

Chapter 14

The Resilience of Emerging Economies During the Great Recession: Lessons Learnt from Recent Data

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ABSTRACT

This chapter focuses on the decoupling hypothesis between emerging countries and the advanced world. On the basis of quarterly seasonally adjusted data over the period 1995q1–2014q1 we present some evidence in favor of a decreasing vulnerability of emerging market economies to global economic and financial development, particularly convincing for Asian countries. Results confirm a common finding in the related literature: The acute phase of the financial crisis triggered by the US mortgage crisis corresponds to a period of substantial increase in business cycle synchronization, arguably determined by the synchronized trade collapse and foreign credit retrenchment, although in the aftermath of the global financial crisis, all the different groups of emerging economies started to decouple again from the United States, and also relative to the Eurozone and to Japan. Therefore, extending the time span to recent data allows us to envisage the recoupling phase with respect to the United States' business cycle as a temporary halt over a long-run decoupling initiated a decade ago.

INTRODUCTION

The US financial crisis, which originated in a small portion of the US housing market (subprime mortgages), has rapidly acquired a global dimension, stimulating a renewed interest in early warn-

ing system (EWS) indicators and models. From a normative perspective, early warning systems are crucial because they allow the symptoms of a crisis to be identified sufficiently in advance so as to adopt preemptive policy measures. Nevertheless, it remains very challenging to figure out how best

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to motivate authorities to implement corrective action once the escalation of systemic risk has been recognized. Hence, it is still important to understand the exposure of individual countries to exogenous shocks emanating from external financial crisis. In this respect, the empirical validation of the decoupling hypothesis is to be considered complementary to early warning systems literature in that it allows us to gauge in advance the magnitude of systemic repercussions of idiosyncratic shocks for the international financial and real system as a whole.

Over the past two decades, the global economy has experienced profound changes. Growing trade and financial integration might have altered the nature and strength of cross-border transmission of shocks. While rising interdependence in the world economy would suggest closer co-movement of economic activity across regions and countries, the successful catching-up process of emerging economies has led some scholars to advocate the hypothesis of a decoupling, according to which the emerging economies may continue to keep growing relatively robustly even when the advanced world undergoes a severe downturn.

In the decoupling debate, it has become important to distinguish between trend and cyclical decoupling. While long-term trend decoupling is a well-established stylized fact due to the higher trend growth rates of emerging market economies, little evidence has been produced so far on the alleged business cycle decoupling between advanced economies and emerging ones, especially during recessions (see Yetman (2011) and Cutrini and Galeazzi (2011, 2012) for a survey and some evidence until the end of 2011). During the last five years, the interest in a possible cyclical divergence has increased since the recent global financial crisis was considered a natural experiment to verify the vulnerability of emerging economies to adverse global shocks and thus evaluate the validity of the decoupling hypothesis.

During the first phase of the Great Recession triggered by the Lehman collapse in 2008, Asia

and Latin America – and to a lesser extent Eastern European and Commonwealth of Independent States (CIS) countries – were apparently better able to cope with the repercussions of the trade collapse and the deep slump in the advanced world, while there is no evidence for the more recent period covering the Eurozone sovereign debt crisis. The central question of this chapter is whether emerging markets could escape a long recession even though much of the rest of the advanced world is slowing down. Hence, we focus on cyclical decoupling, i.e. emerging countries display a dynamic in their economic cycle less tied to the cycle prevailing in the advanced economies. In our analysis, we measure business cycle synchronization of emerging economies vis-à-vis the US and the Eurozone, to account for the changing epicenter of the crisis that has moved from the United States to the Eurozone. As for business cycle synchronization between emerging economies and the United States, we found a downward trend from the aftermath of the global financial turmoil onward that was deeper than the decoupling interlude characterizing the 2003–2007 period.

The chapter first provides updated evidence on the emerging markets' decoupling hypothesis. The analysis of business cycle synchronization conducted through quarterly seasonally adjusted data over the period 1995q1–2014q1 is followed by a discussion of each transmission channel: trade and financial linkages.

BACKGROUND: AN OVERVIEW OF THE CHANGING WORLD ECONOMIC ORDER

In the last 30 years the global economic order has changed markedly, largely because emerging economies achieved sustained high rates of growth of GDP whereas advanced economies (AEs), although they were reasonably dynamic and stable, underwent a slowdown in growth rates of GDP.

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