United we fall
Sep 26th 2002
From The Economist print edition

Increasing globalisation could lead to bigger economic booms and busts

WHEN America sneezes, the rest of the world catches cold, and last year the effect of America's downturn on the rest of world seemed more brutal than usual. As America went into recession, the euro area's economies ground to a halt, Japan's slump deepened, and emerging economies from Mexico and Argentina to Singapore and Taiwan suffered deep recessions. Does global economic integration mean that business cycles now move more closely in step?

Economies have often been hit simultaneously by common global shocks, such as the jump in oil prices in the 1970s. However, during most of the 1990s business cycles were unusually desynchronised because of shocks that affected only particular countries. When the American economy stumbled in 1990, German unification kept continental Europe aloft until 1993, and Japan, buoyed by rising land prices, continued to boom until 1992.

In contrast, last year's global downturn was unusually synchronised. According to J.P. Morgan, an American bank, the dispersion of growth rates across 41 economies fell to its lowest level in at least 30 years (see chart 11). Some of this was due to common factors, such as the bursting of the IT bubble and higher oil prices. But it seems that different economies' business cycles are also becoming more closely correlated over time, possibly because of greater economic integration.

It used to be argued that increasing trade would stabilise GDP. In a recession, exports could offset the slump in domestic demand; in a boom, spare overseas capacity would help to hold down inflation. But increased trade also causes economies to move more closely in step. Last year an investment slump in America spread quickly to Asia as American firms imported less IT equipment. In turn, Asian economies bought less from the United States and elsewhere, which depressed growth further. Greater synchronisation is likely to exacerbate the business cycle.

World trade now accounts for 25% of GDP, double its share in 1970. However, trade figures understate the degree of international interdependence. Foreign direct investment, cross-border mergers and financial markets have an even bigger effect.

A recent OECD study explored the growing internationalisation of production through global supply chains. Multinational firms base different parts of their operations in different economies to make use of comparative advantages, such as cheap or highly skilled labour. Foreign direct investment has increased the importance of international trade within firms. One-third of both America's and Japan's total trade takes place within multinationals and their affiliates. The share of intra-firm trade is especially high in the IT sector, which is why the IT investment bust spread so rapidly around the world. The OECD concludes that thanks to the internationalisation of production, a demand shock in one country will have wider international effects than in the past.

For many multinational firms, foreign direct investment has also become a substitute for trade. For example, a German car maker will produce locally in America rather than exporting there. European firms' dollar sales from their American subsidiaries are now four times bigger than their exports to America. The slump in America last year squeezed such parent firms' profits, prompting some cutbacks in Europe. American multinationals also
responded to the slump at home by cutting back at their European subsidiaries.

**It's the same the whole world over**

Financial markets are another important channel for transmitting shocks across borders. Stockmarkets in Europe have fallen by just as much as Wall Street over the past two years. William Goetzmann, an economist at Yale School of Management, calculates that in recent years the correlation between the markets of America, Britain, France and Germany has been closer than at any time in the past century (see chart 12). The cost of capital for European firms may therefore be more sensitive to ups and downs in America than in the past. A collapse of share prices on Wall Street will also have a bigger effect on wealth and spending all around the globe.

There are many reasons why share prices are dancing to the same beat. Cross-border trading in shares has increased hugely over the past decade, creating a global equity market. In most rich countries, household are increasingly investing in foreign equities. Many big firms are also listed on more than one stockmarket. And thanks to cross-border mergers and foreign direct investment, a growing slice of firms' profits comes from abroad.

Is the recent close-coupling of national stockmarkets a temporary phenomenon, caused by the IT bubble and the consequent global slowdown, or does it reflect the growing international integration of firms? Robin Brooks, an economist at the IMF, and Marco Del Negro, at the Federal Reserve Bank of Atlanta, tried to discover whether the increased correlation of stockmarkets can be explained by firms becoming more global, as measured by the percentage of their sales and profits that are generated abroad. They analysed company accounts and share prices for 10,000 firms in 42 markets over the period 1985-2002, and found that such global factors had indeed become more important in explaining variations in companies' profits in the late 1990s. Global factors were especially important in explaining the relative share prices of firms that derive a high proportion of their profits from overseas. This suggests that the rise in stockmarket correlations in the late 1990s may indeed reflect global integration. If so, it is likely to increase further over time.

Another way in which recession can spread from country to country is through business confidence. The IMF finds that there has been a substantial increase in the correlation between business confidence in America and the euro area in recent years. This probably reflects the stronger links between firms in America and the euro area through mergers, as well as the effect of global share prices on business confidence. Either way, the mood of businessmen can be a lethal form of contagion.

As economic and financial interdependence continue to increase, developments in one economic area will affect other economies more than in the past. As a result, global business cycles are likely to become self-reinforcing, which could make booms and recessions in developed economies more severe.

Policymakers clearly need to take more account of what is happening in other countries. Traditional economic models that look only at trade will understate the effect of a shock in America on other economies. Foreign investment, share prices and confidence are likely to be far more important. The ECB was caught out last year when it underestimated the impact of America's downturn on the euro area. Even though Europe did not suffer from the sort of imbalances seen across the Atlantic, its economies stumbled as falling equity markets hurt business confidence.

Does growing economic interdependence increase the case for international policy co-ordination? In the past, attempts at this by the G7 group of rich countries have had unhappy consequences. At the Bonn summit in 1978, Germany agreed to reflate and act as the world's locomotive. But oil prices then surged, triggering a burst of inflation. In the late 1980s, at the Louvre meeting, Japan agreed, under pressure, to ease its monetary policy in return for America cutting its budget deficit. Many now regard this as a prime cause of Japan's financial bubble.

The regular exchange of information and frank discussion about policy in each other's economies is useful. But,
wisely, the G7 have avoided formal agreements to co-ordinate policy in recent years. The best global economic policy is the sum of the best national policies that take account of developments elsewhere.