Business Cycles in Emerging Markets
(Экономические циклы в развивающихся странах)
Oleg Zamulin

Proposal for a 2008-2009 research project
New Economic School

Motivation

Macroeconomic literature on business cycle has traditionally been dedicated to rich developed economies. Indeed, the developed world has been following a rather stable steady state growth trend, and the public has been more concerned with booms and recessions occurring around that trend. Developing countries, on the contrary, are much less concerned with the fluctuations around a certain growth path – their goal is normally to speed up the growth and catch up with the rich countries. Fluctuations are much less of an issue.

Some recent literature has tried to close this gap in research and investigate the business cycle properties of developing economies. Such cycles can have many faces. For example, they can be boom-bust cycles in financial markets: economists Tornell and Westermann argue that they are caused by appearance and initial abuse of new financial instruments. Although painful, such cycles lead to faster economic growth, according to these authors. Another type of cycles is the more standard economic fluctuations. Philippe Aghion with co-authors have written a series of papers arguing that such business cycle hurts economic growth, especially in countries with poorly developed financial markets.

For these reasons, it is important to understand, how important the issue of fluctuations is for developing countries is, whether their cycles have similar nature to the developed world, and what the policy response should be.

Research methodology

In order to answer the above questions, one needs to understand first, what the primary differences between developing and developed countries are. One way of modeling such a difference is by assuming that developing countries are operating with a capital stock below the steady state level, and capital accumulation is an important source of growth. This contrasts with the developed countries, where, by classical theory, technological progress is the only source of growth, and investment merely follows this progress. Such differences in the nature of investment may be an important component of the business cycle movements.

Another difference, explored by some economists (e.g. Aguiar and Gopinath 2004) is that emerging markets have a different nature of shocks: permanent productivity shocks are a bigger source of fluctuations than temporary demand shocks.

Kaminsky et al. (2004) make an argument that whatever the reason for the cycle, developing countries amplify the fluctuations by adding pro-cyclical macroeconomic policies on top of the cycle and thus stimulating the booming economies and contracting the falling economies even further. Similar arguments were made by Lane (2003).

Aghion et al. (2005, 2006) assume that the most important difference is the poor development of the financial markets. Poorly developed financial markets prevent companies from borrowing in bad times and thereby aggravate the negative effect of economic downturns, slowing down long-term growth. Their recommendation is that governments, especially in developing countries, pursue counter-cyclical policies, which, according to both Aghion et al. (2005, 2006) and Kaminsky et al. (2004), these governments do not do.

Yet another reason for a big difference between countries is that the developing world has poorly developed institutions (Acemoglu, Johnson, and Robinson 2005). Institutions can matter for business cycle at least because they may re-direct the capital flows. Thus, Tornall and Velasco (1992) demonstrate in a model of a tragedy of the commons how poor property right protection causes capital to flow from poor to developed countries. Furthermore, they make a provocative argument that liberalization of capital flows can actually improve, not worsen, the capital flight problem.

All of these arguments suggest that there is scope for both theoretical and empirical work on this issue. Empirical methods can be used to compare the nature of the cycle in poor and rich countries, as well as in poor countries that do grow and the ones that do not. This will allow to test for different hypotheses about the central differences between the cycle in the two types of countries.

Theoretical methods can be applied even more broadly to investigate a number of issues. Thus, one may try to pose questions about the sources of, consequences of, and policy responses to the cycle in standard models modified to capture the properties of developing countries. Thus, once can construct business cycle models of economies functioning below steady state, economies with poor financial markets, economies with poor property right protection, etc.

Potential topics for master's thesis.

These questions and these methods allow for a wide variety of topics for research papers. At the same time, students participating in this project are not required to write papers within the topics outlined in this proposal. In fact, any topic within macroeconomics is welcome.

Here are some potential topics for the theses:

1) Sources of the cycle in developing countries.

Here, one can explore different hypothesis for why cycles are different, looking at different shocks, different institutions, and different level of financial development. Papers can be both theoretical and empirical.

2) Optimal stabilization policy for growth

Here, one can look at the dependency of the growth of the economy on the fluctuations and investigate which exact policy can mitigate the effect of shocks on growth. More specifically, one can look at such features as

2.1) Dependency on natural resource exports
2.2) High liability dollarization of the economy
2.3) Poorly developed financial markets
2.4) Etc.

3) Stabilization fund and growth

This question relates to the recent history of Russia and is meant to study the question of whether the stabilization fund in Russia can help with economic growth or whether the fund is concerned merely with short-run stabilization issues. Potentially, the effect on growth can come in the form of improving institutions in response to macroeconomic stability, and mitigating the effects of negative shocks on long-term investment.

3.1) Can demand for proper protection of property rights be generated in an unstable macroeconomic environment?
3.2) What are the possible ways in which the stabilization fund can enhance long-run growth via reduction of political risk?
3.3) Can stabilization fund enhance long-run growth via reduction in economic fluctuations in presence of learning-by-doing in manufacturing?

4) Financial crises and growth

Here, causal relationship can run several ways, hence the topics:

4.1) Are financial crisis an inevitable part of rapid growth? What are the conditions, under which fast growth creates distortions in credit markets?
4.2) Do financial crises slow down long-run growth? Empirical and theoretical investigation.

References:

Acemoglu, D., S. Johnson, and J. Robinson, 2005, “Institutions as the Fundamental Cause of Long-Term Growth,” in the *Handbook of Economic Growth*, Philippe Aghion and Stephen Durlauf eds, North Holland

Aghion, Phillipe and Abhijit Banerjee, *Volatility and Growth*, Oxford: Oxford University Press, 2005

Aghion, Philippe, Philippe Bacchetta, Romain Ranciere, and Kenneth Rogoff, "Exchange Rate Volatility and Productivity Growth: The Role of Financial Development", National Bureau of Economic Research Working Paper 12117, May 2006

Aguiar, Mark and Gita Gopinath, “Emerging Market Business Cycles: The Cycle is the Trend”, NBER WP 10734, 2004.

Kaminsky, Graciela L., Carmen M. Reinhart, and Carlos A. Vegh, “When it Rains, it Pours: Procyclical Capital Flows and Macroeconomic Policies” NBER WP 10780, 2004

Lane, Philip, "Business Cycles and Macroeconomic Policy in Emerging Market Economies," International Finance, 6(1), 89-108, Spring 2003

Tornell, Aaron and Andres Velasco, “The Tragedy of the Commons and Economic Growth: Why Does Capital Flow from Poor to Rich Countries?”, JPE 100(6), December 1992, pp. 1208-31.

Tornell, Aaron and Frank Westermann, *Boom-Bust Cycle and Financial Liberalization*, The MIT Press, 2005