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ABSTRACT

International Business Cycle Spillovers*

This paper studies business cycle interdependence among the industrialized countries since 1958. Using the spillover index methodology recently proposed by Diebold and Yilmaz (2009) and based on the generalized VAR framework, I develop an alternative measure of comovement of macroeconomic aggregates across countries. I have several important results. First, the spillover index fluctuates over time, increasing substantially following the post-1973 U.S. recessions. Secondly, the band within which the spillover index fluctuates follows an upward trend since the start of the globalization process in the early 1990s. Thirdly, the spillover index recorded the sharpest increase ever following the peak of the global financial crisis in September 2008, reaching a record level as of December 2008 (See http://data.economicresearchforum.org/erf/bcspill.aspx?lang=en for updates of the spillover plot). I also derive measures of directional spillovers and show that the U.S. (1980s and 2000s) and Japan (1970s and 2000s) are major transmitters of shocks to other countries. Finally, during the 2008-2009 global recession shocks mostly originated from the United States and spread to other industrialized countries.

JEL Classification: C32, E32 and F41
Keywords: business cycles, cointegration, industrial production, spillovers, unit roots, variance decomposition and vector autoregression

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I. Introduction

What started in the United States as the sub-prime mortgage crisis in 2007 has since been transformed into a severe global financial crisis that inflicted all major advanced and emerging economies. Indeed, the global economy has experienced the worst recession in decades, if not a global depression. As expected, the global recession increased the academic and policy interest in the business cycles research.

There has been quite an extensive literature on international business cycles that dates back to early 1990s. Since then, research on business cycles across countries has displayed ample evidence that macroeconomic fluctuations in industrial and developing countries have a lot in common. Using pairwise correlations of GDP, Backus et al. (1995) and Baxter (1995) show that output in major industrial countries follow similar short run paths. Employing a Bayesian dynamic latent factor model, Kose, Otrok and Whiteman (2003) find strong support for a persistent world common factor that drives business cycles in 60 countries. In a recent paper, using a multicountry Bayesian VAR model with time variations, Canova, Ciccarelli, and Ortega (2007) also find evidence in favor of world business cycles among the G-7 countries. They also show that the world- and -country-specific fluctuations are more synchronized in contractions rather than expansions.[1]

As the evidence on international business cycles accumulated, the literature started to focus on the effect of globalization on international business cycles. Kose et al. (2003) find that with increased globalization, the impact of the world factor on the correlation of macroeconomic aggregates (output, consumption and investment) across countries increased in the 1990s and after. More recently, Kose et al. (2008) extend their previous findings to the second moments of output, consumption and investment. Doyle and Faust (2005), on the other hand, found no evidence of increased correlation of growth rates

[1] In addition, empirical studies employing time series and spectral methods also find support for the presence of international business cycles (See Gregory et al., 1997, Lumsdaine and Prasad, 2003).

of output in the United States and in other G-7 countries over time. Stock and Watson (2005) show that the comovement of macroeconomic aggregates has declined in the globalization era of 1984-2002. However, rather than linking their results directly to the globalization process, Stock and Watson (2002) conclude that their results are likely due to diminished importance of common shocks among the G-7 countries. Eickmeier (2007) emphasizes that the impact of globalization on international propagation of macroeconomic shocks is unclear and needs to be studied further.

In this paper I calculate a business cycle spillover index across G-6 countries using forecast-error variance decompositions obtained from a Vector Error Correction (VEC) model to differentiate between own-shocks versus spillover of shocks. Diebold and Yılmaz (2009) recently proposed this methodology to study return and volatility spillovers across major stock markets around the world. The methodology they propose can also be used to study business cycle spillovers across major countries. I apply the spillover index methodology to the seasonally adjusted monthly industrial production indices for G-6 countries (excluding Canada from the G-7 group).

The spillover index framework is simple to implement. It follows directly from the variance decomposition associated with an *N*-variable vector autoregression, where all variables in the system of industrial production indices, are assumed to be endogenous. The time-variation in spillovers is potentially of great interest as the intensity of business cycle spillovers is likely to vary over time. Using a rolling windows approach and calculating the spillover index for each window, I allow the business cycle spillovers across G-6 countries to vary over time since 1958. I show that business cycle spillovers across G-6 countries are important; spillover intensity is indeed time-varying; and the United States and Japan are the major transmitters of business cycle shocks to other countries.

The spillover index framework is different from earlier studies of international business cycles, in that, rather than finding a common world factor or indicator that measures international business cycles I identify how shocks to industrial production in one country affect the industrial output in other countries. Obviously, one is likely to find evidence for international business cycles either if the shocks are common and/or country-specific shocks spill over across countries in a significant manner. Unlike the previous contributions to the literature, the spillover methodology also allows one to identify directional spillovers transmitted from one country to others, as well as the spillovers across country pairs (see Diebold and Yılmaz, 2010).

Finally, this study differs from the majority of earlier contributions to the literature in terms of the data used. I use industrial production indices at monthly frequency rather than the quarterly data from the national income accounts. There are two reasons for this choice. First, the use of monthly data allows us to capture the spillovers of shocks much faster, as seen in the latest economic crisis. Second, the use of monthly data allows us to have more observations in calculating the spillover index for each rolling sample window.

In the rest of the paper I proceed as follows. In Section 2, I discuss the spillover index methodology, emphasizing in particular the use of generalized variance decompositions and directional spillovers. In Section 3, I first discuss the time-series properties of industrial production indices for G-6 countries and then present the results of the business cycle spillovers analysis. In particular I discuss the total spillover plot along with the gross and net directional spillover plots for each of the G-6 countries. Section 4 concludes the paper.

II. The Spillover Index Methodology

In this section, I provide a summary of the spillover index methodology, which is developed in Diebold and Yilmaz (2009) and (2010). As I have already mentioned in the Introduction, the spillover index is built upon the variance decomposition associated with an *N*-variable vector autoregression. The total spillover index is the ratio of the sum of off-diagonal elements of the forecast error variance-covariance matrix to the sum of all elements of the same matrix.

Consider a covariance stationary *N*-variable VAR(*p*), $x_t = \sum_{i=1}^{p} \Phi_i x_{t-i} + \varepsilon_t$, where $\varepsilon \sim (0, \Sigma)$. The moving average representation is $x_t = \sum_{i=0}^{\infty} A_i \varepsilon_{t-i}$, where the *N*x*N* coefficient matrices A_i obey the recursion $A_i = \Phi_1 A_{i-1} + \Phi_2 A_{i-2} + ... + \Phi_p A_{i-p}$, with A_0 an *N*x*N* identity matrix and $A_i = 0$ for *i<0.* The moving average coefficients (or transformations such as impulse response functions or variance decompositions) are the key to understanding dynamics. I rely on variance decompositions, which allow us to split the forecast error variances of each variable into parts attributable to the various system shocks. Variance decompositions allow us to assess the fraction of the *H*-step-ahead error variance in forecasting x_i that is due to shocks to x_j, $j \neq i$, for each *i*.

Any study of the business cycle spillovers cannot be deemed complete without an analysis of directional spillovers across countries. Calculation of variance decompositions requires orthogonal innovations, whereas the VAR innovations are generally correlated. Identification schemes such as that based on Cholesky factorization achieve orthogonality, but the variance decompositions then depend on the ordering of the variables. As a result, it is not possible to use the variance decompositions from the Cholesky factor orthogonalization to study the direction of spillovers. With this understanding, Diebold and Yılmaz (2010) propose to circumvent this problem by exploiting the generalized VAR framework of Koop, Pesaran and Potter (1996), and Pesaran and Shin (1998), which produces variance decompositions invariant to ordering. Instead of attempting to orthogonalize shocks, the generalized approach allows correlated shocks but accounts for them appropriately using the historically observed distribution of the errors. As the shocks to each variable are not orthogonalized, the sum of contributions to the variance of forecast error (that is, the row sum of the elements of the variance decomposition table) is not necessarily equal to one.

Using the VAR framework introduced above, let me define *own variance shares* to be the fractions of the *H*-step-ahead error variances in forecasting x_i due to shocks to x_i, for *i*=1, 2,..,*N* and *cross variance shares,* or *spillovers*, to be the fractions of the *H*-step-ahead error variances in forecasting x_i due to shocks to x_j, for *i, j* = 1, 2,.., *N*, such that $i \neq j$.

The generalized impulse response and variance decomposition analyses also rely on the MA representation of the N-variable VAR(p) equation above. Pesaran and Shinn (1998) show that when the error term (ε_t) has a multivariate normal distribution, the *h*-step generalized impulse response function scaled by the variance of the variable is given by:

$$\gamma_j^g(h) = \frac{1}{\sqrt{\sigma_{jj}}} A_h \Sigma e_j \;, \quad h = 0, 1, 2, \quad . \tag{1}$$

where Σ is the variance matrix for the error vector ε, σ_{ii} is the standard deviation of the error term for the *i*th equation and $\boldsymbol{e_i}$ is the selection vector with one as the *i*th element and zeros otherwise.

Similarly, country *j*'s contribution to country *i*'s *H*-step-ahead generalized forecast error variance, $\theta_{ij}^g(H)$, for *H = 1, 2, ...*, is defined as:

$$\theta_{ij}^g(H) = \frac{\sigma_{ii}^{-1} \sum_{h=0}^{H-1} (e_i' A_h \Sigma e_j)^2}{\sum_{h=0}^{H-1} (e_i' A_h \Sigma A_h' e_i)} \tag{2}$$

As explained above, the sum of the elements of each row of the variance decomposition table is not necessarily equal to 1: $\sum_{j=1}^{N} \theta_{ij}^g(H) \neq 1$. In order to use the information available in the variance decomposition matrix in the calculation of the spillover index, Diebold and Yılmaz (2010) normalize each entry of the variance decomposition matrix (equation 2) by the row sum as[2]:

$$\tilde{\theta}_{ij}^{g}(H) = \frac{\theta_{ij}^{g}(H)}{\sum_{j=1}^{N} \theta_{ij}^{g}(H)} \qquad (3)$$

Now, by construction $\sum_{j=1}^{N} \tilde{\theta}_{ij}^{g}(H) = 1$ and $\sum_{i,j=1}^{N} \tilde{\theta}_{ij}^{g}(H) = N$.

Using the normalized entries of the generalized variance decomposition matrix (equation 3), Diebold and Yılmaz (2010) construct the *total spillover index* as:

$$S^{g}(H) = \frac{\sum_{\substack{i,j=1 \\ i \neq j}}^{N} \tilde{\theta}_{ij}^{g}(H)}{\sum_{i,j=1}^{N} \tilde{\theta}_{ij}^{g}(H)} \bullet 100 = \frac{\sum_{\substack{i,j=1 \\ i \neq j}}^{N} \tilde{\theta}_{ij}^{g}(H)}{N} \bullet 100. \qquad (4)$$

Next considering directional spillovers, Diebold and Yılmaz (2010) define *gross directional spillovers received* by country *i* from all other countries *j* as:

$$S_{i\bullet}^{g}(H) = \frac{\sum_{j=1, i \neq j}^{N} \tilde{\theta}_{ij}^{g}(H)}{\sum_{j=1}^{N} \tilde{\theta}_{ij}^{g}(H)} \bullet 100. \qquad (5)$$

In similar fashion, *gross directional spillovers transmitted* by country *i* to all other countries *j* can be measured as:

[2] Alternatively, one can normalize the elements of the variance decomposition matrix with the column sum of these elements and compare the resulting total spillover index with the one obtained from the normalization with the row sum.

$$S_{\bullet i}^{g}(H) = \frac{\sum_{j=1, j \neq i}^{N} \tilde{\theta}_{ji}^{g}(H)}{\sum_{j=1}^{N} \tilde{\theta}_{ji}^{g}(H)} \bullet 100 . \quad (6)$$

One can think of the set of directional spillovers as providing a decomposition of total spillovers into those transmitted by each country in the sample. Obviously, once I calculate the spillovers of business cycle shocks transmitted by country *i* and spillovers of business cycle shocks received by country *i*, the difference between the two will give us the *net directional spillovers* transmitted from country *i* to all other countries as:

$$S_{i}^{g}(H) = S_{\bullet i}^{g}(H) - S_{i \bullet}^{g}(H) . \quad (7)$$

The net directional spillover index (eq. 7) provides information about how much in net terms each country contributes to business cycle fluctuations in other countries.

III. The Empirics of Business Cycle Spillovers

In the empirical analysis, I use monthly observations of the seasonally adjusted industrial production (IPSA) indices from January 1958 to February 2010. Even though it is one of the G-7 countries, I do not include Canada in the analysis, because the Canadian IPSA is highly correlated with the IPSA of the United States.[3]

[3] Year-on-year industrial production growth rates for the two countries have a correlation coefficient of almost 86.5%, much higher than the correlation coefficients for other country pairs (See Table A-1). Similarly, the correlation coefficient between the monthly IPSA industrial production growth rates of the two countries is equal to 38.3%, a value much higher than the ones for other pairs of countries (See Table A-2). Artis *et al.* (1997) show that with a value of 85.6% the contingency correlation coefficient between the US and the Canadian industrial production is the highest among the G-7 countries.

Seasonally Adjusted Industrial Production Series: Unit Roots and Cointegration

Before going ahead with the analysis of business cycle spillovers, I first test whether the seasonally adjusted industrial production series for G-6 countries are stationary or not. I use the most-preferred augmented Dickey-Fuller (ADF) test for this purpose. Test results for the whole period (1958:01-2010:02) are presented in Table 1. For all G-6 countries, the augmented Dickey-Fuller test fails to reject the null hypothesis that the log of IPSA series (allowed to have a constant and a linear trend term) possess a unit root even at the ten percent level of significance. This result obviously implies that none of the six IPSA series are stationary in levels. Applying the tests to the first-differenced log IPSA series, however, I reject the non-stationarity of this series for all six countries at the one percent level of significance. Together these results indicate that all IPSA series included in the analysis are integrated of order one, I(1).

Once I show that all industrial production indices in the sample possess a unit root, I then test for the presence of a cointegration relationship among these six series. Johansen cointegration test results (both trace and maximum eigenvalue tests) show that there is a single cointegration relationship among the seasonally adjusted IP series for the G-6 countries over the 1958:01-2010:02 (See Table 2). Altogether test results imply that, instead of estimating a VAR model for the industrial production series for the G-6 countries, I need to estimate a VEC model, which is effectively the VAR in first differences with the lagged error correction term from the cointegration equation included.

The Business Cycle Spillover Table

In the empirical analysis of business cycle spillovers I first estimate the VEC model for the full sample and report the spillover index and the directional spillovers in Table 3 along with the underlying generalized variance decomposition. The spillover index for the full sample period is 28.2%, indicating that less than one-third of the total variance of the forecast errors for G-6 countries is explained by spillovers of shocks across countries, whereas the remaining 72% is explained by idiosyncratic shocks.

It is important at this stage to note that the spillover index for the whole sample is very sensitive to the inclusion of new observations to the sample. The spillover index for the period from 1958:01 to 2008:12 is only 27%. When the sample is extended to May 2009, the spillover index for the full sample jumps to 69%. Finally, the inclusion of observations from June 2009 to February 2010 lowers the index down to 28%.

In terms of the directional spillovers transmitted to others (measured by $S_{\bullet i}^{g}(H)$) throughout the full sample, Japan is the country that contributed the most to other countries' forecast error variance (61.3 points, which is equivalent to approximately 10% of the total forecast error variance to be explained), followed by France (31.7). According to the full sample directional spillover measures, U.S., Germany and France contributed at similar rates (between 20 and 22.3 points), followed by Italy (12.9 points).

In terms of the directional spillovers received from others, $S_{i\bullet}^{g}(H)$, the US appears to be the country that received the least of spillovers from other countries (12 points, equivalent to just 4.3% of the total forecast error variance to be explained) followed by the UK (20.5) and Japan (21). Germany received the most (45.6 points) in terms of spillovers from other countries, followed by Italy (35.1 points) and France (35 points).

Finally, I calculate the difference between the column-wise sum (what I call as "contribution from others") and the row-wise sum (what I call as "contribution to others") to obtain the net directional spillovers given by $S_{i}^{g}(H)$. Japan (40.3) and the US (10.3) are net transmitters of industrial production shocks to other countries, while France and the UK received very little business cycle spillovers.

Germany (-24.7 points) and Italy (-22.2 points), on the other hand, are definitely the net recipients of business cycle spillovers over the full sample.

The Rolling-Sample Business Cycle Spillover Index

The spillover table for the full sample provides important clues as to how the spillover index is calculated and interpreted. However, as emphasized in the introduction, the focus of the paper is more on the dynamics of business cycle spillovers over time. The fact that the inclusion of new observations in the sample leads to significant jumps in the spillover index definitely highlights the need to study the dynamics of spillovers over time.

As VEC is the correct model for the full sample, the dynamic analysis of spillovers also relies on the variance decomposition from the VEC model estimated over rolling 5-year windows. Here is how I obtain the spillover plot: I estimate the VEC model for the first 5-year sub-sample window (April 1958-March 1963) and obtain the value for the generalized variance decomposition-based spillover index (from now on, the spillover index). Moving the sub-sample window one month ahead, I obtain the spillover index for the next window and so on. Graphing the spillover index values for all sub-sample windows gives us the spillover plot.

In Figure 1, I present the rolling sample generalized spillover index plot alone. I also calculated an alternative spillover index based on the Cholesky variance decomposition. When I plot the two indices together, I observed that the difference between the two indices is in general not very large for all sub-sample windows considered, seldom exceeding 10 percentage points. Even though the small gap between the two indices varies over time, the two indices tend to move very much in harmony. Therefore, it would be sufficient to focus on the generalized VD-based spillover index for the rest of the paper.

Turning back to Figure 1, my first observation about the spillover plot is the absence of a long-run trend. The spillover plot clearly shows that while there are periods during which shocks to industrial production are transmitted substantially to others, there are yet other periods during which the spillovers of output shocks were much less important. Actually, during or after all U.S. recessions (indicated by shaded bars in Figures 1 through 5), the spillover index recorded significant upward movements. The only exception is the 1969-70 recession, during which the index moves down. In addition, the index goes up in late 1993, and after a brief correction in late 1994, it goes up again in 1995. While there is no U.S. recession during this period, France, Germany, Italy and Japan experienced recessions ending in late 1993 or early 1994 (See ECRI, 2008). As a result, the upward move in the spillover index is most likely due to the spillovers originating from these countries.

Second, while the spillover index fluctuates over time, I can differentiate between several trends. First, during the 1973-75 recession the spillover index increases by almost 20-25 percentage points and fluctuates around 50 percent after the 1981-82 recession. Starting in 1984, the spillover index declines all the way down to 33 percent. This result is consistent with findings of McConnell and Perez-Quiros (2000), and Blanchard and Simon (2001) that the volatility of U.S. GDP declined after 1984 (great moderation). As the volatility of GDP declines, the spillover index declines down to pre-1973 levels.

Third, after the great moderation era of the late 1980s, the behavior of the spillover index reflects the influence of globalization. From 1989 onwards, the band within which the spillover index fluctuates starts to move upwards with the current wave of globalization which started in earnest in early 1990s. As the sample windows are rolled to include 1996, the index reaches 60%, but declines down to 40% as the data for the late 1990s and 2000 are included. The index starts to increase again towards the end of the mild recession of 2000-2001, reaching 60% by the end of 2002. However as the other G-6 countries followed the quickly recovering US economy to a major expansion, the spillover index reached 65% in the second quarter of 2004. The index then declines to 60% again as the window is rolled to include second half of 2004, and then gradually moves down reaching its bottom around 40% from the last quarter of 2006 until the first quarter of 2008.

When I focus on the behavior of the index since 1989, I observe three complete cycles. It is interesting to note that, each time the cycle lasts longer and has a larger bandwidth than the previous one. During the first cycle which lasts from 1989 to the end of 1992, the index fluctuates between 33% and 53%, while in the second cycle that lasts from 1993 to 1999 the index fluctuates between 37% and 60%. Finally, during the third cycle from 2001 to 2007, the index fluctuates between 44% and 65%.

This result is consistent with Kose et al.'s (2003) finding that with the globalization process the business cycles have become more synchronized. It basically indicates that the comovement of industrial production fluctuations tends to be more significant since the late 1980s. In other words, when there is a shock to industrial production in one or more countries in the G-6 group, its tendency to spill over to other countries increases as we move from 1989 toward 2007.

This result can also be interpreted as consistent with Doyle and Faust's (2005) conclusion that the correlation coefficients among the industrial production series have not increased much since the late 1980s. The output fluctuations tend to move together during periods of high spillover index, compared to the periods with low spillover index. When one analyzes the period since the late 1980s as a whole, s/he may not obtain high correlation coefficients. Actually, for the period from 1989 to 2007 the spillover index is only 36 percent.

Next I focus on the most important part of the results, namely the behavior of the spillover index since June 2008 (see Figure 2). I want to focus on its most recent behavior, not only because it provides us with more clues about the business cycle spillovers since the beginning of the sub-prime

[4] There is a spike in the index in May 1968, as the French industrial production makes its largest (38%) historical drop in May 1968, which was followed by 23% and 19% increases in June and July. However, the sudden drop in May 1968 did not have any lasting impact on industrial output in France and in other G-6 countries.

crisis in the United States, but also because in 2008 and 2009 the index has recorded the biggest jump in its history. The index jumped from 41% in May 2008 to 53 % in July, to 68% in September, and then to 80% in December 2008. The index declines slightly down to 71% as the data for January through October 2009 are included in the analysis. However, as the economic recovery went underway in the G-6 countries the index moved upwards again to reach 75% in December 2009 through February 2010.

The behavior of the index during the Great Recession of 2008-2009 is in stark contrast to previous recession episodes. It has increased 39 percentage points from May to December 2008. The jump in the index during the Great Recession is an indication of how G-6 countries were pulling each other down. To give an example, during the recession following the first oil price hikes in a matter of four years from 1972 to 1976, the spillover index recorded a relatively smaller increase, from a low of 31 to a high of 61%.

So far I have discussed the spillover plot based on 5-year rolling windows. Obviously here the window size is a critical factor that can have an impact on the shape of the spillover plot. For that reason, I present the spillover plots for 4, 6, and 7-year rolling windows in Figure 3. Irrespective of the window size I choose, the spillover index follows similar patterns. For example, in all three plots the spillover index jumps between 30 and 40 percentage points since the start of the Great Recession of 2008-09. Furthermore, as the window size increases, the spillover plot becomes smoother, giving additional clues about the business cycle spillovers. The result that the band within which the spillover index fluctuates increases during the current globalization process continues to hold with 4, 6 and 7-year rolling windows.

The Rolling-Sample Directional Business Cycle Spillovers

Following a detailed analysis of the business cycle spillover index, I can now focus on directional spillovers across countries. As described in detail in Section 2, directional spillovers are critical in understanding the respective roles of each of the G-6 countries in spreading shocks to local industry output to other countries. I present the net directional spillovers plot in Figure 4.[5]

Throughout the 1970s, Japan had been the most important source country of net spillovers (Figure 4). During the 1973-1975 recession and during the second half of the 1970s, the spillovers originated from Japan to others reached as high as 25% of the total gross spillovers, whereas the spillovers received by Japan from others was only around 8% of the total spillover, leading the net spillovers from Japan to reach as high as 20% of the total spillovers (Figure 4). Germany was the second most important source of business cycle spillovers during the 1970s, followed by France. The United States, on the other hand, was a net recipient of business cycle spillovers over most of the 1970s.

The roles were reversed in the 1980s: the United States has become the major net transmitter of the spillovers, whereas Japan became the net recipient of spillovers. The gross spillovers transmitted by the United States to others jumped above 15%, and as high as 30%, and the net spillovers from the U.S. fluctuated between 10 and 20% after the 1982 U.S. recession (see Figure 4). Japan's net spillovers, on the other hand, declined to as low as -11% of total spillovers after the 1982 recession and stayed at low levels until the end of 1987. While Germany and the U.K. were also net positive transmitters of spillovers after the 1981-1982 recession, their roles were rather secondary compared to the United States and Japan (Figure 4).

Throughout the 1990s, Japan was neither a net transmitter nor a net recipient of the business cycle spillovers among the G-6 countries. This is consistent with the decade-long recession Japan had suffered with almost no effect on other G-6 countries. Neither the United States nor Germany was one of the major net transmitters of spillovers in the 1990s. It was rather France and United Kingdom that were net transmitters of spillovers, even though the spillovers originating from these countries were not as large and not as persistent as the ones that originated from the U.S., Japan and Germany in the 1970s

[5] The plots of the gross directional business cycle spillovers transmitted to others and received from others are presented in the appendix, Figure A4 and A5, respectively.

and 1980s. The role these countries played during the 1990s is closely related to the aftermath of the ERM crisis of 1992 and the ensuing slowdown in these economies.

Moving forward in time, the United States and Japan returned to their locomotive roles in the 2000s. The US was especially a net transmitter of business cycle shocks after the 2001 recession, with its net spillovers reaching close to 20%. Japan, on the other hand, was a net transmitter of spillovers throughout the 2000s, its net spillovers fluctuating between 5 and 10%. Germany was a net recipient in the 2000s and during the crisis. France, Italy and the UK were also net recipients in the 2000s, before the global recession of 2008-09.

Lately, with a -15% net spillover transmission rate since 2007, Japan has become a net recipient rather than a net transmitter of business cycle spillovers. In the meantime, the net spillovers from the U.S. gradually increased with the intensification of the sub-prime crisis since mid-2007. As emphasized above, from April to December 2008, the total spillover index jumped substantially up to reach to 80%. The United States was the most important contributor to the increase in business cycle spillovers, with a net spillover contribution of more than 25% (Figure 4). The gross directional spillovers from the U.S. jumped close to 33% since the collapse of the Lehman Brothers in September 2008. While the United States is the major net transmitter of shocks to others, France, Italy, and the UK had also become net transmitters during the 2008-2009 Great Recession, albeit with smaller contributions.

According to Figure 4, throughout the 1990s and the 2000s with the exception of a brief spell in the late 1990s, Germany has been a net recipient, rather than a transmitter, of business cycle spillovers. The net spillovers to Germany increased to 15% as the observation for March 2009 is included in the rolling window. As the window is rolled to include June and July 2009, the net spillovers to Germany declined slightly to 8% to increase again to 15% with the January and February 2010 data.

Germany has been the biggest economy and the manufacturing powerhouse of Europe. It is therefore not easy to reconcile the above result with the image of Germany as the engine of growth of the European economy. Let me discuss the logic behind this result. Manufacturing trade plays a key role in the transmission of shocks across countries. When there is a shock to domestic demand, this shock spills over to other countries through the trade channel. As the aggregate demand takes a hit, the demand for imports decline and the shock is transmitted to the countries that are major exporters to that country. As can be in Table 4 from 1999 to 2008 Germany's average trade surplus in manufacturing vis-à-vis other five countries was equivalent to 6.5 percent of its industrial output. Over the same period United Kingdom, United States, and France run manufacturing trade deficits, while Japan and Italy run manufacturing trade surpluses vis-à-vis other G-6 countries. Germany happens to be the most important exporter of manufacturing goods to France, UK and Italy, and it comes only the second or the third exporter to the U.S. or Japan. As a result, when the domestic industrial production in one or more G-6 countries decline this shock is likely to spill over, first and foremost, to Germany and then to other countries. With this perspective, it is logical to have Germany as a net-recipient of industrial production shocks rather than a net-transmitter.

IV. Conclusions

Based on the spillover index methodology introduced by Diebold and Yılmaz (2009 and 2010), this paper developed an alternative measure of comovement of macroeconomic aggregates across major industrialized countries. Forecast-error variance decompositions from a VEC model are used to calculate the business cycle spillover index across G-6 countries.

The paper makes several important contributions to the literature on international business cycles. First, the spillover index methodology is different from the empirical approaches widely used in the literature. While the factor model approach aims at obtaining a world business cycle measure, the spillover index framework distinguishes between idiosyncratic shocks to industrial production and spillover of industrial production shocks from other countries. Furthermore, the spillover index that is based on a multivariate VEC can better be placed to capture the increased comovement of business fluctuations in more than two countries compared to an analysis based on bi-variate correlation coefficients.

Second, the analysis sheds new light on the nature of business cycles, clearly showing that the cross-country comovement of business fluctuations is not constant over time, nor does it follow an upward trend. Rather, the business cycle spillovers fluctuate substantially over time. However, the band within which the spillover index fluctuates increased since 1984. This result is consistent with the findings of both Kose et al. (2003) and Doyle and Faust (2005): When shocks in individual countries are not significant, they cannot be expected to spill over to other countries irrespective of the degree of integration among these countries. When the shocks are big enough to spill over to other countries, then the correlation of macroeconomic aggregates across countries will be greater.

Third, the directional spillover measures are used to identify each country as gross and/or net transmitters of business cycle shocks to other countries as well as gross/net recipients of business cycle shocks from other countries over different time periods. The directional spillover measures show that the U.S. (1980s and 2000s) and Japan (1970s and 2000s) are the major net transmitters of shocks to other countries, while Germany is the major net receiver of shocks in 2000s.

Last, but not the least, with an unprecedented jump between May and December 2008, the business cycle spillover index captures the global nature of the current recession perfectly. Given how fast the shocks spill over across countries, it is legitimate to argue that the recovery from the current recession/depression requires coordinated policy actions among the major industrial and emerging economies.

In the current paper, I choose to analyze business cycle spillovers across the G-6 countries only. In future research, I plan to study the business cycle spillovers across major emerging market economies along with the G-6 countries.

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Table 1. Unit Root Test – G-6 Industrial Production (1958:01-2010:02)

Augmented Dickey-Fuller Test Statistics						
	USA	**Germany**	**Japan**	**France**	**UK**	**Italy**
Log levels (with constant term and trend)	-3.124	-2.746	-2.656	-1.311	-1.148	-2.092
Log first differences (with constant term)	-10.371	-13.023	-8.525	-25.935	-29.561	-32.837

Critical Values for the Augmented Dickey-Fuller Test			
	1%	**5%**	**10%**
Log levels (with constant term and trend)	-3.973	-3.417	-3.131
Log first differences (with constant term)	-3.441	-2.866	-2.569

Notes: In applying the Augmented Dickey-Fuller test to log industrial production we include a constant term and a trend, but only a constant term in the case of first differences of log industrial production. Critical values for the Augmented Dickey-Fuller test are provided in the lower part of the table at the 1%, 5% and 10% level of significance.

Table 2: Johansen Cointegration Test - G-6 Industrial Production (1958:01-2010:02)

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	P-Value
None **	0.0969	139.3	117.7	0.0011
At most 1	**0.0474**	**76.1**	**88.8**	**0.290**
At most 2	0.0318	45.9	63.9	0.606
At most 3	0.0211	25.8	42.9	0.748
At most 4	0.0130	12.5	25.9	0.774
At most 5	0.0071	4.4	12.5	0.681

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Maximum Eigenvalue Statistic	0.05 Critical Value	P-value
None **	63.3	44.5	0.0002
At most 1	**30.2**	**38.3**	**0.317**
At most 2	20.1	32.1	0.645
At most 3	13.3	25.8	0.782
At most 4	8.1	19.4	0.811
At most 5	4.4	12.5	0.681

Notes: We assume that there is a liner deterministic trend in the data and an intercept and trend term in the cointegrating equation; ** denotes rejection of the hypothesis at the 0.01 level

Table 3: Business Cycle Spillover Table for G-6 Countries (1958:01-2010:02)

	USA	Germany	Japan	France	UK	Italy	Directional *FROM* Others
USA	88.0	0.8	3.4	3.8	2.6	1.4	**12.0**
Germany	3.4	54.4	27.8	7.1	6.4	0.9	**45.6**
Japan	6.7	5.1	79.0	6.0	2.2	1.1	**21.0**
France	2.9	8.9	11.7	65.0	3.8	7.8	**35.0**
UK	6.0	4.4	4.9	3.3	79.5	1.8	**20.5**
Italy	3.3	1.7	13.6	11.6	4.9	64.9	**35.1**
Directional *TO* Others	**22.3**	**20.9**	**61.3**	**31.7**	**20.0**	**12.9**	**Index=28.2%**
Net Directional Spillovers (*TO* – *FROM*)	**10.3**	**-24.7**	**40.3**	**-3.3**	**-0.5**	**-22.2**	

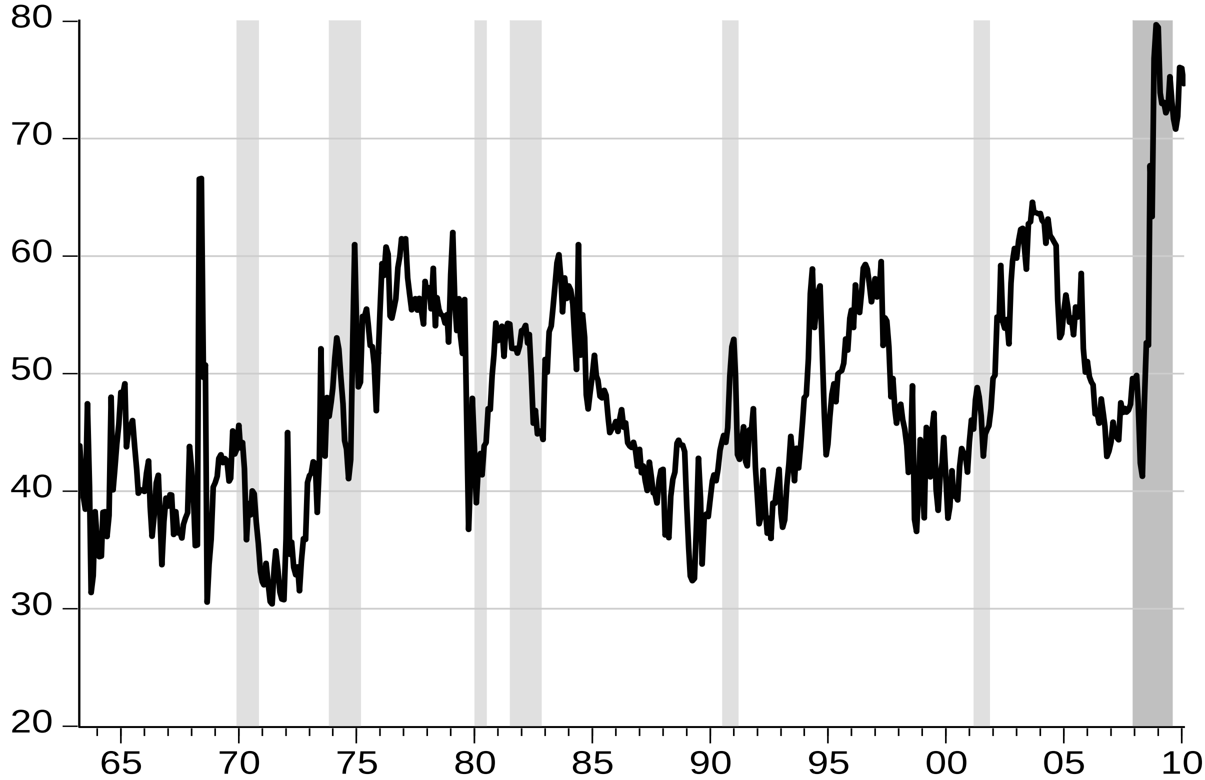
Notes: Each cell in the 6x6 matrix section of the Table reports the relative (n percentage terms) contribution of the "column" country to the variance of the forecast error for the "row" country. "Directional FROM Others" column reports the total variance (of the forecast error) share attributable to other countries. "Directional TO Others" row reports the sum of the contributions of each country to all other countries' variance of forecast errors. Each cell in the "Net Directional Spillovers (TO-FROM)" row reports the difference between the corresponding cells in the "Directional TO Others" row and the ones in the "Directional FROM Others" column. The Index is the sum of the elements of the "Directional FROM Others" column (similarly, the "Directional TO Others" row) divided by the total possible variance contributions, which is by definition equal to 600 for 6 countries.

Table 4: Bilateral Manufacturing Trade Balance / Local Manufacturing Production (1999-2008, Average)

	USA	Germany	Japan	France	UK	Italy
USA	--	2.4	2.7	1.4	1.6	0.6
Germany	-0.6	--	0.1	-2.4	-5.0	-1.7
Japan	-1.2	-0.2	--	-0.1	-1.6	-0.1
France	-0.1	1.6	0.02	--	0.1	0.8
UK	-0.1	1.5	0.3	0.7	--	0.9
Italy	-0.2	1.1	0.02	-0.2	-1.2	--
Total	**-2.0**	**6.5**	**3.1**	**-0.5**	**-6.1**	**0.5**

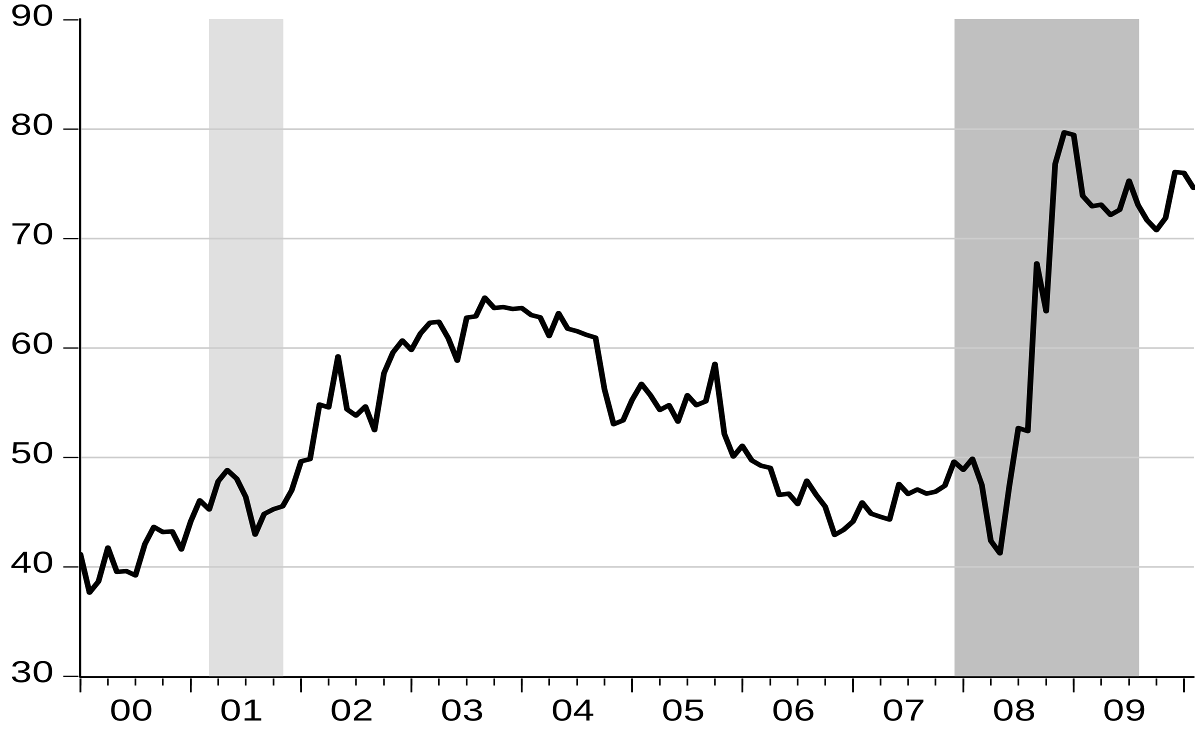
Notes: Each cell shows the manufacturing trade balance of the column country with the row country, divided by the industrial production of the column country. For example, while Germany's manufacturing trade surplus vis-à-vis the US is 2.4% of the German industrial production, the corresponding US manufacturing trade deficit vis-à-vis Germany is 0.6% of the US industrial production. (Source: Author's calculations using on data from OECD statistics website)

Figure 1. Business Cycle Spillover Index for G-6 countries (1958:01-2010:02)



Notes: The spillover index is calculated for 5-year rolling sample windows based on a Vector Error Correction model with 3 lags. The index is denoted in percentage terms. Gray bars indicate the U.S. recessions.

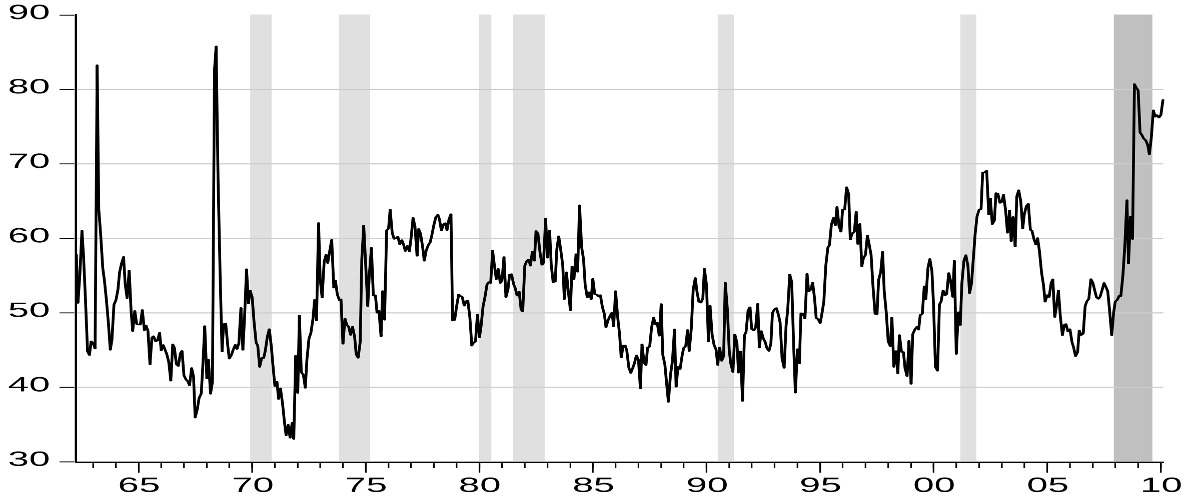
Figure 2. Business Cycle Spillover Index for G-6 countries (2000:01-2010:02)



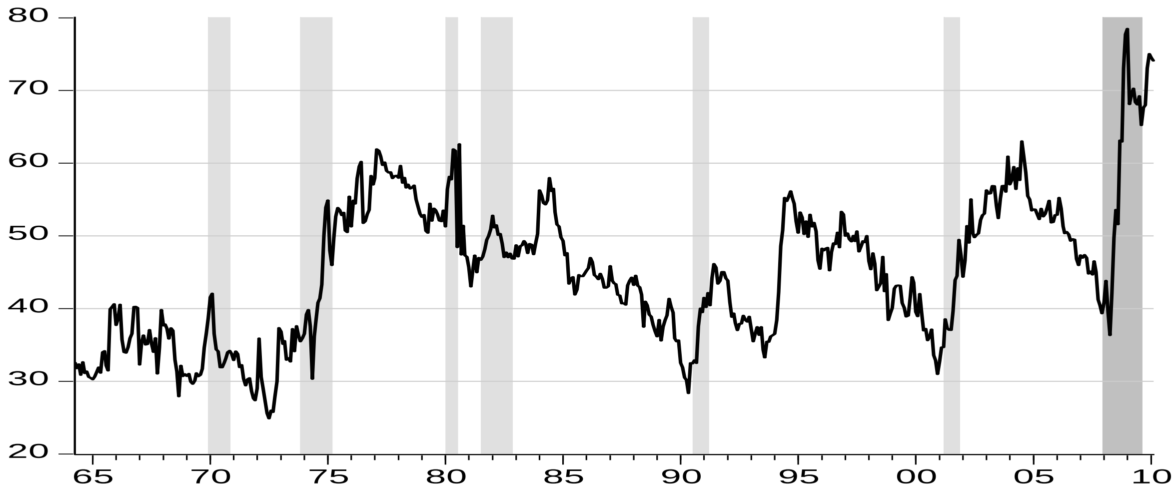
Notes: See Figure 1.

Figure 3. Business Cycle Spillover Indices for G-6 countries
(1958:01-2010:02)

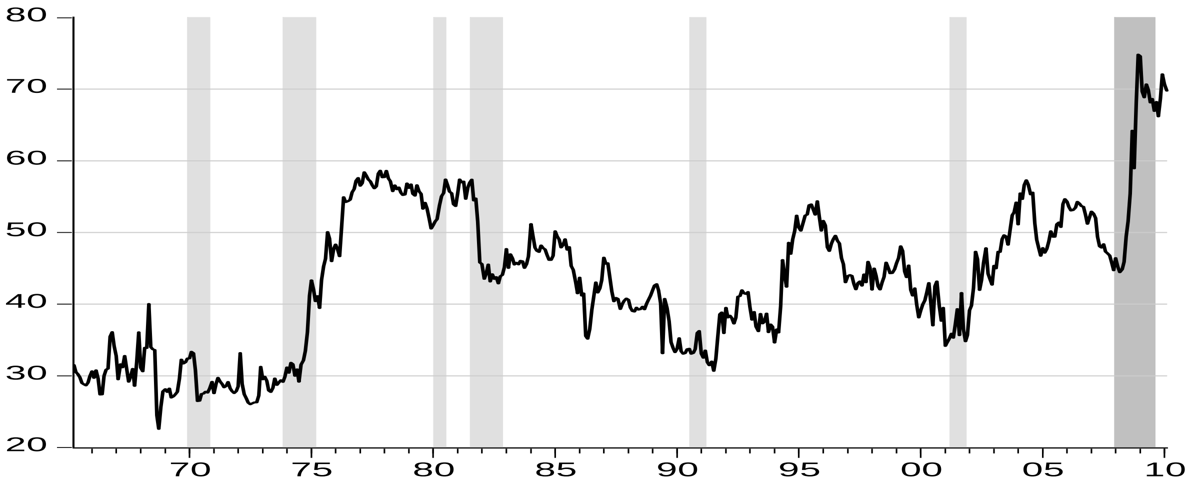
a) 4-year rolling window



b) 6-year rolling window

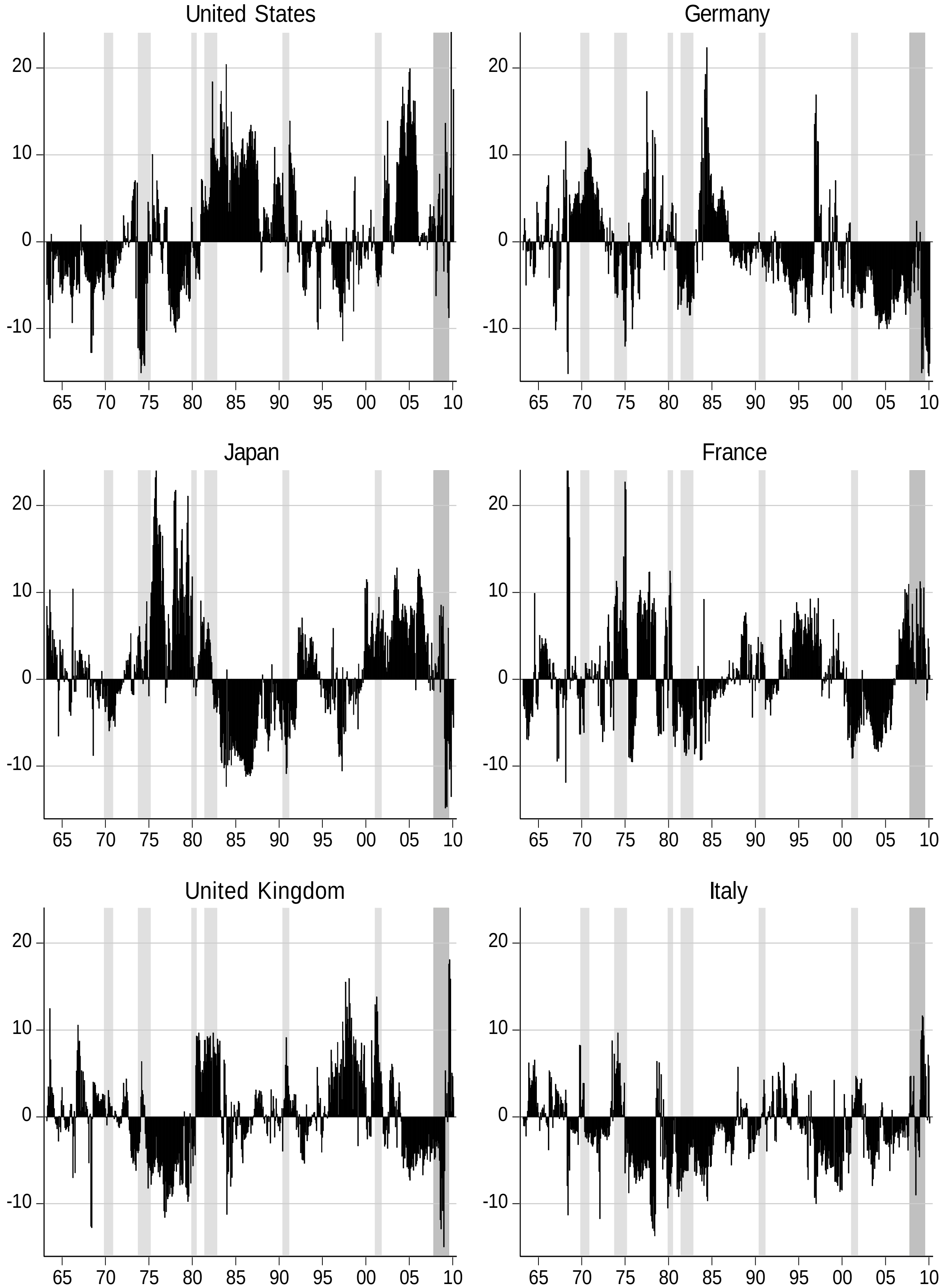


c) 7-year rolling window



Notes: See Figure 1.

Figure 4. Net Directional Business Cycle Spillovers Transmitted to Others (1958:01-2010:02)



Notes: See Figure 1.

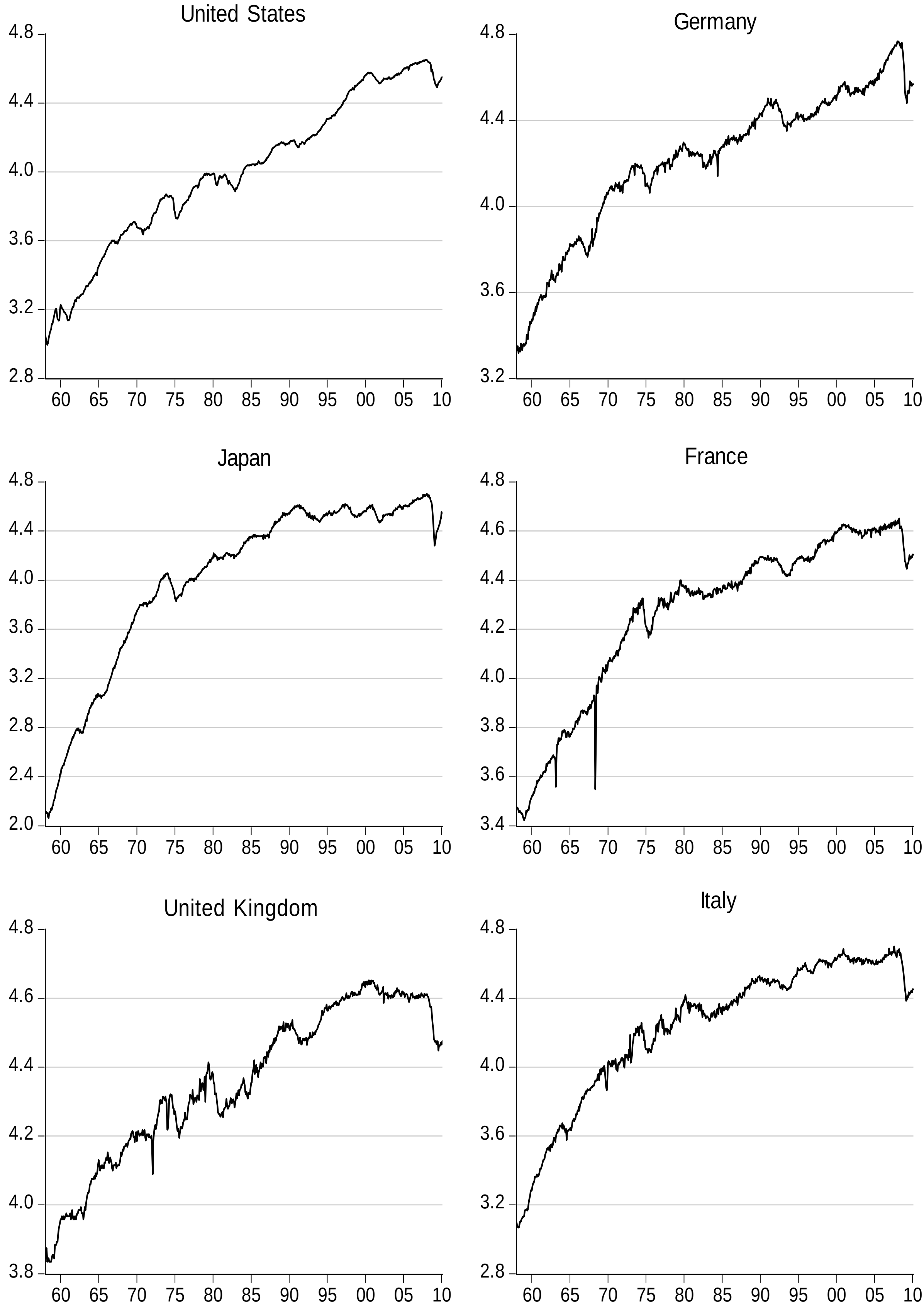
APPENDIX

Table A-1: Correlation Coefficients - Monthly and 12-monthly Growth Rates of Industrial Production (1961:01-2010:02)

↓ 12-Monthly Growth Rates	→ Monthly Growth Rates						
	USA	**Germany**	**Japan**	**France**	**UK**	**Italy**	**Canada**
USA	1	0.155	0.235	0.044	0.158	0.131	**0.383**
Germany	0.524	1	0.223	0.108	0.156	0.092	0.083
Japan	0.572	0.669	1	0.100	0.087	0.063	0.178
France	0.536	0.634	0.621	1	0.027	0.049	0.090
UK	0.569	0.525	0.500	0.502	1	0.182	0.156
Italy	0.580	0.574	0.672	0.658	0.438	1	0.088
Canada	0.865	0.486	0.563	0.537	0.558	0.554	1

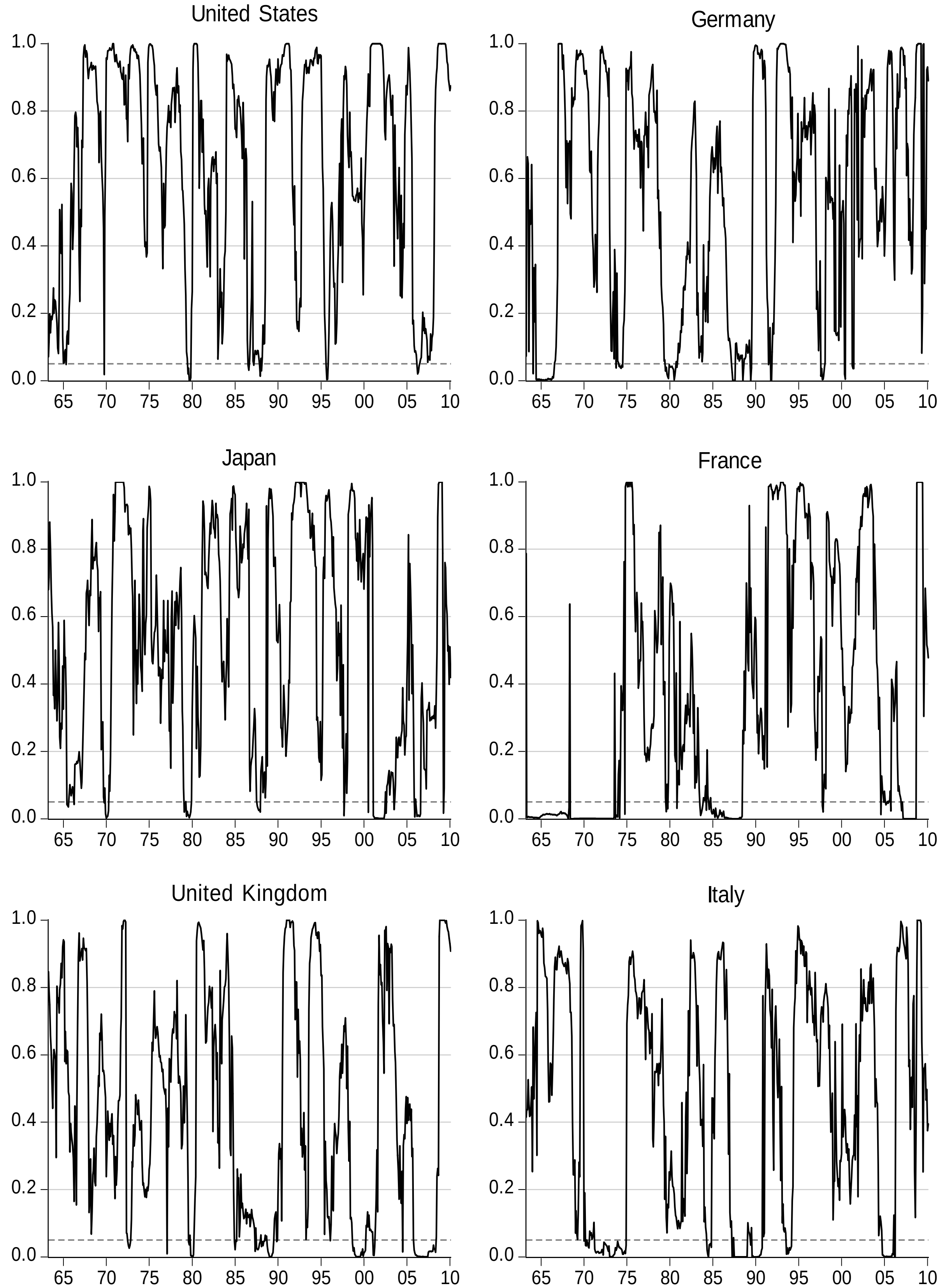
Note: As Canada's industrial production data starts on January 1961, we calculate the correlation coefficients for the monthly (12-monthly) industrial production growth rates over the period from January 1961 (January 1962) to February 2010.

Figure A1. Seasonally Adjusted Log Industrial Production Indices for G-6 Countries (, 1958:01-2010:02)



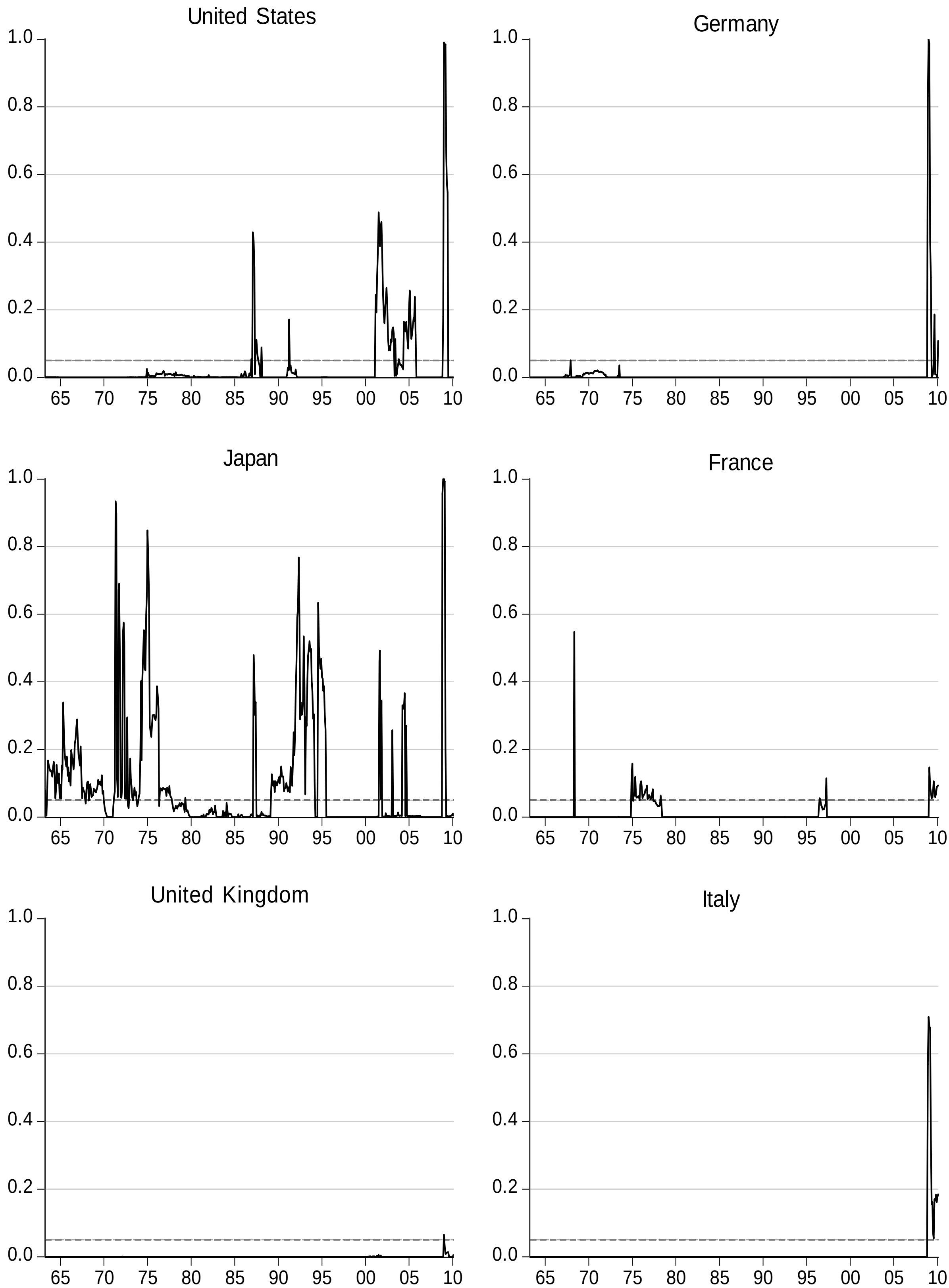
Source: OECD

Figure A2. Unit Root Tests for SA Log Industrial Production Index in Levels (5% significance level, 1958:01-2010:02)



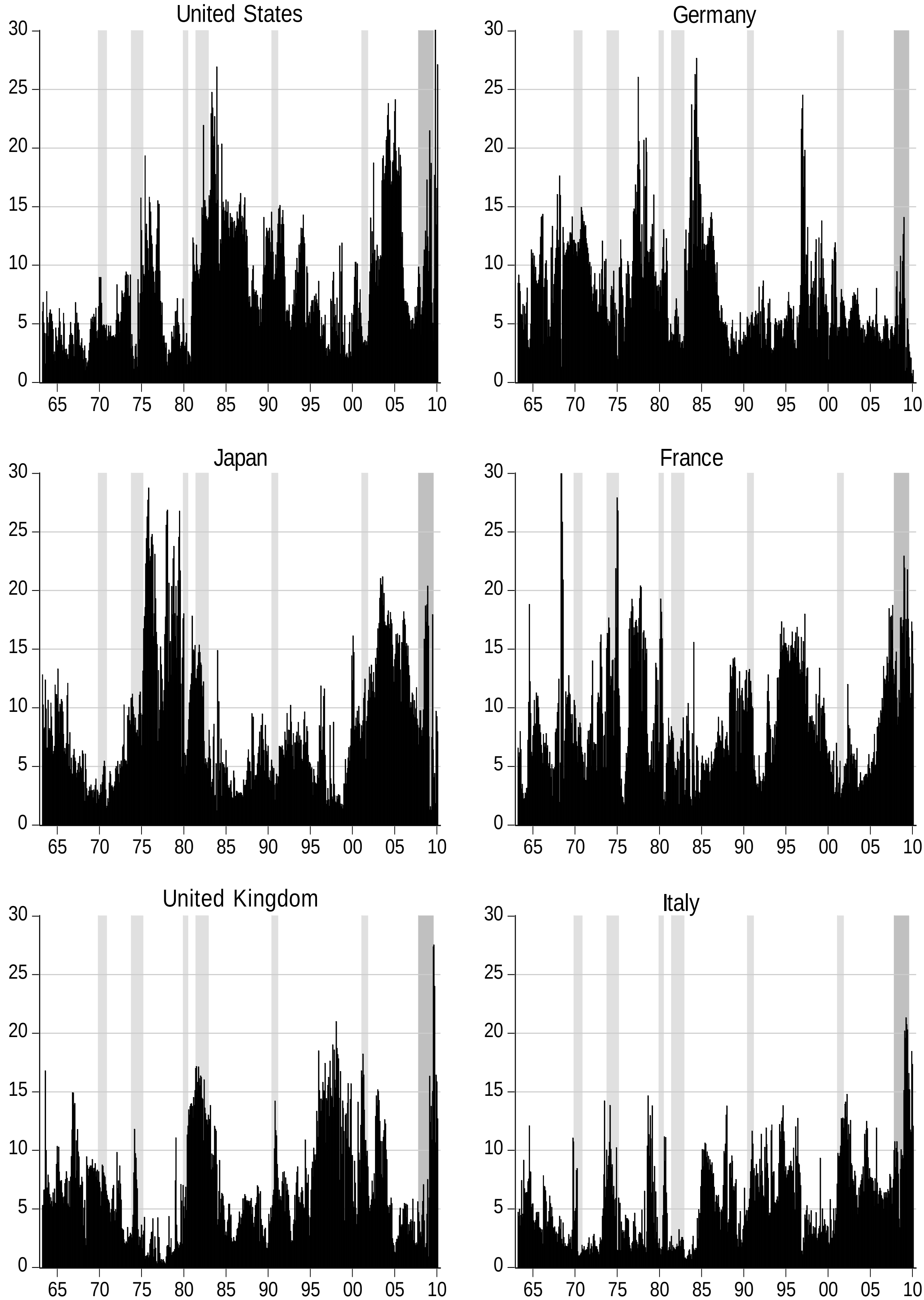
Source: Author’s Calculations

Figure A3. Augmented Dickey-Fuller Test for Unit Roots in First Differences of SA Log Industrial Production Index (5% significance level, 1958:01-2010:02)



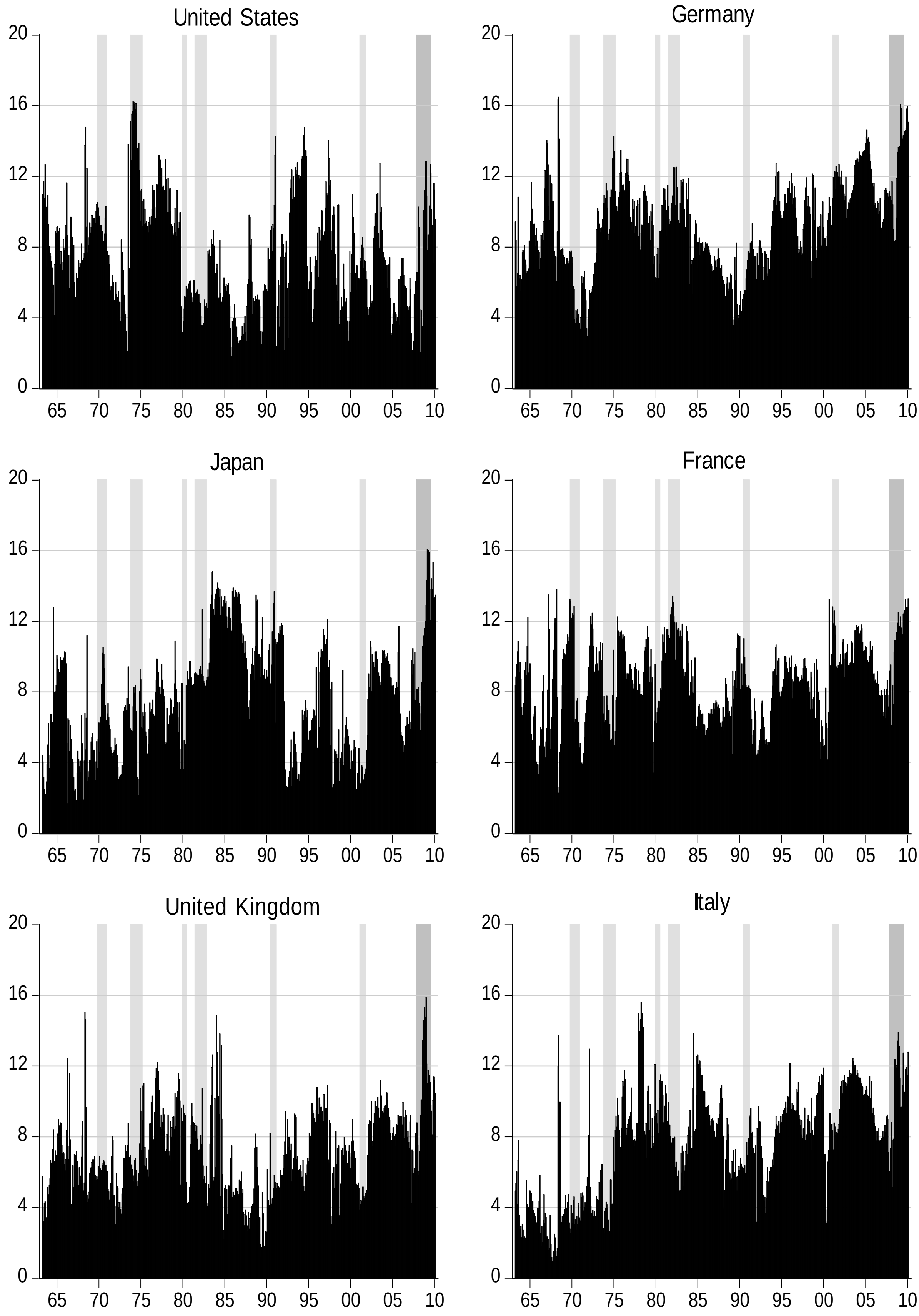
Source: Author’s Calculations

Figure A4. Gross Directional Business Cycle Spillovers Transmitted to Others (1958:01-2010:02)



Notes: See Figure 1.

Figure A5. Gross Directional Business Cycle Spillovers Received from Others (1958:01-2010:02)



Notes: See Figure 1.