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REVIEW OF "EMERGING MARKETS RESILIENCE AND GROWTH AMID GLOBAL TURMOIL BY M. AYHAN KOSE AND ESWAR S. PRASAD"

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Review of "Emerging Markets Resilience and Growth Amid Global Turmoil by M. Ayhan Kose and Eswar S. Prasad"*

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Abstract

Emerging Markets Resilience and Growth amid Global Turmoil provides an excellent contribution to the literature. The book covers a variety of important topics on emerging market economies and offers invaluable information for a wide range of audience; from academics to policy makers as well as anyone interested in learning about these countries. The vast amount of information provided in the book is, then, used to shed light on an important question: What explains the resilience of emerging market economies observed during and in the aftermath of the global financial crisis? This review presents a brief summary of the book and a discussion about its implications for future research.

*This review is written for the *Journal of International Economics*. I thank Emine Boz for useful comments. Address: International Finance Division, Federal Reserve Board, Washington DC 20551, USA. Email: `Bora.Durdu@frb.gov` The views in this review are solely the responsibility of the authors and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or of any other person associated with the Federal Reserve System.

1 Introduction

M. Ayhan Kose and Eswar S. Prasad (KP, henceforth) provide an excellent contribution to the literature on emerging markets with their book, *Emerging Markets Resilience and Growth amid Global Turmoil*. The book covers a variety of important topics on emerging market economies (EMEs, henceforth) and offers invaluable information for a wide range of audience; from academics to policy makers as well as anyone interested in learning about these countries.

The first chapter of the book presents stylized facts on the rising importance of EMEs in world economic activity. The chapter highlights that, within the last two decades, these countries' shares of world GDP, private consumption, investment, and trade nearly doubled. These developments challenge the conventional wisdom that activity in EMEs is very much dependent on activity in advanced economies. During 2003-07, EMEs recorded a particularly strong growth despite tepid growth in the advanced economies. The divergence of economic performance in the EMEs from advanced economies attracted great attention in academic and policy circles and led to a discussion on whether EMEs were decoupling from advanced economies. The global financial crisis caused the "decoupling" view to lose some persuasive power, as EMEs were severely affected by the financial stresses in advanced economies. Since the middle of 2009, however, EMEs rapidly regained their strong footing, thereby, bringing back the decoupling debate.

Rising importance of EMEs in global economic affairs and signs of decoupling raise a number of important questions: How have the trade and financial linkages between EMEs and advanced countries evolved? What are the implications of these changes for the dynamics of cyclical spillovers between EMEs and advanced countries? How has the global

financial crisis impacted EMEs' macroeconomic stability and their growth prospects? What policy implications do these developments imply? The book provides a collection of excellent analysis on these questions in methodologically ordered chapters.

In chapter 2, KP survey existing literature on the cyclical implications of rising global trade and financial linkages on the transmission and synchronicity of business cycles. They argue that these implications depend on the level of development, the nature of the shocks and the pattern of specialization, thereby, concluding that the theoretical literature on this topic is mixed. This mixed evidence makes a case for a careful empirical analysis of the topic, which KP provide in the subsequent chapters.

In chapter 3, KP present the details of a comprehensive database used in the remaining chapters. This database covers 106 countries over the period from 1960-2008. The sample of countries is split into three major groups (advanced economies, EMEs, and other developing economies (ODEs)); with the BRICs (Brazil, Russia, India, and China) and emerging Europe also analyzed separately in some chapters. With consideration to structural breaks, the sample is split into three major periods: the Bretton Woods (1960-72), preglobalization (1973-85), and globalization (1986-2009).

Chapter 4 examines the size distribution and growth dynamics over these periods. The chapter establishes the significant rise of EMEs' contribution to world output and GDP growth. EMEs' contribution to world growth rose especially in the aftermath of the global financial crisis, as advanced economies had low growth rates while EMEs expanded rapidly. This chapter also points out that EMEs have been increasingly specializing in manufacturing while advanced economies have been in services. This change in the specialization of activity appears to have shaped the nature of trade and financial linkages among advanced economies

and EMEs, as characterized in the subsequent chapters.

In chapters 5 and 6, KP analyze developments in global financial and trade linkages. Following trade liberalization during the globalization period, cross border trade flows have increased rapidly. Export-led growth strategies in several EMEs have contributed to a significant rise in trade openness. Further, EMEs' trade linkages amongst themselves have also markedly increased. Trade flows within emerging Asia, for example, rose much faster than those with the United States. The financial linkages during the globalization period have also increased, even more so than the trade linkages, thanks to the rapid liberalization of capital accounts.

How have the stronger trade and financial linkages between advanced economies and EMEs as well as amongst EMEs shaped the synchronization of business cycles and transmission of real shocks? In chapter 7, KP shed light on this question by examining the dynamics of volatility of output, consumption, and investment across groups of countries and over time. The chapter argues that financial and trade integration may have increased the volatility of GDP growth among EMEs, but the component of growth attributable to greater integration has not had an adverse effect on growth. Moreover, having access to global trade and financial markets helped EMEs recover faster from recessions and crises, contributing to their resilience.

In chapter 8, KP shed further light on the comovement of business cycles and financial markets between advanced economies and EMEs. They employ a variety of indicators including correlations of GDP growth, industrial production indices, and stock returns. The evidence suggests that, across advanced economies and EMEs, output indices have become less correlated over time while financial market indices have become more correlated. This

finding underscores the need for a careful examination of patterns in economic and financial activity in evaluating the decoupling of EMEs from advanced economies.

Simple correlations of economic and financial activities provide a useful benchmark, but do not offer any insights about lead-lag relationships between indicators of economic activity or on identifying commonalities in fluctuations for country or group-specific macroeconomic fluctuations. In chapter 9, KP fill this gap by using a state-of-the-art econometric methodology –a dynamic factor model– to provide a comprehensive empirical characterization of business cycle linkages between different groups of countries. The chapter answers two important questions. What are the major factors driving business cycles in different groups of countries? And how have these factors evolved over the past two decades?

Chapter 9 finds that for both advanced economies and EMEs, global factors became less important while the group-specific factors became more pronounced. Further, international synchronization of business cycles has decreased slightly. These findings challenge the conventional wisdom that globalization leads to higher business cycle synchronicity across all countries. The chapter highlights two observations that appear to have led to these results. During the preglobalization period, large common disturbances (i.e., two oil price shocks) and correlated shocks in the major advanced economies (i.e., tight monetary policy stance in the early 1980s) drove economic fluctuations both in advanced economies and EMEs. During the globalization period, increased intragroup financial and trade linkages appear to have driven economic fluctuations for both groups. Moreover, during the same period, countries in these two groups increased their diversification of industrial and trade bases. This, in turn, led to higher intragroup spillovers. The chapter highlights changing linkages among advanced economies and EMEs, but does not distinguish the behavior of these linkages in recessions

or expansions; an aspect that KP fill in the next chapter.

Chapter 10 examines EMEs' macroeconomic performance around recessions. This chapter finds that recessions and financial crises in EMEs are more costly than those in advanced economies. In addition, recessions accompanied by financial crises are deeper than other EME recessions. KP's findings in this chapter indicate that given the significant financial disruptions EMEs faced during the global financial crisis, it is natural to expect a marked deterioration of economic activity in EMEs.

In chapter 11, KP analyze EMEs' macroeconomic performance during the global financial crisis. They find that EMEs fared the crisis much better than advanced economies or other developing economies. During the crisis, EMEs' growth only decelerated while advanced economies' and other developing economies' growth contracted significantly. In the aftermath of the crisis, EMEs rebounded sharply while advanced economies have had a relatively tepid recovery. Although EMEs performed well during the global recession as a whole, performance varied across some regions. EMEs' overall performance was driven largely by strong growth performance in Emerging Asia, especially that of China and India. Excluding those countries, however, emerging Asia appears to have had a less impressive performance. Across EMEs, emerging Europe had the sharpest contraction of output, while Latin America's contraction followed closely.

In chapter 12, KP take a deeper look at the performance of Emerging Asia and emerging Europe during the global financial crisis. As highlighted in the previous chapter, emerging Asia fared the crisis reasonably well whereas emerging Europe experienced a deep contraction. KP point out to a number of important factors that led to this outcome. Emerging European countries had a high dependence on external finance to sustain their large current account

deficits. These countries also had a significant exposure to foreign banks. As the crisis started to unfold and foreign bank credit reduced lending, it became difficult to sustain the rapid credit expansion that emerging European countries had in the run up to the global financial crisis. With this sharp tightening in credit, activity in those countries deteriorated rapidly.

In chapter 13, KP compile the main factors that have contributed to the apparent resilience of EMEs, which can be summarized as follows:

- EMEs have had less dependence on foreign finance and a shift away from external debt denominated in foreign currencies.
- Large buffers of foreign exchange reserves that EMEs have accumulated prior to the global crisis proved handy in combating the reversals in capital flows.[1]
- EMEs have had greater trade linkages amongst themselves, which, in turn, reduced their reliance on advanced economies. They have also become more diversified in their production.
- EMEs have significantly improved their macroeconomic policies. More disciplined fiscal policies, implementation of inflation targeting frameworks and flexible exchange rates all appear to have contributed to EMEs' resilience.
- Last, but not least, rising per capita incomes in EMEs led to the creation of a middle class, which, in turn, increased domestic demand in EMEs and reduced their reliance on advanced economies.

[1] See Durdu, Mendoza and Terrones (2009) for an analysis of the role of self-insurance in driving the rapid rise of reserve holdings in EMEs.

2 Directions for Future Research

Findings of the book suggest several areas for further research. The evolving linkages between advanced economies and EMEs call for further research for a thorough understanding of these linkages; especially the relative importance of trade vs. financial linkages in transmission of shocks across these two groups. Kalemli-Ozcan, Sorensen and Yosha (2003), Kose, Prasad and Terrones (2003a, 2003b, 2006), among others are important contributions on this front. But the literature is far from reaching a consensus.

Understanding the driving forces of business cycles is relevant for assessing the likely spillover effects of domestic shocks. Research in this area would also help account for some of the puzzling behavior of the macroeconomic fluctuations in EMEs (e.g., higher variability of consumption relative to output and strong countercyclicality of trade balance). On this front, Kose, Otrok and Whiteman (2003) examine the role of global, regional, and country-specific factors. Aguiar and Gopinath (2007) study the importance of trend shocks in accounting for these salient features of economic fluctuations in EMEs. Building on Aguiar and Gopinath's framework, Boz, Daude and Durdu (2010) examine the role of uncertainty and informational frictions in driving these fluctuations. Mendoza (2010) examines the role of financial frictions in driving macroeconomic fluctuations in EMEs. However, the literature still lacks a consensus on which one of these factors is more relevant or whether there have been structural changes in the way these driving forces have affected EMEs.

Finally, the literature on optimal response to financial crises is still developing. How should EME authorities counteract a sudden reversal in capital inflows? What is the optimal response in boom times to contain boom-bust cycles? Is there a role for macroprudential regulation? Durdu and Mendoza (2006), Durdu (2009), Korinek (2009), Bianchi (2011), Be-

nigno et al. (2011), among a few others are more recent contributions that shed light on these questions. But both the literature and policy circles could potentially benefit significantly from further efforts in this direction.

To conclude, the book is a must read for anyone who is interested in learning about EMEs. Using state-of-the art techniques, the book sheds light on evolving linkages between advanced economies and EMEs as well as EMEs' apparent resilience during the recent global financial crisis. The book also raises a set of important questions and invites researchers to think deeply about issues relevant for EMEs.

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