THE GLOBAL RECESSION AND EMERGING ECONOMIES

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A large body of literature has emerged on various ways in which the emerging economies were affected by the global recession that originated in USA and Europe. This paper reviews a section of this literature and tries to assess the relative importance of the trade and finance channels through which the global crisis affected emerging economies. It also briefly examines the appropriate policy response in emerging economies under such crisis situations.

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1. Introduction

The developing world has experienced over three decades of market-based economic policies along with openness to international trade and investment flows. As such, by the time the sub-prime crisis began to unfold in the US, most of these nations were highly integrated with the world economy via international trade and capital flows. This paper reviews the literature on the implications of the recent global crisis for developing countries. We essentially try to identify the relative importance of various channels through which these nations were affected and the appropriate policy response in crisis situations.

To what extent were the effects of the crisis transmitted via trade shocks? What were the changes in global capital flows and how did these impact financial and real sectors in the developing world ? We examine how the literature has analysed and attempted to answer these questions as we try to highlight the key variables that transmitted the effects of the crisis. Alongside we also try to present a clear idea regarding the analytical underpinnings of the inter-linkages between advanced and emerging market economies. Our attempt here is to provide an overview of some of the important papers in the literature and outline the contours of the main issues and arguments presented till date, so as to facilitate further research in this area.

The paper is organized as follows. Based on available literature, first we provide a brief overview of the nature of impact of the crisis on emerging economies in the short and

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medium run (Section 2). Thereafter, we discuss how the effects of the crisis were transmitted to the developing economies and whether trade or finance was the primary channel of transmission (Section 3). This is followed by a brief discussion on the policy response in developing economies and a few areas for further research on related issues (Section 4).

2. Impact of the Crisis on Emerging Economies

Initially, as the US sub-prime crisis originated in 2007, spread and was followed by crisis in the Eurozone by the end of 2008, it was expected that developing countries would be insulated from this severe downturn and remain by and large 'de-coupled' from the world economy (IMF, 2007 & 2008). But the 'de-coupling' hypothesis was proved wrong. At the height of the crisis, spread over the two quarters, 2008Q4 and 2009Q1, when advanced economies experienced negative growth, developing economies also faced a deep downturn.

Yet the initial downturn was followed by fairly swift recovery in developing economies by 2010 and it became clear that as a group, emerging economies had fared far better than advanced economies. In 2010, output growth in emerging economies was estimated to be 7 per cent, compared to around 3 per cent in the advanced economies (ICRA, 2011).

But growth recovery in emerging markets was relatively short-lived and the pre-crisis rates of growth remained elusive. In fact, growth slowdown became apparent once again from 2011-2012 onwards. This was also the period when the Eurozone crisis unfolded, initially affecting nations such as Greece, Ireland, Italy, Portugal, Spain and later, even France and Germany. In 2012, output growth in the Asian region was about 5 percentage points lower than the rate achieved in the pre-crisis period, while in Latin America it was roughly half the pre-crisis rate (Akyuz, 2013a). Since then, the slowdown has deepened and affected even the Chinese and Indian economies that were major engines of growth for the world economy in the pre-crisis period. These economies, especially China, also played an important role in initial recovery in the developing world in the post-crisis phase (Akyuz, 2013a, 2013b; and ICRA, 2011).

A large literature has emerged on the impact of the global crisis on emerging economies. Some studies focus on specific country experiences (see for instance, McNally (2008), Whalley *et al*. (2009) on China; Kim (2012) on Korea; Nagaraj (2013), Ram Mohan (2009), Ghosh and Chandrasekhar (2009) etc. on India); while others seek to characterize trends either for developing countries in general or for a specific set of nations such as India and China or the BRICS nations (Brazil, Russia, India, China and South Africa) (see e.g., Akyuz 2013a and 2013b; Aloui *et al*., 2011; Dastidar, 2014; Dua and Tuteja, 2015; Massa *et al*., 2012; Nayyar, 2011;UNCTAD, 2009 etc.).

The literature addresses several questions in this context. First, what explains the breakdown of the 'decoupling' hypothesis? Second, what explains subsequent growth recovery in the developing countries? Third, why did growth slow down once again in the developing world? In what follows, we briefly examine how these questions are answered in the literature.

It was argued that in a globalized world, it would be virtually impossible for countries to remain insulated from the effects of an economic crisis of this magnitude (see e.g., Ghosh and Chandrasekhar, 2009). As growth contracted in advanced economies, emerging economies were hit by negative shocks related to both international trade and finance channels and experienced sharp exchange rate depreciation. Exports were hit by the slowdown of aggregate demand and negative consumer confidence in the US and Eurozone; commodity exporters in particular, faced sharp worsening of terms of trade. While the financial crisis in the US and thereafter, the sovereign debt crisis in the Eurozone had a dampening impact on capital inflows into emerging markets (Akyuz, 2013a & b). However, there was considerable heterogeneity within developing countries as a group. For instance, China and India performed much better than expected, with relatively small shortfall (less than 5 percentage points) of actual growth from the forecasted rate. However, a diverse group of countries, including Turkey, Taiwan, Russia and East European countries like Lithuania, Lativa, Estonia, Slovenia, suffered much larger growth shortfall, with actual growth being negative and falling short of forecasted growth by over 20 percentage points (Blanchard *et al*., 2010). Initial conditions with respect to size of current account deficits, extent of external indebtedness, especially stock of foreign currency debt and the exchange rate regime were instrumental in shaping the nature of impact of the crisis on these nations (Blanchard *et al.* , 2010).

So what explains subsequent recovery in the emerging economies ? A number of factors have been identified in the literature to explain the recovery process. The policy response to the crisis both in emerging and advanced economies played a crucial role in this context. Counter-cyclical Keynesian policies based on fiscal expansion revived domestic demand and fueled strong recovery in the developing countries (Rakshit, 2012). The strong expansionary policy response in the developing economies was made possible by the comfortable fiscal and BOP positions of the emerging economies that followed due to the period of high growth in the world economy from 2000 to 2007; this period had witnessed a boom in commodity prices and a surge of capital flows into emerging markets (Akyuz, 2013a & b). On the other hand, easing of monetary policy in the advanced economies also helped revive capital flows into emerging markets. Even though such flows remained volatile, yet they provided crucial BOP (Balance of Payments) support, helping to finance widening current account deficits resulting from policies of domestic demand-led growth. In fact, it appeared large economies like China, India and Brazil would remain relatively unaffected, possibly owing to the advantage conferred by size; the domestic market would drive demand-led growth in these populous developing nations, as long as they practiced sound macroeconomic policies and kept a check on the pace of financial deregulation and capital account liberalization (see e.g., Nayyar, 2011). Further, the strong network of trade and financial ties that developing countries had established among themselves also helped to mitigate the negative shock and overcome its impact to a significant degree (Kose and Prasad, 2010). In particular, domestic investment-led growth in China fueled commodity demand and revived commodity prices, which is important in reviving growth in commodity exporting developing countries (Akyuz, 2013a & b).

Why was the recovery short-lived? The reasons are linked to a complex interplay of factors associated with the slowdown in advanced economies and its implications for world trade and financial flows. The prolonged slowdown in advanced economies had a disproportionately large impact on international trade (reasons for this are discussed in the following Section) and via this channel it impacted growth, especially in export-oriented economies like China. Slowdown in Chinese exports sharply reduced exports of manufactures especially by Asian economies, as Chinese exports had a large import content sourced from the region. As investment-led growth slowed down in China and with recession in the Eurozone, exports of commodities and world commodity prices were also depressed. Domestic consumption in China is not import-intensive and hence it has limited spillover effects for the country's trade partners.

With signs of slowdown in China and robust recovery yet to get underway in advanced economies, international capital flows, especially short-term portfolio flows remain volatile and sensitive to financial and policy related developments, especially in the US and Eurozone. This climate of uncertainty has delayed revival of private investments in emerging markets. Moreover, after the initial expansionary stance, emergence of a binding fiscal constraint in many countries has severely restricted the scope for further expansion, putting limits on policy led revival in growth. With sustained recovery in commodity prices and exports to advanced economies still proving elusive, growth prospects before emerging economies appear grim.

3. The Key Channels of Transmission

International trade and capital flows are two vital facets of the links between domestic and world economies, through which the effects of the crisis in advanced economies were transmitted to the developing world. This emerges clearly from the literature. In what follows we analyse the analytical underpinnings of the arguments regarding the various ways in which the trade and finance channels affected outcomes in emerging economies. In this context, Blanchard *et al*. (2010) make an important contribution to the literature. They develop a simple model that provides an analytical structure and clearly demonstrates the role of trade and financial channels in affecting output and interest rates in emerging markets in the short run.

The Trade Channel: One feature of the impact of the crisis was its relatively larger impact on world trade (especially trade in manufactures) as compared to aggregate output levels. The reasons for this have been widely discussed in the literature and several explanations emerge (Eaton *et al*., 2011). The contraction in demand in advanced economies had a disproportionately large impact on trade flows due to the phenomenon of global value chains and large volumes of intra-industry trade that characterizes production and export of manufactures by emerging economies (Eichengreen, 2009). There is evidence to show that growth performance in countries' trade partners had a significant impact on their growth performances and played an important role in shaping the way the trade channel impacted emerging markets (Blanchard *et al*., 2010). With the slowdown in growth in US and the Eurozone, there was a large reduction in the demand for tradables. During the deep recession in these regions, amidst growing unemployment and rising uncertainty about the future, demand for durables and investment goods suffered a large decline. This further induced firms to cut back on production and rely largely on inventories; since both these components of aggregate demand are highly import intensive, it had a large dampening effect on trade and exports of emerging economies (Alessandria *et al*., 2010; Eaton *et al*., 2011; Levchenko *et al*., 2010). Further, with a crisis in the financial sector, the resulting crisis in trade credit also contributed to the collapse of trade flows between emerging markets and advanced economies (Auboin, 2009; McKinnon, 2009; and Bhagwati, 2009).

The trade effects were manifested in a reduction in *net* exports of emerging economies, primarily owing to a reduction in quantum and/or unit value of exports, as well as a sharp increase in import bills due to significant depreciation of exchange rates. In particular, commodity exporters faced huge adverse shocks in terms of trade. In this context, financial speculation in commodities also contributed to volatility in emerging markets via large swings in commodity prices. In the short run, all these factors contributed to widening current account deficits that had to be financed mainly by running down foreign exchange reserves. There was sharp decline in net capital inflows into emerging markets in the immediate aftermath of the crisis, with the fall of Lehman brothers and onset of the sovereign debt crisis in Greece, Portugal, Ireland and Spain. Moreover migrants' remittances, that provide crucial BOP support for many emerging economies, were adversely affected, contributing further to widening of current account deficits.

Exchange rate depreciation is likely to have a positive impact on output via the trade channel, in case the Marshall-Lerner conditions hold. According to the Marshall-Lerner conditions, currency depreciation brings about quantity adjustments, switching expenditure from imports to domestically produced goods leading to improvements in the trade balance; however, typically these adjustments take time. So in the wake of the crisis, the short run impact of the reduction in exports and currency depreciation was to worsen the current account balance in emerging markets via the trade channel.

Currently even the Chinese economy, one of the largest engines of growth in the developing world, is slowing down with its strategy of investment led growth running into sharp limits. Further, as mentioned earlier, domestic consumption led growth in China is unlikely to have strong trade spillovers, owing to its relatively low import content. This along with subdued growth in the Eurozone is also contributing to slowdown in world commodity prices, further affecting chances of recovery via the trade channel in the near future.

The Finance Channel: The disruption of capital inflows into emerging markets played a very important role in disrupting growth in these economies in the immediate aftermath of the crisis in 2008-09. At least two sets of forces led to this reduction in net capital inflows. The financial crisis in the advanced economies led to an 'increase in home bias' (Blanchard *et al*., 2010). It created a problem of liquidity for numerous investors and financial institutions, inducing them to reduce foreign lending. Further the environment of uncertainty created by the financial crisis in advanced economies, led to an increase in risk perception of foreign lending. This raised the cost of borrowing for emerging market entities, reduced demand for external borrowings and through this channel had an additional negative impact on capital flows and investments. The 'sudden stop' in capital inflows and the negative trade effects together led to sharp depreciation of currencies in emerging economies.

In turn, currency depreciation had a negative impact on growth via a negative effect on balance sheets, especially of leveraged entities with relatively high exposure to foreign currency debt. In emerging economies, external debt (private and sovereign) is typically denominated in foreign currency. Currency depreciation enhances the real burden of foreign debt and hence, worsens the balance sheet position of all such firms and tends to reduce planned investments further, over and above the negative impact of the recessionary conditions in the world economy. How severe were these balance sheet effects? *Inter alia,* that depended on the *quantum* of debt denominated in foreign currency as well as its *composition* in terms of the proportion of short term debt. The larger these two, the larger is the expected size of the negative balance sheet effect.

The role of leverage in external crisis is also emphasized by Reinhart and Rogoff (2009) who show how conditions of excessive leverage, especially in case of external debt of short term maturity, may lead to liquidity crisis in case of a shock wherein there are problems rolling over short term debt. Net capital inflows decline sharply when short term debt is called in and not rolled over. In turn, this creates further pressures for currency depreciation, intensifying the negative balance sheet effect on entities exposed to foreign currency debt. Empirical analysis in Blanchard *et al*. (2010) indicates that the larger the initial short-term debt or larger the current account deficit, the greater is the likely negative impact of a financial shock in an emerging economy.

So what do we learn overall regarding the channels of transmission of shocks from advanced to emerging economies? in this context the econometric analysis in Blanchard *et al* (2010) though limited to a data set of 29 countries highlights a few interesting findings. Their analysis indicates that both trade and financial channels were important and short-term foreign debt emerges as a critical conduit for the negative effect on output in the short run. The study finds ambiguous effect of exchange rate changes, indicating that the positive effects (through trade channel via Marshall Lerner condition) may cancel out the negative effects (through finance channel via balance sheet effects). On a rather surprising note, they find a limited role for foreign exchange reserves in mitigating the impact of trade and financial shocks on the growth rate. This may be related to evidence suggesting that countries may actually be reluctant to use such reserves for fear of losing them by using them too early (Aizenman and Sun, 2009). In view of the limited sample and time frame for this study, the findings cannot be considered conclusive; however, they certainly throw up issues for further research in this area.

In the medium-run, with easing of monetary policy in the advanced economies, capital inflows into emerging markets have picked up. This has provided much needed BOP support by helping to finance widening current account deficits in the wake of domestic demand led expansion in the emerging economies. Yet, it has also prevented currency depreciation and even led to real appreciation in many cases, affecting export performance in the developing world. Ironically this is happening at a time when monetary policy stance in the advanced economies is geared to weakening their currencies with a view to improve export performance.

4. Lessons for Policy

Our discussion above clearly shows that the literature finds that both trade and finance channels played an important role in transmitting the negative impulses of the crisis from advanced economies to emerging markets. We now conclude the paper with a few lessons for policy that also emerge from the literature. The simple model in Blanchard *et al*. (2010) highlights the complexity of policy choice faced by emerging economies in the face of capital outflows, depreciating currency, deterioration in international trade prospects amid downturn in aggregate demand and enhanced risk perceptions that negatively impact the investment climate. In particular, the role of fiscal, monetary and exchange rate policies are highlighted with respect to their impacts on the output, interest rate and exchange rates.

In the face of a downturn in external demand, an expansionary fiscal policy stance is essentially called for. In fact the expansionary fiscal policy stance adopted by the developing countries was largely responsible for the initial growth recovery in 2009 and it helped to mitigate the initial impact of the crisis on emerging economies (Rakshit, 2012). Further, the monetary easing adopted in the US and Europe revived capital flows, aiding recovery in the developing world.

Governments' capacity for providing a fiscal stimulus would depend on their fiscal position at the onset of a crisis. A large fiscal gap to start with puts sharp limits on capacity for further expansion as such a strategy might widen current account deficits and create a risk of exchange rate depreciation; it also puts upward pressure on interest rates. While currency depreciation might raise output via the trade channel, it can also have a negative impact. In particular, the higher the quantum of external debt, the larger is the negative impact of currency depreciation on aggregate demand and output via a negative impact on the balance sheet of leveraged domestic entities. In such cases, governments may be keen to use reserves for intervention in the foreign exchange market to avoid currency depreciation and hence a negative impact on output. However, the decline in reserves would have to be sterilized in order to neutralize its impact on the interest rate.

A rise in the interest rate would tend to reduce investments by raising the cost of borrowing, something governments would be keen to avoid in the face of a downturn in external demand. In this context monetary policy could be used to sterilize the impacts of capital outflows and foreign exchange intervention on the domestic policy rate. As such, monetary as well as expansionary fiscal policies would be critical components of policy response in emerging markets. However, the problem of inflation experienced by emerging economies can potentially create problems for the conduct of monetary policy, especially in the medium run. To the extent central banks would like to follow a tight money policy to keep inflation under check, it puts limits on the extent to which it could exercise the option of sterilization to keep interest rates unchanged especially in the medium-term.

Finally, we would like to draw attention to a number of research areas that have opened up in this area. For instance, it is worth enquiring about the impact of the crisis on countries that experienced a *rise* in net capital inflows in the immediate aftermath of the crisis. This happened in case of Chile and a number of other emerging economies including countries as diverse as Colombia, Israel, Mexico and Thailand. Yet these economies also experienced severe growth downturn. As such, there is ample scope for research into the factors that shape the contours of the impact of trade vis-à-vis financial shocks on the domestic economy. Country studies may be useful in this context, especially to capture the role of institutional factors that tend to vary greatly across countries and play a critical role in shaping the outcome policies. These would provide further insights into the heterogeneity of experiences observed across the developing world. The difference between the experiences of manufacturing exporters in Asia vis-à-vis commodity exporting nations in Latin America is another interesting issue for further research. This would provide newer insights, especially on the role of *structural factors* in shaping outcomes in the face of external shocks.

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