Since the episode known as the "taper tantrum"[1] in May 2013 until last spring emerging markets have remained notably stable. Although there were some negative reactions to both global and idiosyncratic shocks, over time these became less substantial, shorter and more restricted to a smaller geographical area (see Chart 1). The decrease in the vulnerabilities of these economies in various aspects – such as the reduction of political instability, the greater soundness of their banking systems or their lower dependence on external financing –, the absence of monetary policy surprises in the advanced markets and the rebound of growth and global commerce explain, to a large extent, these developments.

However, the situation changed in mid-April 2018. In the United States, the interaction between the process of monetary policy normalisation and the fiscal expansion approved by the current administration led to an increase in short and long-term rates, to substantial capital inflows and to a strong appreciation of the dollar, factors which have tightened global financial conditions. This new environment is particularly adverse for emerging economies which still have strong external imbalances (high current account deficits and external debt) and relatively low volumes of international reserves.

The deterioration in the emerging financial markets became more pronounced during the summer months, in the face of growing concerns associated with the adoption of protectionist measures and rising geopolitical tensions. The worsening occurred in two phases, with an initial temporary episode of increased volatility around mid-June and a subsequent one, starting at end-July, triggered by the problems specific to Argentina and Turkey and, to a lesser extent, by those of other large emerging market economies. This led, in the third quarter of the year, to a strong outflow of capital ($25 billion, especially in equities – see Chart 2) and a stagnation of fixed-income issuance (declining by 54% in comparison with summer last year).

Although most emerging countries were affected by these events, some degree of market discrimination has been observed (see Chart 3). Thus, the countries whose stock market prices underwent more corrections were those that were more integrated in global trade and, in particular, in China's production chain. Specifically, the Asian stock market as a whole fell from mid-April by 11% (with sharper declines in Hong Kong, Korea and China). The currencies which depreciated the most against the dollar were those of countries with more internal or external vulnerabilities, such as the Argentine peso (-29%), the Turkish lira (-27%), the South African rand (-13%) the Russian rouble (-11%) and the Brazilian real (-8.5%) (see Chart 4). Conversely, the Mexican peso appreciated by almost 7% since mid-June, following the presidential elections and the preliminary agreement reached for a new trade deal with the United States. In contrast with these changes in the stock market and exchange markets, sovereign spreads and the implied probability of default in sovereign CDS prices have hardly changed, except in Turkey and Argentina.

Overall, the magnitude of the most recent phase of turbulence is comparable to that observed when the Chinese stock exchange experienced a profound correction in 2015, although it is still clearly milder than that evidenced during the "taper tantrum" (see Chart 1). Also, unlike during that event, a widespread sell off has not been observed yet. The factors that are containing the effects of the current bout of volatility on the emerging economies as a whole include the high volume of international reserves – which, excluding China, is very close to the all-time high in 2013 (see Chart 5) –, the improvement in economic fundamentals and, especially, the authorities' response to the turbulence.

However, Turkey and Argentina, the two most affected economies, have certain idiosyncratic elements of vulnerability. In Turkey – where GDP grew by 7.3% in 2017, inflation is around 18% and the current account deficit stands at around 6% of GDP – the main source of vulnerability comes from foreign currency indebtedness of the private non-financial sector, partly channelled through banks whose balance sheets display a very high and growing short-term debt burden in foreign currency, which is reflected in a strong worsening of their net external position (see Chart 6). Dependence on external finance has grown as a result of the guarantees provided by the State for the granting of certain loans. Although banks' net foreign currency funding positions were provisioned in their balance sheets, some of these foreign currency loans were granted to firms in non-tradable sectors for which, therefore, there are few natural hedges against the strong exchange rate depreciation currently experienced by this economy, which could derive in an increase in non-performing loans. Against this backdrop, uncertainties about central bank independence and the mounting political tension with the United States, which led to a series of trade sanctions, triggered a very negative reaction in the markets. Initially, the response from the authorities focused on alleviating the banking sector's situation at short term. Regulatory changes easing the classification criteria for loans in default were introduced, the calculation of capital at non-current exchange rates was allowed and the cost of short positions in lira was increased, thereby providing liquidity to the system through the reduction of reserve requirements. Additionally, a bilateral loan was arranged with Qatar, which announced a €15 billion direct investment in Turkey, and the two central banks entered into a swap agreement for an additional €3 billion.

In Argentina, both the sources of vulnerability and the response from the authorities were different. Specifically, it was the public sector which had significantly increased its foreign indebtedness in recent years, thanks to ample international liquidity and a high global appetite for risk (see Chart 7). The new government aimed to reduce the large inherited imbalances through a budgetary programme

1 "Taper tantrum" is the term used for the period of instability in the financial markets which followed the Federal Reserve's announcement that it would gradually reduce the volume of Treasury bond purchases within the framework of its quantitative easing programme. The financial markets reacted to this announcement with a strong appreciation of the dollar against emerging economies' currencies and high capital outflows from these economies.

Chart 1
MARKET REACTION DURING EPISODES OF TURBULENCE (a)

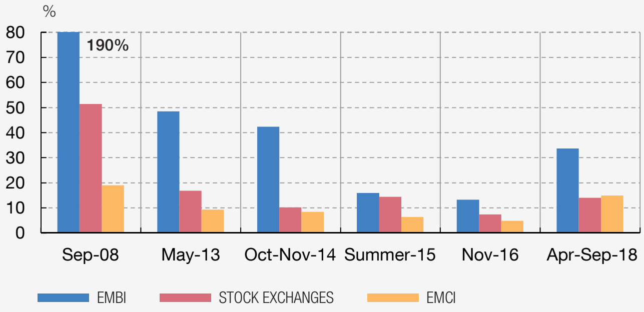


Chart 2
CHANGES IN CAPITAL FLOWS (b)

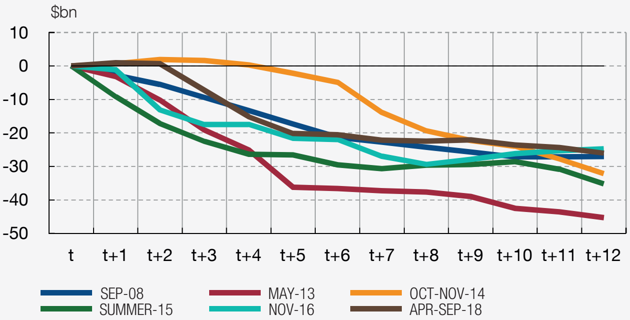


Chart 3
EMERGING MARKET STOCKS

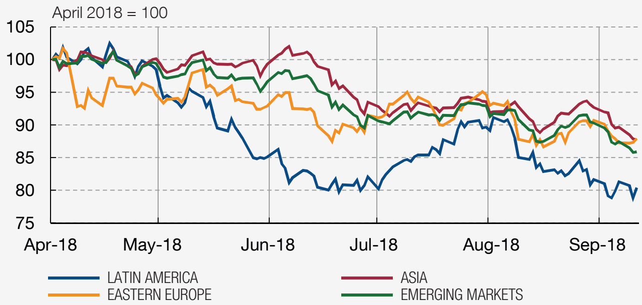


Chart 4
EXCHANGE RATES AGAINST THE DOLLAR

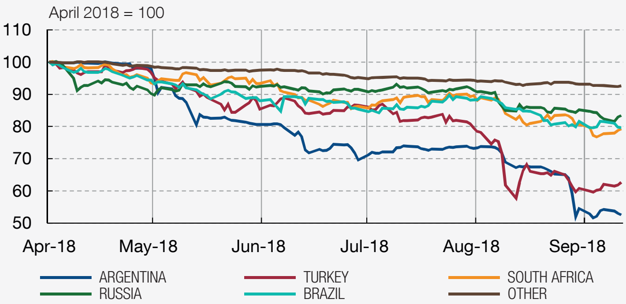


Chart 5
INTERNATIONAL RESERVES

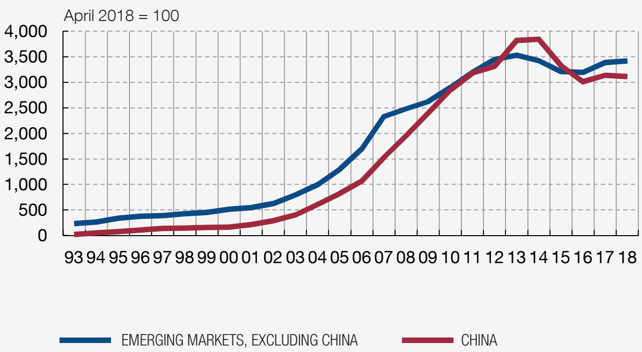


Chart 6
VULNERABILITY INDICATORS IN TURKEY (c)

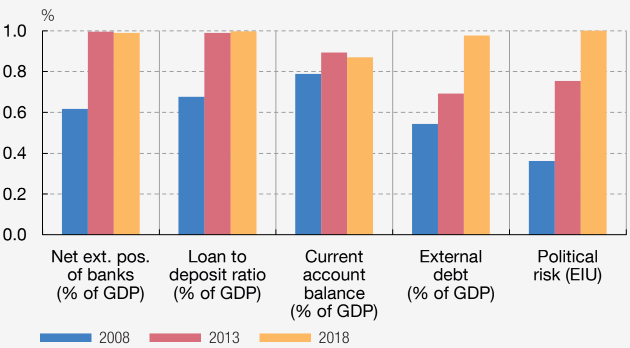


Chart 7
VULNERABILITY INDICATORS IN ARGENTINA (c)

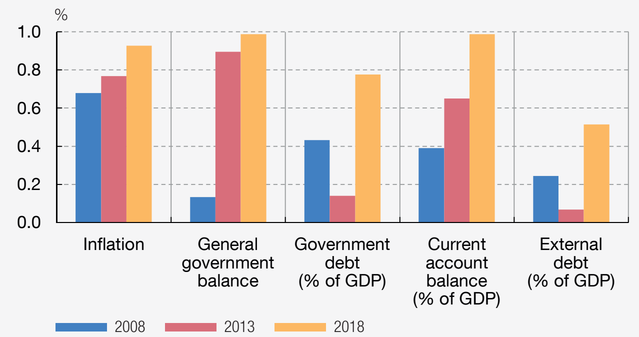
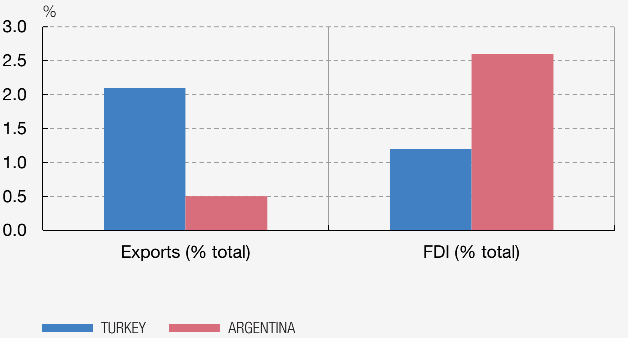


Chart 8
SPAIN'S EXPOSURE TO TURKEY AND ARGENTINA



SOURCES: Banco de España, Datastream, IIF and JP Morgan.

a The bars denote an increase in the risk premium, falls in stock markets and exchange rate depreciation. The dates refer to the collapse of Lehman Brothers (September 2008), the taper tantrum (May 2013), the plunge in oil prices (October and November 2014), China's stock market crash (July and August 2015) and Trump's US presidential election victory (November 2016).
b Weekly changes following the onset of the event indicated in note (a).
c Risk percentile in a historical distribution since 1993 where each indicator was plotted for each of the years represented. An increase denotes an increase in risk.

whose pace of adjustment was so gradual that it was hardly able to reduce the structural primary deficit. Confidence in the correction of imbalances was further damaged when the government eased its inflation targets and the central bank lowered interest rates. Against this background, tightening international financial conditions and a severe drought which reduced agricultural production and exports gave rise to a strong capital outflow and a depreciation of the peso which the authorities tried to counter through foreign exchange market intervention, higher official rates and, finally, the request for assistance from the International Monetary Fund (IMF).

The Spanish economy's exposure to these two economies through the trade channel is moderate, with the foreign investment and banking channels being more important (see Chart 8). Specifically, in 2017 Turkey was the eleventh export market for Spain (the fourth outside the EU) and Argentina was the 35th. Spanish goods exports to Turkey that year, mainly consisting of manufactured goods, accounted for 21% of the total (0.5% of GDP, slightly lower than the 0.6% relating to the EU) and grew at a slower pace than imports. Sales of goods to Argentina only accounted for 0.5% of Spain's total goods exports (0.1% of GDP), although they grew more than imports. As regards financial relationships, Turkey is the 19th most important market in direct investment, accounting for 1.2% of Spanish total assets abroad, concentrated in the banking and insurance sectors (40% and 12%, respectively, of the total). Argentina accounts for 2.6% of total direct investment assets abroad (ranking 12th), with predominance of the financial and telecommunications sectors.

During the early weeks of September, emerging markets overall tended to stabilise. Several central banks' responses, in the form of raising policy rates (Czech Republic, Indonesia, India and Philippines), intervention in the foreign exchange markets (India and Hong Kong) and a series of measures adopted by China to sustain short-term growth and stabilise the renminbi, contributed to calm the markets. The two countries most affected by the shocks have also adopted orthodox economic measures. Thus, Turkey's central bank raised interest rates significantly, to 24%, while Argentina's monetary authority increased the policy interest rate to 60%. The Argentine government also announced an important fiscal adjustment (seeking to obtain a balanced budget in 2019 and a primary surplus of 1% of GDP in 2020) and at the same time requested an advance on the disbursement of funds envisaged in the agreement entered into with the IMF.