

FOCUS · Growth in the emerging economies and global financial conditions: a close relationship

The emerging economies are enjoying an invigorating economic momentum: since the Great Recession of 2009 and up until 2017, they grew at slightly more than 5% per year and are expected to continue to grow at this rate for the next five years, according to analysts' forecasts. As we have emphasised in other articles,¹ there should be no doubt that part of the economic boost stems from the unprecedented loosening of global financial conditions which began following the Great Recession. However, now that the monetary policy of developed countries is shifting towards a slow but relentless path to normalisation, the key question is to what extent the future tightening of global financial conditions will erode their economic growth.

Historically, the relationship between growth in the emerging economies and indices for global financial conditions has been very close.² Clearly, a correlation does not imply causation, but if we use more sophisticated econometric techniques, the correlation between the two set of variables remains very high. Specifically, we have analysed the ability to explain GDP growth in emerging countries of three benchmark indicators: financial conditions,³ geopolitical factors⁴ and financial volatility (VIX). These global factors account for a large part of the variance in growth, specifically 70% during the period between 2007 and 2012, the years most heavily affected by the Great Recession and by the introduction of non-conventional monetary policy, and 55% during the period between 2013 and 2017. Of the total variance explained, financial conditions are the most significant factor during both periods. What is more, this factor becomes increasingly important as we move away from the financial crisis (see first chart).

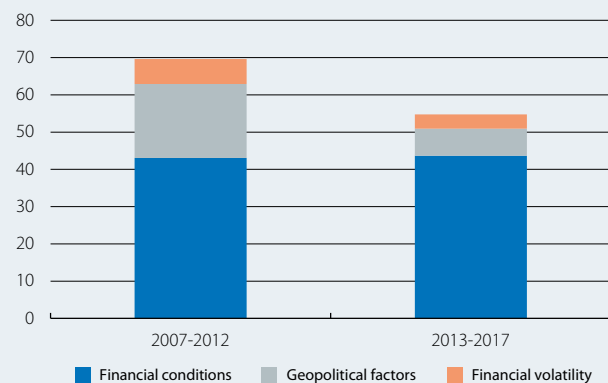
In order to sharpen the analysis of the impact the tightening of financial conditions could have on the growth of emerging markets, we have analysed the impulse-response functions of a VAR model (see second chart). The shock we have applied to the emerging economies corresponds to a 1.5 point tightening of the

financial conditions index. A tightening of this magnitude seems reasonable if we analyse how financial conditions have historically evolved during periods of rising interest rates in the US, together with the outlook for the next few years.⁵ It turns out that a tightening of the financial conditions of this nature, if it were to occur suddenly, would have an impact on the growth of the emerging markets of around 1 pp after two quarters. This magnitude is far from negligible.

Of course, we expect that the tightening of financial conditions will occur much more gradually, which should allow the emerging economies to continue to maintain a high rate of growth. However, if the Fed has to accelerate the pace of interest rate hikes, for instance due to wage and/or inflationary pressures increasing more than expected, the impact on emerging countries could be remarkable.

Global factors that explain the growth of emerging markets

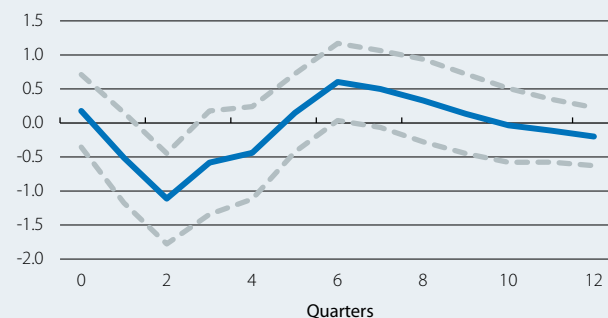
Contribution of each factor to the explained variance (%)



Source: CaixaBank Research.

Response of the growth of emerging markets to a global financial shock

(pps)



Note: A fourth-moment vector autoregression is estimated, including quarterly data on the growth of emerging economies, the global financial conditions index and the VIX index. The broken lines represent a 95% confidence interval.

Source: CaixaBank Research, based on data from the IMF, Goldman Sachs and Thomson Reuters Datastream.

1. See CaixaBank's MR02/18 for example.

2. Indices for global financial conditions are scarce. In this regression analysis, we use the global financial conditions (GFC) index by Goldman Sachs. This index summarises financial conditions by integrating information from different financial assets (interest rates, spreads, stock market prices and exchange rates) relating to a set of developed and emerging countries.

3. We have included the Goldman Sachs GFC index, the Federal Reserve Bank of Chicago GFC index, the S&P 500, the MSCI Emerging Markets index and the Bloomberg emerging stock markets index.

4. We have used the Iacoviello and Caldara risk index, the CaixaBank Research conflicts index and the global political uncertainty index by Baker, Bloom and Davis.

5. An additional benchmark is that in April 2013, during the episode known as «taper tantrum», this index rose by 1 pp in just two months.