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Decoupling Debate Will Return: Emergers Dominate in Long Run

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Summary

- 'Decoupling' will be declared dead as the global economy heads into a synchronized downturn.

- However, more careful assessment of the decoupling argument is needed, as it will be relevant in assessing long-term trends beyond the current crisis.

- The plunge into the abyss will only be temporary – economies will recover and the emerging-market economies will once more streak ahead of the mature OECD bloc.

- On the other hand, more of the high-income, high-growth newcomers could be incorporated into the OECD over time, perhaps stabilizing the OECD's share of global GDP, compared with the sharp decline seen in recent years.

- The leading emergers need to be recognized as key players in the global economy and in the policy-making arena.

Introduction

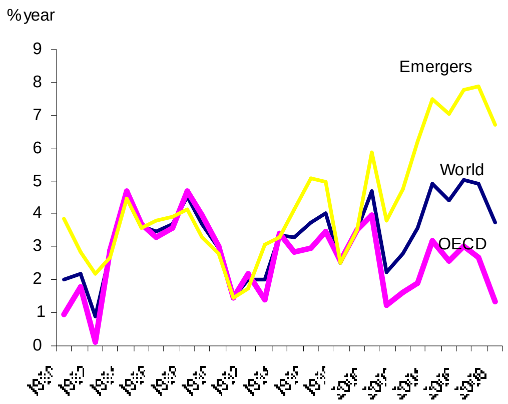
Since the onset of the US slowdown in late 2005, debates have continued over the potential for 'decoupling'[1] to sustain global growth versus the risk of 'recoupling' provoking a sharper economic crash. This was, in part, because these concepts meant somewhat different things to different people,[2] even when the focus was clearly on correlations in GDP growth rates and the potential desynchronization of the global economic cycle – i.e. a weak OECD coexisting alongside a buoyant emerging-market bloc.

1 We note that decoupling is used as a scientific term, generally implying a disconnection or break in a previous relationship. In economics it is used to refer to breaks in trends such as stock-market correlations and the energy/GDP ratio and not just to changes in global growth correlations, although this is the usage that has most often appeared in the news headlines over the last couple of years. In this briefing, we focus only on the question of GDP correlations across countries and regions.

2 This issue has also been illustrated in presentations and reports by M. Ayhan Kose, IMF; see, for example, Kose (2008).

The ambiguity was also fostered by the development during 2007 and early 2008 of an unusual variance in views over economic prospects for 2008–09. Might continued robust growth in emerging-market economies (‘decoupling’) help foster a US recovery by 2009? Or would the global economy ‘recouple’ in a synchronized downturn, with the OECD heading into recession and the non-OECD world also suffering a significant slowdown? This divergence in views about the direction of the world economy persisted until September 2008, when the explosion in financial markets rocked the global system so severely that the debate practically disappeared. In the midst of such turbulence, it seems impossible that any country will be able to avoid suffering at least some ill-effects from the turmoil, whether through trade, the property boom-bust, financial markets or the banking sector.

Figure 1: GDP growth for the emergers drops but still riding high in 2008



Source: IMF.

Many will see a synchronized global downturn as proof that decoupling cannot work – yet this may not be the right message. It is essential to take more care over the description and analysis of decoupling not because of the predictions for the current downturn but because of the importance for the recovery and long-run trends.

So what do we mean by ‘decoupling’ and how best can we understand the process by which emerging-market economies undeniably kept up high rates of growth during 2005-2008 despite weaker US demand? Indeed growth rates for the non-OECD world not only diverged from those of the OECD bloc, but the growth ‘gap’ continued to rise, reaching 4–5 percentage points by 2007–

08. Those[3] who argued vehemently from the onset of the US slowdown in late 2005 that this weakening would deliver a rapid blow to Asian trade prospects and world growth were clearly wrong, in large part due to their poor assessments of global linkages and the impact of strong demand growth within the emerging markets themselves. US import growth has plummeted but world GDP[4] continued to expand at close to peak rates up to mid-2008, in the 3.5–4% range (see Figure 1), in spite of an established slowdown in the US, the first phases of the banking crisis, tumbling stock markets, commodity price spikes and, in the second quarter of 2008, a decline in Eurozone GDP. The developing world has enjoyed over five years of buoyant growth and even saw growth *quicken* slightly, to over 7% in 2006–07, although the rate has edged down in 2008, to around 6.5% by mid-year.

Was this divergence in growth rates evidence of decoupling or not? What if divergence persists but the growth 'gap' declines slightly – is this 'recoupling' or not? These are not such simple questions as they may seem and, for a variety of reasons, decoupling remains a relatively contentious issue. Even the technical definition of 'decoupling' is open to interpretation. For example, can decoupling refer to a temporary phenomenon or does it have to be permanent? Does it refer to less correlated *cycles* or divergent *trends* in GDP growth?

Arguably, one reason for decoupling being contentious is that it presents a potential challenge to the US's economic hegemony: not everyone is prepared for or willing to accept the possibility of a new global leader although, given the rise of China, such a change in leadership must become inevitable. Another reason may be resistance to the concept by commentators who based their forecasts on continued US dominance of the global cycle; indeed, it may be a convenient forecasting assumption that the rest of the world simply follows the US cycle. In addition, the policy implications of episodes of successful decoupling may not appeal to some governments – this could lead to calls to manipulate economic policies in order to target desynchronization in the future, all too reminiscent of debates over alternative 'locomotives' for growth that went on between the US and EU in the 1980s. And there are more subtle critiques: if indirect linkages to the US (e.g. via interest rates or, in the longer run, new technological developments) can help explain the emergers' GDP performance, does this

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3 Such as Roubini (reported in various newspaper articles in 2005–06).

4 Real GDP growth measured at market exchange rates (MER), IMF and World Bank estimates.

mean that many economies are still *fundamentally* ‘coupled’ to that of the US even if their GDP growth rates show divergence from it? Some analysts have used the ‘recoupling’ (in this case simultaneous weakness) in financial markets in 2008 to argue that this will lead to recoupling in economic growth. However, it is also possible that the drop in the Federal Reserve’s official interest rates from the onset of the banking crisis in August 2007 delivered a stimulus to many emerging-market economies, where interest rates tend to be coupled with those in the US. Not all the changes seen in the US economy in 2007–08 have been negative for the rest of the world.

This paper will address the issue of defining ‘decoupling’ as well as the evidence for it, along with drawing out the arguments in favour of a return to relatively high emerging- market and global growth rates over the longer run.

What is decoupling?

In general, economic decoupling can be defined as growth in one area of the world economy becoming less dependent on (less coupled with) growth in another area – thus GDP growth rates might tend to appear less correlated than they previously were (although we note the critique mentioned above about indirect linkages to the US and the problems in defining decoupling on the basis of GDP correlations alone). More specifically, the term is used to refer to the possibility that, in contrast to a marked weakening in US (and thus OECD) demand, emerging-market economies (especially China) may continue to enjoy high growth rates and sustain robust global growth. If decoupling is defined in this way, there clearly has already been at least a temporary experience of decoupling over 2006–08.[5] This outcome contradicts the naïve concept of an automatic and immediate synchronization of the global growth cycle with that of the US (and OECD), which would have predicted a fall in global growth, probably to well below 3%, in 2006–07 as US growth slowed down to rates much lower than long-run potential (generally assessed to be in the 3–3.5% range).

Nevertheless, although the emergers’ growth rates are much higher than the OECD average rate, and this gap has widened, the *cyclical pattern for most years is very similar* (2007 was an exception) – in other words, excluding the trend and looking only at the cycles around the trend, OECD and developing world growth rates continue to be highly correlated, not ‘decoupled’.

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5 This claim has also been made in various articles published in the Economist (including 6 March 2008) and by Robert Prior-Wandesforde (The Times, 12 February 2008).

Regarding the statistical evidence for a change in correlations, in principle the data can be tested to assess the possibility that there has been a shift in relationships over the last few years – and to examine whether this shift has been in trends or in cyclical patterns. In practice, there are insufficient data to draw any firm conclusions over such changes – especially in view of the difficulties in comparing US and OECD growth patterns with those in the emerging markets on a quarterly basis (this would be foolish). Using annual data, there are only a few years' worth of evidence – not enough to satisfy the critics. A tentative conclusion, using data from 1994 and comparing this with 1980–93, is that the correlation between OECD and emerging markets' growth trends appears to have weakened along with the correlation between OECD and world growth trends. But these statistics only confirm the visual evidence (Figure 1) of a relatively strong uptrend in emerging-market growth and its impact on the global average since the early 1990s.

Certainly it is the case that synchronization may only have been temporarily suspended and the cycle could shortly 'recouple'. Those who believe that the emerging-market world has currently decoupled from the US and is pulling the world economy along with it will tend to expect the US (and the OECD) to reap benefits from this strength, encouraging a new upturn in 'old world' growth – effectively recoupling global growth through pulling up the weaker OECD. In contrast, the pessimists expect growth in the developing world to fail as the emergers will be unable to sustain momentum alone, and they expect this to result in a synchronized downturn. In fact, short bursts of mild desynchronization in cycles have been seen before, but they have never lasted long.

If statistical evidence cannot distinguish whether the recent divergence in growth trends is anything more than a temporary aberration or not, the case for decoupling has to depend on other economic arguments. It may be a mistake to be too dismissive of the decoupling concept given the circumstances in which recent changes in growth patterns have emerged, namely in conjunction with the rise of China and other large emerging- market economies. In past episodes of desynchronization, this was not the case – the emergers may have grown rapidly before but they were still 'too small' to drive the global economy on their own. Now there is evidence that this is feasible, at least for a few years at a time, and, more importantly, this potential to act as the driver will grow.

Nevertheless, whatever case can be made in favour of decoupling, and even if statistical tests were to show strong evidence of a change in GDP correlations, this would still not convince those analysts who see decoupling as a deeper issue, with the US still effectively the key driver of global trends, whether directly or indirectly through its wider impact on variables such as monetary policy, technological leadership and commitment to activist pro-growth policies. For these arguments to be refuted, the emergers would have to provide evidence of decoupling over a very long time-frame of twenty years or more.

Divergence and diversification

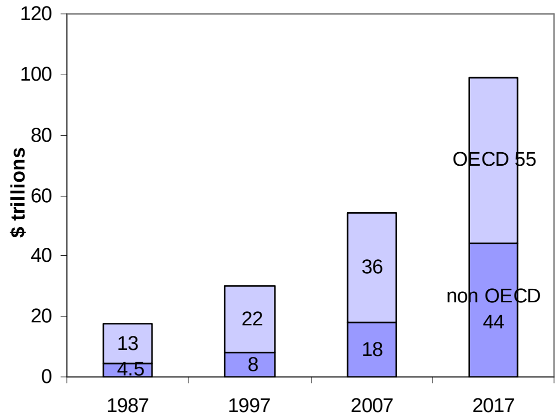
If it is virtually impossible to nail down the decoupling argument, which seems to confuse trends with cycles, the short term with the long run and the philosophical with the pragmatic, perhaps it is best avoided altogether. Indeed, some analysts have preferred to side-step the issue, focusing instead on the evidence for less emotive and clear-cut concepts of 'divergence' and 'diversification' in growth (although the argument over lack of statistical evidence for a change in long-run trends would still apply to these phenomena – we cannot yet be sure if they are permanent or transitory changes).

Divergence and the impact of a shrinking OECD share in global GDP

A strong divergence in global growth trends first became visible in the early 1990s before collapsing at the time of the Asia crisis. After a pause, the gap started to reappear around the time of the last serious slowdown in the world economy in 2001–02, and it has grown even larger over the last five years, as described above. The average growth rate for the major developed countries is clearly showing a much weaker performance than the global average, in contrast to the close correlation seen in previous decades.

The background to this is also clear: the OECD's share of world GDP is shrinking, as the weighty mega-emergers are booming, led by China but including other populous developing countries such as India and the Latin American economies.

Figure 2: The developing world's contribution to global GDP, 1987–2017



Sources: World Bank and own estimates.

Developing countries' GDP has quadrupled in the last 20 years, from just $4.5 trillion in 1987 to $8 trillion in 1997, and as much as $18 trillion by 2007 (see Figure 2). It accounted for about $10 trillion (40%) of the rise of almost $25 trillion in global GDP over the past decade, with $9 trillion of this coming in the past five years alone (the previous five years were affected by the sequence of Asian, Russian and Latin American crises).

Although the share varies according to the measure used, the emerging markets now represent almost one-third of global GDP in current price terms and at market exchange rates (up from around 26% in 1987–97), a little more than the slower-growing US economy. At 2000 constant prices, the share is somewhat lower. The increase in the share shows a similar uptrend for all measures, with a marked acceleration visible from around 2000.

About half of the increase in the emergers' share is due to China, where GDP growth, supported by rapid investment and productivity gains, has averaged almost 10% per annum in the past decade and over 11% in 2006–07. From 2003, India has seen growth shoot up from its typical 4–6% range to a more China-like pace of 8–10% while the energy economies (including Russia and the Gulf states) have also enjoyed higher average growth rates, above 6%. This contrasts sharply with previous years of low growth (often below 3%) and even recessionary conditions.

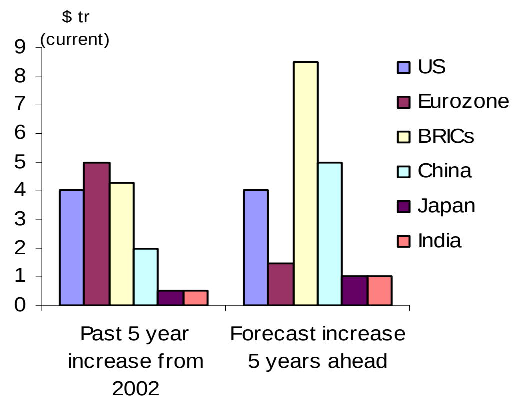
In terms of contributions to world GDP growth, China alone is overtaking the US, while India is neck and neck with Japan. The EU only temporarily boosted its recent standing (in current dollar terms) owing to the impact of the surge in the euro from 2006 to early 2008. In terms of their collective contribution to growth, the emergers are now poised to exceed the OECD.[6] Even allowing for a further (moderate) slowdown in the developing world and a likely recovery in the US and EU by 2010, the emerging-market bloc will now remain the dominant contributor to the expansion of world GDP (see Figure 3).

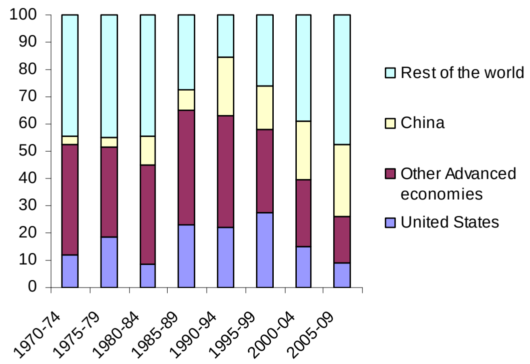
Further fast growth in the emerging markets means that their share of global GDP (at MER) will probably reach 50% by about 2020 and continue to rise. Of course, in PPP[7] terms, more appropriate for comparing living standards, the emergers' share is already around 50%, similar to their share in world energy and commodities consumption. Indeed, it is estimated that the developing world has recently accounted for as much as 60–70% of global GDP growth in PPP terms (although the exact scale of this depends on assumptions adopted concerning appropriate PPP weightings).

6 Using GDP at MER, in PPP terms, the contribution of the emergers to GDP growth is much higher, close to 70% according to IMF statistics (see Kose, 2008, for example).

7 Purchasing power parity (PPP) measures of GDP are based on adjustments that aim to reflect estimated discrepancies between actual living standards in a country and its GDP measured at market prices and exchange rates (MER), which tend to underestimate the living standard of people in poorer countries. As a comparable measurement of economic performance across countries, many see the PPP-adjusted GDP figure as more appropriate. This adjusted measurement affects the ranking of GDP for China in relation to the US, with China appearing much closer in size to the US using PPP. With high-growth China having a larger GDP in PPP terms, the PPP measurement of global GDP growth is also higher than the MER measurement. For example, for 2007 these measurements of global growth were estimated at about 3.7% and 4.8% respectively. PPP-based data are supplied by the World Bank (but we note that its figures were revised heavily in late 2007, indicating uncertainty about PPP assessments).

Figure 3: Leading emerging markets' contribution to GDP growth





Sources: Own assessments and IMF estimates.

The rising share of the developing world in global GDP raises its weight in global growth estimates, so an ever greater emphasis is placed on the fastest growing parts of the world economy. This has gradually pushed up the 'trend' for global GDP growth from the typical OECD rate of around 3% seen 10–20 years ago to recent rates of 3.5–4% per annum. While many have hailed the recent period of high GDP growth as the best performance in thirty years, this comparison should take into account that the rising weight of large, fast-growing emergers is actually pushing up the 'normal' rate of world growth. As the large developing countries still have many years of high growth rates ahead, this global trend will continue.

It is also clear that if world growth were to be calculated using the same weighting as 1985, then most of the recent divergence in the OECD and global growth rates would disappear, in spite of the high growth in emerging markets. Peak growth would have remained about 3% based on 1985 weights – not the 3.5–4% rates actually observed using 2000 weights. Looking ahead, if we re-estimate 2005 growth based on the likely weights in 2025, the figure could be close to 5%.

This analytical argument for divergence, based on the estimated impact of weightier emergers on average global growth rates, does not rely on statistical tests of correlations. It both explains the current situation and predicts the further continuation of divergent trends for many years to come, at least until the mega-emergers begin to converge on OECD productivity levels (when growth will naturally slow). This does not contradict the concept of globalization, nor does it deny the possibility that progress may begin to be tougher and slower the further developing countries (even China) rise up the productivity ladder.

In addition, this analysis does not preclude temporary interruptions should there be a sharp downswing in the business cycle within the developing world itself, such as that seen in 1998 when the already rising divergence in old and new world growth rates was temporarily brought to a halt. In fact, it is quite probable that the *pattern* of growth in the emerging markets will continue to reflect cycles in the OECD world. It is also plausible to argue that, over time, it is the OECD that will start to reflect the cycle in the emergers (based on current membership, which, of course, could change over time, for instance if China were to join the OECD). Either way, cycles could remain synchronized. As Figure 1 indicates, the year-to-year swings in growth rates are mostly synchronized – it is the trend that has strongly diverged. So the future looks set to be a still bumpy ride but on a higher-trend growth path for the emergers and for world GDP.

Diversification in trade and drivers of growth

Sustained high growth in the emerging-market economies has been supported by the successful diversification seen in the engines of growth, with stronger dynamics in domestic consumption in the emergers (notably in China and also the energy producers) offsetting slower growth of exports to the weak OECD. In addition, exports are becoming more diversified in terms of destination, and thus less reliant on US demand. The share of emergers' exports to the US has dropped below 15% of the total from a peak of about 25% a decade ago[8] and consequently these countries have avoided the slowdown in trade that many analysts expected as US import growth fell.

The US itself has seen strong export growth offset weakening domestic demand. US import growth has dropped sharply (Figure 4) – the global pessimists were right about this but not about its implications. These trends

8 Estimates quoted by Kose (2008) and also by Oxford Economics.

have helped rebalance US growth from the internal to the external sector and reduce the US trade deficit. In this sense, there has been a convergence towards more favourable, balanced trends in the world economy.

Figure 4: US imports & real GDP in emerging Asia[9]

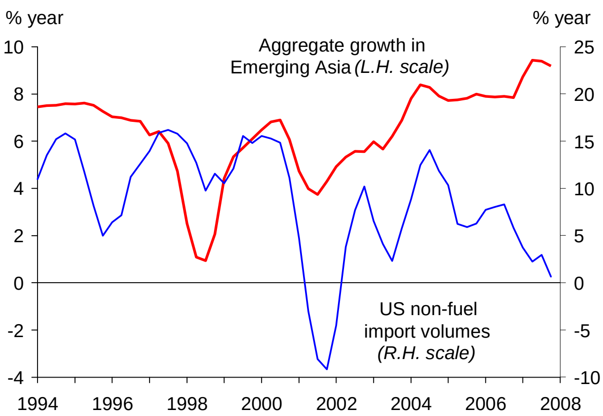
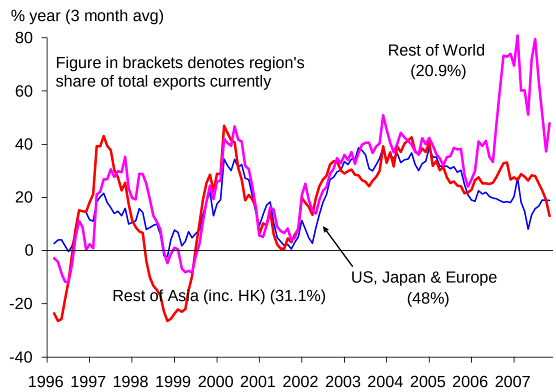


Figure 5: China: exports destination of exports[10]



Looking at the example of China, its growth dynamic has shifted markedly in favour of domestic demand, generating more demand for imports, largely from Asia and the oil producers. A consumer boom has finally materialized after many years of the Chinese government trying to boost spending and curb excess savings (including policies such as taxing savings accounts and granting more public holidays). Retail sales in 2008 have grown by more than 20%, for example, while investment growth has remained high, probably around 25% in 2008. At the same time, soaring Chinese exports (Figure 5) to the rest of Asia and other high-growth regions, such as the Gulf states, have taken over from sales to the US as the main drivers of export growth. This means that total export growth remains high, although it is about half the remarkably high rates seen during the peak of the post WTO entry boom. While export growth was predicted to cool off[11] as China settled into its new position in the world order trade, the opportunity to sell into new growth markets (in terms of goods as well as geography) has cushioned this decline. However, it is still true that Chinese export growth will not be able to keep on

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9 Charts reproduced from 'Global financial markets: how emerging-market economies are enlarging the playing field' by Vanessa Rossi in *The Gulf Region: A New Hub of Global Financial Power*, edited by John Nugée and Paola Subacchi, Chatham House, forthcoming November 2008, with thanks to Oxford Economics.

10 As above.

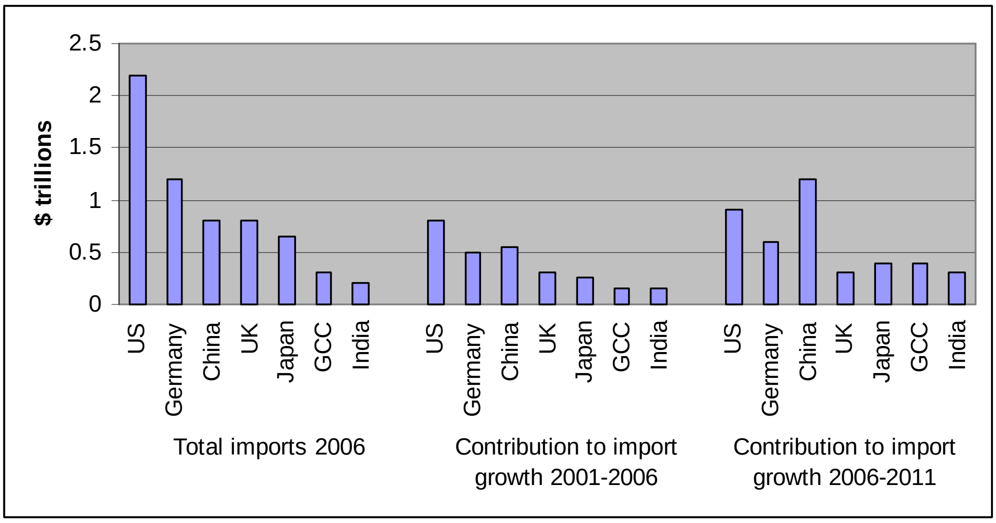
11 See Rossi (2005).

growing faster than the average for world trade in long run: market shares will eventually stabilize in all the key traded-goods sectors.

These Chinese trends have been replicated more or less across all of Asia – exporters have been successful in maintaining growth by diversifying sales, including an even greater share of exports going to China. For example, China is now the largest market for exporters in Japan, South Korea and Thailand and there have been increasing sales to the Middle East as well.

Given the substantial changes seen in both Asian trade and energy demand and prices, it is not surprising that trade patterns are now significantly different to those of a decade – or even five years – ago. The energy producers have risen sharply up the trade rankings and so has Asia. Figure 6 illustrates this changing pattern of trade.

Figure 6: Leading emerging markets' contribution to the growth of imports, 2001–2011



Sources: WTO, National Accounts data and own estimates.

The data illustrate three key points: the significance of intra as well as inter-regional exchanges in trade, the impact of energy prices and the substantial exchanges now taking places between Asia and the Middle East oil producers.

This diversification and its implications (for decoupling) do not conflict with the concept of globalization – the two are compatible. Indeed, the success of growing cross-emerger trade and diversification in the drivers of growth should be seen as confirming the benefits of globalization. These benefits become more apparent as the emergers get to stand on their own, collective, feet and even help sustain US growth by boosting world trade. Globalization need not mean that global growth depends on the US consumer.

Conclusions

However it is described, as decoupling, divergence or diversification, and whether it will be sustained or not in the difficult year ahead, there can be little doubt that there has been an important shift in global economic leadership and trading patterns during the last few years.

The emerging-market economies have moved into the driving seat: they are now big enough, sufficiently interlinked and successful in promoting pro-growth policies to sustain their own growth in trade and GDP against a background of low growth in the US and other major OECD economies.

Whatever the outcome for 2009 turns out to be – most likely a global downturn – long-term trends will reveal a continuation of the recent pattern of growth, with the emerging markets racing ahead once more as they succeeded in doing following the crises of the late 1990s. They may even come to dominate the global business cycle. The decoupling debate will return.

However, the prospects for decoupling of the OECD and non-OECD blocs could be radically changed if more of the leading emergers join the OECD – and similar 'top table' organizations – in coming years. This would integrate the impact of the larger and faster growing emerging-market economies within the OECD bloc, reversing the recent decline in the OECD share of global GDP. This is not only a question of economic growth, of course. Membership represents both recognition and responsibility in global economic affairs. Some countries should be ready to take this step before long.

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World Bank GDP Data

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