

The financial strains recently experienced by some emerging market economies (EMEs) reflect growing global interdependence, which has accentuated these countries' exposure to international economic and financial events. Specifically, in the past year, EMEs have been shaken by the effects of the trade tensions between China and the United States, and to those arising from the US fiscal and monetary policy mix, which have prompted an appreciation of the dollar and a tightening of international financial conditions.¹

However, the deterioration in the EMEs' financial indicators has not been uniform; rather, investors have taken the degree of vulnerability of the different countries into account in their portfolio decisions, as was the case in previous bouts of turbulence linked to changes in US financial conditions, the so-called "taper tantrum" from May to August 2013 being a case in point. Specifically, in the episode from April to September 2018, the financial tensions particularly affected those economies with sizeable vulnerabilities, in particular in terms of a weak external position (see Charts 1 and 2). The two countries that most suffered in this phase of instability were Argentina and Turkey, which have already been the subject of recent detailed analysis.²

This box assesses the current degree of vulnerability in EMEs as a whole, before focusing on the most relevant countries, either in terms of their weight in global activity and their systemic relevance (as is the case of China), or because of their importance to the Spanish economy (Brazil and Mexico).³

The indicators habitually used to examine the emerging economies' vulnerabilities include some relating to their external position (current account balance, external debt and international reserves), their fiscal stance (budget deficit and public debt), their macroeconomic situation (GDP growth and inflation), the soundness of their banking systems (credit growth, traditional funding via deposits versus external financing) and political risks.⁴ In aggregate terms, when considering this set of indicators the diagnosis about whether the degree of vulnerability is higher or lower currently compared with the aforementioned episode in

2013 is not clear, since some of these indicators have improved, but others have worsened (see Chart 3). In particular, inflation has fallen compared with five years earlier (from 5% to 3.8%), growth rates have remained high (slightly over 5% in both cases) and the situation of the banking sector is sounder (their banks' net external assets have risen from 0.5% to 2% of GDP). Conversely, the fiscal margin has now diminished (the average deficit has dipped from 2.1% of GDP in 2013 to 3.5% in 2018 Q1), public debt and external debt ratios have risen, international reserves have fallen and the geostrategic risk indicators and domestic political tensions are greater than they were in 2013.⁵ Furthermore, from a shorter time perspective, the emerging economies' vulnerability has increased in the external and fiscal arena since early 2017.

As to the three individual economies considered, the main risks in the case of Brazil are in the fiscal domain, since the budget deficit has been standing above 7% of GDP for three years and public debt has climbed to 77.2% of GDP, a historical high (see Chart 4). Against this background, it is essential to curb the expected high growth of Social Security spending, through the reform of the pension system, which has been pending for over a year.⁶ Further, there are several factors of vulnerability in some financial institutions, including banks and investment funds, which have absorbed a very high proportion of new government debt issues, and in public-sector banks, owing to the segmentation of credit markets (in which almost half of total loans have been granted at subsidised interest rates by public banks, as opposed to the rest, granted at higher rates – and with bigger margins – by private banks, which are concentrated in segments such as consumer credit). These factors have given rise to a deterioration in the sector's valuation by analysts and investors. However, other indicators have tended to improve recently. The usual indicators of political uncertainty, which had risen owing to the uncertainty surrounding the presidential vote, have abated following these elections. Moreover, Brazil has managed to adjust its current account deficit in recent years (from 4.4% of GDP in early 2015 to 0.5% in 2018, Chart 4), meaning external debt has fallen slightly. Inflation, meanwhile, has been substantially cut from 10.8% on average in 2015 to 4.5% in September 2018. Finally, reserves stand at historical highs (\$338 billion), with very limited exposure by the public sector to the external sector.

The fiscal position is also a factor of vulnerability in Mexico, although the imbalances are far lower than in Brazil: the budget deficit has held at between 2.5% and 3% of GDP since 2010, while public debt increased by more than 10 pp from 2010 to 2016, stabilising thereafter at around 45% of GDP (see Chart 5). On the contrary, the current account imbalance and external debt

1 Box 2 ("Recent turbulence in emerging markets") of the "Quarterly Report on the Spanish Economy", *Economic Bulletin* 3/18, Banco de España, describes the tensions experienced this year by these economies.

2 See the reference in footnote 1.

3 See Molina L., E. Alberola and E. López (2016), "El posicionamiento exterior de la economía española", Documentos Ocasionales, No 1602, Banco de España, in which a hierarchy is established of the significance of various economies to Spain, based on goods export figures, tourism revenues, non-tourist services exports and direct investment assets.

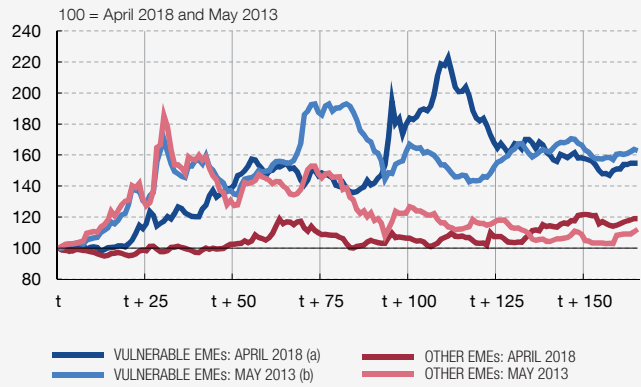
4 The identification of these variables is based on various models of foreign exchange and banking crises: Krugman, P. (1979), "A model of Balance of Payments crises", *Journal of Money, Credit and Banking* Vol.11; Obstfeld, M. (1986), "Rational and Self-fulfilling Balance-of-Payments Crises", *American Economic Review*, Vol. 76(1); Eichengreen, B. and R. Hausmann (1999), *Exchange Rates and Financial Fragility*, NBER WP 7418.

5 In some of these indicators, the deterioration observed is due to the Chinese economy. Specifically, if China is excluded, an increase in international reserves and a reduction in the current account deficit of almost 0.6 pp of GDP can both be seen.

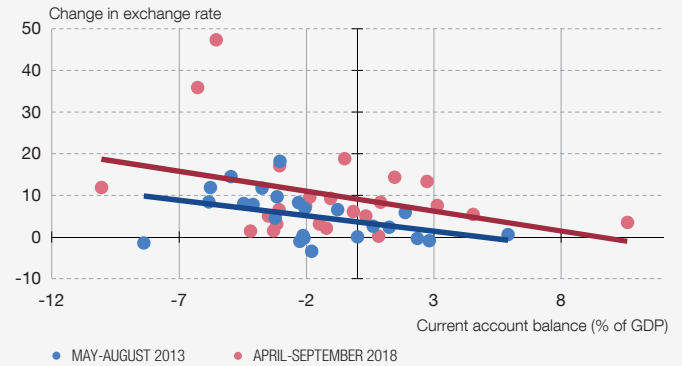
6 For further details see Banco de España (2016), "Report on the Latin American economy. Second half of 2016", *Economic Bulletin*, October 2016.

Chart 1
VULNERABILITIES IN EMERGING MARKETS

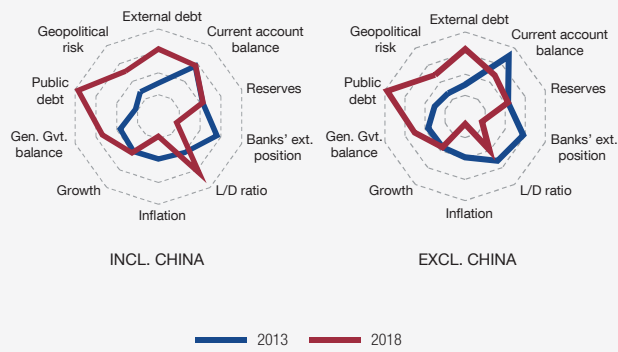
1 SOVEREIGN CDSs



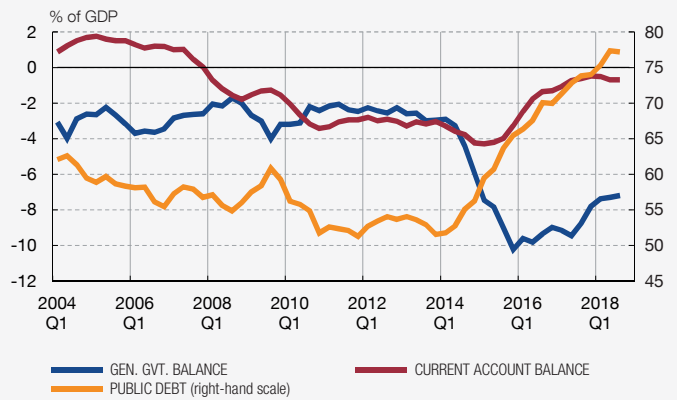
2 VULNERABILITIES AND EXCHANGE RATE DEPRECIATION



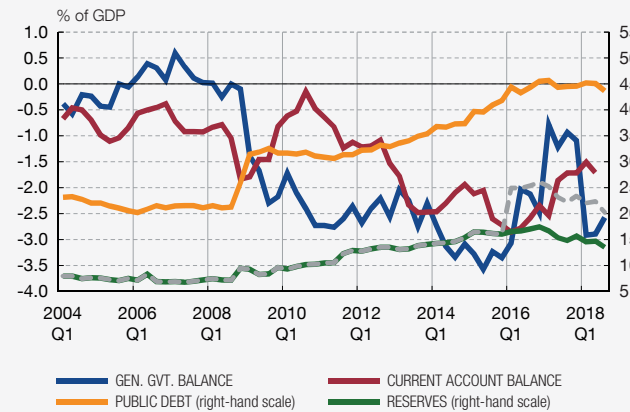
3 EMERGING ECONOMIES' VULNERABILITY INDICATORS (c)



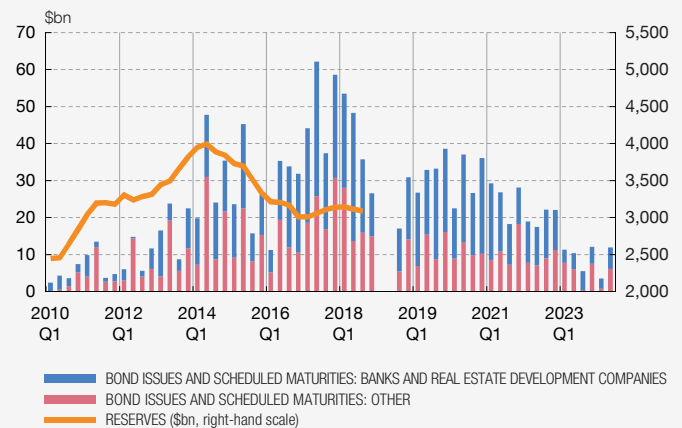
4 VULNERABILITIES AND STRENGTHS IN BRAZIL



5 VULNERABILITIES AND STRENGTHS IN MEXICO (d)



6 VULNERABILITIES AND STRENGTHS IN CHINA



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

- a Argentina, Brazil, Turkey, Tunisia and Nigeria.
- b India, Indonesia, Brazil, South Africa and Turkey.
- c Standardised series with average and standard deviation from 2008. Outward movement by the variables entails greater vulnerability.
- d The dotted line depicts reserves as a percentage of GDP were Mexico to receive the \$88 bn of the FCL entered into with the IMF.

have been adjusted in the past two years and international reserves, despite having fallen, hold above their historical average. Moreover, in this latter area, Mexico has a Flexible Credit Line (FCL) with the IMF worth \$88 billion, half its current reserves.

In the case of China, the main vulnerabilities stem from the trade tensions with the United States and, from a more structural perspective, from the ongoing re-balancing of the Chinese economy towards a growth model based more on the services sector and private consumption, and less on investment and exports, with very high rates of corporate debt. In the transition from one model to the other, the Chinese authorities face the dilemma, in the current context of less favourable external conditions, of choosing between maintaining the pace of the process of transformation, on one hand, and supporting economic growth, on the other, even though this may check the correction of its macrofinancial imbalances. Against this backdrop, the corporate debt ratio exceeded 150% of GDP in 2017; that said, the proportion accounted for by shadow banking in this figure has declined at the expense of bank lending, which has grown at a real rate of 9% in the past two years.⁷

7 See, in this connection, Box 3 (“Some implications of the announced expansionary stance of China’s macroeconomic policies”), “Quarterly Report on the Spanish Economy”, *Economic Bulletin 3/2018*, Banco de España.

The financial vulnerabilities of the Chinese economy are also significant. Firstly, banks increasingly resort to the markets for financing (the issuance of certificates of deposits in 2017 and 2018 doubled) which, together with the slowdown in deposits, has raised the loan/deposits ratio to close to unity. Secondly, a strong increase in Chinese banks’ and real estate development companies’ bond issues on international markets was observed throughout 2017, which might entail certain risks when these sectors have to face their external debt maturities, most of which are concentrated in the next three years (see Chart 6). Notwithstanding, China continues to hold a high volume of international reserves (\$3.1 trillion) and its levels of external and public debt are low, which affords it substantial room for manoeuvre.

In short, analysis of the vulnerabilities of the main emerging economies points to an increase in fiscal imbalances in the cases of Brazil and, to a lesser extent, Mexico, and to high corporate sector debt in China. Nonetheless, the high volumes of reserves in China and Brazil (along with Mexico’s contingent borrowing arrangement with the IMF) and the healthy external position of these economies are factors that offer a degree of protection to mitigate the effect of the potential risks that might arise in a setting of tighter global financing conditions and uncertainty over international trade developments.