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THE RISE, FALL, AND RISE AGAIN OF DECOUPLING

Emerging markets' cyclical growth prospects remain tied to the developed world, but their potential growth may have decoupled

Sometimes, it seems that economic theories never really die: they just disappear for a while before making a comeback. This might take a long time: think, for example, of the so-called Treasury View of fiscal policy, which had a run in the 1930s before being vanquished by Keynesianism, but has recently been reinvented by die-hard sceptics of fiscal stimulus.

Alternatively, the cycle of death and rebirth can be much quicker. Remember the theory of decoupling? Popular in 2007 and early 2008, in its strongest form this was the proposition that emerging markets would be able to sail on largely unaffected by a significant hit to the US economy.[1] Its origins can be found in the impressive economic performance of developing economies compared to the developed world. During the 1980s, the growth gap between these two groups had averaged about half a percentage point in favour of the former; during the 1990s the gap widened a little bit, to just under one percentage point; and by the first decade of the current century, the average growth gap between emerging and developing economies and the developed world was more than four percentage points (see the chart on the next page).[2]

Such was the size of this relative shift in growth momentum that it sparked the hypothesis that developing economies would become less reliant on the developed world as an external driver of their success and even, eventually, become new and independent growth poles for the world economy. In other words, their growth – and also their financial market performance – would 'decouple' from that of the developed world.

At first (and also at second) glance, this seemed a somewhat strange proposition. After all, wasn't this the Age of Globalisation, a time when trade and investment ties between the world's two economies were growing closer and deeper, and when financial integration in particular was proceeding in leaps and bounds? Shouldn't this imply *more*, not less, synchronisation between the world's economies?

Certainly, periods of recession in the world's biggest and most important developed economy, the United States, were typically associated with a big fall in global growth: hence the expression, 'if the US sneezes, the rest of the world catches a cold'.[3] Yet there was at least some empirical evidence that the growth relationship between the developed and developing world was changing, including a decline in the relative importance of the former.[4] Moreover, following the bursting of the US subprime bubble in mid-2007, and on into early 2008, there was little sign of a major hit to growth in emerging markets. Indeed, even as the Fed was cutting policy rates in an

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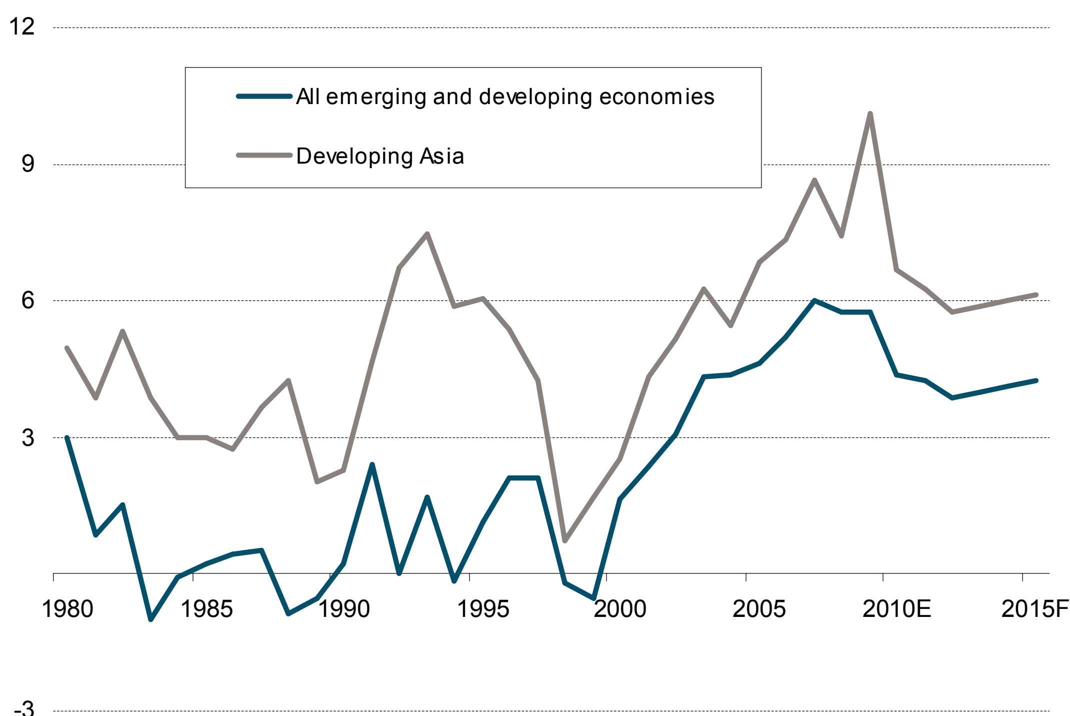
attempt to shore up faltering activity, policymakers in several key emerging markets were tightening policy in response to worries about overheating.



Source: Author's calculations based on data from IMF World Economic Outlook database, October 2010

As the crisis in the rich world deepened, however, the theory quickly started to lose its appeal. First to go was financial market decoupling: growing international risk aversion saw investors pull their funds out of emerging markets and flee to what it turned out they still viewed to be the safest assets – US treasuries. In the three months to September 2008, emerging markets suffered their largest financial outflows since 1995, and after the collapse of Lehman Brothers on 15 September 2008, there were huge falls in emerging economy stock markets as well widespread weakness in developing country currencies. Next went the real economy version of decoupling: in the final quarter of 2008 and the first quarter of 2009, activity – trade, industrial production – in nearly all of the world's economies basically fell off a cliff. That fall looked to be a fatal one for the theory: maybe 'decoupling was always bunkum after all.'[5]

Yet the idea of decoupling has since staged a remarkable recovery, thanks in large part to an equally remarkable emerging market growth performance. In 2009, only three OECD economies managed to generate positive growth, and taken overall, rich

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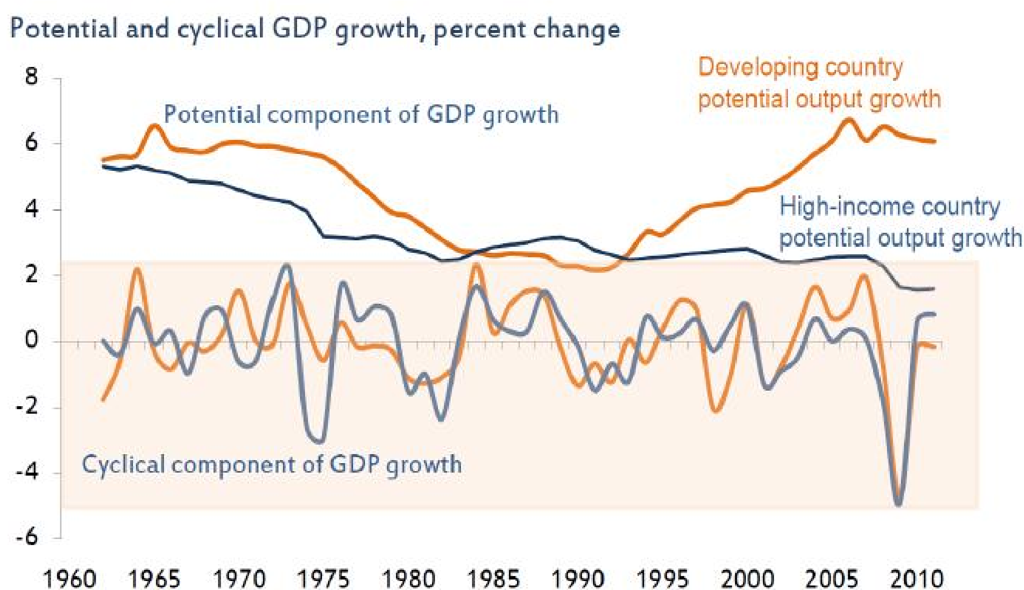
economies *shrank* by a bit more than 3 percent. In contrast, emerging and developing economies as a group *grew* by about 2.5 percent.[6] This year, the IMF estimates that while advanced economies will only grow by 2.7 percent, developing and emerging economies will expand by a much more impressive 7.1 percent. Next year, the two growth forecasts are for 2.2 percent and 6.4 percent, respectively. In other words, the growth gap between developing and developed economies has survived the crisis intact.

Two things seem to be going on here:[7]

1. The growth performance of emerging markets appears to have become progressively more resilient to downturns in the developed world: emerging economies performed better after the 1991-93 and 2001 advanced economy recessions than they did after the 1974-75 and 1980-83 recessions.

2. This is *despite* the fact that in many ways linkages – and correlations – between the developed and developing world have increased over time.

There are also two – related – ways to think about these changes.



Source: Figure 2 in Canuto, *Recoupling or switchover: Developing countries in the global economy*. (2010)

First, as an improvement in the average resilience of emerging economies to external shocks in the form of stronger and more sustainable fiscal and external positions.

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Not only has this improved the quality of countries' shock absorbers, but it has also allowed policymakers to be much more proactive in responding to external shocks: the current crisis brought a particularly aggressive fiscal and monetary policy response to the downturn on the part of some emerging markets – one that was significantly stronger than past experience would have suggested.[8]

Second, in terms of a distinction between trend and cycle. In an interesting World Bank working paper released earlier this year, Otaviano Canuto noted that while there is no evidence to support decoupling in terms of *cyclical* developments this is not necessarily the case with *trend* growth, where it does seem that there has been an increase in the potential growth rate of developing economies.[9] That is, what we now have is a combination of cyclical coupling plus trend decoupling.

What are the implications? The good news is that the world economy does now benefit from some new and increasingly important sources of economic growth. However, greater international economic integration means that these new growth drivers still remain heavily influenced by developments in the rich world. Finally, those two preceding points also suggest that the developed world is likely to become increasingly vulnerable to growth shocks originating in emerging markets: that is, cyclical coupling is probably going to be more of a two-way street from now on.

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[1] The Economist, The decoupling debate. *The Economist*, 6 March 2008.
[2] For the countries of developing Asia, growth out-performance is less of a recent phenomenon: the average growth gap in the 1980s was more than three-and-a-half percentage points and in the 1990s about four-and-a-half percentage points, even after taking the impact of the 1997-98 financial crisis into account. Still, the first ten years of the millennium did see a further increase in the growth gap – to almost six-and-a-half percentage points.
[3] There is a nice discussion of these issues in Thomas Helbling, Peter Berezin, M. Ahyan Kose, Michael Kumhof, Doug Laxton and Nikola Spatafora, Decoupling the Train? Spillovers and Cycles in the Global Economy, in *World Economic Outlook: Spillovers and Cycles in the Global Economy.* Washington DC, International Monetary Fund, 2007. The chart is their Figure 4.1.
[4] See for example Cigdem Akin and M. Ayhan Kose, *Changing nature of North-South linkages: Stylized facts and explanations.* IMF Working Paper WP/07/280. Washington DC, International Monetary Fund, December, 2007.
[5] Lex, Asian markets wilt. *Financial Times*, 18 September 2008.
[6] All growth numbers and forecasts are from International Monetary Fund (IMF), *World Economic Outlook: Recovery, risk and rebalancing.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2010.
[7] See Box 1.1 in Ibid.
[8] International Monetary Fund (IMF), *How did emerging markets cope in the crisis?* IMF Staff Paper. Washington DC, International Monetary Fund, 15 June, 2010.
[9] Otaviano Canuto, *Recoupling or switchover: Developing countries in the global economy.* Washington DC, The World Bank, 2010.

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