

# **Can Emerging Economies Decouple?**

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**April 2, 2008**

# **This talk is primarily based on the following sources**

- **IMF World Economic Outlook**  
April 2007, Chapter 4; October 2007, Chapter 1
- **Global Business Cycles: Convergence or Decoupling**  
by Kose, Otrok and Prasad (forthcoming IMF WP)
- **Changing Nature of North-South Linkages**  
by Akin and Kose  
(*Journal of Asian Economics*, 2008)
- **Emerging Markets: On the Verge of a New Era?**  
by Claessens and Kose  
(Foreword for the *Euromoney Emerging Markets Handbook 2008/09*)

# **Disclaimer!**

**The views presented here are those of the authors and do NOT necessarily reflect the views of the IMF or IMF policy.**

# A new question for the new century?

*"For the past hundred years, the rate of growth of output in the developing world has depended on the rate of growth of output in the developed world. When the developed grow fast, the developing grow fast, and when the developed slow down, the developing slow down.*

*Is this linkage inevitable?"*

Who? When? (wait for the end...)

# Questions Facing the World Economy

- *“Can the rest of the world decouple from the United States?”*

*Answer: will be discussed today...*

- *“Will there be a “recession” in the United States?”*

*Answer: "Recession is possible, but recession is a technical term ... I'm not ready to say whether or not the U.S. economy will face such a situation..." Ben Bernanke, April 2, 2008*

# What is “decoupling”?

- Dictionary definition:

*decouple (verb): uncouple; disconnect; separate; detach.*

- Decoupling view (from financial market participants):

*“Emerging economies will not follow the United States into recession...”*

# A discussion w/ many nuances...

*(evolving assessments...)*

- *“You either believe in decoupling or globalization-but not both” (Stephen Roach, Financial Times, Jan. 23)*
  
- *“Those arguing that Asia and other emerging markets can't decouple from the US are forgetting one very important fact — they already have.”*  
*(Robert Prior-Wandesforde, The Times, February 12)*
  
- *“You can have both decoupling and globalization at the same time” (Economist, March 8)*

# Outline

- Setting the stage: When the US sneezes... what happens?
- How important is the U.S. economy?
- What happened in the past?
- Understanding channels of transmission: Trade and Finance
- Are emerging markets decoupling? Some recent perspectives
- What is new in the decoupling debate?

# Setting the stage:

*When the US sneezes... what happens?*

## Past and Present

# When the U.S. Sneezes...

- Is the old saying, “when the U.S. sneezes, the rest of the world catches a cold,” still relevant?
- How would the slowing of the U.S. economy affect other countries/regions? Can other countries “**decouple**” from the U.S. and sustain strong economic growth?
- Is today different than yesterday? Last 3-4 years appear to be different.. But, how sustainable is this trend?

# Past: Contagion of US flu...

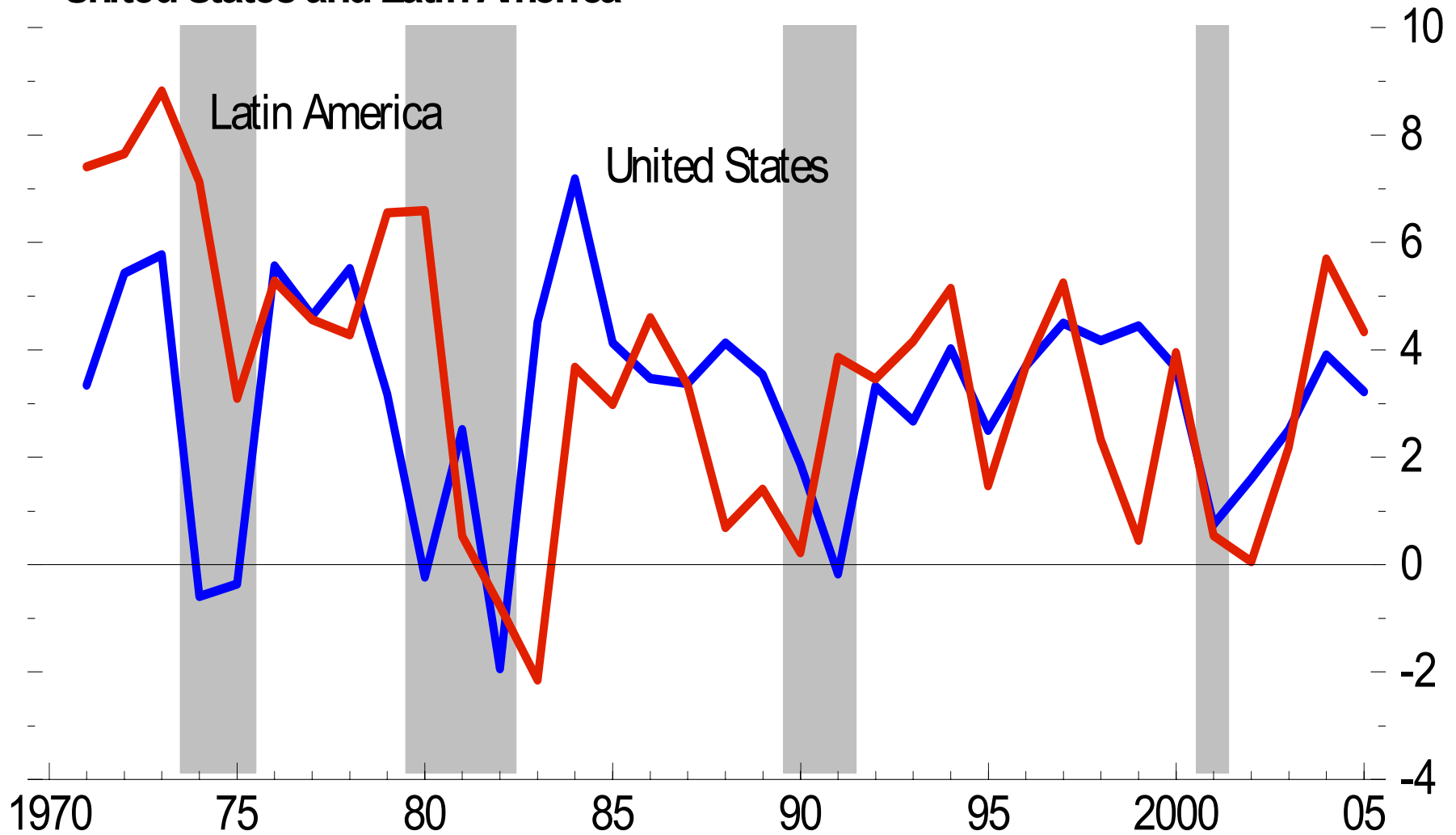
When the U.S. sneezed...

- Latin America... got pneumonia
- Japan and Emerging Asia... caught a cold

# U.S. Recessions and Latin America

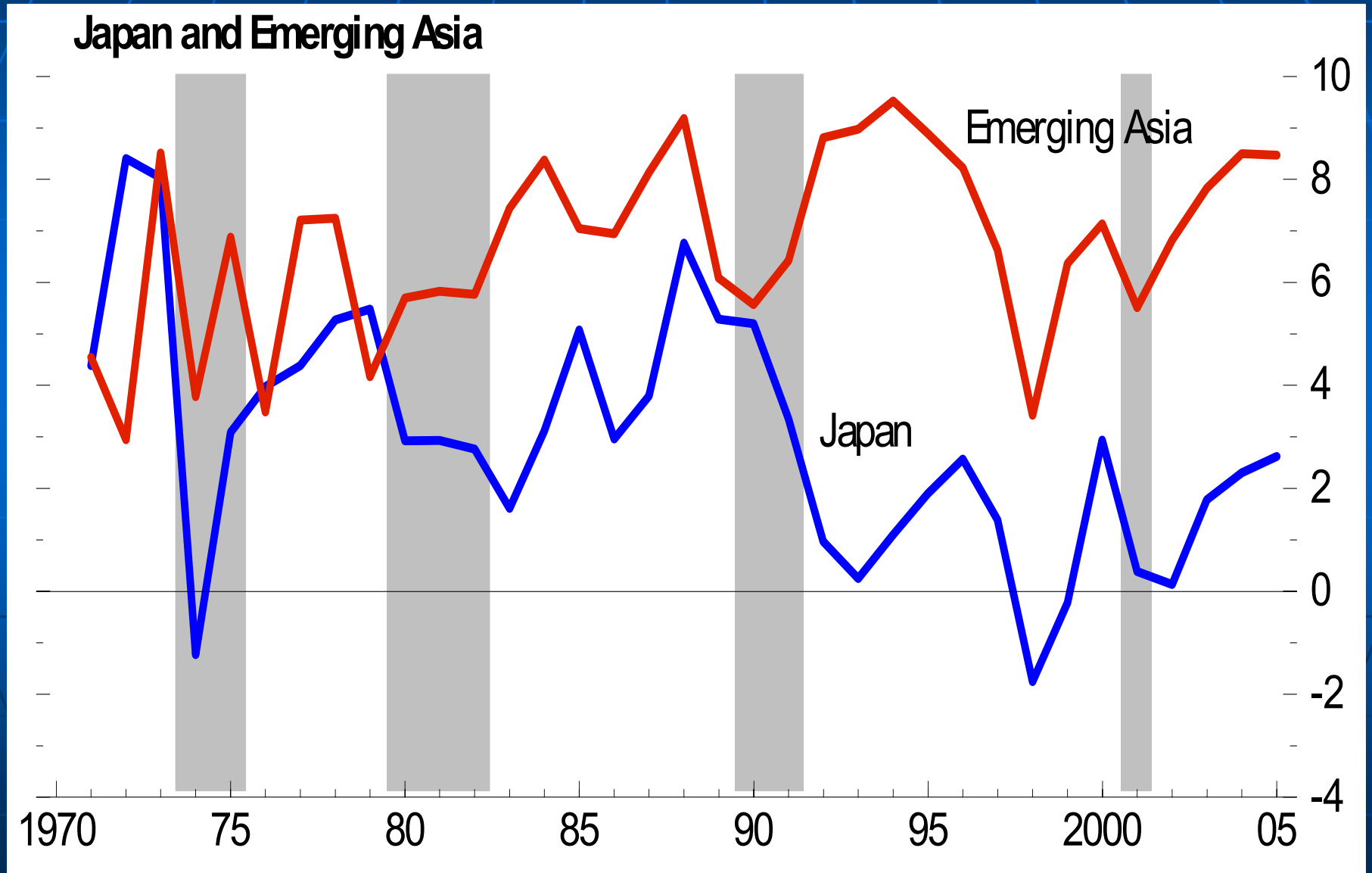
*(Real GDP growth, annual change in percent)*

## United States and Latin America



# U.S. Recessions and Japan & Emerging Asia

*(Real GDP growth, annual change in percent)*

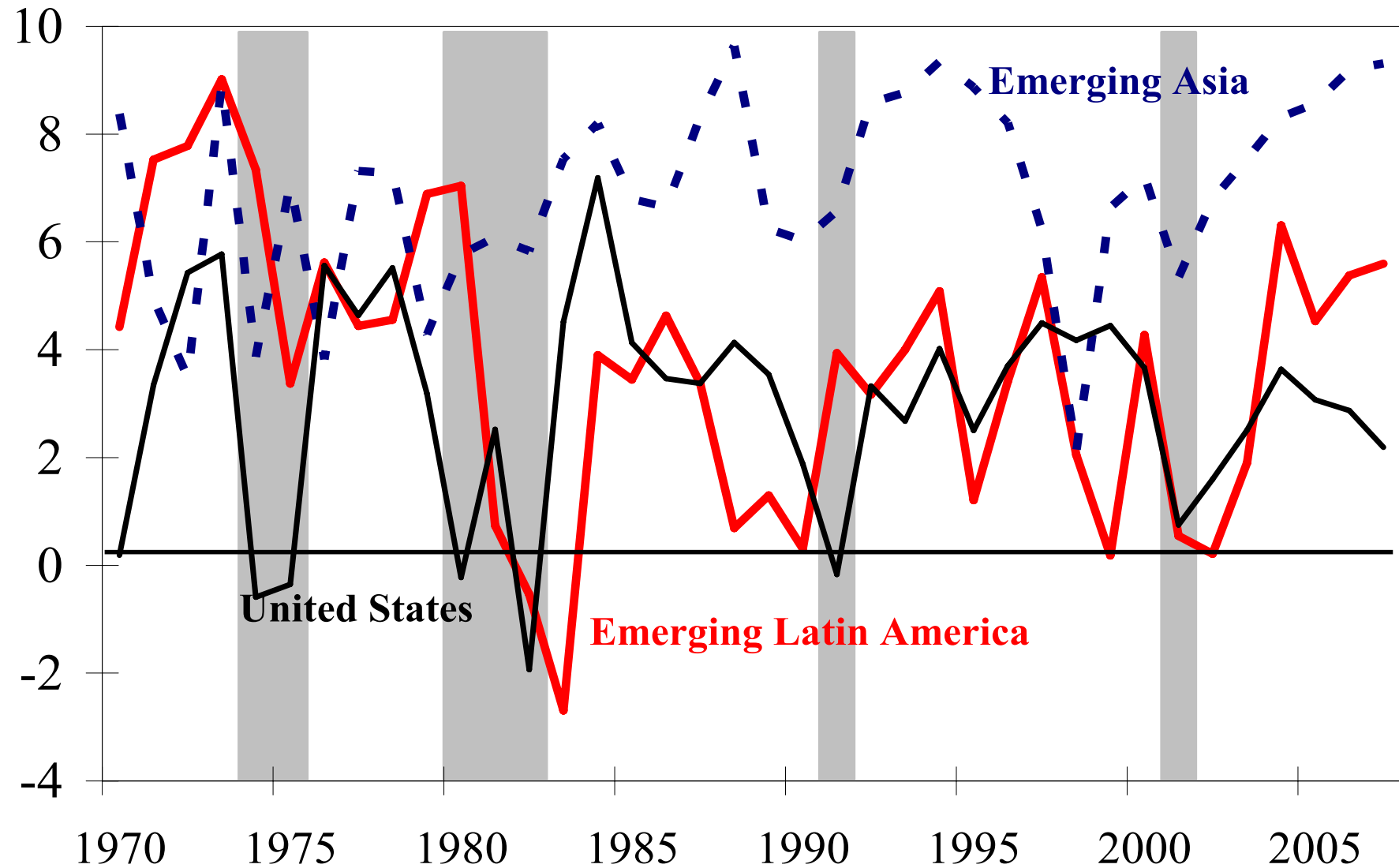


# Present: Last 2-3 years different?

- The U.S. has been slowing down, but rest of the world has been growing rapidly...The world growth rate over the period 2004:1-2007:3 was much more rapid than at any time since the early 1970s.
- *“The idea that the world economy was being pushed along in an American supermarket trolley was always an exaggeration... The difference is now is that the rest of the world is doing more of the carrying..”*  
(The Economist, February 24, 2007).

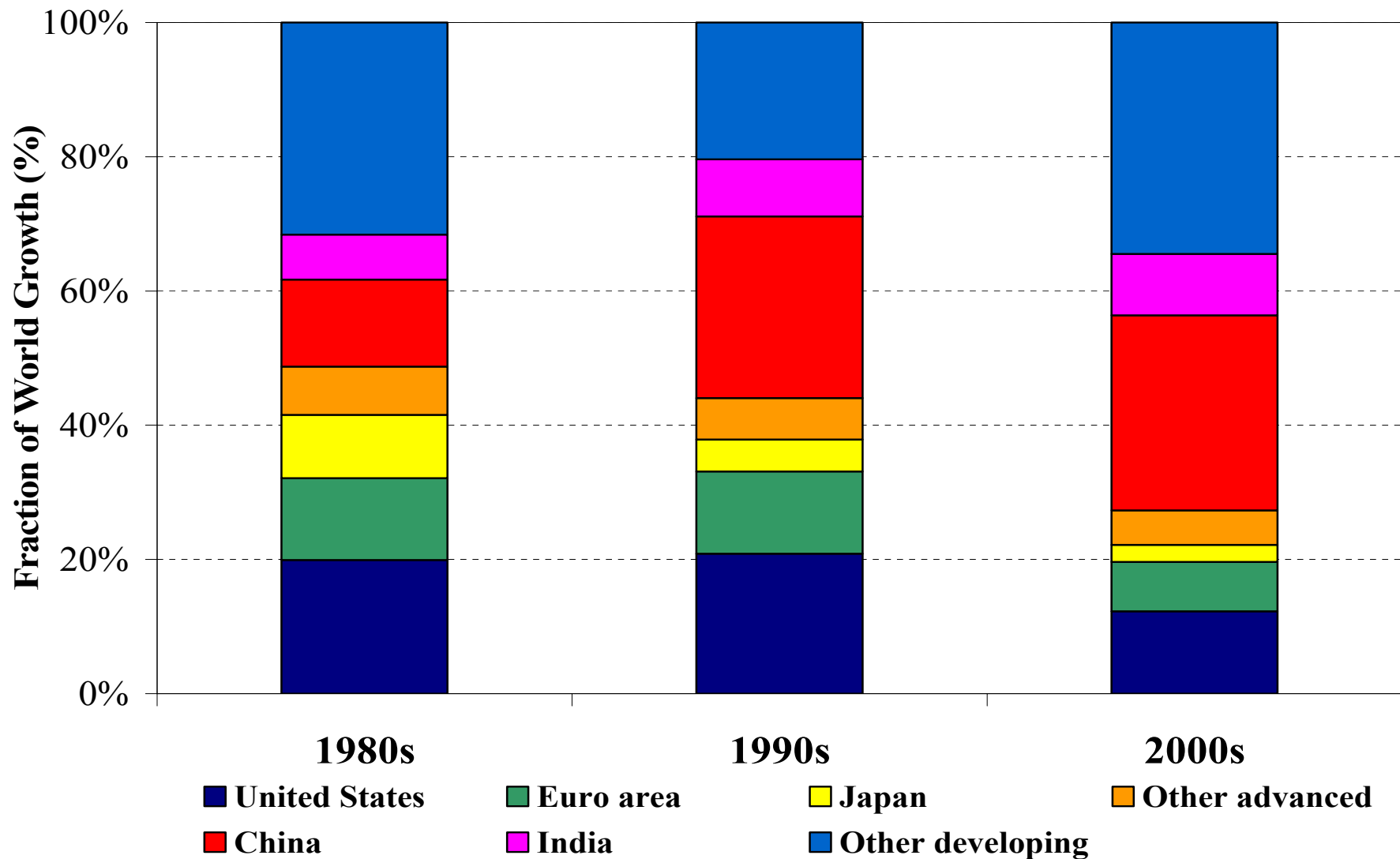
# Growth Has Softened in the U.S.; But Remains Strong in Emerging Markets

*(Real GDP; percent change from four quarters earlier)*



# What Explains World Growth?

*Developing Countries' Share Increasing (based on PPP)*



# Questions

## ■ Can Emerging Economies Decouple?

- What have been the global repercussions of past U.S. recessions and slowdowns?

- How much do shocks to the U. S. economy affect macroeconomic conditions elsewhere?

- What are the roles played by the global and group-specific factors in explaining business cycles?

- Has the growth impact of industrial countries been declining?

# Results-1

- The old saying, “When the U.S. sneezes, the rest of the world catches a cold,” remains relevant.
- However, the importance of growth spillovers should not be exaggerated... Spillovers are larger during recessions than during mid-cycle slowdowns.
- Previous episodes of global slowdowns were the result of worldwide developments, not pure U.S. shocks.
- There are differences in financial and real decoupling. It is hard to envision a prolonged period of financial decoupling...

# Results-2

- Group-specific factors have been becoming more important in explaining business cycles (at the expense of global factors)
- Impact of industrial economies on the growth performance of emerging markets has been declining
- If the U.S. slowdown continues to be limited with certain sectors and financial market conditions are restored in a timely fashion, spillovers to elsewhere could remain limited
- If the downturn spreads to consumption and investment in the U.S. and turns into a full-blown recession, then much larger cross-border spillovers could be expected.
- Policy responses can moderate the U.S. spillover effects



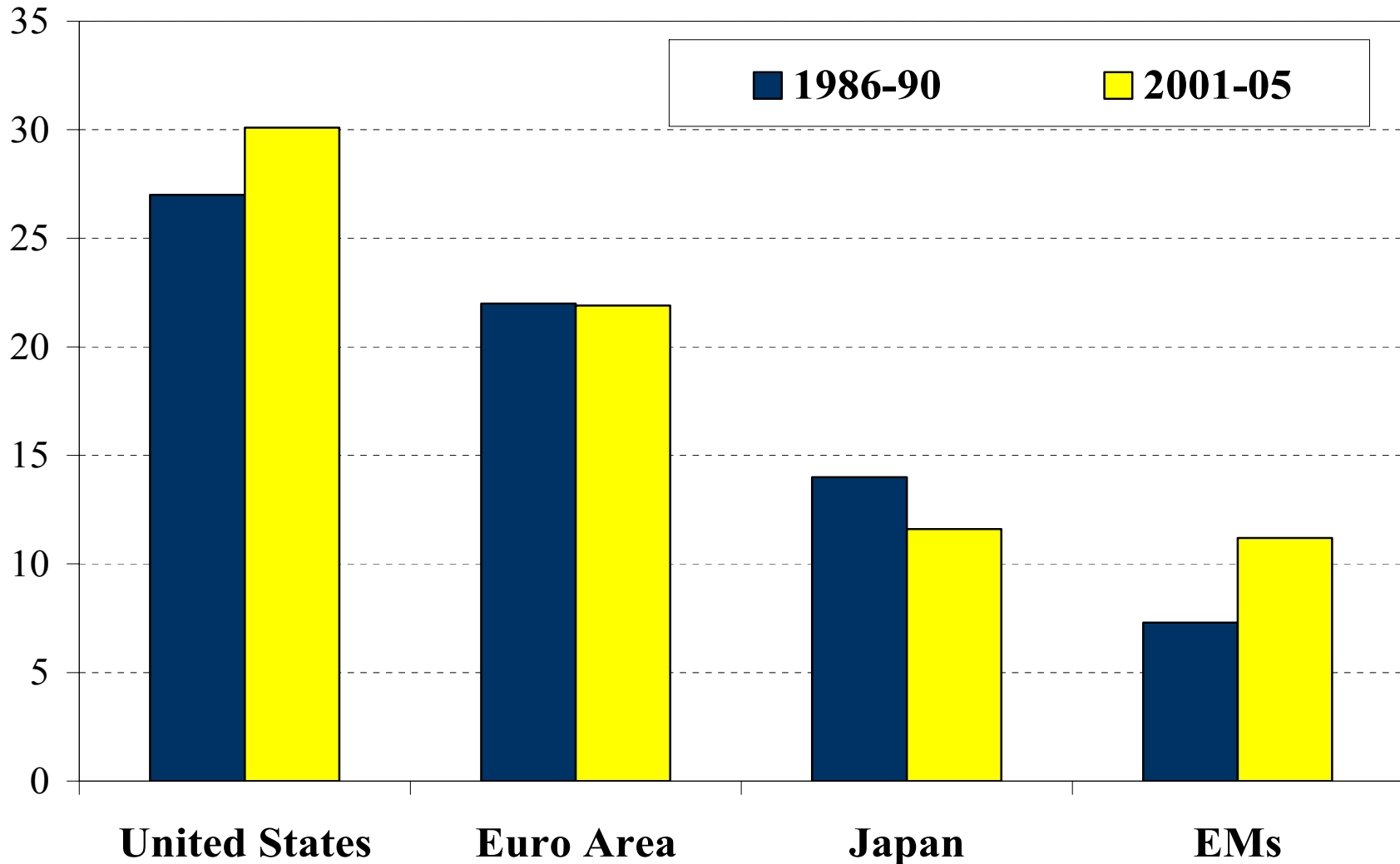
**How important is the U.S.  
economy?**

# The U.S. Economy in the World

- By far the world's largest economy.
- The largest importer. The second largest exporter after the euro area.
- Export exposure to the United States has generally continued to increase.
- U.S. financial markets by far the largest

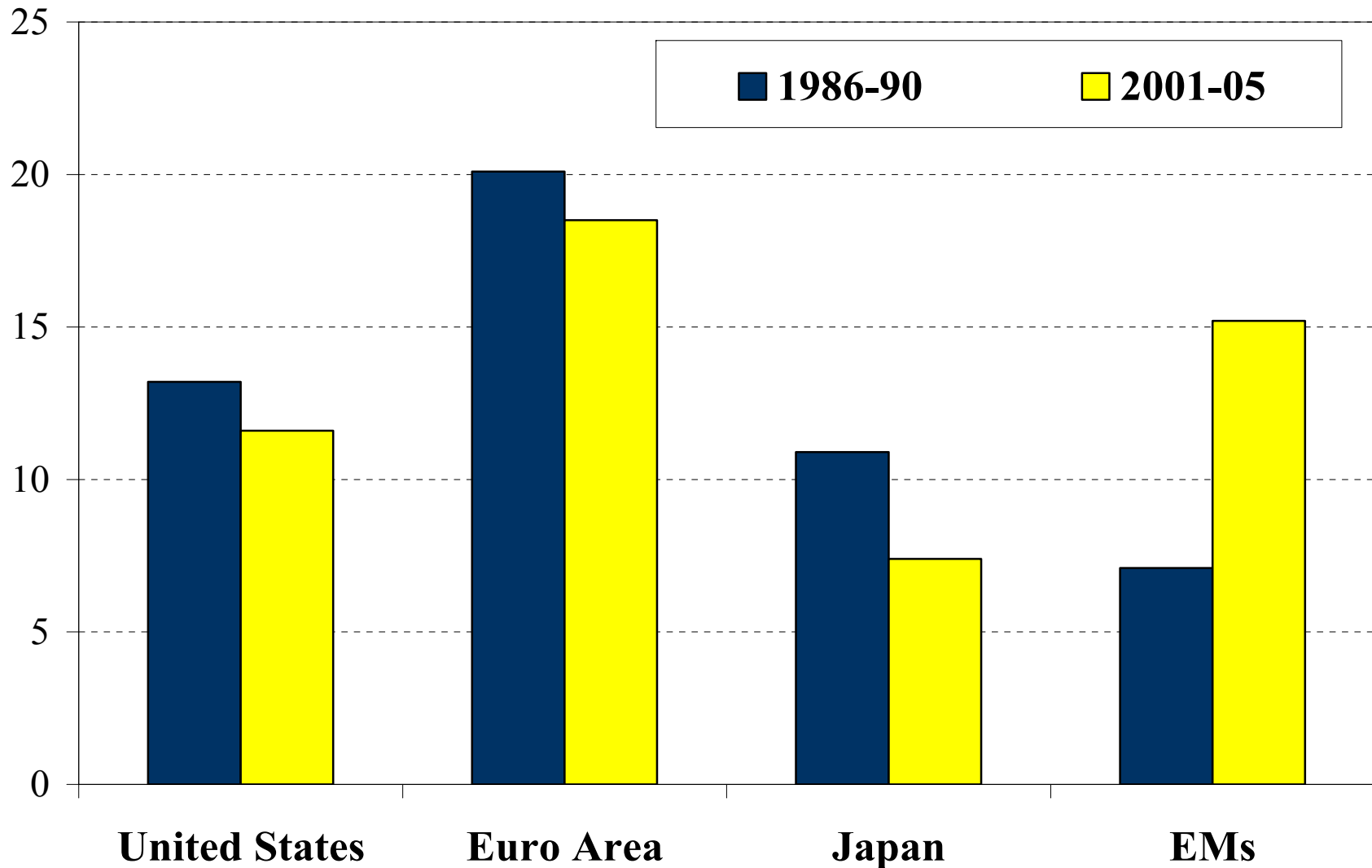
# U.S. still the largest economy..

**GDP (% of World Total, Market Rates)**



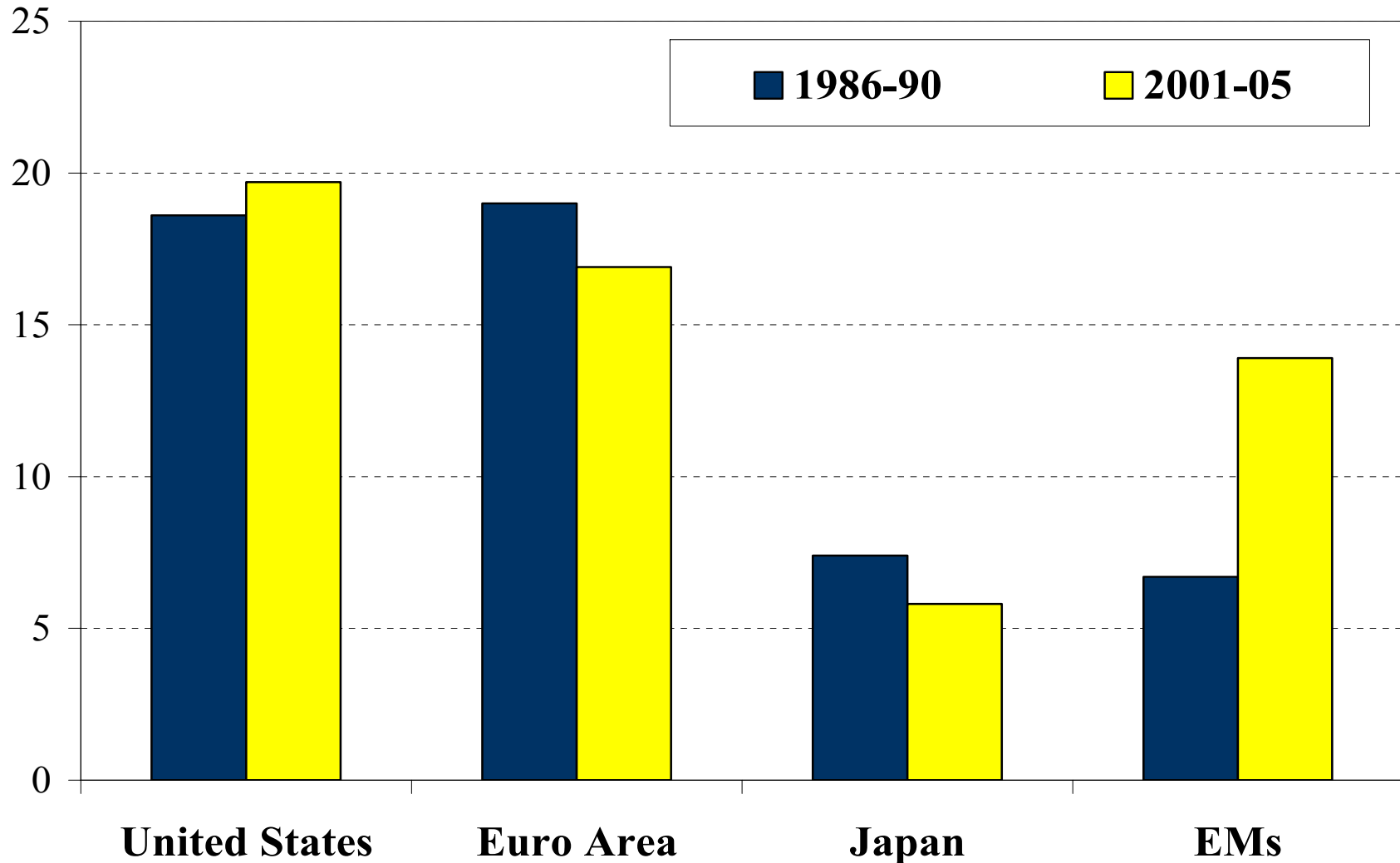
# U.S. second largest exporter...

**Exports (% of World Total)**



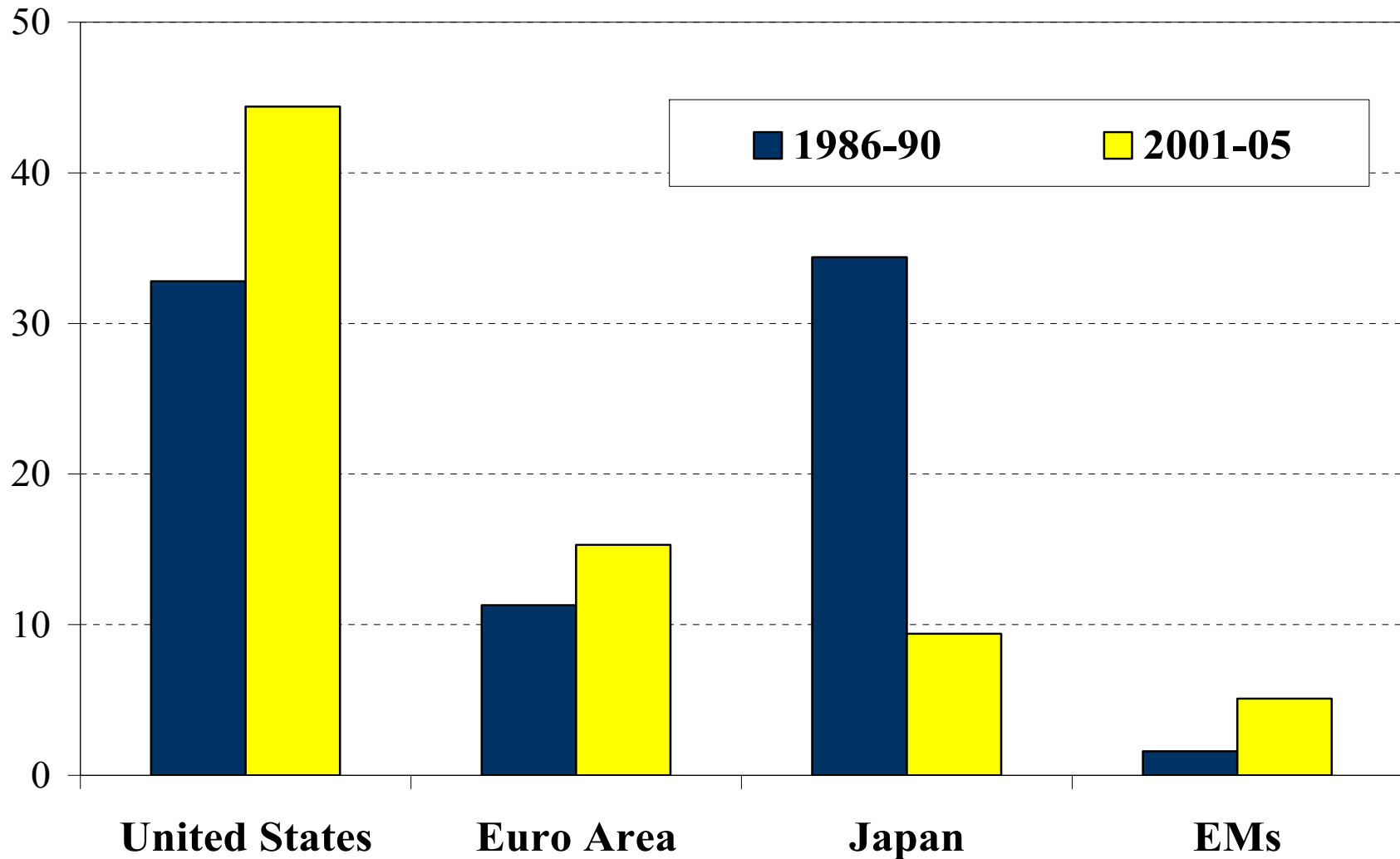
# U.S. the largest importer...

**Imports (% of World Total)**



# U.S. the largest financial market..

## Stock Market Capitalization (% of World Total)

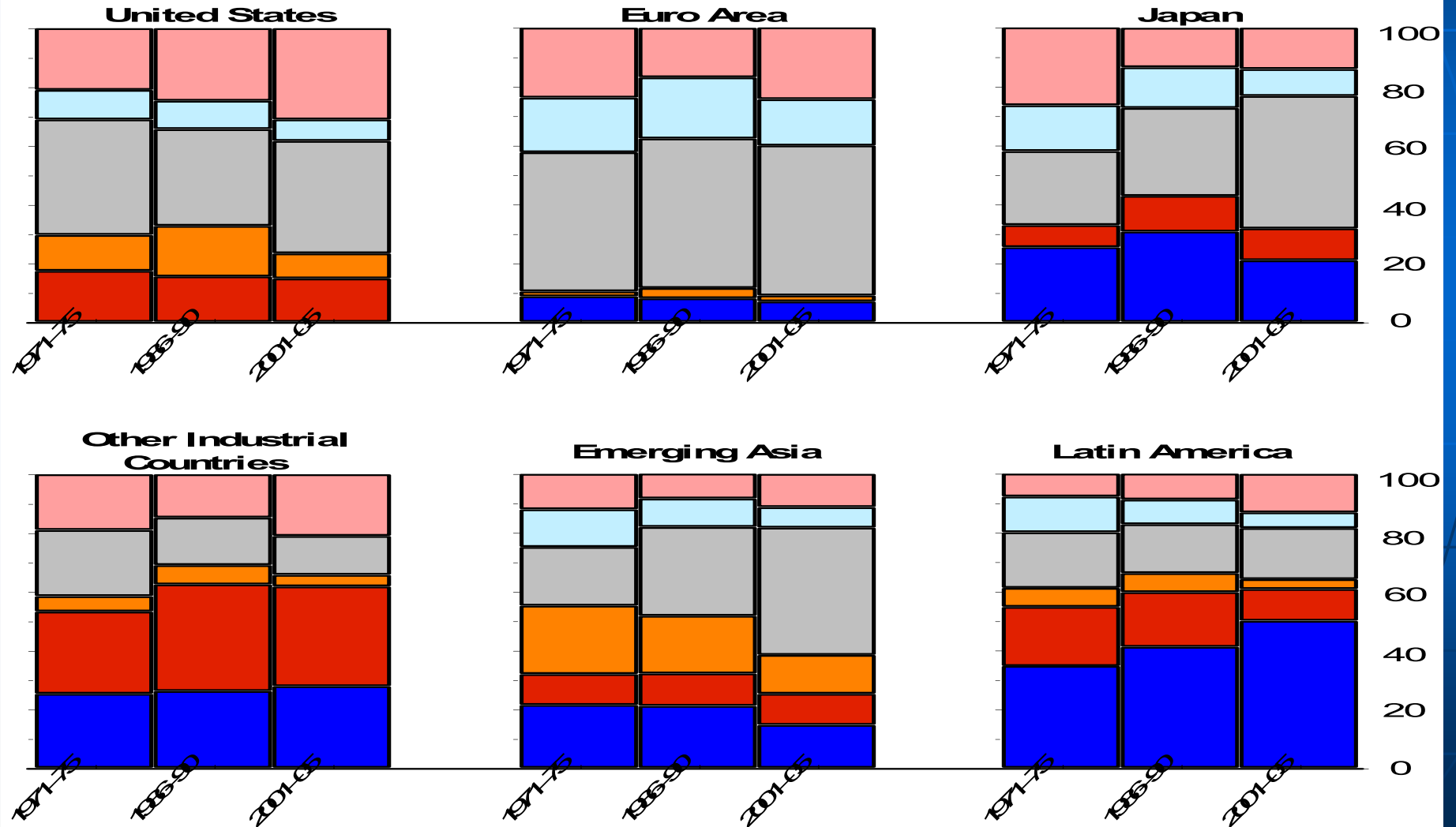


# Export Exposure to the U.S.

- Export exposure to the U.S. (the share of exports to the U.S. as a share of GDP) has continued to increase
- Even for countries where the U.S. share of total exports has declined as trade openness has increased
- Exposure to the U.S. tends to be larger than that to the euro area and Japan, except in neighboring regions

# Trade Orientation

*(Trade with indicated areas as % of total trade)*





**What have been the global repercussions of past U.S. recessions and slowdowns?**

# What Happened in the Past?

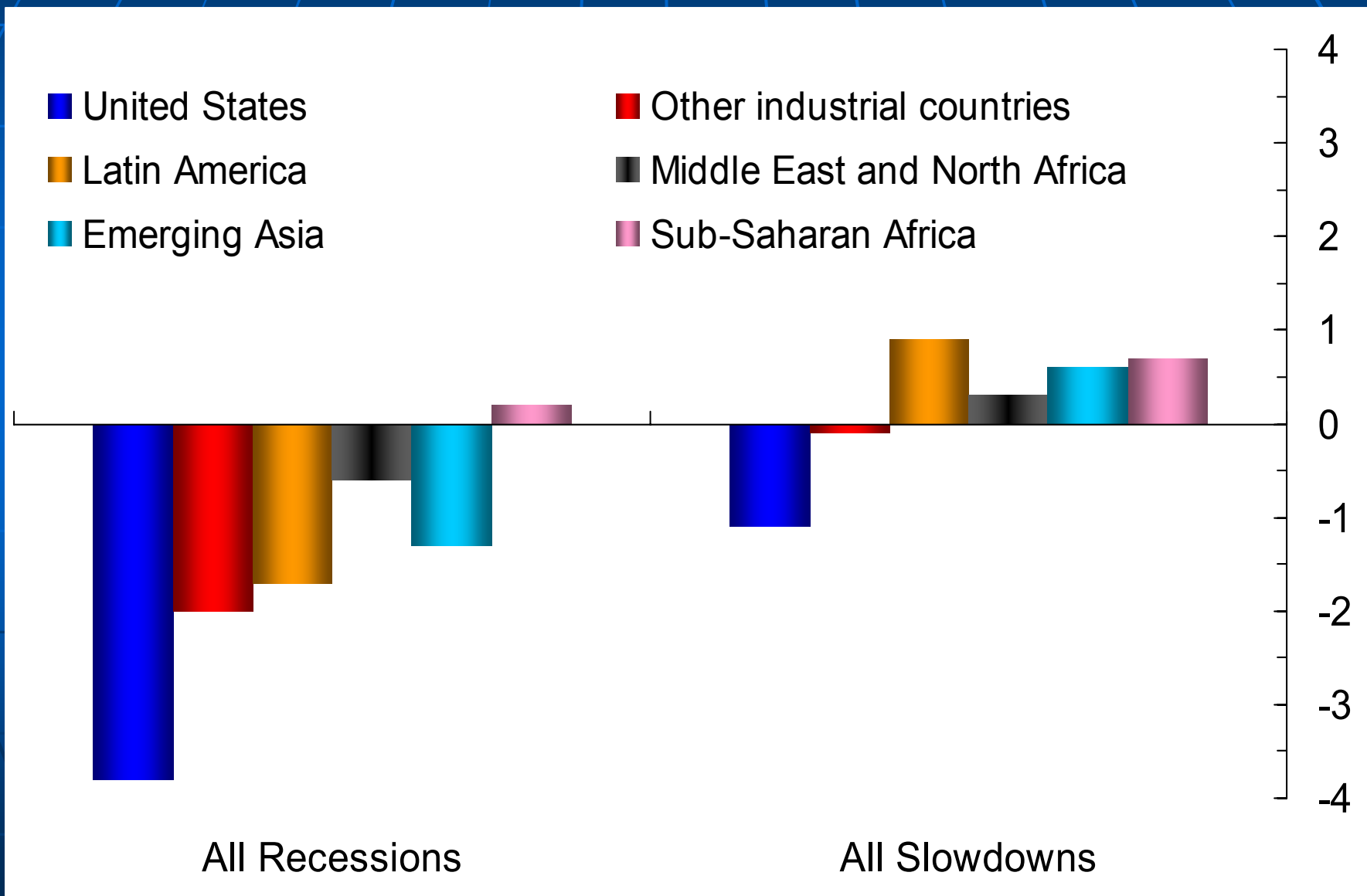
- **Recessions:** Two consecutive periods of negative growth...
- **U.S. recessions:** 1974–75 (-6.1) , 1980 (-3.4), 1981–82 (-4.5), 1991 (-2.1), and 2001 (-2.9)  
Average Decline in Growth: 3.8 percentage points
- **1974–75:** oil price shocks; **1980, 1981–82:** LA debt crisis, contractionary policies in industrialized countries; **1991:** the aftermath of the Savings and Loan Crisis and the associated credit crunch; **2001:** bursting of the IT bubble

# What Happened in the Past?

- **Midcycle slowdowns:** Periods during which output was below potential...
- **U.S. midcycle slowdowns:** 1986 (-0.7) and 1995 (-1.5)  
Average Decline in Growth: 1.1 percentage points

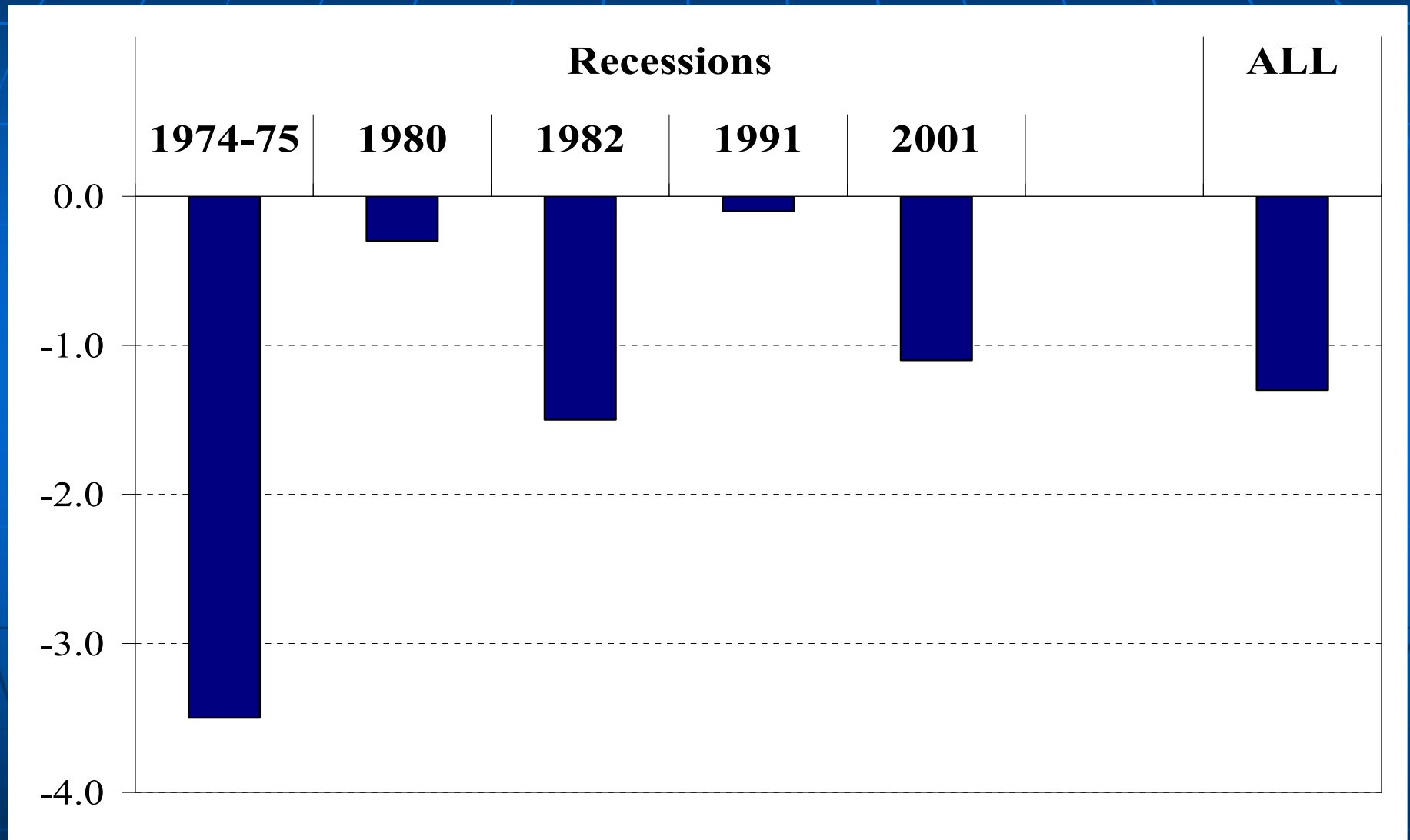
# Recessions are a Greater Cause for Concern

*(Change in GDP growth; median for region)*



# Growth in Emerging Asia and U.S. Recessions

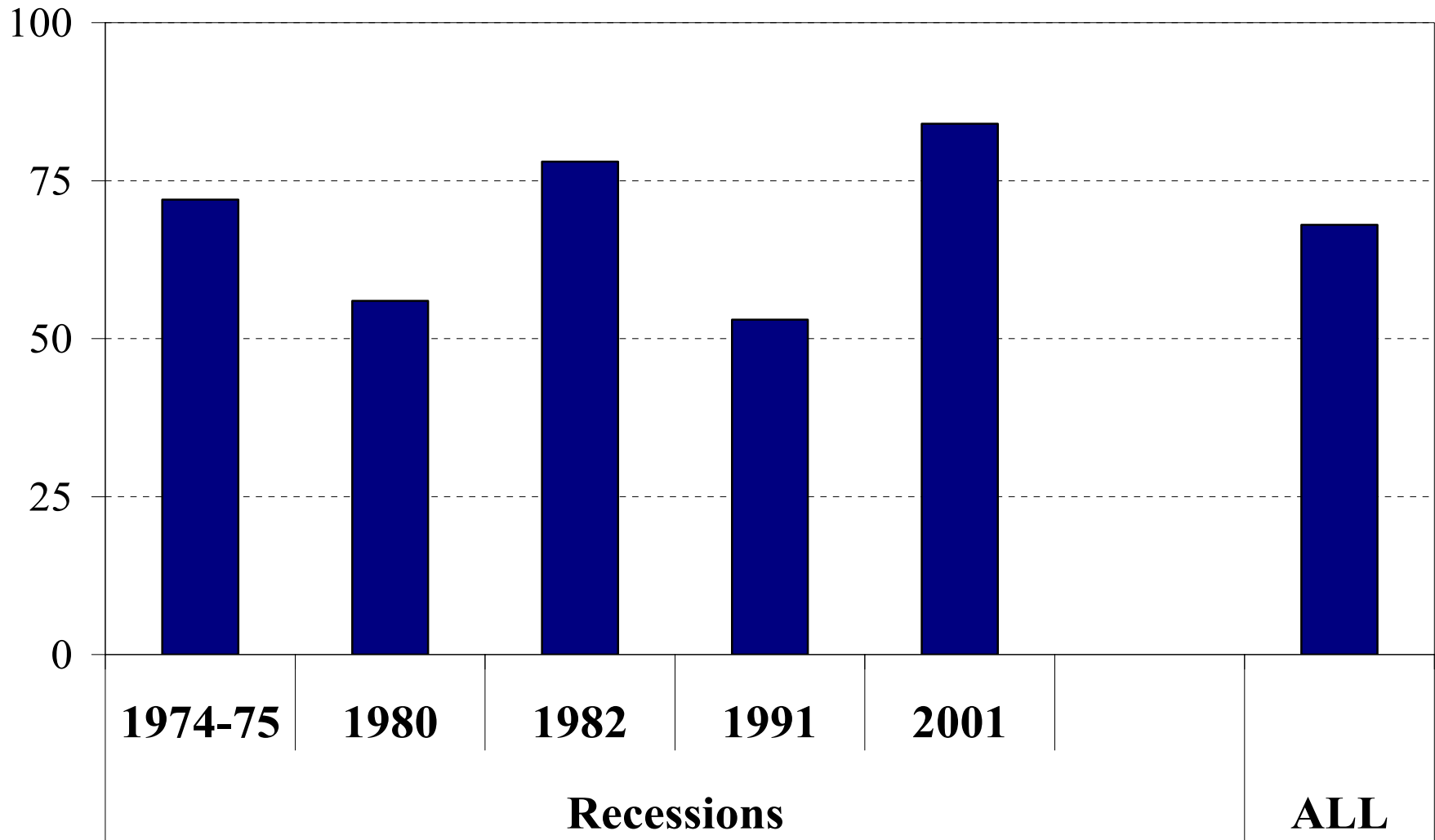
*(Change in GDP Growth, Median for Region)*



Emerging Asia: China, HK, Korea, Singapore, Taiwan POC, Indonesia, Malaysia, The Philippines, and Thailand

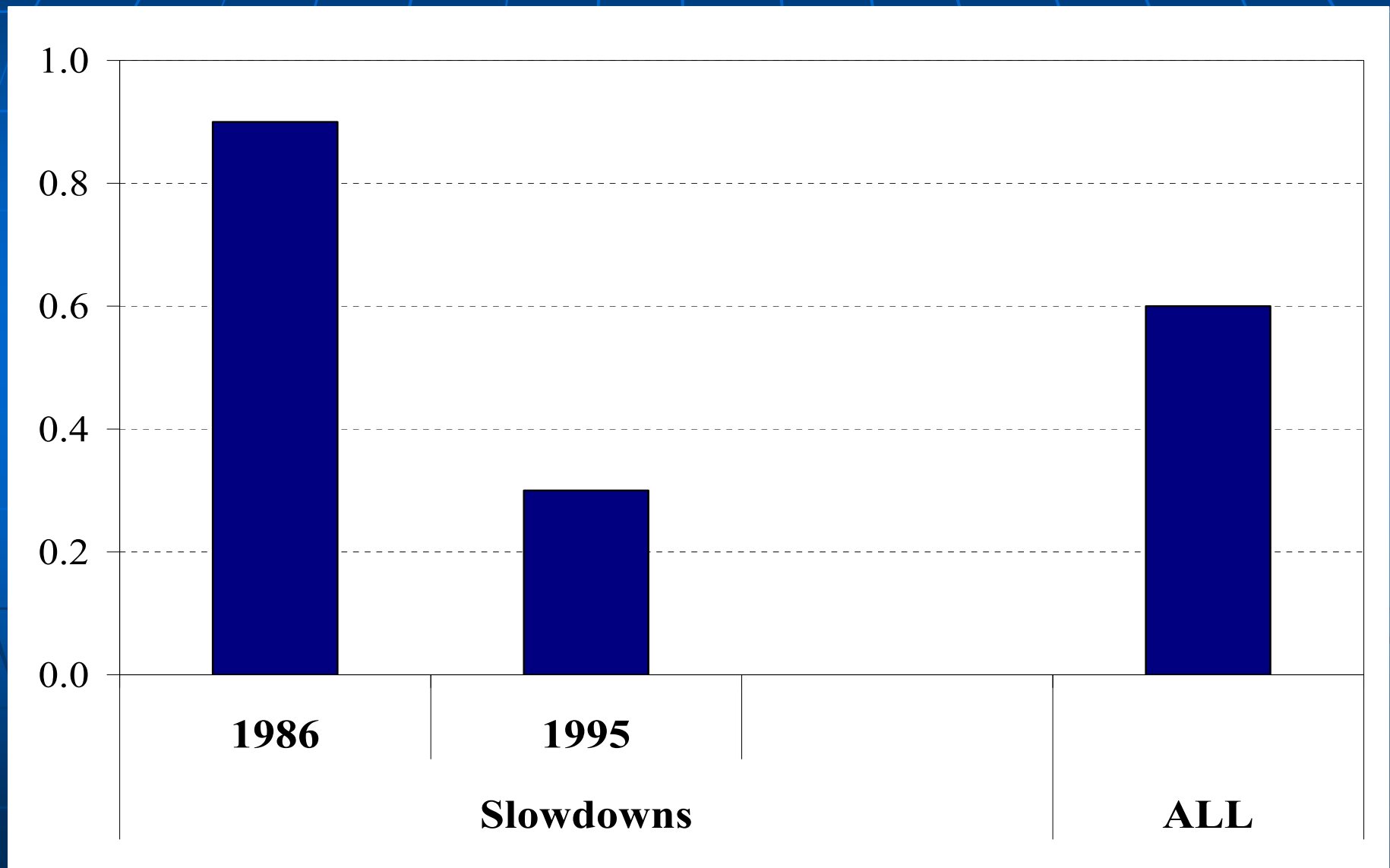
# Emerging Asia and U.S. Recessions

**% of Countries with Growth Declines**



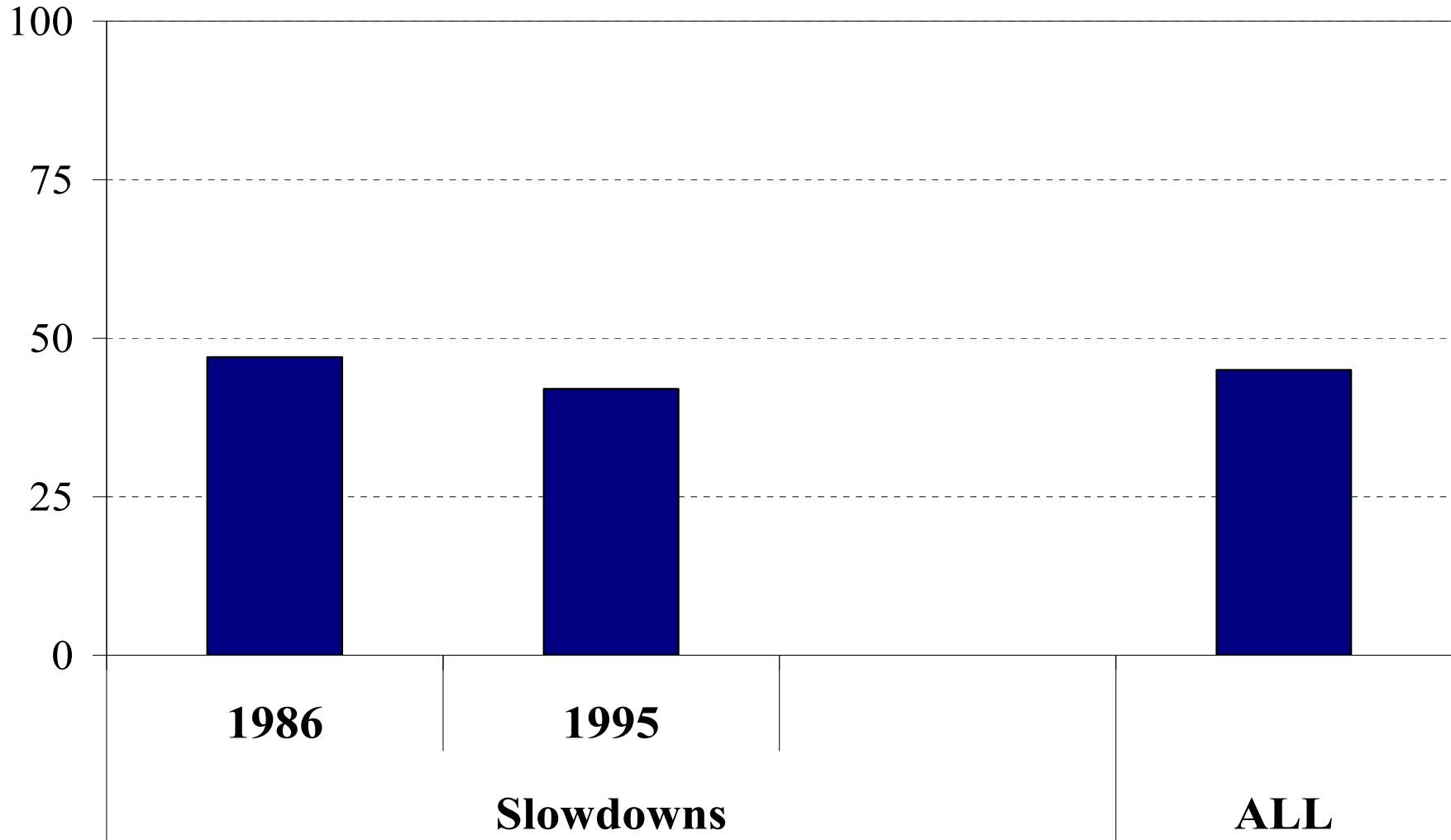
# Growth in Emerging Asia and U.S. Slowdowns

*(Change in GDP Growth, Median for Region)*



# Emerging Asia During U.S. Slowdowns

**% of Countries With Growth Declines**





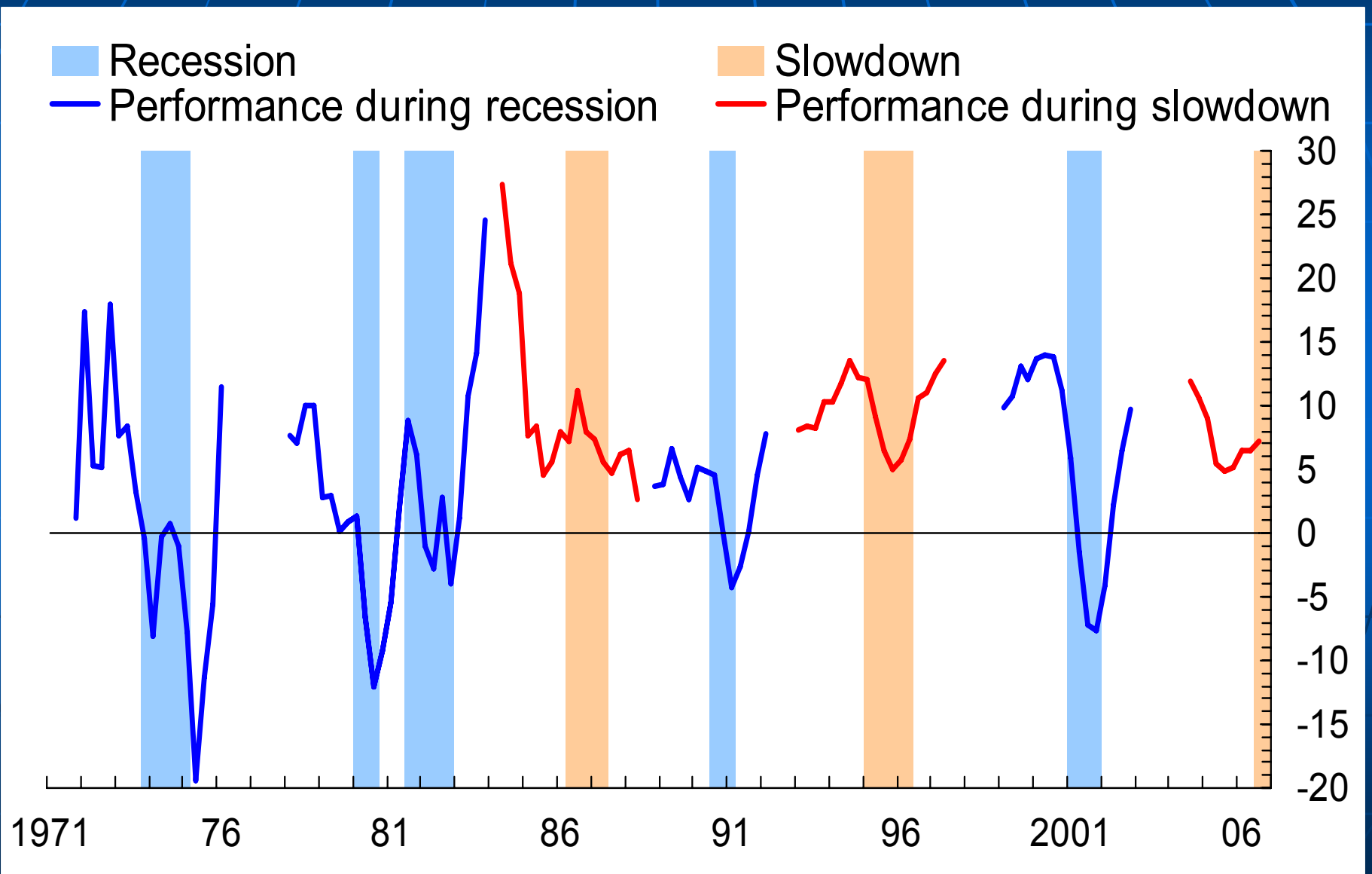
# **Channels of transmission: Trade and Finance**

# Channels of Transmission: Trade

- U.S. import growth turned sharply negative during recessions
- U.S. imports are strongly pro-cyclical reflecting the relatively high import share of cyclically sensitive components of domestic final demand
- Countries with the greatest export exposure to the United States suffered the largest declines in output gaps during US recessions.

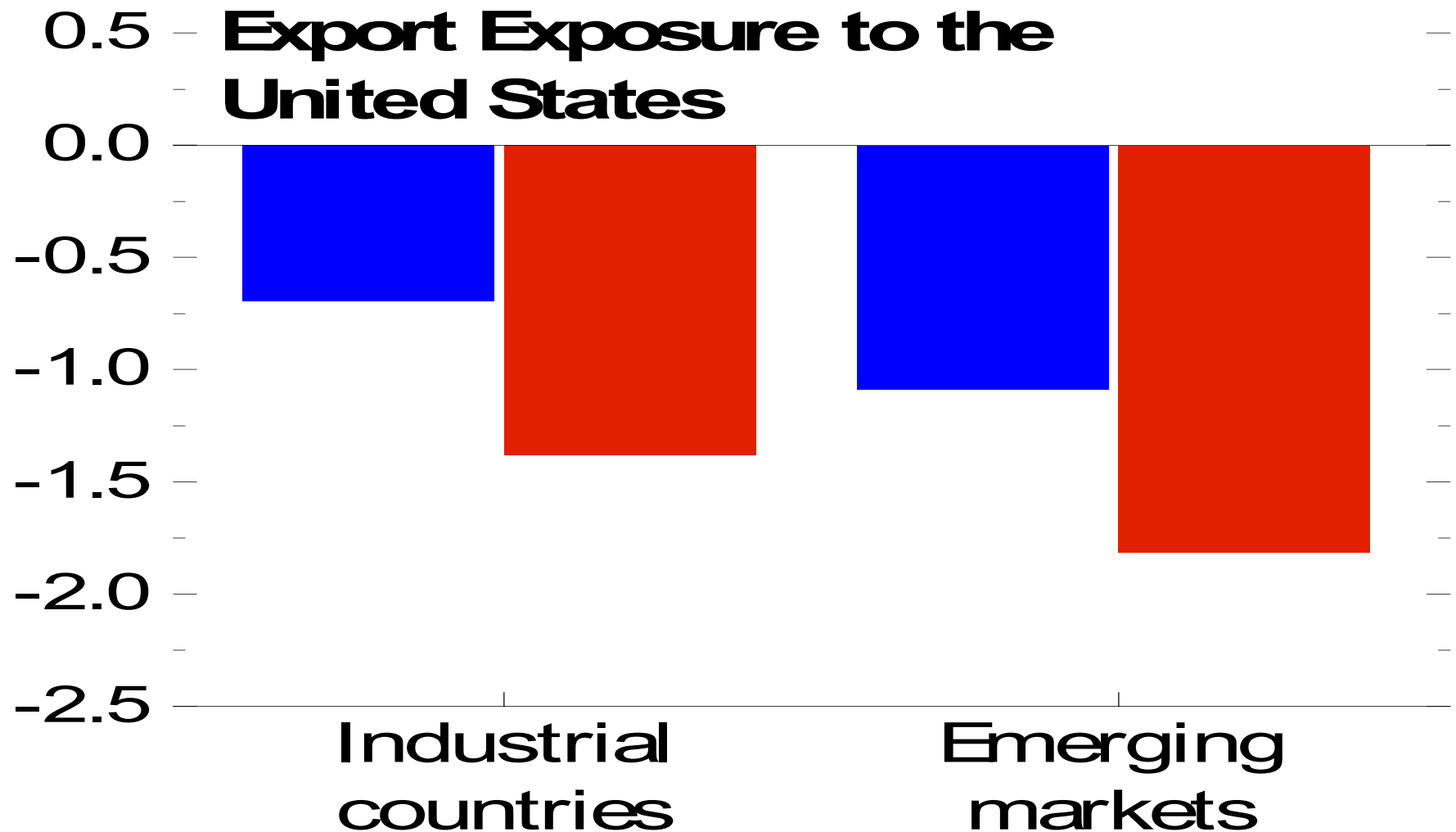
# Import Growth Sharply Negative in Recessions

*(Real Import Growth, Percent)*



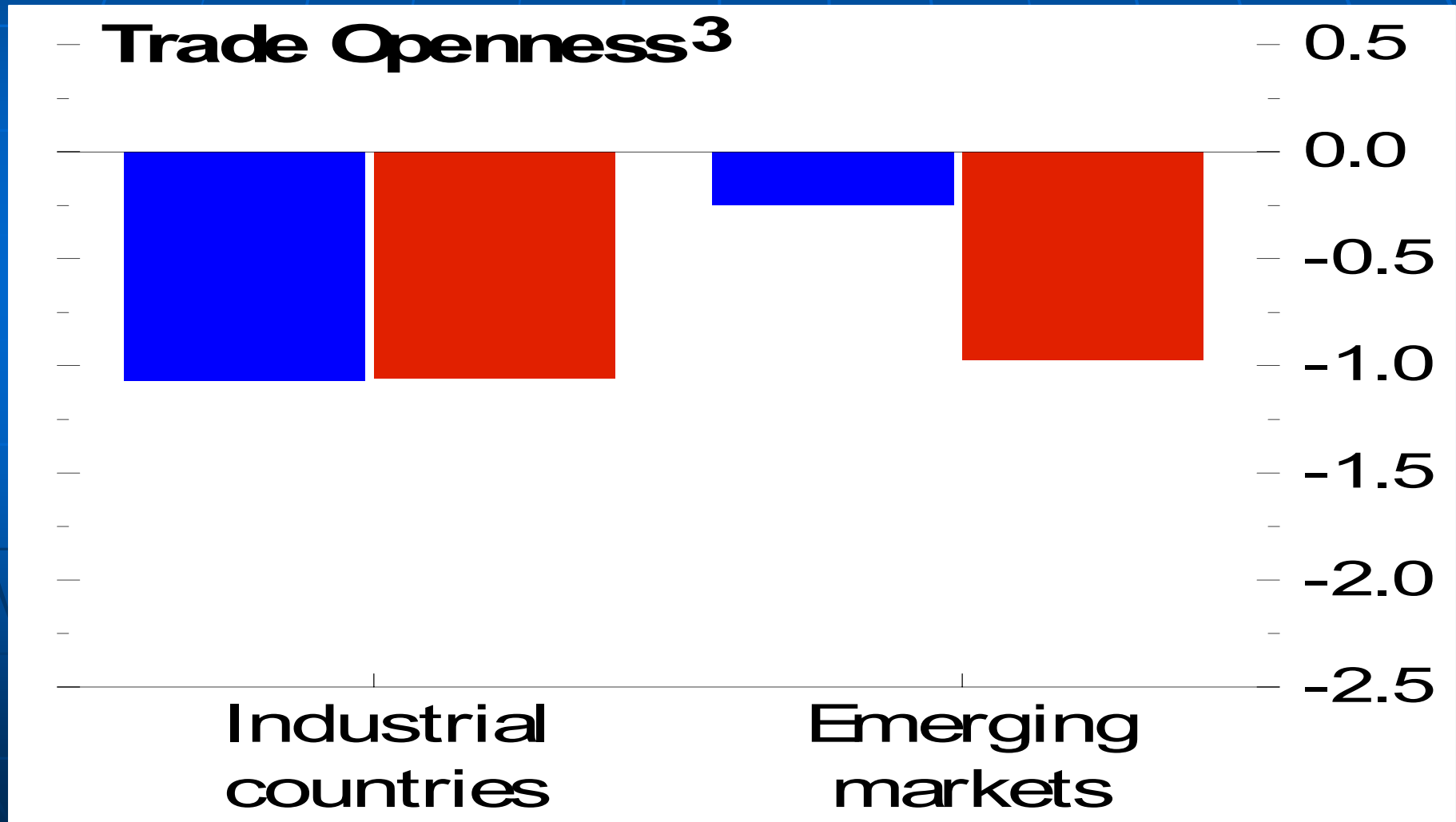
# More Export Exposure to U.S. More Severe Growth Decline

- Change in average output gap in lower half of category
- Change in average output gap in upper half of category



# More Open Trade with More Severe Growth Declines

- Change in average output gap in lower half of category
- Change in average output gap in upper half of category

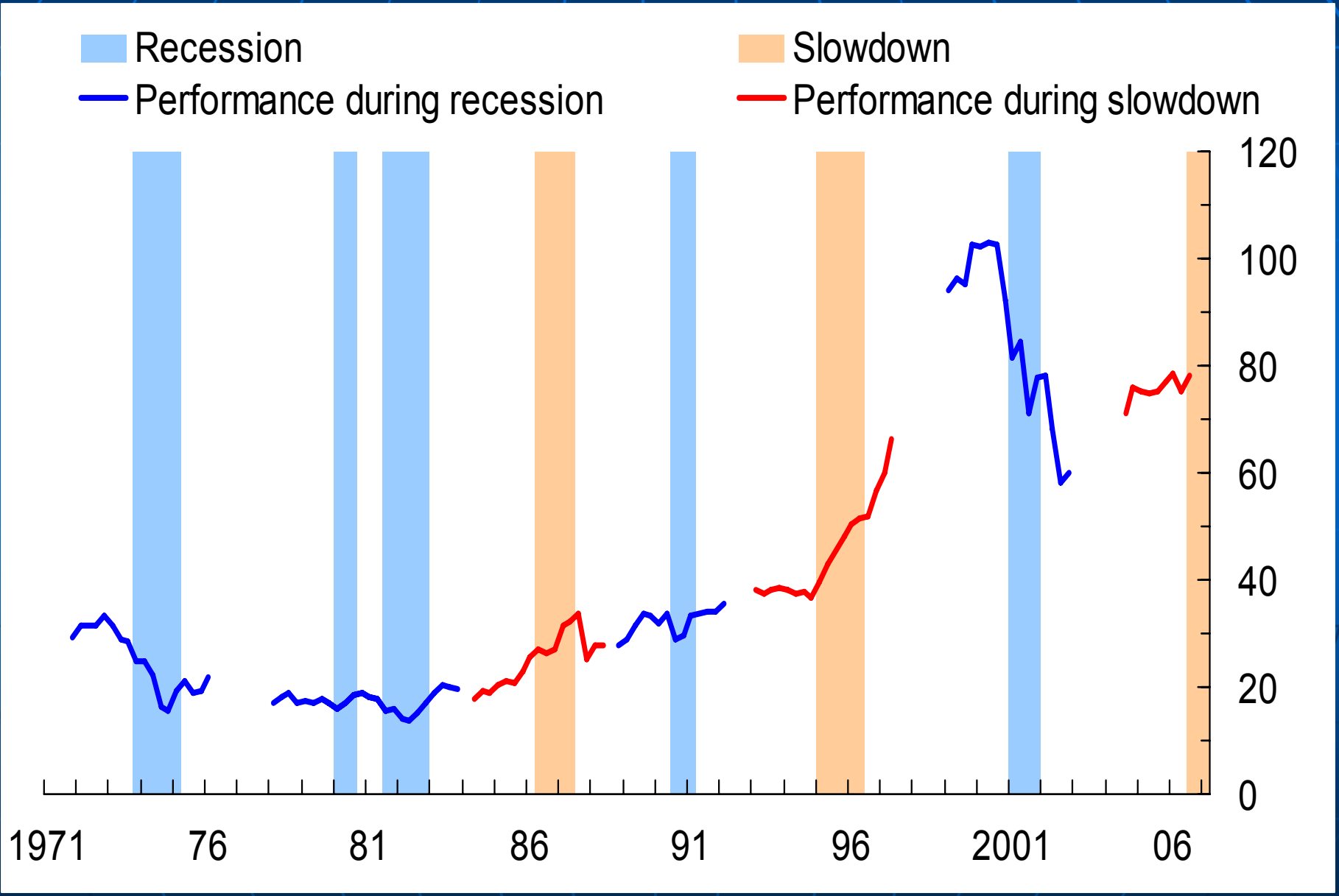


# Channels of Transmission: Finance

- Past U.S. recessions were generally preceded and to some extent accompanied by stock market declines
- Given strong equity price linkages, stock prices also tended to fall in other economies especially during periods of market stress in recessions
- U.S. stock market indices did not decline during U.S. mid-cycle slowdowns
- The weakness of U.S. stocks in the lead up to recessions generally coincided with significant declines in corporate earnings, while during slowdowns, corporate earnings generally have not declined

# Stock market declines before/during U.S. recessions

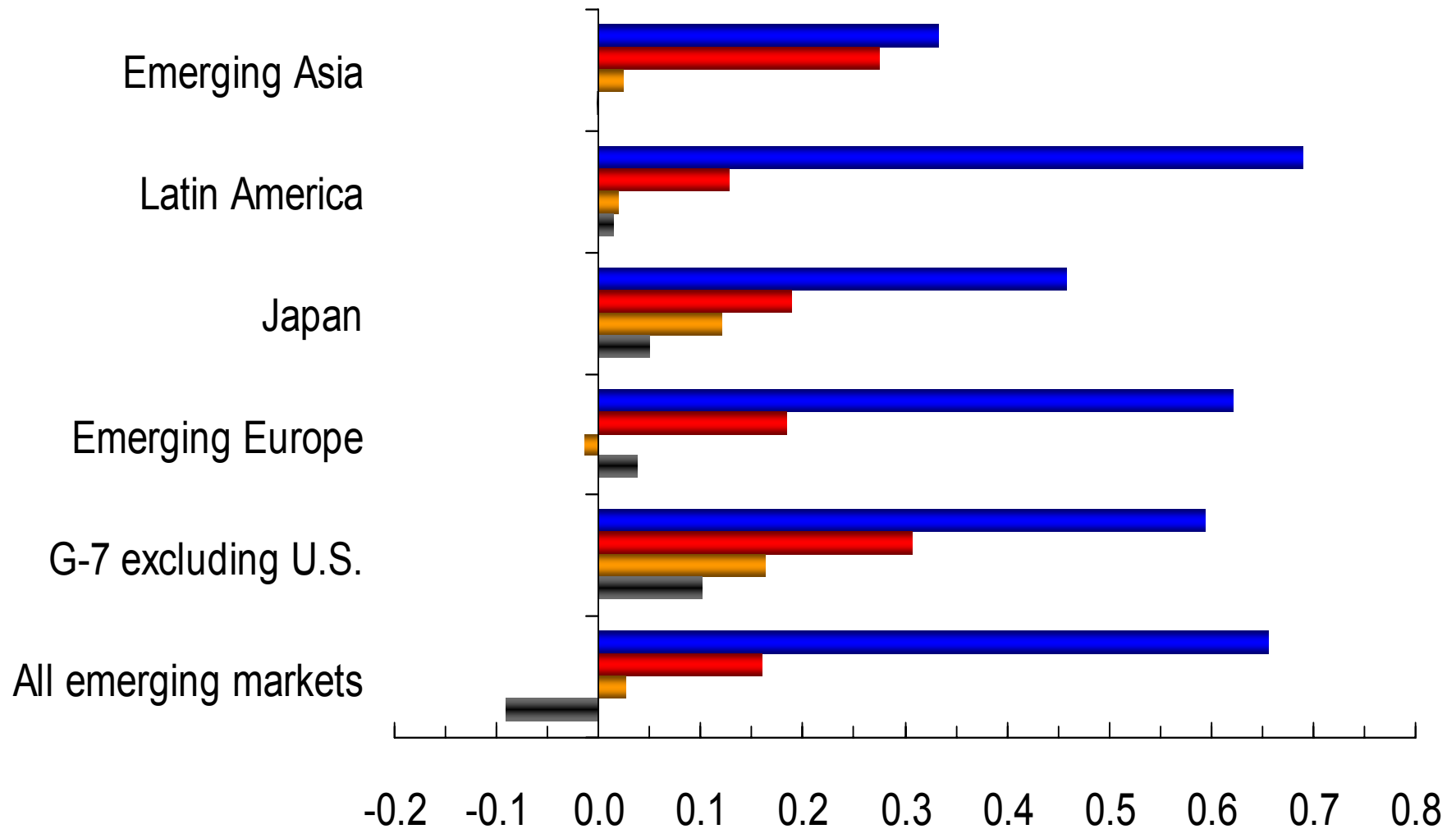
*(Real Stock Market Performance; index, 2000 = 100)*



# Stock Market Correlations Increase During Bear Markets

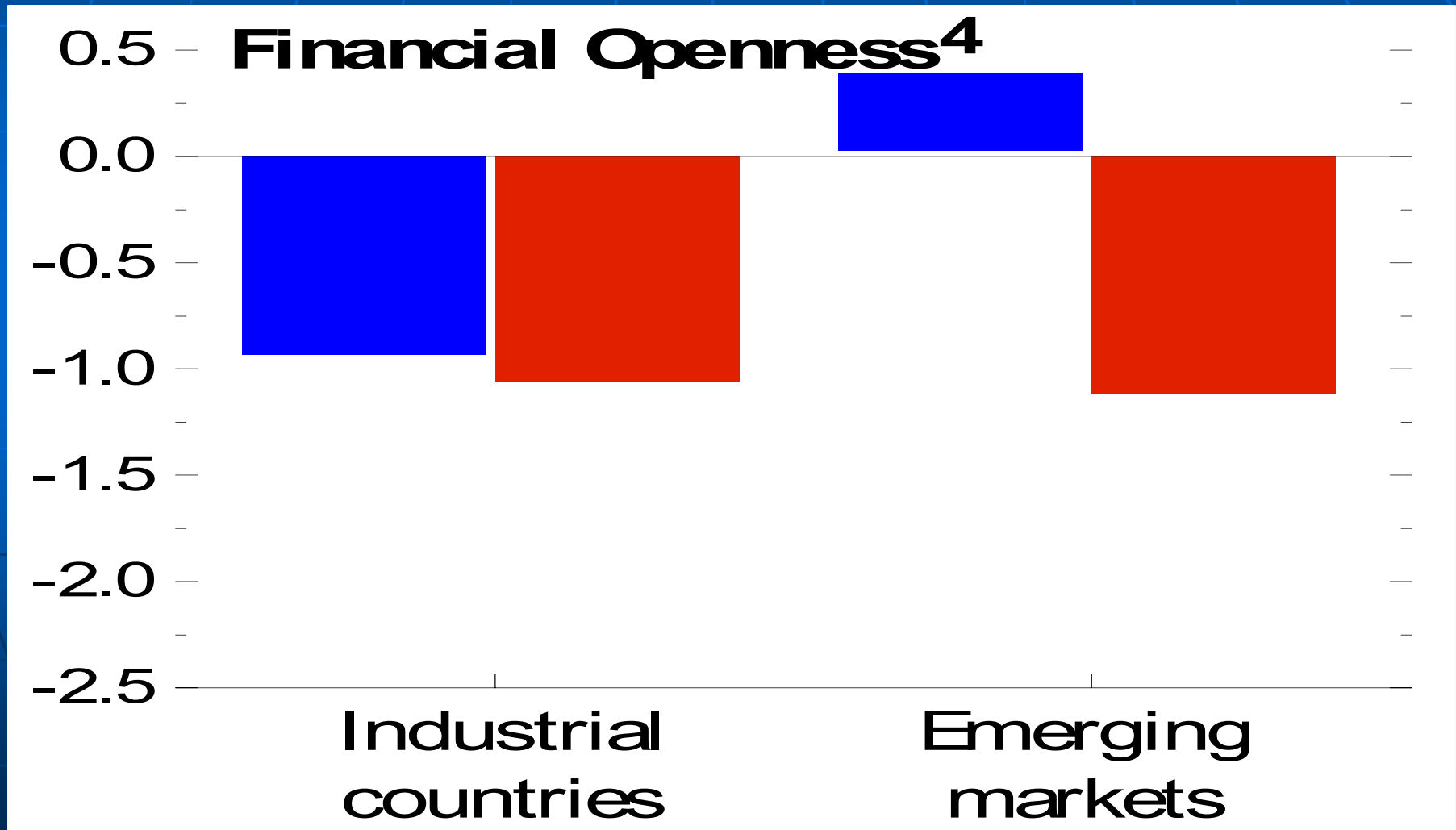
(1991–2006; Correlation with U.S. stock market, monthly)

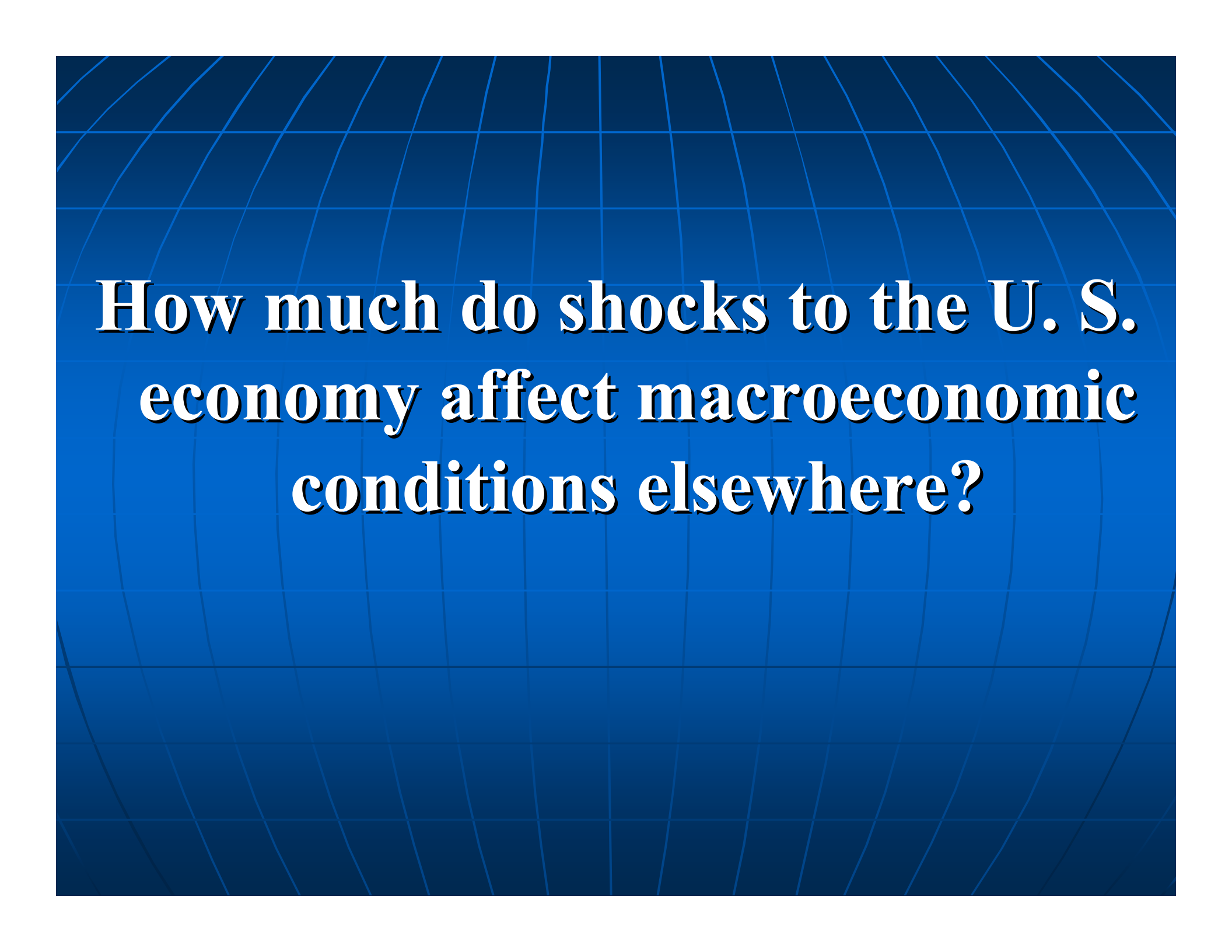
■ Less than -5%   ■ Between 0 and -5%   ■ Between 0 and 5%   ■ Greater than 5%



# Financially More Open... More Severe Growth Declines

- Change in average output gap in lower half of category
- Change in average output gap in upper half of category





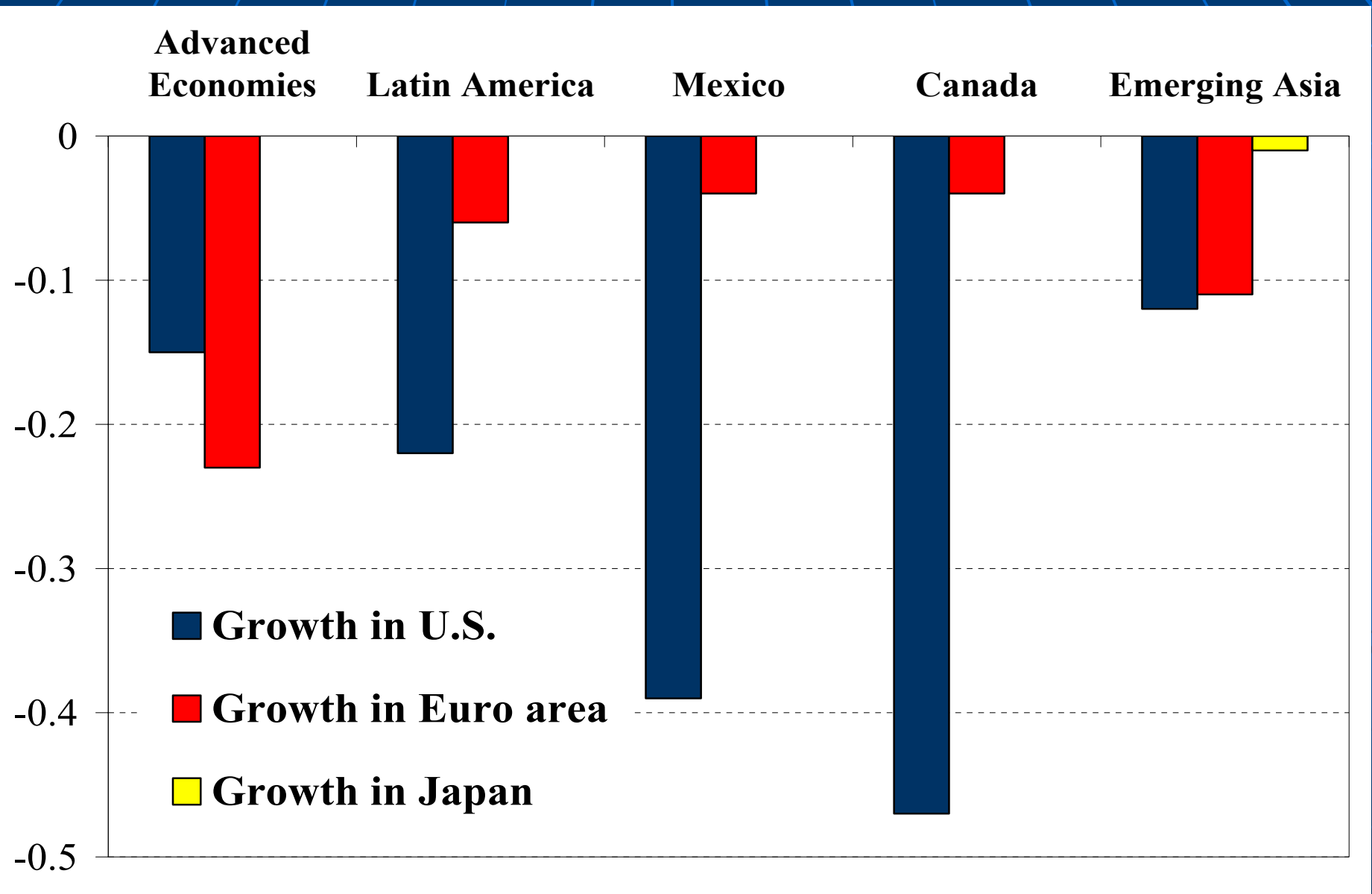
**How much do shocks to the U. S.  
economy affect macroeconomic  
conditions elsewhere?**

# Extent of Linkages and Spillovers

- The links between spillovers and the structure of trade linkages were used to calculate growth effects for different regions
- Canada, Latin America and the Caribbean are most strongly influenced by the U.S. growth, reflecting their sizeable trade links with the United States.
- On average, a one percentage point decline in U.S. growth is associated with a slowing in growth of almost  $\frac{1}{4}$  percentage point in Latin America as a whole, about 0.4 percentage points in Mexico, and about 0.5 percentage point in Canada.
- Emerging Asia is also affected significantly by U.S. growth, but (perhaps surprisingly) not by growth in Japan. Africa is influenced most clearly by growth in the euro area.

# Extent of Linkages Matters for Spillovers

*(Impact of a 1 Percentage Point Decline in Growth Rates of Euro Area, Japan, and the United States)*



# **Emerging Markets Decoupling? Some Recent Perspectives (I)**

**[for details see:  
“Global Business Cycles: Convergence or Decoupling”  
by Kose, Otrok and Prasad, forthcoming IMF WP]**

# Emerging Markets: Decoupling or Not?

- Recent discussions increasingly focus on the potential of emerging market economies decoupling from the United States
- What does “*decoupling of emerging market economies*” mean?
- It means the emergence of a group-specific cycle primarily driven by factors specific to emerging markets.

# Are Group-Specific Factors Becoming More Important?

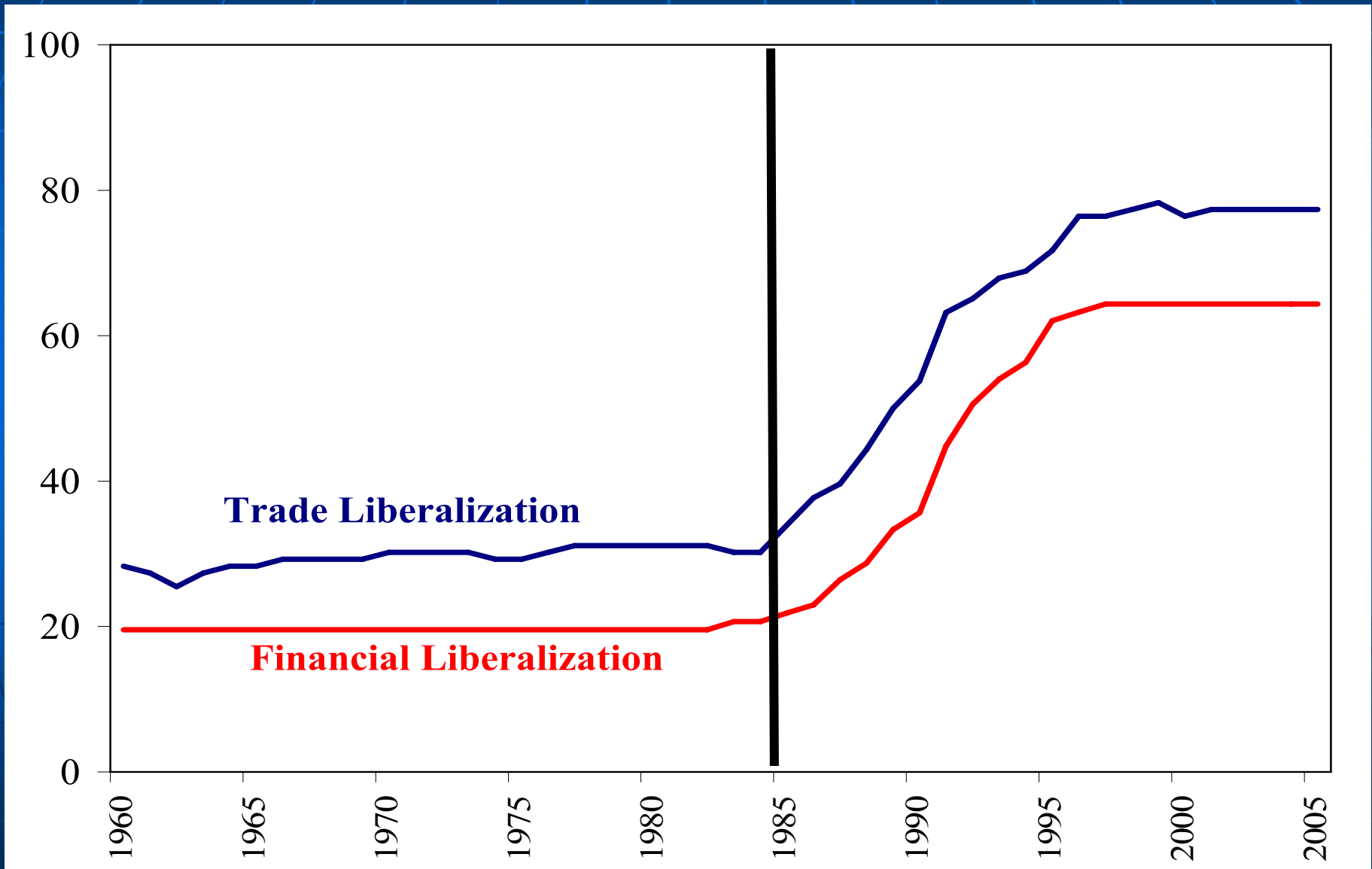
- To answer this question, analyze how important the global and group-specific factors in explaining cyclical fluctuations over the periods 1960-1984 and 1985-2005
- The global factor has, on average, played a less important role in the latter period
- Group-specific factors have become more important

# Evolution of Synchronization Over Time

- **Two periods:** 1960-1984 and 1985-2005; Why 1984?
- **1960-1984 (“Pre-globalization” period)**
  - Weak global/group linkages and common shocks
- **1985-2005 (“Globalization” Period)**
  - Strong global/group linkages
  - Expansion of trade and financial flows
  - Increase in intra-industry/vertical trade flows
  - Rise in the number of regional trade agreements
- **Great Moderation:** Structural decline in the volatility of business cycles in the mid-1980s  
(80 percent of the countries which have a break in the unconditional variance experience that break in or before 1984)

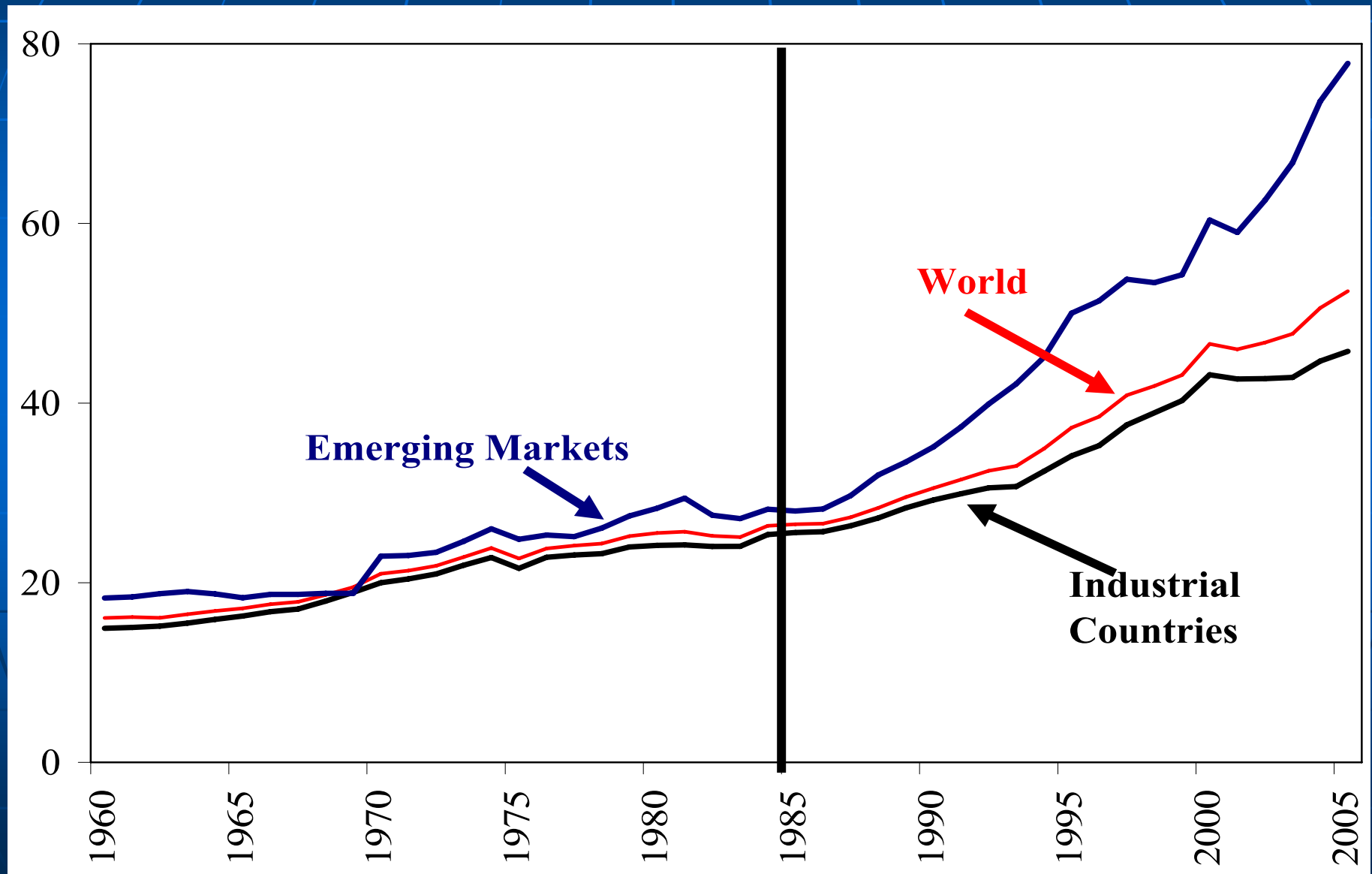
# Evolution of Financial and Trade Liberalization

*(Fraction of Liberalized Countries, percentage)*



# Evolution of Trade Openness

( $(Exports+Imports)/GDP$ , percentage)

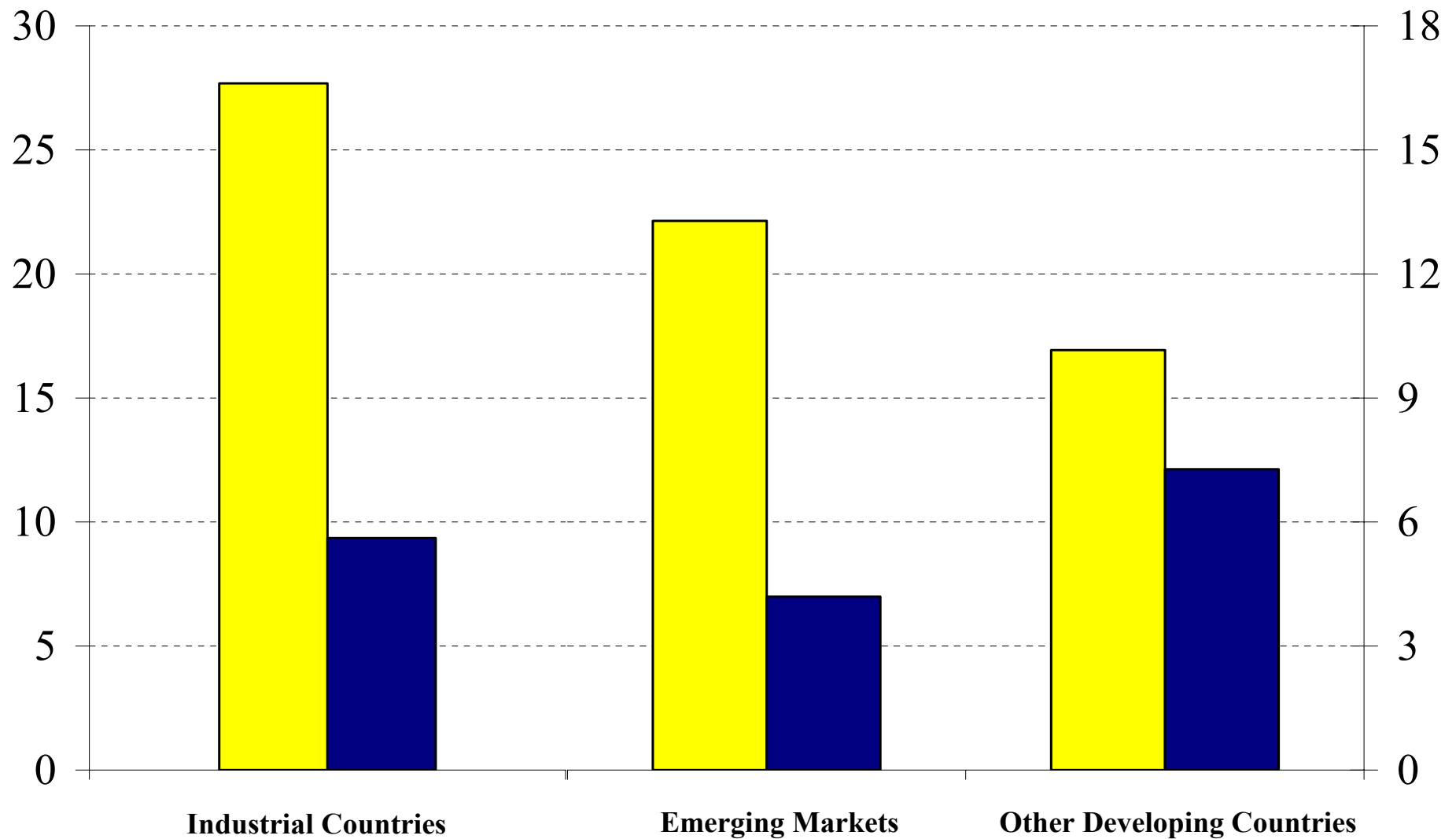


# Results: Emerging Markets Decoupling?

- The group specific factors have been becoming more important in driving business cycles in emerging markets.
- Both the global and group-specific factors play important roles in explaining business cycles.
- These factors appear to be more significant in industrialized countries than they are in emerging and developing economies.
- There has been a role reversal between the global and group-specific factors over time. While the group-specific factors have become more important in driving business cycles, the importance of the global factor has decreased.

# Global Factors Becoming Less Important

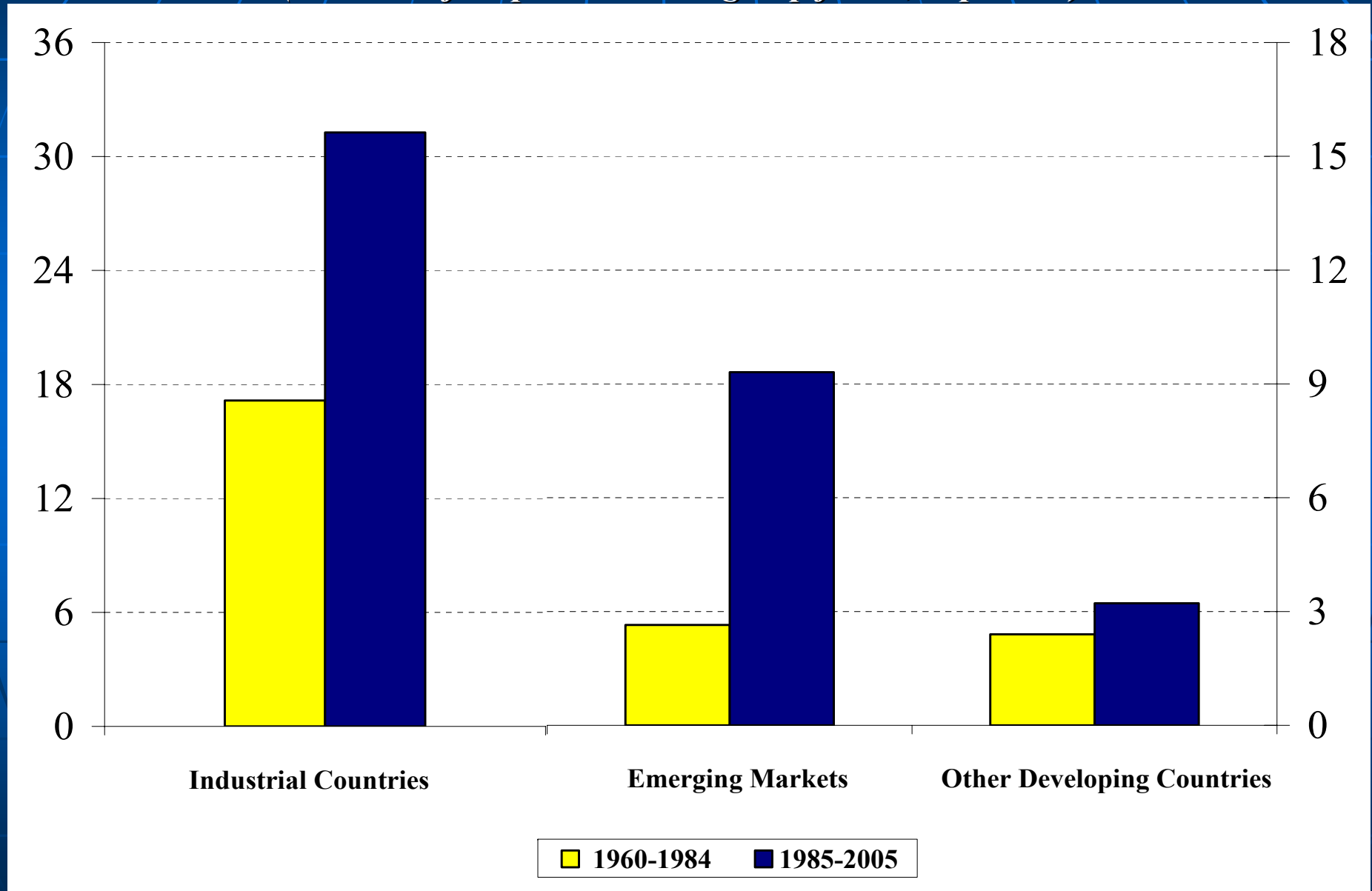
*(variance of output due to the global factor, in percent)*



■ 1960-1984 ■ 1985-2005

# Group-Specific Factors Becoming More Important

*(variance of output due to the group factor, in percent)*



# A discussion w/ many nuances...

*(evolving assessments...)*

- **Convergence View:** *“You either believe in decoupling or globalization-but not both”* (Stephen Roach, Financial Times, Jan. 23)
- **Decoupling View:** *“Those arguing that Asia and other emerging markets can't decouple from the US are forgetting one very important fact — they already have.”*  
(Robert Prior-Wandesforde, The Times, February 12)
- **Reconciliation:** *“You can have both decoupling and globalization at the same time”* (Economist, March 8)

# What do these results mean?

- Contrary to the convergence view, rising trade and financial integration are not necessarily associated with global convergence of business cycles, as evidenced by the decline in the importance of the global factor.
- But there is indeed some evidence of convergence at a different level. Greater economic integration among industrial countries and among emerging market economies has been associated with the emergence of group-specific cycles.
- There has been a **convergence** of business cycles among industrial economies and among emerging market economies over time, but there has also been a concomitant divergence, or **decoupling**, of business cycles between these two groups of countries.

# What Did We Learn?

- **Global factor has become less important. Why?**
  - Large common disturbances during the pre-globalization period—the two oil prices shocks—and some correlated shocks in the major industrial countries.
  - Disappearance of these during the globalization period

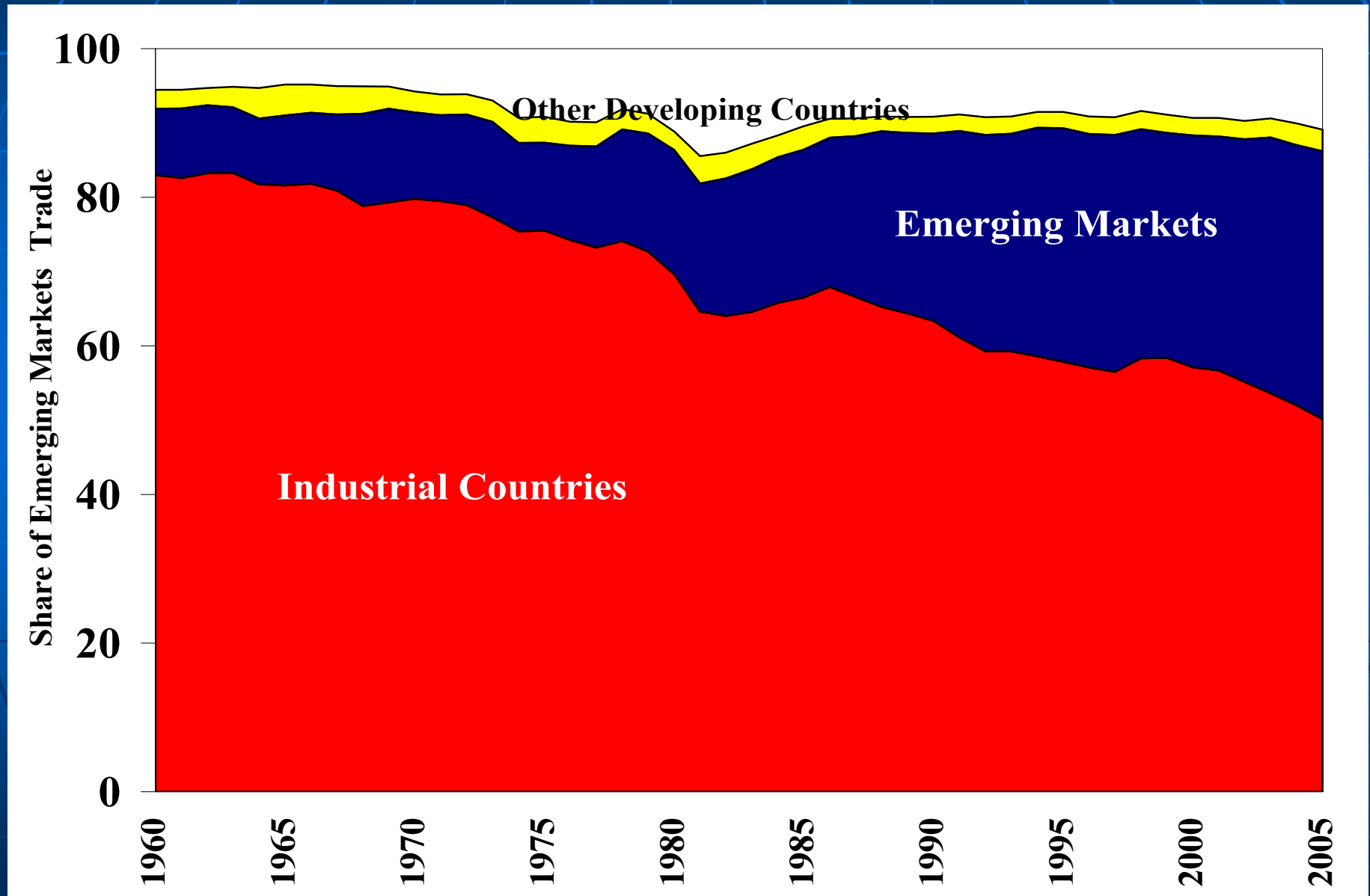
# What Did We Learn?

## ■ **Group-specific factors have become more important.** **Why?**

- Increase in intra-group trade and financial linkages among industrial countries and EMEs after the mid-1980s
- Intra-group trade linkages have become stronger among EMEs during this period.
- EMEs' trade with the group of industrial countries as a share of the EMEs' total trade has declined from 70 percent to 50 percent.
- Increase in the pace of diversification of their industrial (and trade) bases; accompanied with a greater degree of sectoral similarity across countries within each group.

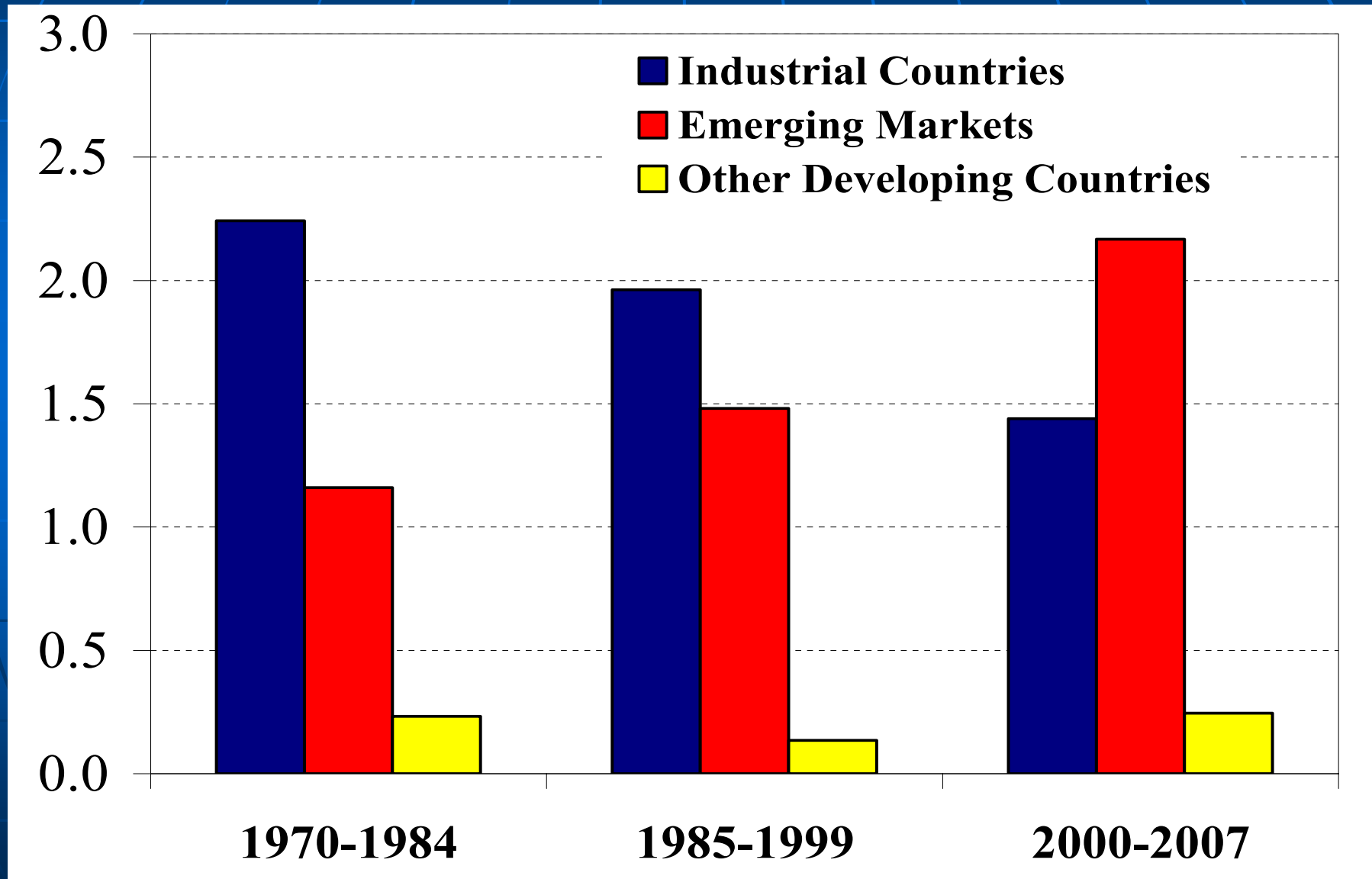
# Emerging Markets' Trade with Other Groups

*(Fraction of the Total Trade from Emerging Markets to Others, percent)*



# Contributions to Global Growth

*(at PPP Exchange Rates, Period Averages)*



# **Emerging Markets Decoupling? Some Recent Perspectives (II)**

**[for details see:  
Changing Nature of North-South Linkages  
by Akin and Kose, *Journal of Asian Economics*, 2008]**

# Impact of Industrial Economies

- On the growth performance of emerging markets
- Over a 5-year period
- 1 percentage point increase in the annual growth of industrial countries corresponds to

0.76 percentage points increase during 1960-1985

0.34 percentage points increase during 1986-2005

in the growth rate of the group of emerging economies.

# Summary

# Results-1

- The old saying, “When the U.S. sneezes, the rest of the world catches a cold,” remains relevant.
- However, the importance of growth spillovers should not be exaggerated... Spillovers are larger during recessions than during mid-cycle slowdowns.
- Previous episodes of global slowdowns were the result of worldwide developments, not pure U.S. shocks.
- There are differences in financial and real decoupling. It is hard to envision a prolonged period of financial decoupling...

# Results-2

- Group-specific factors have been becoming more important in explaining business cycles (at the expense of global factors)
- Impact of industrial economies on the growth performance of emerging markets has been declining
- If the U.S. slowdown continues to be limited with certain sectors and financial market conditions are restored in a timely fashion, spillovers to elsewhere could remain limited
- If the downturn spreads to consumption and investment in the U.S. and turns into a full-blown recession, then much larger cross-border spillovers could be expected.
- Policy responses can moderate the U.S. spillover effects



**What is new?**

# What is new in the decoupling debate?

- Probably not much is new!
- Recent developments have given a new life to an old question since a large literature have already studied similar questions focusing on the North-South linkages
- The old question was about “whether the dependency link between the North and South is inevitable”
- The new question is “ Can Emerging Economies Decouple?”
- Sir Arthur Lewis asked the old question almost 30 years ago in his Nobel lecture

# A new question for the new century?

## *Probably Not!*

*"For the past hundred years, the rate of growth of output in the developing world has depended on the rate of growth of output in the developed world. When the developed grow fast, the developing grow fast, and when the developed slow down, the developing slow down.*

*Is this linkage inevitable?"*

*Sir Arthur Lewis,*

*1979 Nobel Prize lecture*

# Questions & Comments

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