

Decoupling the Train?
Spillovers and Cycles in the Global Economy

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**This talk is primarily based on the
World Economic Outlook,
April 2007, Chapter 4
October 2007, Chapter 1**

Disclaimer!

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

What is “decoupling”?

- Decoupling view argues that “a slowdown in US growth will not necessarily undermine the growth prospects in the rest of the world”

Who believes in decoupling?

- *An extensive discussion about the merits of decoupling view*
- *“We believe in decoupling” Investment Bank A, August 16*
- *“.. Decoupling (view) has already lost much credibility...”
Investment Bank B, August 20*
- *“... The real test for decoupling is yet to come”
Investment Bank C, September 4*
- *“... decoupling (view) stands on solid ground”
Investment Bank D, September 19*

Outline

- Setting the stage: When the US sneezes...
- How important is the U.S. economy?
- What happened in the past?
- Channels of transmission: Trade and Finance
- Emerging Asia: Decoupling or Not?
- Global Prospects: 2007 and 2008

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 2-3 years appear to be different.. But, how sustainable is this trend?

Past...

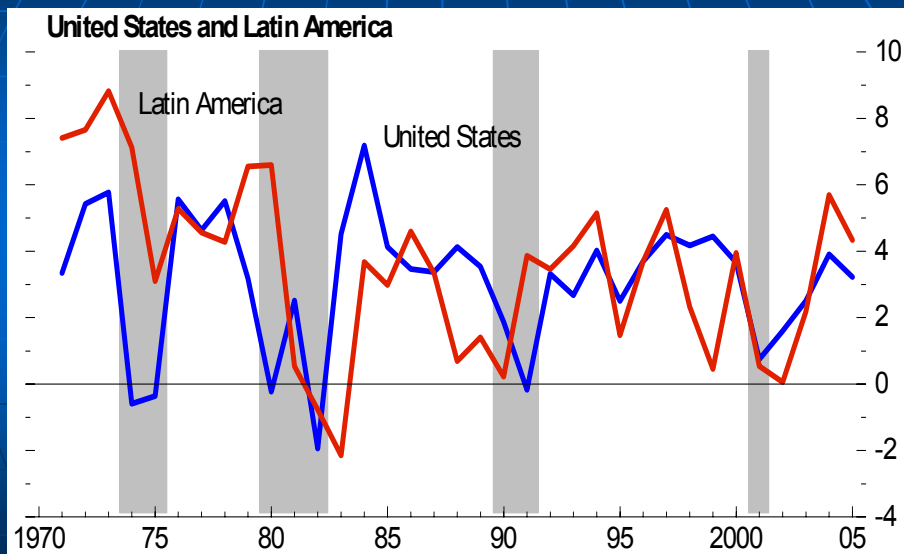
When the U.S. sneezes, who gets what?

When the U.S. sneezes...

- Latin America... gets pneumonia
- Japan and Emerging Asia... catch a cold

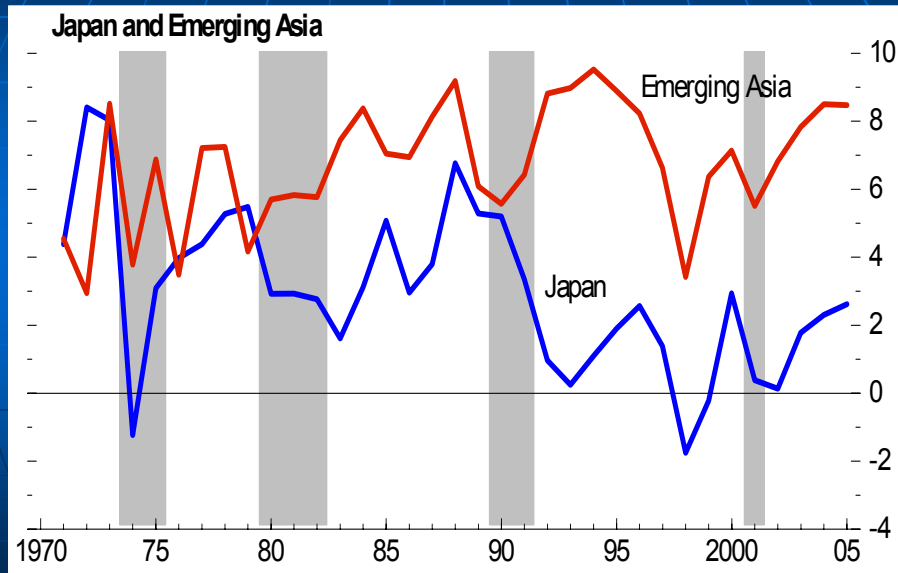
U.S. Recessions and Latin America

(Real GDP growth, annual change in percent)



U.S. Recessions and Japan & Emerging Asia

(Real GDP growth, annual change in percent)

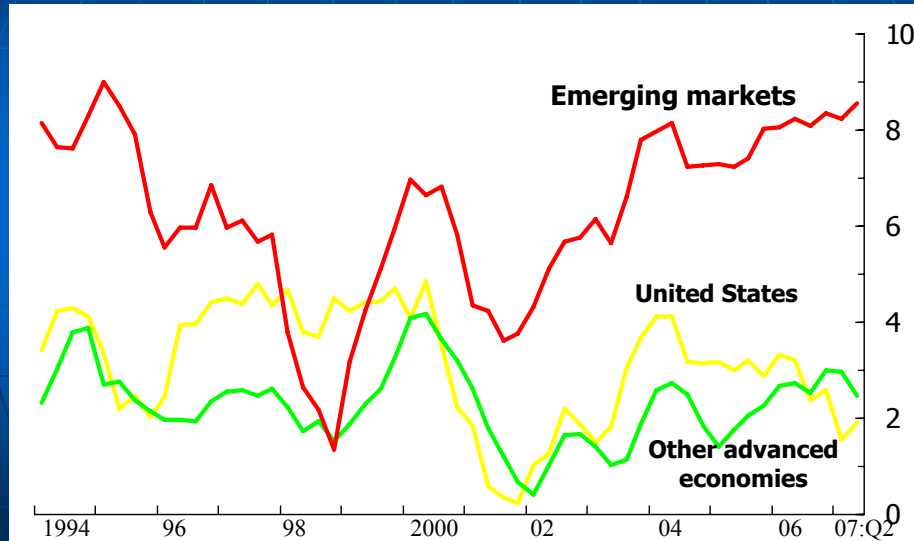


Present: Last 2-3 years different?

- The U.S. has been slowing down, but rest of the world has been growing rapidly... Since 2004, world growth has been 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).

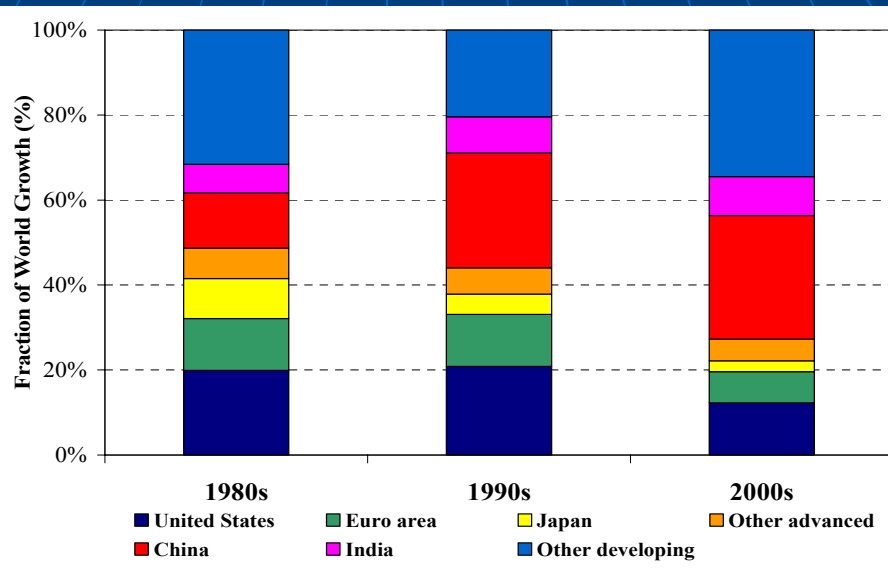
Growth Has Softened in the U.S.; But Remains Strong in Emerging Markets

(Real GDP; percent change from four quarters earlier)



What Explains World Growth?

Developing Countries' Share Increasing (based on PPP)



Global Prospects: Half Full? Half Empty?



Half Full?

- U.S. specific sectoral developments
 - housing market correction
 - difficulties in mortgage/sub-prime markets
- Trade linkages with the U.S. less important now for many countries (still important but less)
- Growth momentum in other parts of the world
 - Emerging markets

Half Empty?

- Growth slowdowns precede recessions
 - difficult to predict turning points (recessions)
- Financial linkages largest ever
 - U.S. at the center
 - tightening credit conditions in some European countries because of the financial turbulence in the U.S.
- The U.S. economy remains the world's largest (PPP)
 - 5 largest EMs (China, Mexico, Korea, India, Brazil) $\frac{1}{4}$ world GDP, but only $\frac{1}{7}$ of world trade

Questions

- 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 regional factors?

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.
- Policy responses can moderate the U.S. spillover effects

RESULTS - 2

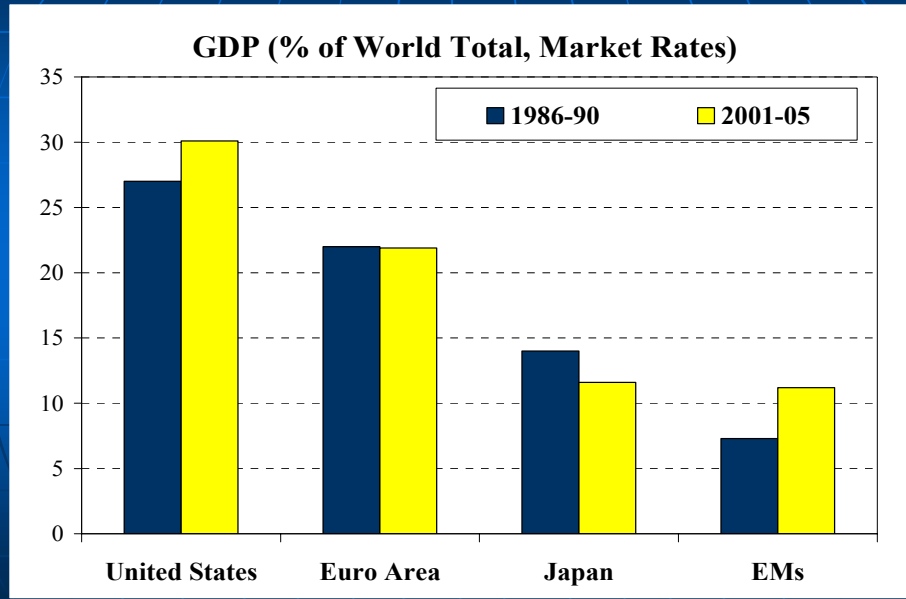
- Regional factors have been becoming more important
- If the U.S. slowdown continues to be limited with certain sectors and financial market conditions are restored in a timely fashion...
... Spillovers to growth elsewhere could remain limited
- If the downturn spreads to consumption and business investment in the U.S. and turns into a full-blown recession, then much larger cross-border spillovers could be expected.

How important is the U.S. economy?

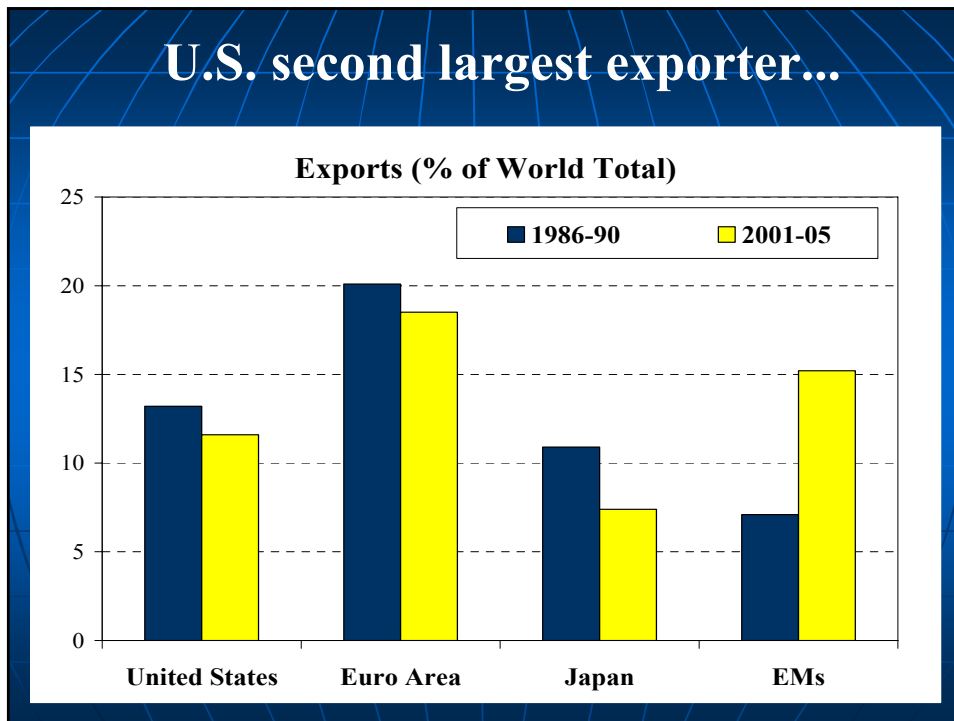
The U.S. Economy in the World

- By far the world's largest economy.
- The largest importer in the global economy. 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

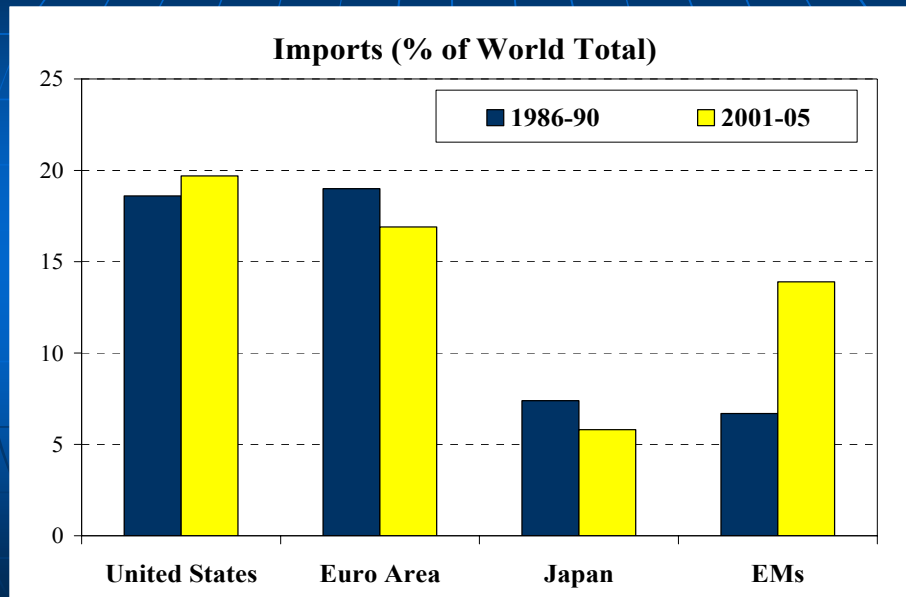
U.S. still the largest economy..



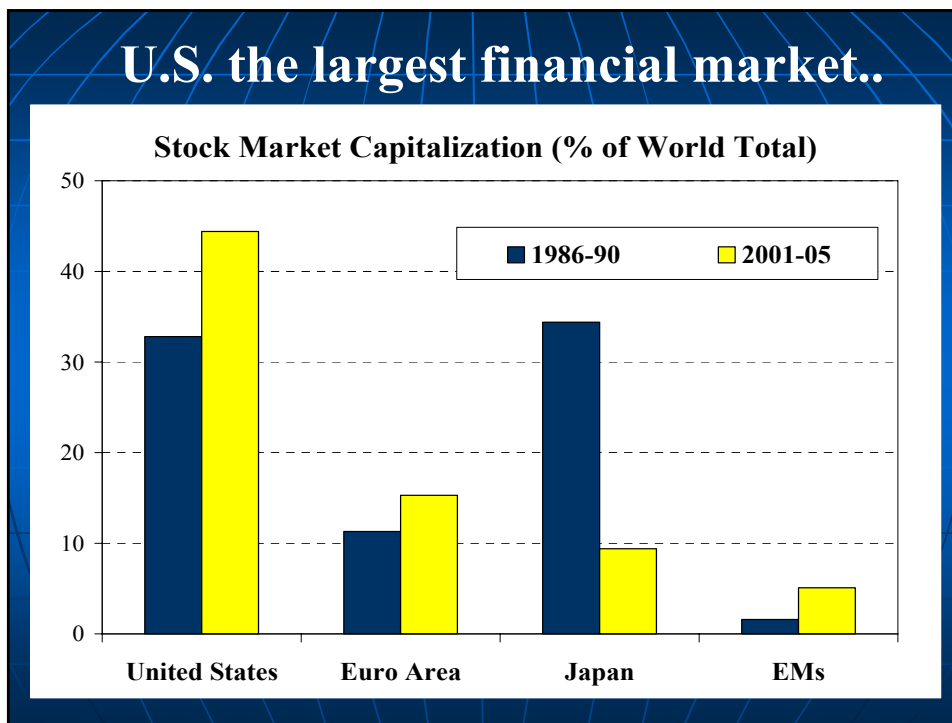
U.S. second largest exporter...



U.S. the largest importer...



U.S. the largest financial market..

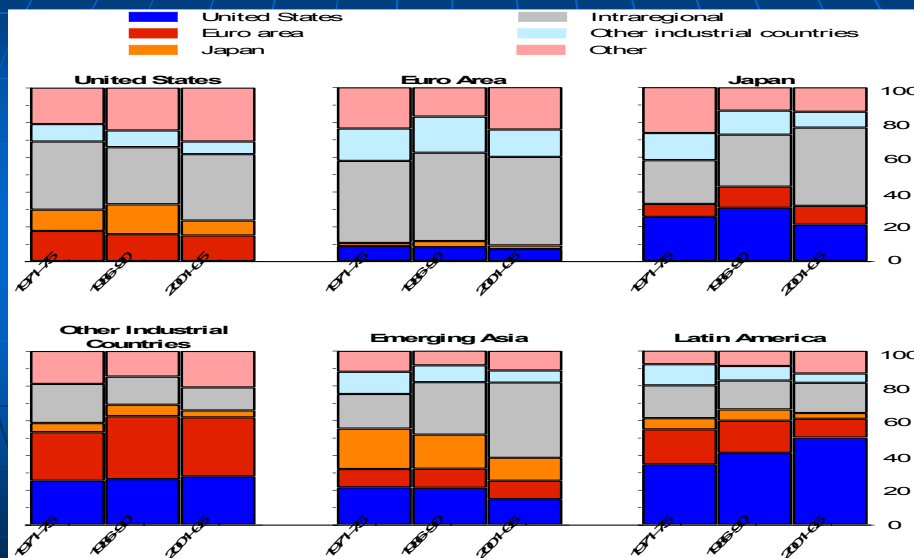


Export Exposure to the U.S.

- 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?

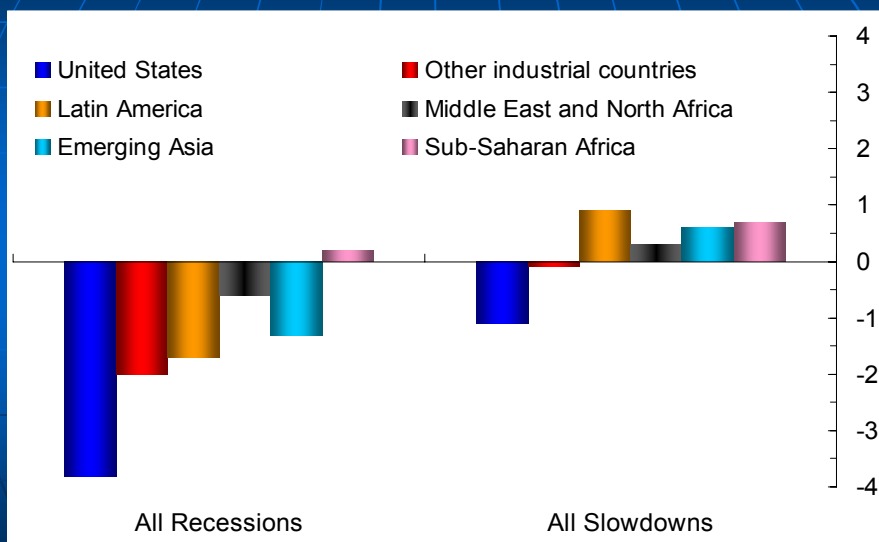
- **Recessions:** Two consecutive periods of negative growth...
- **U.S. recessions:** 1974–75 (-6.1) , 1980 (-3.4), 1981–82 (-4.5), 1991 (-2.1), and 2001 (-2.9)
Average Decline in Growth: 3.8 percentage points
- **1974–75:** oil price shocks; **1980, 1981–82:** LA debt crisis, contractionary policies 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

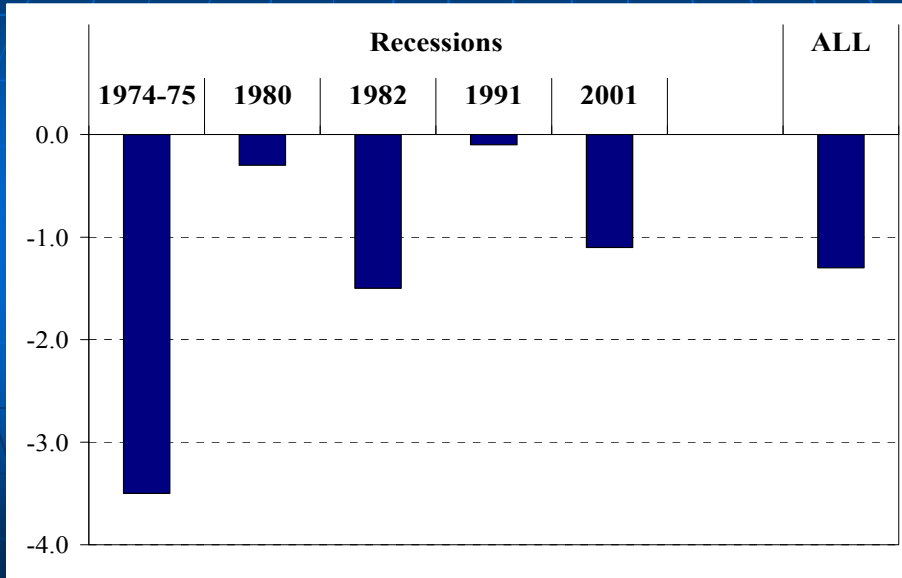
Recessions are a Greater Cause for Concern

(Change in GDP growth; median for region)

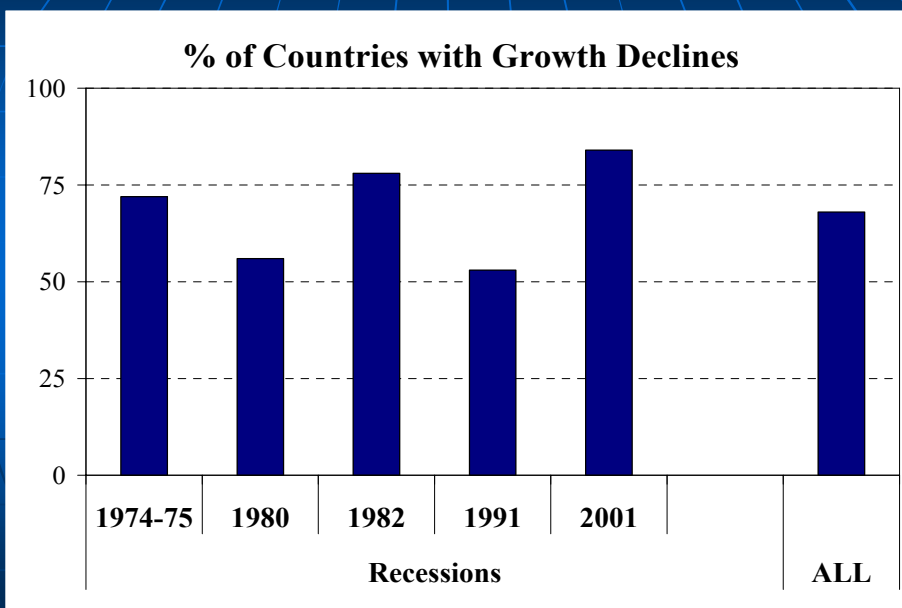


Growth in Emerging Asia and U.S. Recessions

(Change in GDP Growth, Median for Region)

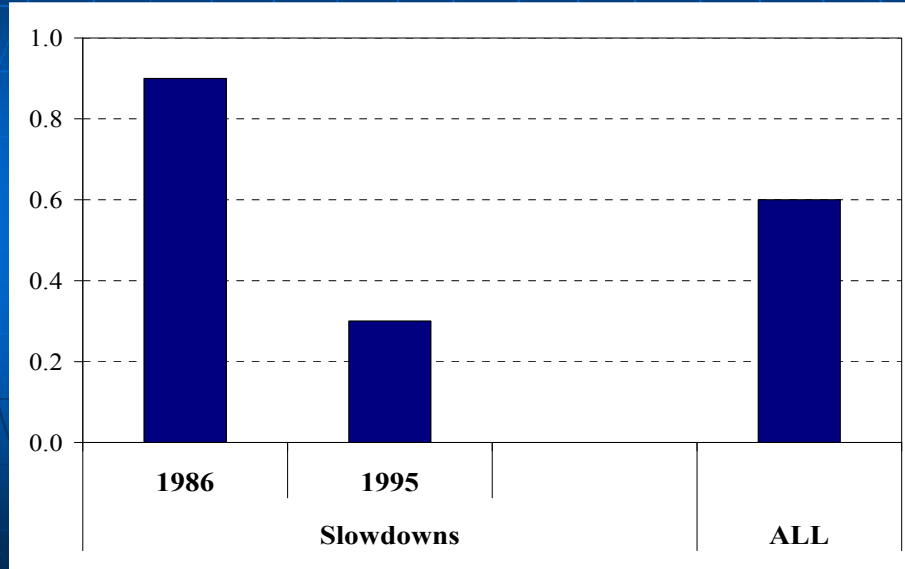


Emerging Asia and U.S. Recessions



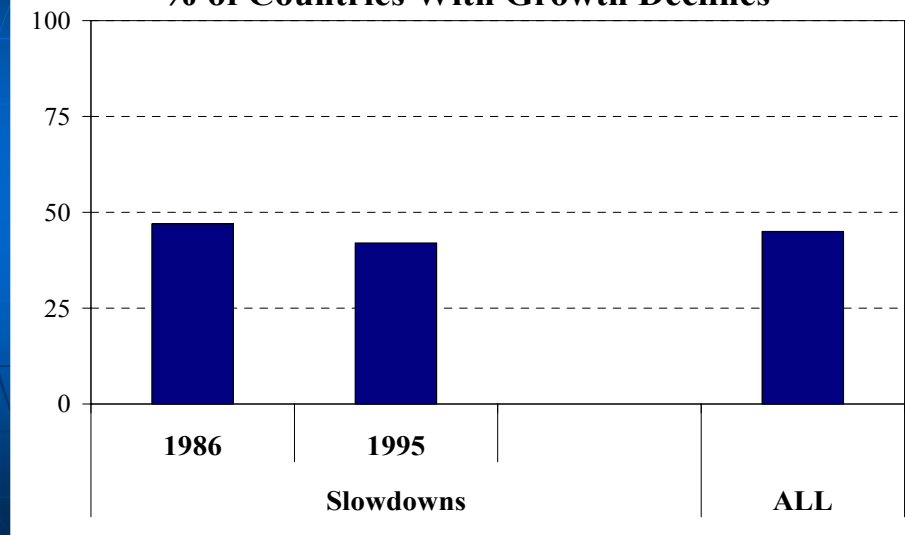
Growth in Emerging Asia and U.S. Slowdowns

(Change in GDP Growth, Median for Region)



Emerging Asia During U.S. Slowdowns

% of Countries With Growth Declines



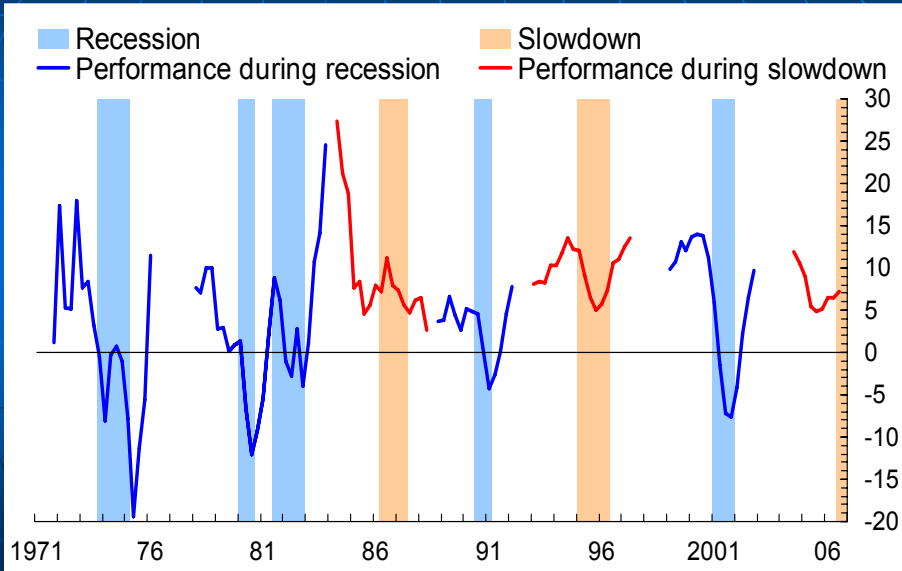
Channels of transmission: Trade and Finance

Channels of Transmission: Trade

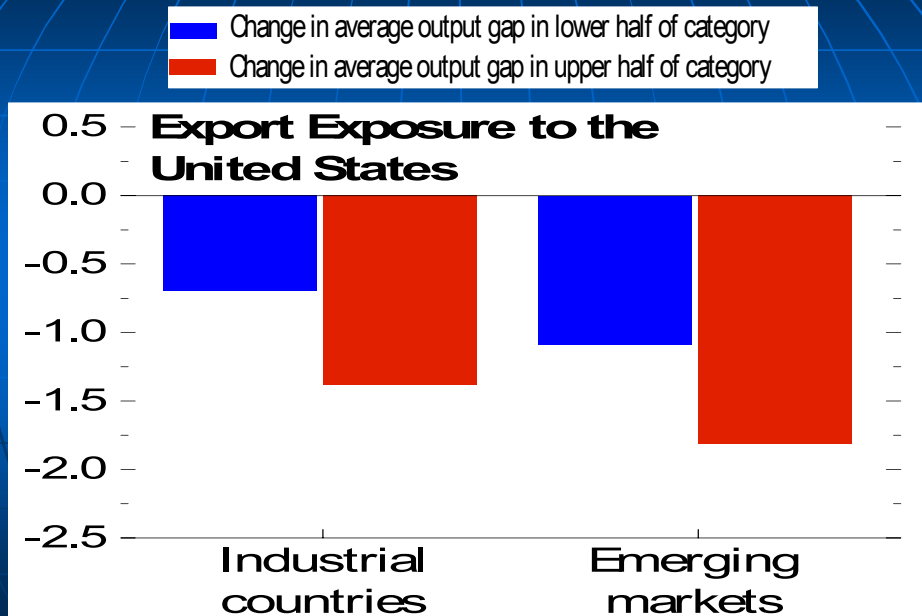
- U.S. import growth turned sharply negative during recessions
- U.S. imports are strongly pro-cyclical reflecting the relatively high import share of cyclically sensitive components of domestic final demand
- Countries with the greatest export exposure to the United States suffered the largest declines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

Import Growth Sharply Negative in Recessions

(Real Import Growth, Percent)

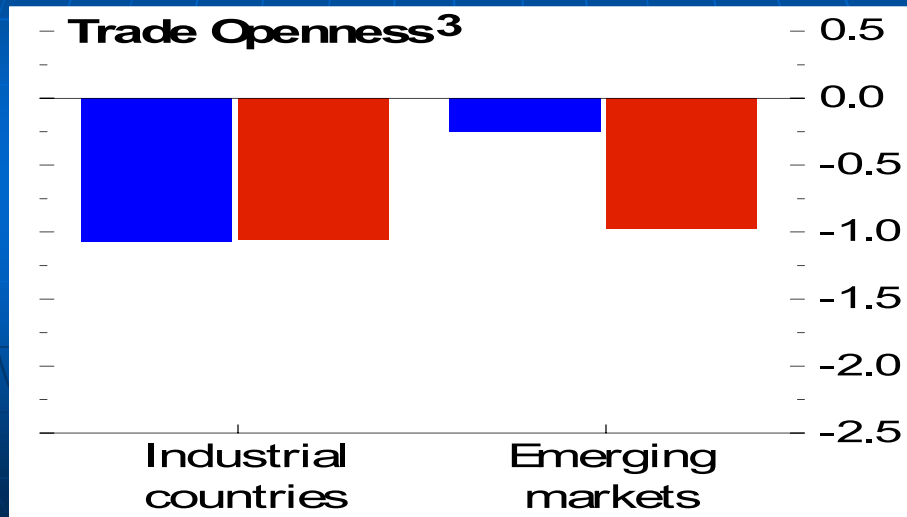


More Export Exposure to U.S. More Severe Growth Decline



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

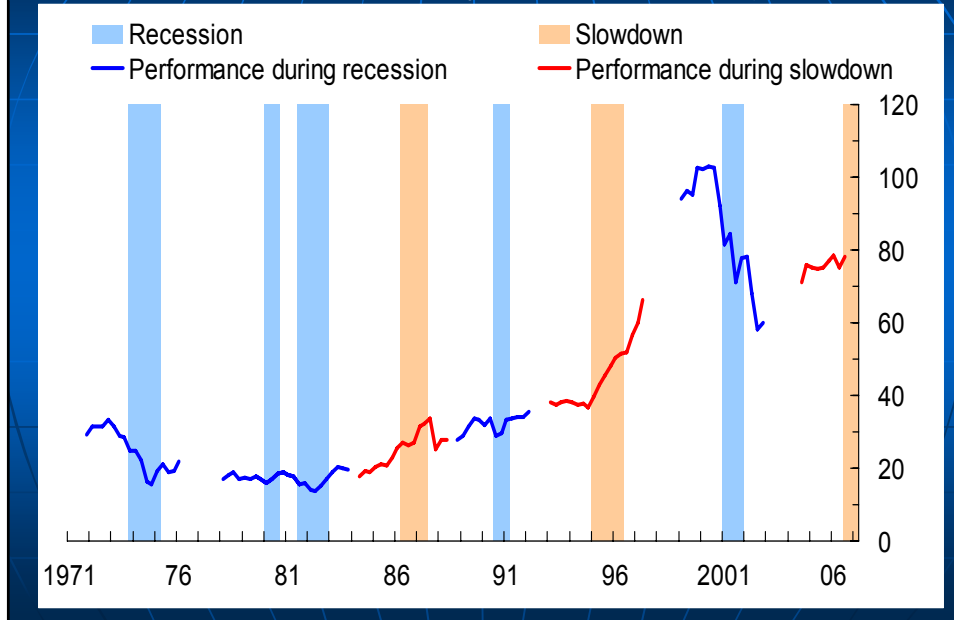


Channels of Transmission: Finance

- 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, including the current one
- 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, including at present

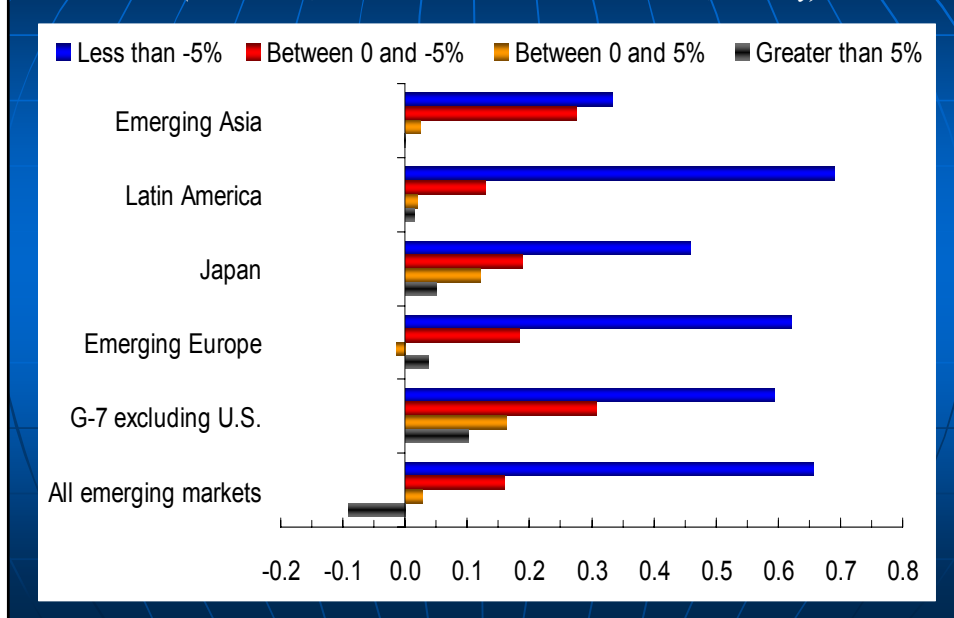
Stock market declines before/during U.S. recessions

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



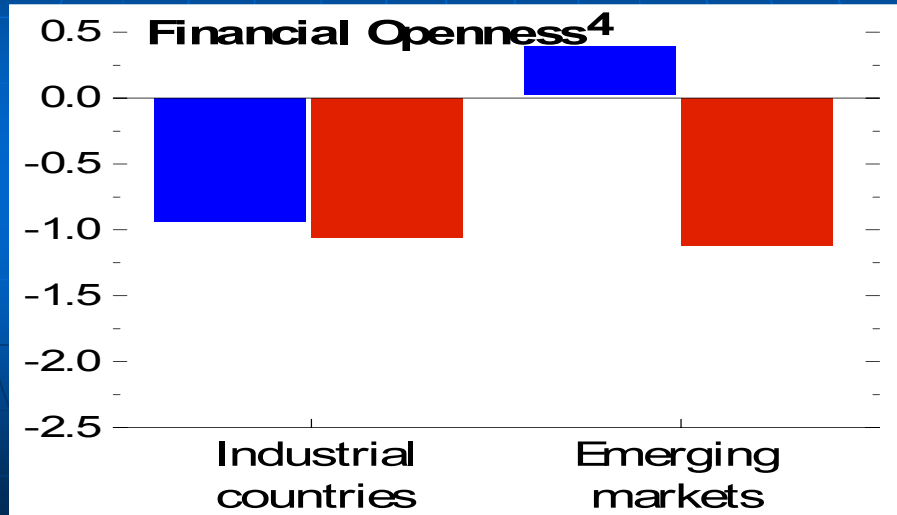
Stock Market Correlations Increase During Bear Markets

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



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



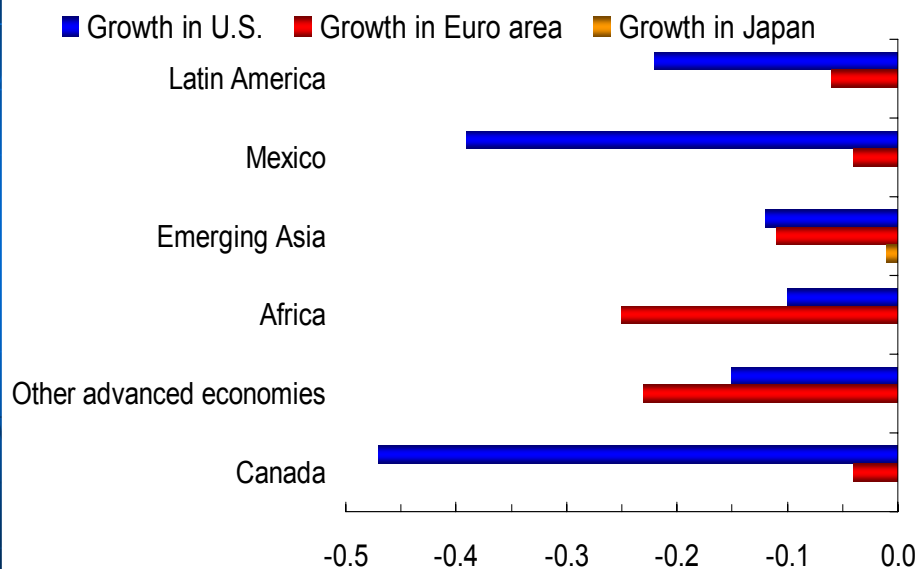
How much do shocks to the U. S. economy affect macroeconomic conditions elsewhere?

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)



What are the roles played by the regional factors?

Emerging Asia: Decoupling or Not?

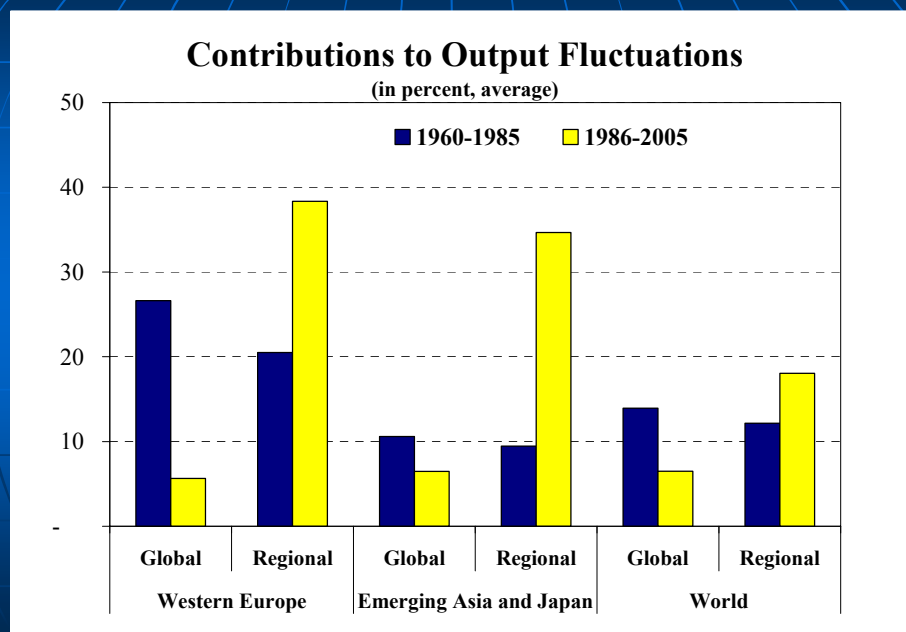
Emerging Asia: Decoupling or Not?

- Recent discussions increasingly focus on the potential of Asia's emerging markets decoupling from the U.S.
- What does “*decoupling of Asia*” mean?
- It means the emergence of a regional cycle in Asia independent of global economy and primarily driven by autonomous changes in regional demand.
- Regional demand and regional factor?

Are Regional Factors Becoming More Important?

- To answer this question, analyze how important the global and regional factors in explaining cyclical fluctuations over the periods 1960-1985 and 1986-2005
- The global factor has, on average, played a less important role in the latter period
- Regional factors have become more important in regions where intra-regional trade and financial linkages have increased substantially.

Regional Factors Becoming More Important Over Time



Summary

SUMMARY – 1

- The old saying, “When the United States 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.
- Policy responses can moderate the U.S. spillover effects

SUMMARY - 2

- Regional factors have been becoming more important
- If the U.S. slowdown continues to be limited with certain sectors and financial market conditions are restored in a timely fashion...
... Spillovers to growth elsewhere could remain limited
- If the downturn spreads to consumption and business investment in the U.S. and turns into a full-blown recession, then much larger cross-border spillovers could be expected.

Global Prospects: 2007 and 2008

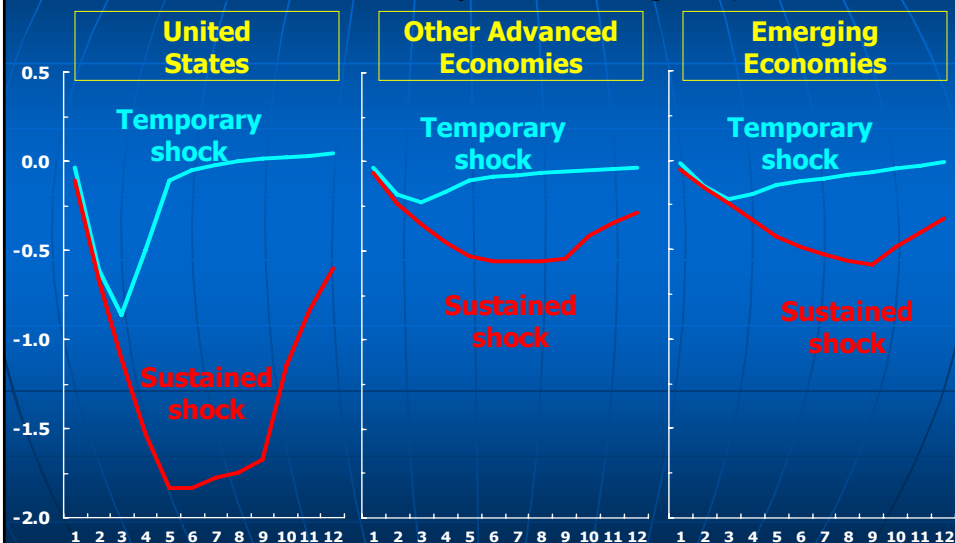
World Economic Outlook
October, 2007

Implications of a Financial Shock in the U.S.

- If there is a persistent large financial disturbance centered on the United States (involving a 10 percent decline in house prices, a 10 percent drop in equity prices, and a 50 basis point widening in the term premium, all relative to baseline)
- This would have a substantial adverse impact on global activity, with spillovers from the U.S. economy through trade and financial channels, including by inducing corrections in housing markets, around the world.
- By contrast, a disturbance of the same initial magnitude that was quickly reversed would have a much smaller macroeconomic impact.

A Sustained Large Financial Shock Could Have a Sizable Impact on Global Growth

(Real GDP, deviation from baseline, in percent)



Global Prospects-2007 and 2008

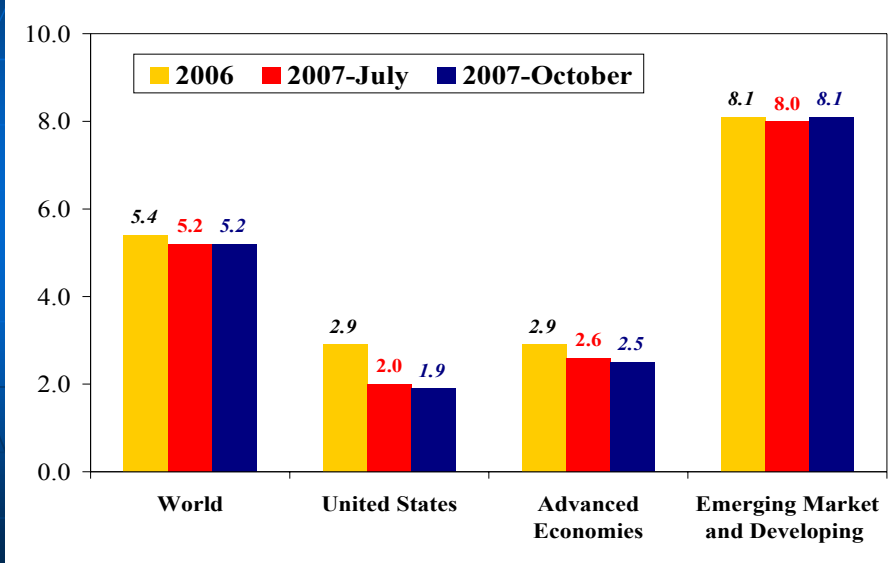
- The baseline projections for the global economy have been marked down moderately since the 2007 July WEO update
- Growth nonetheless is expected to continue at a solid pace
- Global growth would slow to 5.2 percent in 2007 and 4.8 percent in 2008; down from the 5.4 percent in 2006
- The largest downward revisions are in the U.S., and countries where trade and financial spillovers from the U.S. are likely to be largest (Canada, Mexico and parts of emerging Asia)

Global Prospects-2007 and 2008

- The baseline projections assume that market liquidity is gradually restored in coming months (consistent with experience following previous periods of financial turbulence)
- The baseline also assumes that the Fed cuts interest rates by a further 25 basis points by the end of the year, and the ECB and BoJ refrain from further interest rate increases through the end of the year
- On this basis, sound fundamentals would continue to support solid global growth
- However, the risks to the baseline forecast are distinctly to the downside with a 1 in 6 chance of global growth falling to 3.5 percent or less in 2008

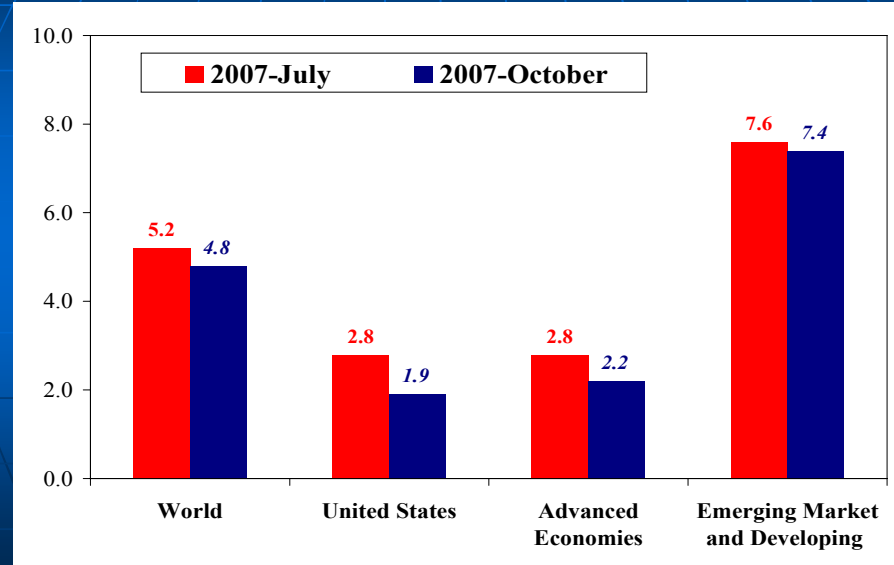
Global Prospects-2007

Global growth would slow to 5.2 percent in 2007 down from 5.4 percent in 2006
WEO Projections (Annual percent percentage)



Global Prospects-2008

Global growth would be 4.8 percent in 2008 supported by the momentum
in emerging markets; WEO Projections (Annual percent change)



Conclusion

- Recent financial turbulence will moderate global growth, particularly in the advanced economies.
- Overall global growth should remain strong, especially in emerging market countries.
- Downside risks still dominate.

Global Prospects: Half Full? Half Empty?



Still half full, but how long?

Questions & Comments

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