Decoupling: The Myth and The Mystery

In emerging markets, something bad happens every 3 to 4 years, and something very bad happens every 7 to 8 years. Bad things tend to happen when periods of high growth store up imbalances which accumulate till breaking point or hide fundamental structural flaws. More often than not, they are borne from lack of diversification or hedging of risk; or the distortion of the price mechanism and deviations from free markets. Accumulating large foreign reserves, accumulating large trade, current account or budget deficits or surpluses, asset liability mismatches either by currency, duration, credit risk or sector concentration in the financial system or the private sector in general, have been sources of instability. When bad things have happened, emerging markets have largely been left to their own previously often constrained and meagre resources. When aid had been sought from international agencies like the World Bank or the IMF, emerging market economies were largely lectured to about their free market deviating tendencies, their predisposition to running large imbalances and been prescribed bitter medicine as solutions to their problems.

In developed markets cycles are also common, but for the last 30 years they have been muted and policy responses has been swift and effective. For years, Greenspan’s Fed policy of allowing asset bubbles to inflate and then picking up the pieces after the bust, clearly contradictory to the Fed’s non-interference in asset markets, has created an asymmetry of risk and reward for the investor. Everything the Fed does is interference; it is unavoidable for an institution of such power, both real and perceived that its signalling power should overreach its own objectives at non-interference.

Now, incredibly bad things have happened. They began in the US, in a grossly inflated housing market, supported by sub-prime lending, which has now collapsed with it, then spread like a genetically enhanced strain of the flu to infect everyone from Europe to Asia, from Iceland to Australia.

The reaction in developed markets has been remarkable, in particular for the speed with which they have been happy to suspend free market principles in an emergency attempt to ‘keep the patient alive.’ There is some good justification for this course of action.

The reaction in emerging markets has been equally remarkable, in particular for their faith in free markets as the most efficient regime to face the crisis.

When we sat in the eye of the storm September / October 2008, it was consensus that the right thing to do was to temporarily suspend free markets and for governments to intervene in the markets. Had Lehman not failed, had AIG not failed, where might we be? Perhaps they might have failed in 2Q 2009 in any case. We saved the patient, but the patient remains on life support.

The one thing we know about the human species is that it will evolve and adapt. We know that it will emerge from the economic crisis stronger, but we don’t know how and we don’t know how long it will take.

Do we abandon a system which has strong theoretical underpinnings, has actual historical and empirical track record and has served us for so long so well, but which in the short term may have acutely uncomfortable consequences? Or do we stick by it, tough it out and let the lame ducks die? These are not easy choices.

The developed world has chosen a middle ground, choosing to temporarily suspend free market principles, bend Chapter 11, increasingly embrace quantitative easing, further emergency interest rate policy, flirting with protectionism, interfering with the banking system.

Emerging markets don’t appear to have taken the same measures. Their problems are a bit different.

When the world thought about decoupling between emerging and developed markets they mostly thought in terms of the relatively actual and potential growth rates between the two classes, not the phase or the nature of that economic growth and development.

When asset markets in emerging markets fell even harder than those of developed markets, the decoupling theme was quickly shelved. This is a mistake. But so too is looking to BRICs as a panacea and as a saviour of global economic growth. So intertwined has the global economy become that decoupling is not a simple separation of the cycles between emerging and developed markets. It is rather an evolution where the make up of each economy evolves around the make up of the other economies. No longer is it when the US sneezes, the whole

world catches a cold. Today, it is that when the US sprains an ankle, the BRICs strengthen their arms.

- Emerging markets are highly export dependent. This is true but to a lesser extent in the BRICs which are large enough to have sufficient diversity and a growing middle class generating domestic demand. Smaller emerging economies do indeed suffer from an over-reliance on exports.

- Emerging market financial systems were not over levered into real estate lending. Again this is more so for the BRIC where scale has brought diversification both in the economy and in loan books. In comparison with US and European banks, this is certainly largely true. Yet again, this may not be true for smaller emerging economies where financial systems tend to be concentrated into one or two industries and in real estate.

- Emerging market households have substantial savings. This is true but developed market savers with a smaller savings ratio might result in more absolute dollars saved. In any case BRICs banking systems have strong and sizeable retail deposit bases from which to lend. An example of this is India, where despite a weaker sovereign balance sheet, private sector lending has held up, precisely for the level of private savings.

- Many emerging markets appear to be maintaining their

support of free market practices when in fact they simply began with a less free system. China's state owned enterprises are still formidable, particularly the banks, which are now being mobilized to increase the supply of credit, not by market opportunity but by degree of the Peoples Bank of China. India's banks are similarly well supported by a large deposit base and are therefore in a position to extend credit.

- Emerging markets are part of the commodity market theme. Demand for commodities originates in China and India, supply in Brazil and Russia, for example. This is likely to make commodities less sensitive to economic growth in developed countries.

Decoupling hasn't been so much a myth as an overgeneralization. As long as communications remain open, trade remains robust, labour and capital mobile, the world will continue to be an immensely connected place and everyone will depend on everyone else. A sharp contraction in world trade can disrupt the connections giving the illusion of decoupling. With the credit triggered financial crisis, trade finance volumes have fallen precipitously with a concomitant impact on trade volumes (by a third in the 4Q of 2008). (The causality is questionable in other crises but the scale of the 2008 crisis leaves little doubt as to causality.) Once the situation normalizes, one would expect that economies interrelatedness will reassert itself. This doesn't mean that decoupling isn't happening, it means a resumption of an evolution already well underway before 2008.