The Decoupling Debate Is Back!

By M. Ayhan Kose, Eswar Prasad

But what on Earth does it really mean?

The decoupling debate is back! Indeed, the notion that the health of emerging markets is no longer determined by the ups-and-downs in developed economies -- or even that emerging markets may be insulated from global shocks -- has been in vogue of late.

Last fall, the collapse of Lehman Brothers and the ensuing stock market crash dragged down emerging markets: decoupling seemed dead. Now, pundits who recently mocked the hypothesis are starting to wonder aloud if there might after all be something to it. The IMF forecasts that advanced economies will contract 3.8 percent in 2009; emerging economies are expected to post 1.6 percent growth this year. And international investors are flocking to emerging markets, which have beat those in developed countries by nearly 50 percent in the past six months.

Yet, neither the synchronized turndown nor uneven rebound is sufficient to prove decoupling true or false. The term is amorphous, and perhaps best used as a Rorschach test for the proclivities and interests of its wielder. But the underlying concept has staying power. And certain aspects of the decoupling hypothesis are important to examine, to see what they portend for the future of the global economy.

First, there is a good deal of confusion about the distinction between cross-country synchronization of financial markets and economic activity. With capital and news flowing more freely and quickly across borders, stock markets around the world are increasingly synchronized. This makes it highly unlikely that we would observe a prolonged period of decoupling in financial markets.

Stock market indices are, of course, a good source of information about countries' overall economic prospects. But stock prices are more volatile than fundamental economic indicators: They react much more quickly to good and bad news. In emerging-market economies, this is particularly true. Small movements in foreign-investor flows cause large fluctuations in equity prices.

The big question is whether and how these financial spillovers affect the "real" economy, as measured by such variables as GDP, investment, and household consumption. Here the answers are less clear. So far, there seems to be a split between real and financial variables in emerging markets. Stock markets plunge and recover rapidly, while declines and increases in output growth are much more moderate. Given emerging economies' potential for economic growth, it is reasonable to expect that the gyrations of equity markets will have little effect over the long term.

Second, it is vital to remember that emerging markets are hardly a monolithic group. During this recession, China and India have continued to post solid, if unspectacular, growth rates. Some emerging-market countries that rely heavily on commodity exports have taken bigger hits and could take longer to recover. Emerging-market countries with large current account deficits, such as those in Eastern Europe, have suffered brutally as external financing has dried up.

Overall, though, emerging-market economies haven't done too badly, and they will likely bounce back to healthy growth quicker.
than advanced economies. Indeed, emerging economies can sustain much higher growth rates than advanced economies — implying a structural, rather than cyclical, kind of decoupling. Emerging markets also have much higher productivity growth, large and underutilized labor forces, and enormous latent domestic demand. This latent demand is not just for typical durable consumption goods, but it is demand for infrastructure, education, and health services, which can in turn propel higher long-term growth.

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The question still remains whether emerging markets as a group have become more self-reliant over the past boom-and-bust cycle. Three important indicators suggest more interdependence among emerging economies — hence, less dependence on advanced economies — though only with some important qualifications.

First, trade flows between emerging-market economies have increased, doubling in the past two decades. This is in no small part due to the internationalization of supply chains and specialization of production. For instance, a large chunk of South Korean and Taiwanese exports to China are ultimately destined for advanced-country markets, after undergoing some final processing in China.

Second, demand for commodities from large emerging markets like China and India has bolstered growth in commodity exporters such as Brazil, Chile, and Russia.

Third, financial flows between emerging economies have increased. China gets nearly two thirds of its foreign direct investment from other Asian emerging countries. In turn, China has begun to undertake substantial investments in many commodity-producing countries. Other emerging markets also have built up massive stocks of foreign exchange reserves. All of this makes emerging markets as a group less dependent on financial flows from advanced economies.

Further, the major emerging economies have bolstered their arsenal of macroeconomic policy tools to combat slowdowns since the 1998 Asian financial crisis and 2001 tech bubble downturn. Countries such as China and India, in particular, have used these policies effectively in this recession, propping up growth.

Thus, there are signs that the major emerging markets are no longer as dependent on the advanced economies as before. The bigger question facing the world is whether emerging economies like China can become self-sustaining and turn to a model of growth that is largely driven by domestic rather than foreign demand. Here, the jury is still out.

China's growth model is heavily skewed toward investment, which has accounted for more than half of GDP growth in this decade. Consequently, the share of national income going to capital rather than labor has risen gradually. Furthermore, households continue to save nearly one quarter of their disposable income. As a consequence, private consumption accounts for only about 36 percent of GDP, far lower than in most advanced and developing economies. China's stimulus package is mostly boosting investment in the short run, creating a further imbalance with domestic demand.

China is an extreme case, but overall saving rates are high in many other Asian economies as well. Many of these countries are already trying to harness this saving effectively and turn it into productive domestic investment, but their policies will take time to bear fruit. Meanwhile, emerging markets still continue to rely on exports for a significant fraction of their output and employment growth even though, in the short run, they can apparently stimulate their economies using other policy measures to offset some of the fall in exports.

The bottom line is that emerging markets now seem much more capable of holding their own in the midst of a global recession. They are also becoming more influential in terms of raw size — and likely to account for a rising share of global output, trade, and financial flows. But to expect them to become drivers of world growth, especially in terms of helping out the advanced economies by absorbing their exports, is premature. The reality of emerging markets is encouraging but will take a while to catch up to the hype about decoupling.

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