

Signs of decoupling again

Lower debts of certain emerging markets will lead to their recovery faster than some of the global leaders, argues **Stefan Hofer**.

The idea of emerging markets having the wherewithal to ride out the financial and economic crisis had broad appeal during 2007 and early 2008. This view was based on the idea that, as home to sub-prime mortgages, US was the epicentre of a financial shock that would have little impact on most emerging markets, such as the BRIC block, which demonstrated impressive growth momentum and had addressed macro vulnerabilities in recent years.

This belief proved to be incorrect, in particular in the wake of the bankruptcy of Lehman Brothers that saw tensions in financial market skyrocket to alarming levels. Despite aggressive monetary easing by major central banks, credit conditions tightened sharply, leading to a credit crunch in many advanced and some emerging markets. Now as 2009 progresses, the economic news flow is pointing to “green shoots of recovery”.

The question to ask at this juncture is whether the recovery will also be synchronised, or will some countries recover faster, thereby decoupling from the rest? As a first step, it should be recognised that recessions are part and parcel of the economic cycle. Indeed, in the April World Economic Outlook (WEO), the International Monetary Fund (IMF) has calculated that

advanced economies have experienced 122 recessions since 1960. They point out that synchronised recessions, where at least 10 major economies go through a contraction, are fairly rare at only three occurrences: 1975, 1980 and 1992.

It is also important to recognise that recessions are caused by a number of different shocks. Categorising recessions by the type of shocks that precede a slowdown is useful because it gives an indication of how long and deep a recession itself will be. Using the same IMF sample, data show that recessions prompted by financial shocks tend to last the longest and have the largest output drops. Further, credit, house prices, private consumption and investment, and interest rates all normalise at a slower rate compared to other recession types in the sample.

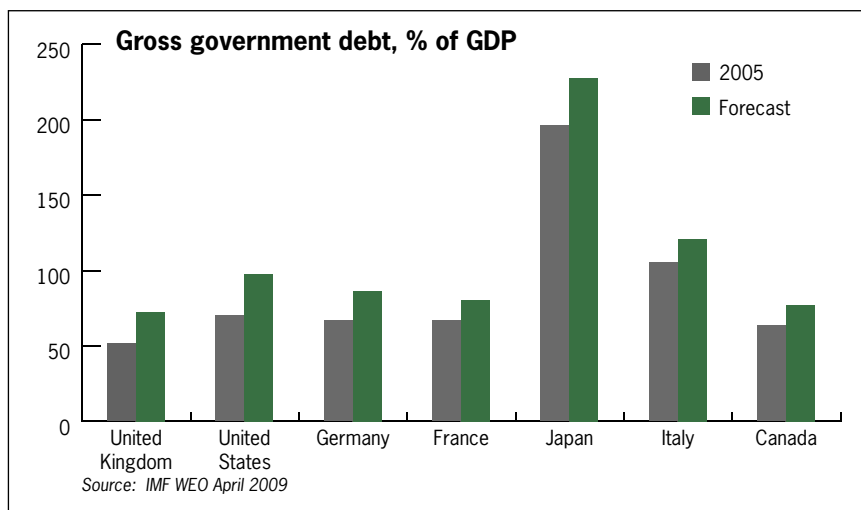
Why are financial shock-driven recessions so bad? Part of the answer lies in the behaviour witnessed prior to the shock. Typically, it has been seen that before financial shock recession hits, house prices, nominal wages and consumption, credit and labour market indicators are all stronger than in the periods that precede other recession types.

The severity of the current global slowdown has mobilised policy makers

virtually everywhere to respond with monetary and fiscal easing. On a GDP-weighted basis, global nominal interest rates are in extreme lows; excluding emerging markets, which tend to have structurally higher interest rates, aggregated rates are close to zero. Governments around the world have enacted recession-fighting measures whose total size is not far from the IMF's call for US\$2 trillion dollars. This raises an immediate question: which country is likely to see the greatest desired impact of these measures?

The main message on this front is that where governments already have high debt levels, the resilience of the economic recovery following fiscal stimulus is diminished, according to IMF. Given government borrowing plans as they stand today, G7 member states will likely see their government gross debt-to-GDP ratios rise between 10 and 73 per cent in 2010 from 2005 levels. Japan is forecast by IMF to see its debt level rise to well above 200 per cent of GDP, even from current highly-elevated levels. As a percentage change increase, the UK stands out with a 73 per cent increase from 2005 levels. Emerging markets, by comparison, have seen their overall external sovereign debt stock decline in recent years, although significant regional variations exist.

The key conclusion is that emerging markets overall are facing a cyclical slow down that does not have an endogenous financial shock at its core. Therefore, while weak external demand from advanced economies will likely generate further headwinds, lower debt levels for some emerging markets (in particular in Latin America and Asia) bodes well for a more rapid recovery. This would suggest that while the global recession has been synchronous, there is scope for decoupling of selected emerging markets in the recovery phase.



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