delve into these internal factors and assess what, if anything can be done to reignite growth, without generating macroeconomic imbalances.

Figure 1. Historical Decomposition of Real GDP Growth with China as an Explicit External Factor
(Percentage points)

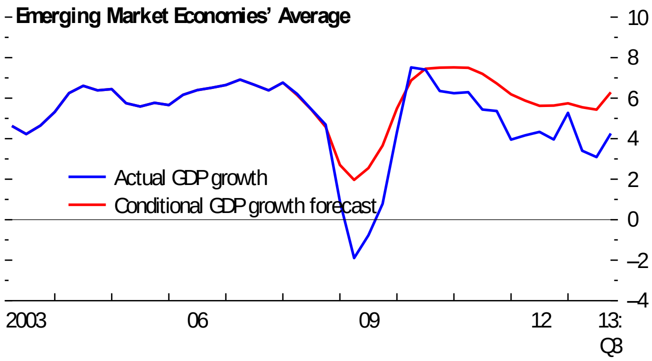
China has been an important offset to other external factors in explaining changes in emerging market growth. During the global financial crisis, China's expansion provided a buffer for emerging market growth. China's recent slowdown, however, has reduced emerging market growth.



Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: See Figure 4.8 in Chapter 4 of the April 2014 WEO for details.
[1]Average for all sample economies except Argentina, China, Russia, and Venezuela.

Figure 2. Out-of-Sample Growth Forecasts Conditional on External Factors
(Percent)

For many key emerging market economies, internal factors have been pulling recent growth below the level expected given current external conditions. The persistence of these factors suggests that trend growth is likely to be affected as well.



Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: Average conditional growth forecasts from two alternative specifications of all sample emerging market economies except Argentina, Russia, and Venezuela. See Figure 4.12 in Chapter 4 of the April 2014 WEO for details.