Global Business Cycles: Convergence or Decoupling?

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The background question

- Has globalization changed the mechanism of international transmission of business cycles?

The approach of this paper

- Provide a synthetic description of the change in business cycles transmission across a large number of countries using dynamic factor analysis (i.e. jazzed up principal component analysis)
- Use this description to learn about international transmission and other issues (i.e. risk sharing)

My comments

- An interpretation of the KOP main result
- A methodological point
- Conclusions

On the decoupling

Globalization has brought a "substantial convergence of business cycles among industrial economies and among EMEs but there has also been a substantial decoupling of business cycles *between* these two group of countries"

The evidence

Percentage of output variance explained by:

Industrial Countries		
	1960-1984	1985-2005
Global factor	27.68	9.36
Group factor	17.16	31.27
Emerging Countries		
	1960-1984	1985-2005
Global factor	13.28	4.20
Group factor	2.65	9.31

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The reduced importance of the global factor and the increased importance of orthogonal group factors contribute, according to KOP, to the decoupling between industrial and emerging.

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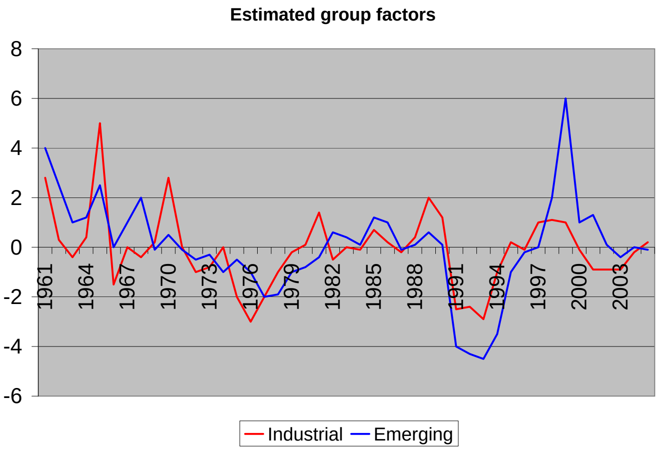

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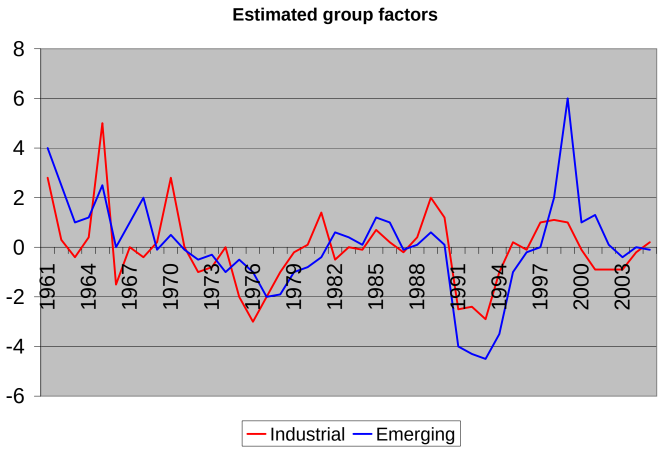

Correlation raises from 0.5 (1960-1984) to 0.7 (1985-2005)!

Decoupling?

If group specific shocks become more correlated across groups and they become more important, the case for decoupling is not so clear!

An alternative (more structural) interpretation, 1

Consider a world with many countries and two shocks:

- A global real shock (i.e. Productivity slowdown, oil shocks, global tech. changes)
- Country specific financial shocks (i.e changes in supply of credit to firms)

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Consider a world with many countries and two shocks:

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In a financially closed world financial shocks show up as idiosyncratic factors.
As economies open financial shocks aggregate (through a common financial market) into a global factor.

An alternative (more structural) interpretation, 2

- 1960-1985. Volatile global shock (Oil shocks) and financially closed economies so no other global factors
- 1985-2006. The global shock becomes less volatile (the good luck hypothesis) and at the same time economies open, so another global shock appears.

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Observe fall in the importance of real global factor and the emergence of a second financial global factor. Consistent with KOP evidence (small group factors in 60-84, large and correlated group factors in 85-05)

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- Factor analysis by KOP might have had trouble picking it up because the financial factor was not global in the first period and because it is collinear with the correlated group factors in the second period.
- An interesting test would be to run a factor analysis allowing for two global factors but no group factors.
- If my conjecture is right the second global factor should play almost the same role as the group factors

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- Fact is puzzling because in a period of open capital markets investment should respond more to idiosyncratic productive opportunities
- Fact no longer puzzling if group specific shocks are interpreted as a global financial shock, which before globalization did not exist and after globalization affects investment strongly (consistent with most models)

Conclusions

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- Viewed through the lens of a simple two shocks BC theory the KOP findings suggest that globalization has not brought a decoupling between emerging and industrial but rather a radical shift in the composition of the global component of business cycles, from real to financial.
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- The implications for stabilization policy in this new environment are, for me, an exciting and new research area