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International shocks and growth in emerging markets

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ABSTRACT

The paper provides evidence on the extent and channels of transmission of international shocks on the economic growth of emerging markets. Using a block dynamic factor model, the shocks are decomposed into four components; a general global component, an activity based component, a financial component and a commodity price component. Using a sample of 75 emerging markets over the period 1992–2009, the paper finds that the average effect of international shocks on emerging markets' growth over the entire sample period is negligible, which supports the classic view of isolated, de-coupled emerging markets. However, there is considerable variation both over time, over cross-section and across factors. When we split our sample by time period, we find greater effect of the international factors on the emerging markets' growth during 2002–2009 period. There is evidence which suggests that sensitivity to international shocks has increased over time and at the country level these sensitivities are more pronounced. Although the drivers of integration vary as does the sensitivity to alternative sources of shocks, we find that certain emerging markets have become considerably more integrated with the global economy than others. Overall, there is evidence of a significant impact on the economic growth of some emerging markets of the international shock caused by the global financial crisis.

1. Introduction

An important issue for academic research, investors and policy makers is the extent to which growth in emerging markets is affected by negative external shocks. This is particularly relevant as with increasing in-

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ternational flows of capital, goods and services, emerging markets become not only further integrated with the global economy but also have greater relevance for global growth.[2] While such integration leads to benefits through access to international markets and capital, there may also be undesirable effects stemming from greater susceptibility to the business cycle and financial market related shocks from advanced economies. This is particularly relevant to consider in view of the global financial crisis following the US sub-prime crisis of 2007–2008 to which emerging markets, at least based on expert evidence at the time, showed increased vulnerability leading to renewed concerns about the benefits of global integration.[3] For policy makers, understanding the size and nature of global contagion aids design of appropriate policy. International spill-overs may have serious consequences for emerging markets that do not have the luxury of protective mechanisms such as 'automatic stabilisers' and where the transmission mechanism of monetary policy may work even less effectively than it does in developed markets. In such circumstances economic rates of growth may decline, the impact may be long lasting and the effect on poorer segments of society may be quite large. For international investors, increased transmission of international shocks would mean reduced diversification benefits which might increase reluctance to invest in such countries and/or may increase the chances of capital flight. This risk aversion may in turn, exacerbate the sensitivity of emerging markets to global shocks.

This paper examines several topical issues. Firstly, we re-visit the issue of emerging markets and their sensitivity to global shocks. Although there is large literature, it is divided on this subject and we consider it worth re-visiting to clarify issues of linkages and impact across a wide cross section of emerging markets and over a period of increasing globalisation. Secondly, the response of emerging markets to the extreme global shock from advanced economies in 2007–2008 is an "extreme event" in modern economic history that deserves further attention. Idiosyncratic growth dynamics may drive emerging market growth for a range of advanced economies shocks but this may not hold for an extreme shock. Average estimates of co-movement therefore fail to capture the time varying nature of the true responsiveness. Thirdly, as the grouping of emerging markets is far from homogenous, the distribution of sensitivity across countries is worth considering. Finally, we study the responsiveness of emerging markets to alternative international factors of relevance, making a clear separation between activity shocks and those emanating from financial movements or from changes in commodity prices.

We start with a summary of the literature on linkages between emerging markets and the global economy. Changes in policy, technology and in politics have led to a dramatic increase in the importance of emerging markets for global growth over the last two decades. While there is little dispute that this has been accompanied by increased flows of trade, capital and services (the more visible side of globalisation), there is less consensus on the impact this has had on output fluctuations in emerging economies. One strand of thought suggests that shocks in advanced economies are major drivers of emerging market growth. Rand and Tarp (2002) and Akin and Kose (2007) support the view that shocks to advanced economies are principal drivers of GDP growth in emerging markets. Similarly, Kouparitsas (2001) finds that up to 70% of consumption volatility in emerging markets is driven by economic shocks in advanced economies. Using high frequency data, Edwards (2010), examines the effect of changes in the US Federal Reserve's fund rate on interest rates of emerging markets. He also investigates the impact of shocks arising from changes in dollar-Euro exchange rate, oil prices, risk ratings and capital mobility. Edward's overall conclusion is that the impact of shocks differs across markets. For Latin American markets the impact is rapid but for Asian markets the impact is felt over a long period of time. Dooley and Hutchinson (2009) examine financial asset prices post the events in the US since autumn 2008 and find an increase in asset price correlations between the US and several emerging markets, while prior to this, such financial correlations were low.

However, this conclusion does not square well with a parallel strand that fails to find evidence of synchronous business cycles between the developed and emerging economies. Kose, Otrok, and Prasad (2008) search for global, regional and country specific co-movement in a sample of 106 industrialised and emerging countries and conclude that while global co-movement can be observed over the period 1960–2005, the global factor has become less important during the latter part of the sample period (1985–2005). Kose et al. (2008) point out that this analysis is not consistent with the hypothesis that increasing trade and financial integration

[2] See Economist (2012).

[3] The IMF April 2009 World Economic Outlook reported a contraction in emerging economy GDP growth of 4% in the fourth quarter of 2008. The WTO noted that falls in trade, financial flows and commodity prices had all affected emerging markets and that no region of the world had been left untouched.