Bank Financial Group

TD Economics

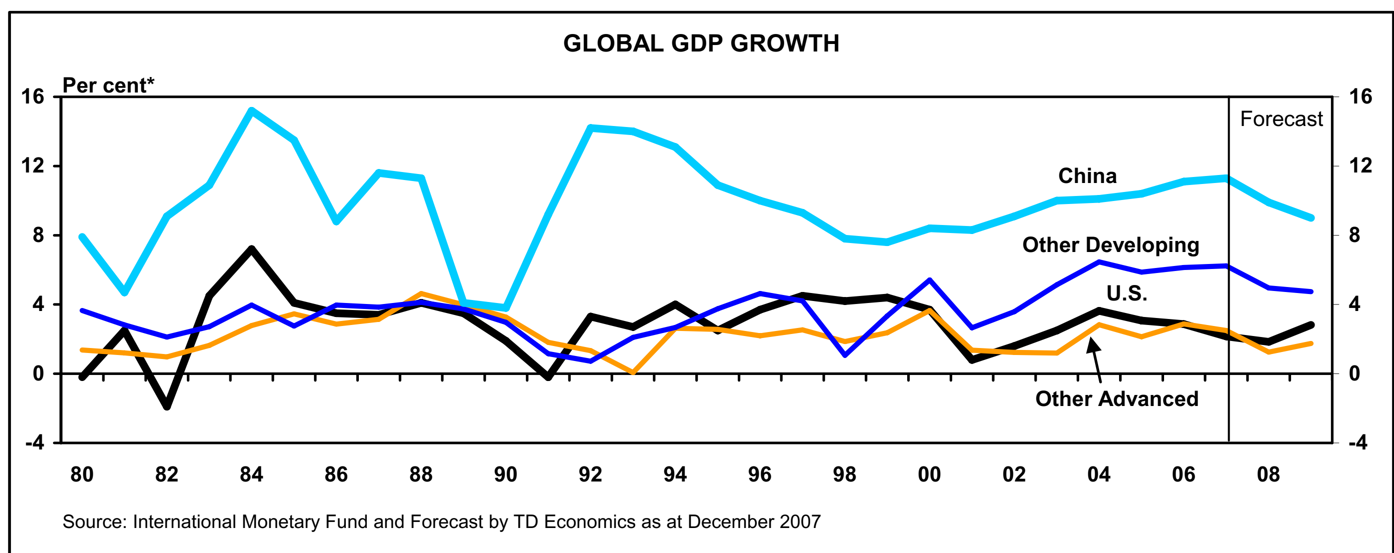
Special Report

January 24, 2008

GLOBAL ECONOMIC DECOUPLING: IS THE COOKIE JAR STILL OUT OF REACH?

HIGHLIGHTS

- **The idea that the world can decouple from a broad-based U.S. economic slowdown and show little to no ill effects is pure fantasy.**
- **Nearly 90 per cent of demand emanating from advanced industrialized economies will see softer growth in 2008.**
- **Global manufacturing chains mean emerging markets are keyed into global manufacturing cycles and the whims of those that demand their final products – consumers in advanced nations.**
- **While emerging markets have matured, flat to negative changes in commodity prices will remove some stimulus and their own domestic demand is as yet insufficient to ride to the rescue.**
- **Arguments based on exceptionalism should put everyone ill at ease. Fortunately, the wellbeing of the global economy does not require that emerging markets are exceptional, just healthy.**
- **Emerging markets have been burned not once or twice, but a collective hundreds of times due to their historical inability to withstand shocks.**
- **The financial vulnerabilities which dogged emerging markets in the nineties have been shored up. But while the risk of a crisis is minimal, the likelihood of a slowdown is clear.**
- **Emerging markets' past underperformance relative to advanced nations was due to a propensity for crises. Conversely, the likelihood for their future success will be because of a limited risk for new emerging market crises in the present.**



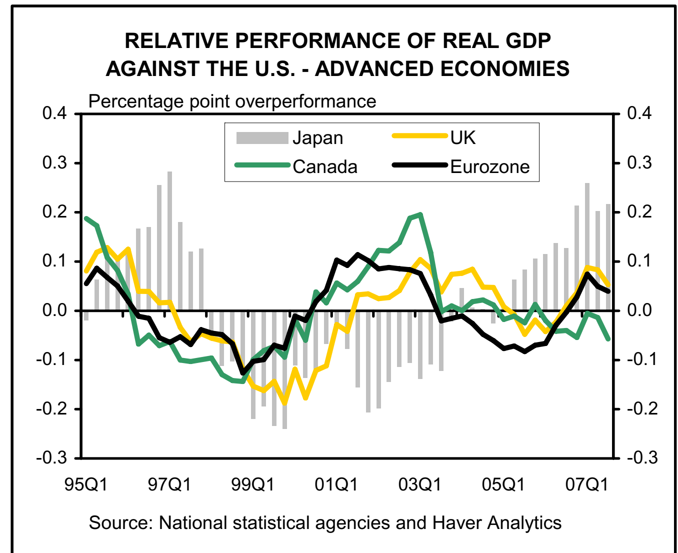
Source: International Monetary Fund and Forecast by TD Economics as at December 2007

One important benchmark of childhood development is being able to reach on top of the counter and steal a cookie from the cookie jar while the parents are away. The question of a similar feat of distinction continues to face the world economy. Can the global economy continue to get by with only limited input from the U.S.? Our last quarterly economic forecast, released in December 2007, warned of further risks for a greater-than-expected economic slowing around the world. Even though emerging markets (EMs) and the developing world now account for half of the global economy, the U.S. economy still matters. However, the vulnerabilities which plagued EMs in the 1980s and 1990s are virtually nonexistent now. This does not mean they are fool proof, but there is a big difference between an economic crisis and an economic slowdown. And it is still the latter that we are likely to see.

What a cute couple

Before addressing whether or not the global economy can or will decouple from the American engine, it is useful to start by explicitly seeing what economic coupling looks like in the first place. The chart at the bottom of the first page breaks out annual GDP growth rates since 1980 for four areas: the U.S., other advanced economies, China, and other developing economies. While Chinese economic growth has historically had only a loose relationship with other global aggregates, the other three regions have remained closely intertwined. Both the rate of expansion and the overall direction of cycles was very similar. Since 2000, however, developing nations outside of China have been able to sustain growth rates an average of two to four percentage points higher than the pace of U.S. expansion, although up to this point, the path of EMs GDP growth remains similar to that in the U.S. economic expansion.

So, looking at growth rates alone, economic decoupling appears to have been a fact of life for EMs so far this decade. But, in reality, they should have grown faster than the U.S. on average for the last several decades. As an economy grows and matures, it's rate of economic growth naturally slows and becomes more stable as growth is driven less by rapid investment growth and more by consumer demand. The fact that EMs did not see more rapid expansions was the result of a series of interrelated economic shocks which began with the commodity boom and hyperinflation of the 1970s, the commodity bust and debt



crises of the 1980s, and ended with the currency and financial crises of the 1990s. These shocks combined with inflexible financial systems, less balanced economies, and economic mismanagement in the broad class of EMs fed this vicious cycle of prolonged underperformance. After being under the heel of the global economy for so long, emerging markets were due for a break.

But looked at from a different vantage point, it is not entirely clear how much of the recent performance is an unprecedented episode of economic decoupling, and how much is perhaps an example of catching up after such pronounced losses. Looking at the relative performance of the advanced economies against that of the U.S. in the chart on this page, it is possible to see that economic coupling among advanced nations has remained largely intact.[1] In fact, the Canadian and Eurozone economies have seen very similar cycles relative to the U.S. expansion over time (for more, see the box on the next page). Even with the Japanese economy, the magnitudes are similar though the Japanese economy was significantly underperforming the U.S. over the 2001-2003 period and has since reached a higher level of overperformance than other advanced economies. Overall, however, there is no "decoupling" from historical norms for advanced nations.

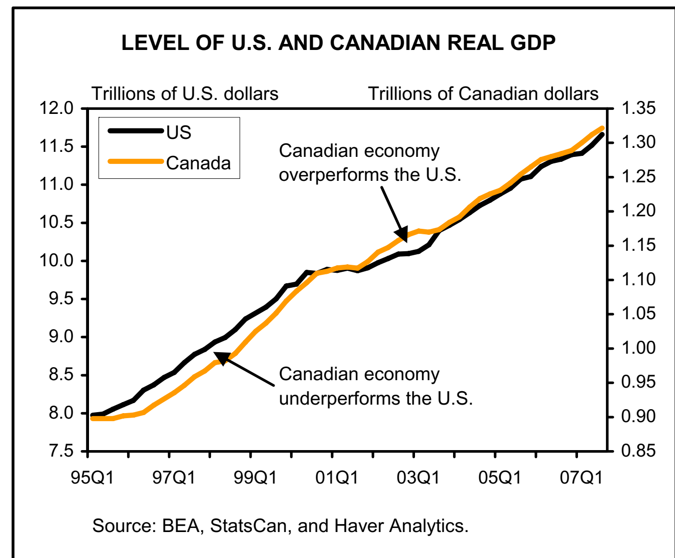
When looking at some large EMs, the current circumstances appear less exceptional, as well. While it is true these economies have had exceptionally high annual growth rates in this decade, this has simply brought the level of local GDP relative to the U.S. back to where it was in the mid-1990s. Moreover, it is interesting to note that this rela-

Box. It's All Relative

When comparing different economies, economists tend to discuss the rate of potential GDP – or the economic speed limit if you will. When an economy grows faster than this pace, inflation tends to rise as scarcity among available workers and other inputs causes wages and prices in the economy to rise more rapidly. Conversely, when an economy grows slower than its potential, the opposite is true and inflation tends to slow.

Central banks often tend to adjust interest rates and governments tend to adjust fiscal spending to bring the economy back to potential and avoid the drawbacks of either extreme. As changes are made in the structure of the economy such as a higher average level of education, more advanced financial institutions, a more effective tax system, or a clearer legal system, this potential rate may change, but this happens only very slowly. Moreover, with international linkages through trade and investment, economies tend to be tied in some regard to their economic partners, as well. As a result, while different economies often grow at different speeds, the relative differences between them tend to change much more slowly.

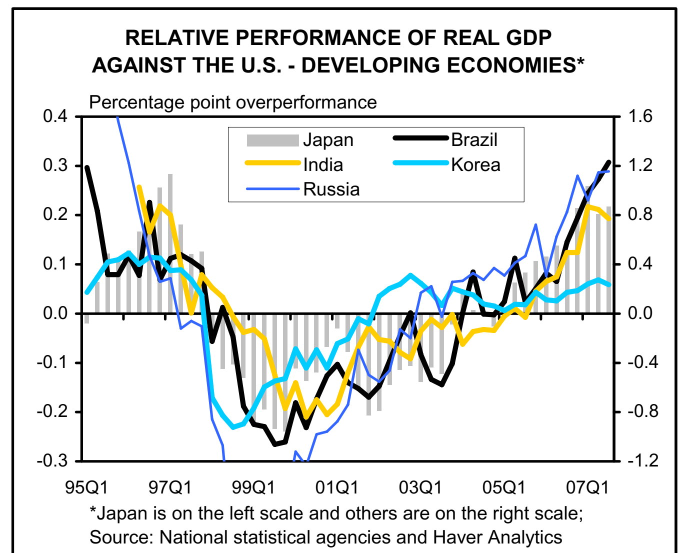
For example, in recent years, the potential pace of U.S. GDP growth has generally been estimated to be higher than that of Canada's. In spite of this, the chart above shows that over time, the level of GDP of the two economies does tend to have a rather stable relationship. One economy may outperform the other for a time, but eventually, there does appear to be some kind of "invisible hand" which tugs the two back together.[3]



Source: BEA, StatsCan, and Haver Analytics.

tive performance vis-à-vis the U.S. has actually tracked the path of Japan, the outlier among the advanced nations, while the absolute magnitudes are about four times those of Japan (as seen in the graph on the right). This would be in keeping with the historical tendency for EM performance to be more volatile than that of advanced nations.[2]

None of this takes away from the fact that EMs have learned from the past and made substantial improvements that make their domestic markets less vulnerable to contagion and overreacting to financial volatility imported from abroad. As the sentiment for the U.S. economy continues to deteriorate, the health of the global economy does not require that EMs are exceptional, just healthy. What follows is a look at four relationships which will be crucial. The first is the weaker prospect for growth among some advanced economies outside of America. While there have been ample signs of vigour in the global economy outside of the U.S. sub-prime mess, concerns in Europe and Japan suggest some regional growth engines may be in the shop for repair for at least part of 2008. Combined with the U.S., this means nearly 90 per cent of demand which emanates from advanced, industrialized economies will soften to one degree or another. But EMs account for around half of the global economy and have contributed even more to the annual increase in global output in recent years so the final three issues revolve explicitly around them. Can these economies escape the global manufac-



*Japan is on the left scale and others are on the right scale;
Source: National statistical agencies and Haver Analytics

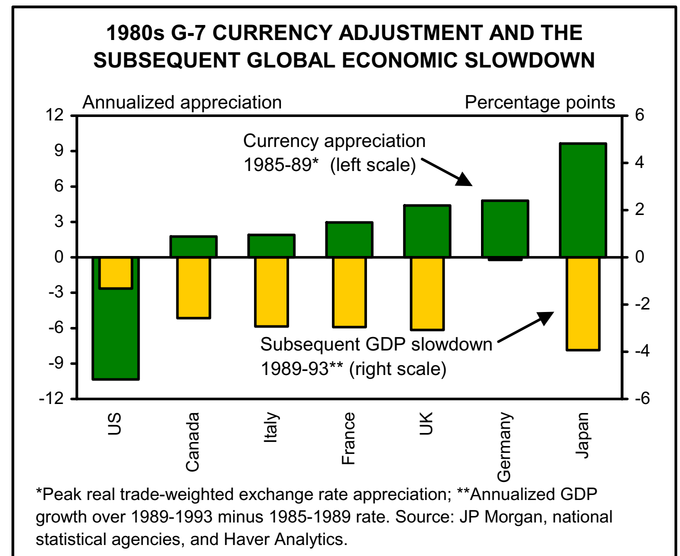
turing cycle? Can ongoing high commodity prices sustain these economies? And lastly, are there signs EM domestic demand is prepared to ride to the rescue?

Classic engines

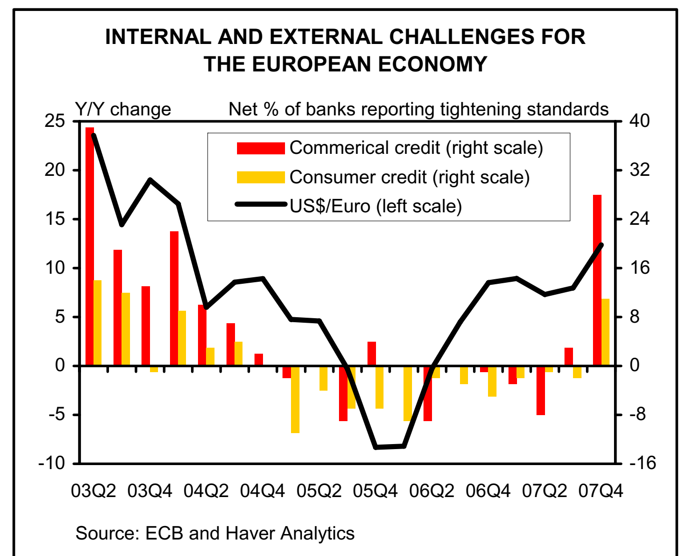
The global economy has a number of checks and balances which keep the various economies in line. In particular, exchange rates help to balance exports and imports over time. The U.S. current account deficit has necessitated a falling U.S. dollar in order to boost exports, reduce imports, and in so doing, bring some balance back to the U.S. trade position. But one man's imports are another man's exports, and a falling U.S. dollar necessitates other currencies are rising, at least vis-à-vis the U.S. dollar. Looking at the experience of the 1980s, the last time we saw a sustained depreciation of the U.S. dollar in tandem with a current account adjustment, this process was followed in short order with a general slowdown in GDP growth among major U.S. trading partners in a reasonable proportion to the extent of past currency moves (see top chart). There is nothing to say that a falling U.S. dollar must be followed by a slowing global economy. However, given a general rise in numerous economies' currencies against the dominant economic power, the subsequent diminished demand for their exports, as well as the pressures this puts on the domestic economy to retool and reorganize, a softer economic performance is not an unreasonable expectation.

Looking at the current experience of the Eurozone, in spite of a strong euro, GDP growth was expected to hold up in large part because the domestic economy was showing evolving strength. The credit crunch and sudden increase in the number of banks reporting a tightening of credit standards has now called that into question (see middle chart). So it may not be the direct impact of the slowing U.S. economy that will weigh on the continent, but indirectly, the U.S. slowdown is being exported in some measure. Also in some part a result of the global credit crunch, U.K. housing markets have quickly cooled. This has raised the risks for a significant consumer retrenchment and at least the possibility of a recession, though we expect the economy to avoid this fate while seeing GDP growth in 2008 at nearly half its 3.1% pace in 2007.

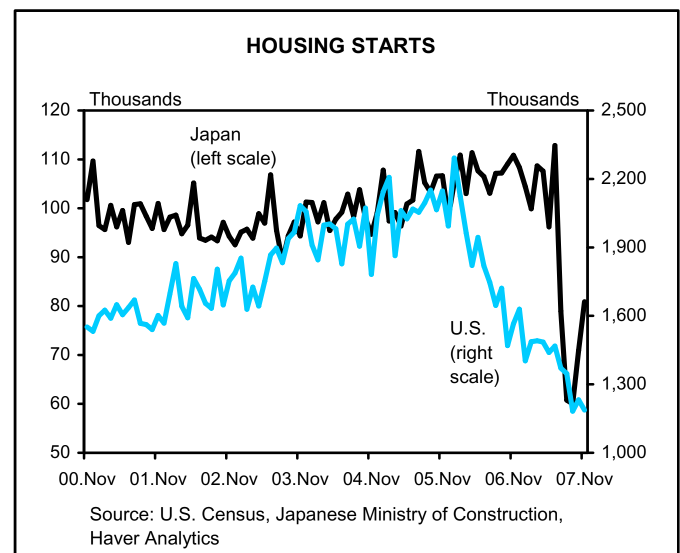
It's not always about direct or even indirect effects. In the case of Japan, it's partly a case of bad timing. Concerns over fraud in the housing permit approval process led the government to change the policies, and in the proc-



*Peak real trade-weighted exchange rate appreciation; **Annualized GDP growth over 1989-1993 minus 1985-1989 rate. Source: JP Morgan, national statistical agencies, and Haver Analytics.



Source: ECB and Haver Analytics



Source: U.S. Census, Japanese Ministry of Construction, Haver Analytics

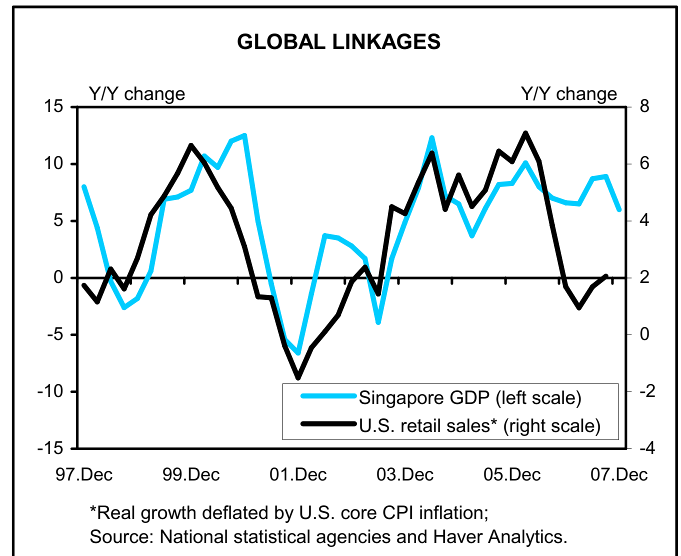
ess, create a substantial bottleneck in getting new construction approved. As a result, it took only three months for Japanese housing construction to collapse by nearly the same percentage point magnitude as it took the U.S. over a year and a half to reach. Needless to say, this has dramatically worsened the prospects for the Japanese economy likely through the first half of 2008 Fortunately, these sorts of declines are typically followed by strong rebounds after the fact but it certainly is not conducive to supporting global demand given the other problems already at hand.

All told, this points to weaker growth in advanced nations. Additionally, it raises the question to what extent the rest of the world can sustain its own momentum.

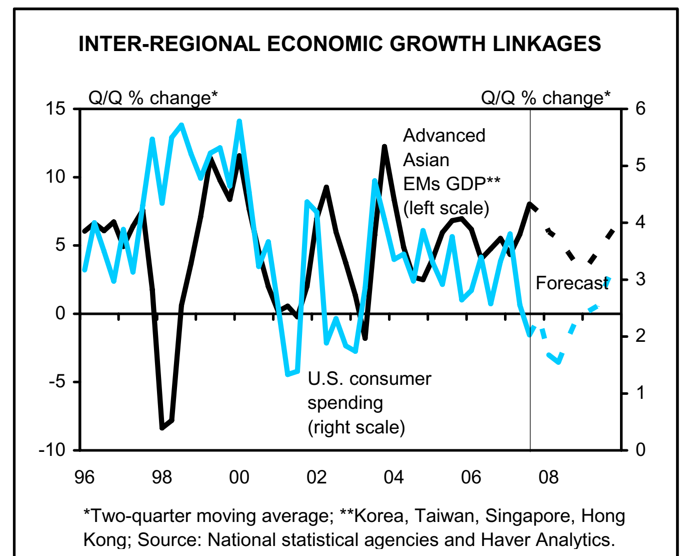
Widgets the World Over

Two hallmarks of this century have been globalization and the resilient U.S. consumer. And these are not unrelated phenomenon. Global manufacturing chains have allowed producers to reduce costs by matching the value-added of each stage of production with the most cost-effective source of labour for that leg of the process. By doing so, they have been able to keep costs low, and, in return, American consumers spending. Given that so much of this productive capacity now emanates from the developing world, it is reasonable to expect some global link between U.S. consumers, global manufacturing cycles, and the developing world.

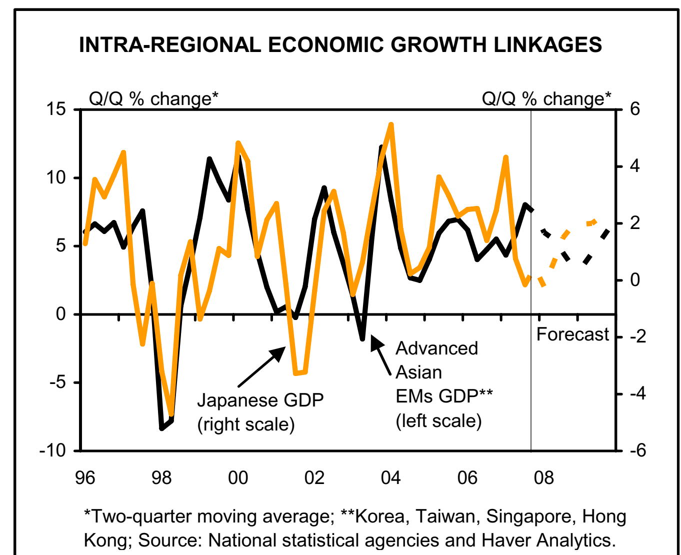
In fact, there is. The Asian region has always been highly leveraged to the U.S. consumer. This began with the Japanese auto and electronic industries and this national strength has turned into a regional focus. As such, the chart here shows that over the last decade, the GDP growth rates of four major advanced Asian economies (South Korea, Taiwan, Singapore, and Hong Kong) have closely mimicked the American consumer, with one exception. This was the regional Asian financial crises of the late 1990s which largely did not impact the American consumer. Our own forecasts for U.S. consumer spending and these Asian economies show that we expect a similar disconnect in performance over the coming year, but in reverse. The financial vulnerabilities which dogged these Asian economies in the nineties have been shored up. But while the risk of a crisis is minimal, the likelihood of an economic slowdown is clear. There is simply less demand emanating from U.S. consumers (as well as Asian



*Real growth deflated by U.S. core CPI inflation;
Source: National statistical agencies and Haver Analytics.



*Two-quarter moving average; **Korea, Taiwan, Singapore, Hong Kong; Source: National statistical agencies and Haver Analytics.



*Two-quarter moving average; **Korea, Taiwan, Singapore, Hong Kong; Source: National statistical agencies and Haver Analytics.

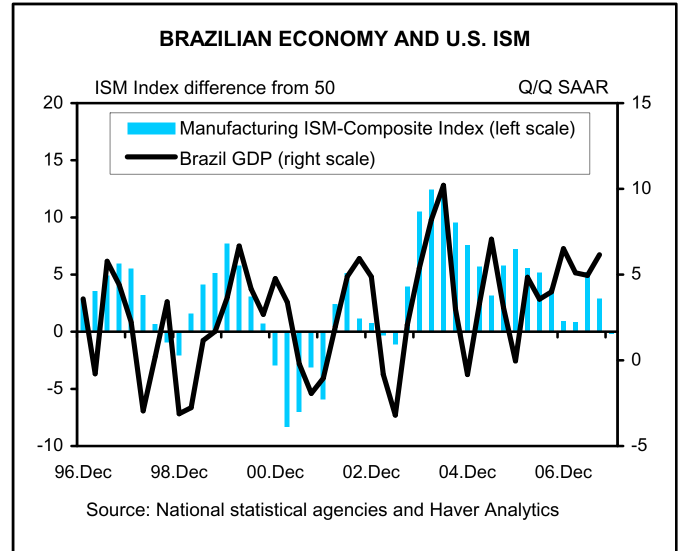
economies' Japanese trading partner). A similar issue is likely to weight marginally on the expansions of some Eastern European EMs, as slowing GDP growth in the more advanced European nations moderates external demand.

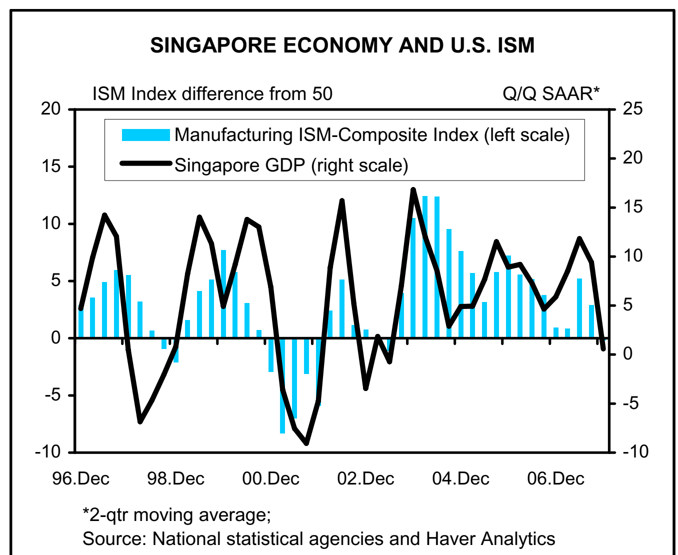
But this is not the only issue. Given the relative stability of service sector employment and output, the goods sector still exerts a disproportionate influence over economic swings. Moreover, manufacturing cycles remain rather global in nature. Looking at the similar moves between the U.S. Manufacturing ISM index and headline GDP growth in Singapore and Brazil reveals the broad influence manufacturing has over the global economy. Not only that, but the precipitous decline of the Manufacturing ISM's import index is an even more ominous sign of the sudden softening of U.S. demand in the fourth quarter of 2007. With substantial risks that U.S. demand will be well off recent levels, the question remains whether high commodity prices and domestic demand can fill this void.

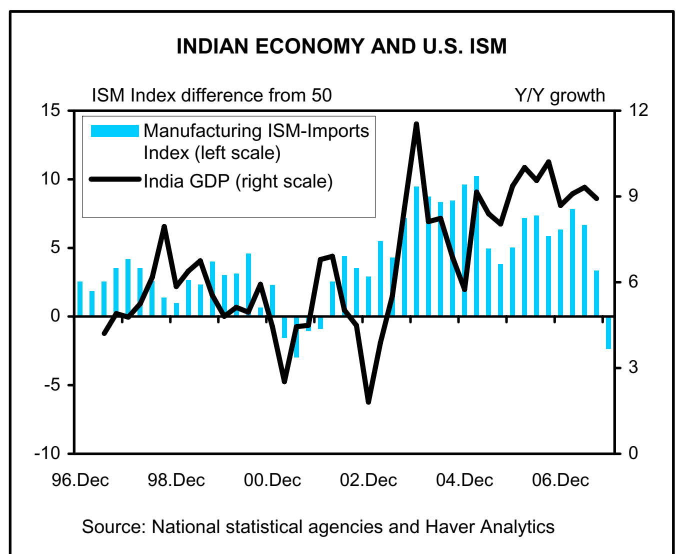
The Commodities Link

There is indeed a long-standing link between changes in commodity prices and changes in EM economic performance. The causality in the current environment is a bit circular. Nearly 65-80 per cent of annual production of most base metals lies outside of OECD economies. So, coupled with the economic maturation process taking hold in the broad class of emerging markets, a disproportionate share of the new demand for commodities emanates from developing countries, as well. For example, India and China alone account for around one-third of global consumption of most base metals, such as copper, zinc, lead, and tin. So, an increased demand for commodities tends to disproportionately benefit developing economies, as the chart on metal prices on the next page shows.

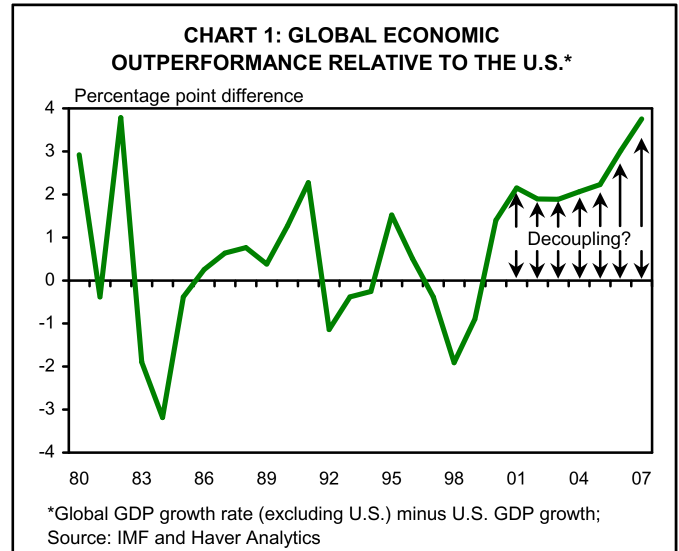
Even more, nearly 80 per cent of annual crude oil production emanates from outside advanced, industrialized economies. Therefore, there is a similar relationship as with metal prices between changes in oil prices (inflation-adjusted) and the rate of growth of EM economies. Chart 1 on the next page shows how unprecedented the division between U.S. economic growth and that of the rest of the world has been in recent years. The global economy excluding the U.S. has not only seen growth rates 2-4 percentage points higher than that of the U.S., but it has been able to maintain them for many years now. The evolution of crude oil prices over the last twenty years is then shown



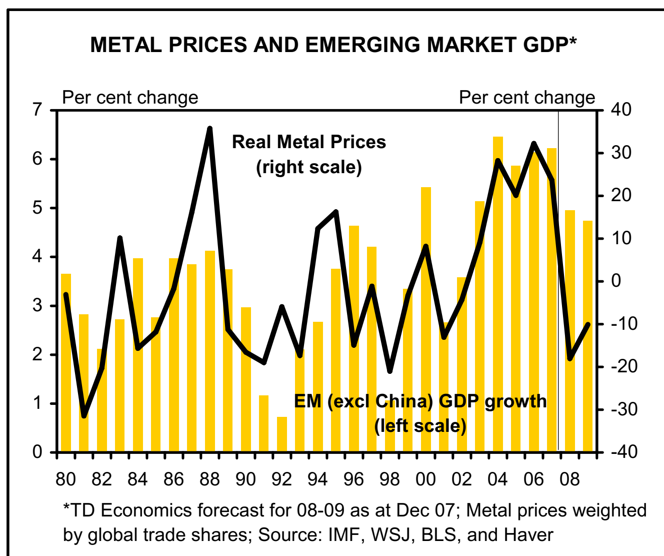




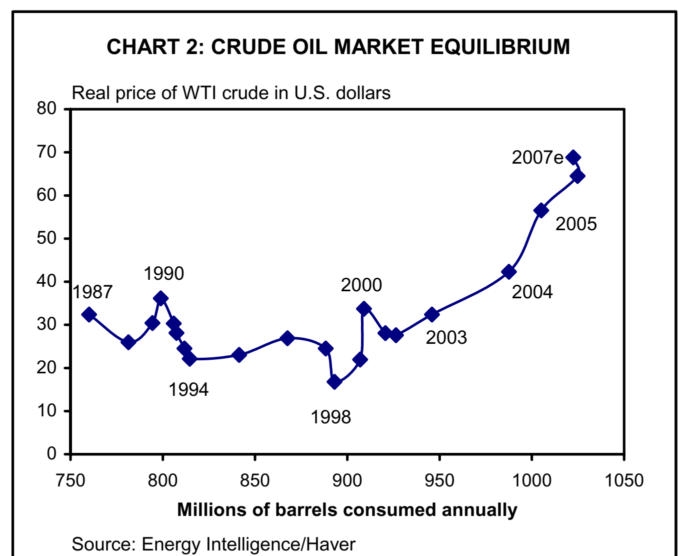
in Chart 2 on the right. Rather than showing these changes over time, however, it shows that from 1987 to about 2002, global consumption of oil continued to increase but real oil prices remained close to $30/barrel. Since about 2003, however, higher levels of consumption have seen higher prices. Combining both charts into Chart 3, we can see a longer-term relationship between the breadth of strength of the global economy and the pressure on oil prices to rise. The brief outperformance in the 1990s did not last. As a result, oil prices remained anchored. The present broad strength, on the other hand, has continued to pull prices higher, feeding into further growth for much of the world. This is the virtuous cycle which has coupled with the rapidly evolving manufacturing base to create the solid foundations for ongoing economic growth.



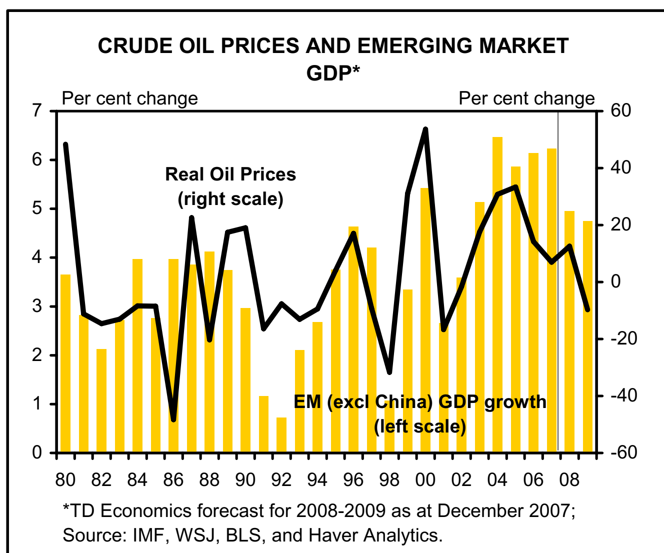
*Global GDP growth rate (excluding U.S.) minus U.S. GDP growth; Source: IMF and Haver Analytics



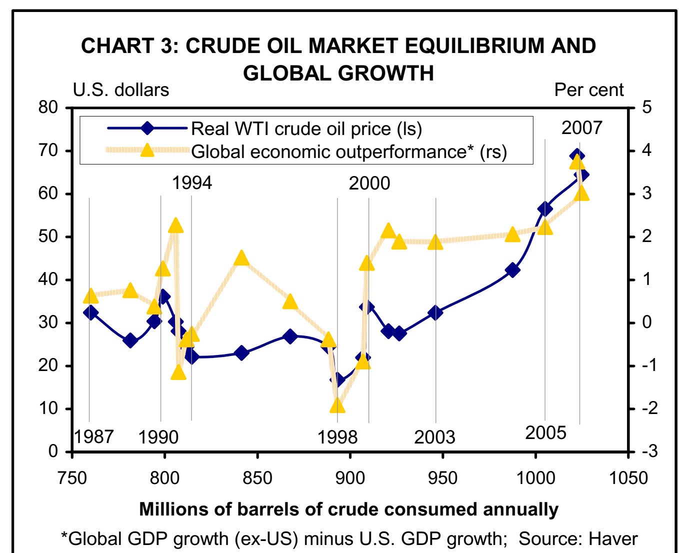
*TD Economics forecast for 08-09 as at Dec 07; Metal prices weighted by global trade shares; Source: IMF, WSJ, BLS, and Haver



Source: Energy Intelligence/Haver



*TD Economics forecast for 2008-2009 as at December 2007; Source: IMF, WSJ, BLS, and Haver Analytics.



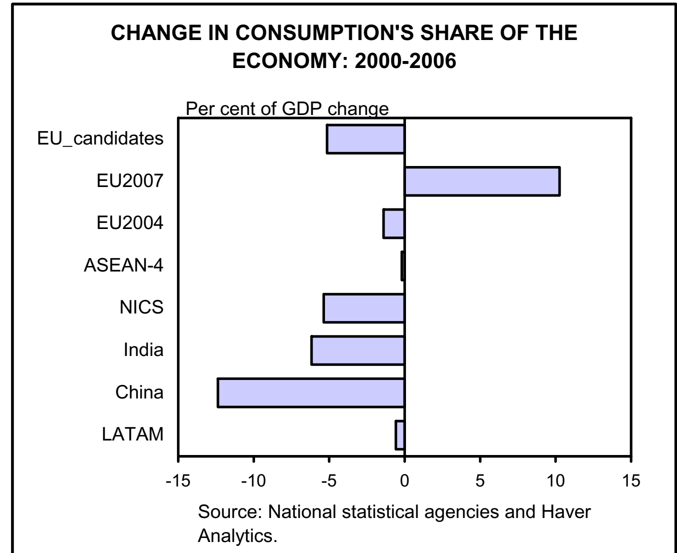
*Global GDP growth (ex-US) minus U.S. GDP growth; Source: Haver

Paging Domestic Demand

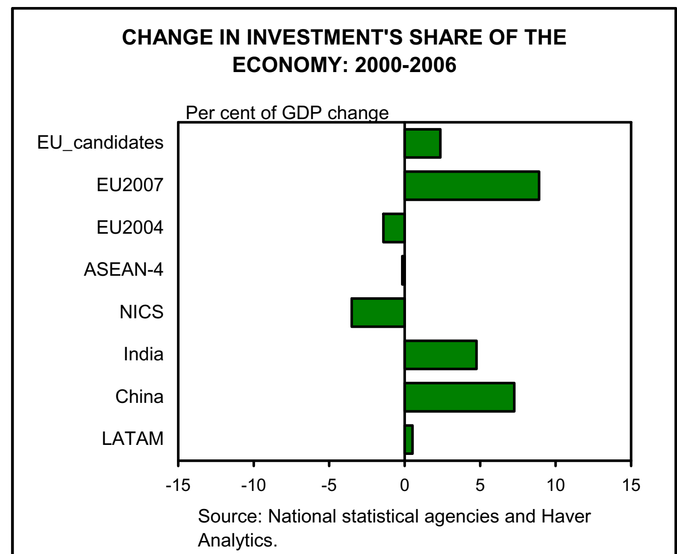
But this does not imply these domestic engines are prepared to be dynamos. Exports have definitely enjoyed a bumper decade so far. The investment and savings needed to develop the manufacturing capacity and expand the infrastructure in emerging markets to achieve this outcome, however, has come at the expense of domestic consumption. Looking across a broad cross-section of emerging markets, the share of the economy which is made up of consumer and government spending on goods and services has fallen in the overwhelming majority of countries. In China, this share has fallen by over 10%. In India and some of the other more advanced Asian markets the share has fallen by 5%. Meanwhile, in some of the less developed Asian EMs, the shares have been more or less unchanged. In many regards, this broad increase is a reflection of the phenomenal growth in exports from the region which has outpaced the growth of their respective domestic economies. For example, in India, consumer spending has been growing at a fairly stable 6-7 per cent pace over the last several years while the economy as a whole has seen overall growth closer to 9 per cent. Domestic spending will provide support to the economy to limit the downside due to the fact that it still accounts for the majority if the economy in most cases, but it will not be enough to support economic growth at current levels.

There have been similar but smaller impacts on domestic consumption among emerging markets in other regions of the world, as well. In Argentina and Brazil, there has been a slight reduction in shares while Mexico has seen a very recent increase in domestic consumption shares. In Europe, consumption shares have broadly fallen across the ten new members who joined the EU in 2004 (with the exception of Lithuania which has seen the share rise from 81% in 2003 to 88% in 2006), as well as the current accession candidates of Turkey and Croatia.

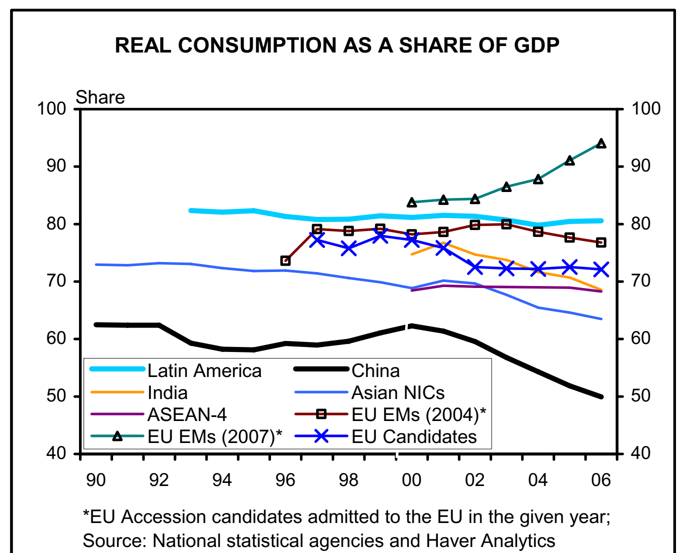
The one major global exception has been Romania (which joined the EU with Bulgaria in 2007), where domestic consumption has risen from 86% in 2000 to 99% by 2006. At the same time, investment's share of the economy has risen to over 20%. This adds to more than 100% and is offset by the negative trade balance, which brings the cumulative shares back to 100%. This also highlights this economy as one of the few at risk for a more "classic" emerging market crisis which can result from large external imbalances. A large part of the booming imports are



Source: National statistical agencies and Haver Analytics.



Source: National statistical agencies and Haver Analytics.



*EU Accession candidates admitted to the EU in the given year; Source: National statistical agencies and Haver Analytics

the capital and machinery purchases fueling domestic investment. Moreover, should the pace of that investment spending slow, there should be an offsetting slowdown in imports and easing of the trade deficit. So while a crisis is by no means inevitable or even likely, this imbalance remains a risk for the Romanian economy.

The domestic investment spending which has supported the rapid pace of growth across emerging markets, however, is vulnerable to souring global sentiment. A large part of this investment spending has been multinational firms bringing in foreign direct investment, establishing warehouses, factories, distribution lines, and retail outlets in these countries. This type of investment brings a lot more long-term stability and potential than the fickle portfolio flows of the past. However, these are the same multinationals whose U.S. operations are lagging, whose stock prices are underperforming, and whose credit conditions have tightened globally. So, just as this financial volatility is having an impact on business investment decisions in the U.S., it will have some impact on decisions globally, as well. This is not to say this sector will disappear altogether. The uncertainty in markets will not be a permanent feature. Investors and businesses recognize this and will still use this period to consolidate their operations and get their ducks in a row for when stability returns.

WORLD ECONOMIC OUTLOOK
Annual per cent change unless otherwise indicated

	2006		Forecast		
Real GDP	**Share**	**2006**	**2007**	**2008**	**2009**
World	100	5.3	5.2	4.2	4.3
U.S.	20	2.9	2.2	1.8	2.8
Canada	2	2.8	2.5	1.9	2.5
Remaining Americas	7	5.3	5.1	3.7	3.7
EU-13	15	2.9	2.7	1.5	1.6
U.K.	3	2.8	3.1	1.7	2.3
Remaining Europe, Middle East, and Africa	12	5.4	6.0	5.0	4.4
Japan	6	2.4	1.7	0.7	2.0
China	15	11.1	11.4	9.9	9.0
Remaining Asia	19	5.9	5.9	4.8	4.8

TD Economics forecast as at January 2008

An Economic Slowdown is Not a Crisis

Taken together, all of this implies that there may yet be a bit too much optimism in expecting the global economy to continue to post record growth even while the U.S. economy – which continues to account for one-fifth of global output – sees more risks and a slower expansion than expected in 2008. Our expectation continues to be that the global economy slows from a 5.2% pace in 2007 to a 4.2% pace in 2008.[4] But as this paper shows, while the world is not immune to the U.S. slowdown, it is unlikely to push economies into full-blown crises. There is a need for a tremendous amount of financial engineering in order to repair the damage created by the sub-prime financial crisis and to limit its ongoing spread into other sectors and countries. This will also calm the fear which is once again driving financial markets, and, if sustained, could feed back into economies by reducing investment and spending decisions. The global economy can not decouple from the U.S. engine, but nor is it likely to buckle under the weight of a slowdown.

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Endnotes

[1] To understand the charts used, they begin by measuring the linear relationship between U.S. real GDP and the local economy's real GDP through the use of a basic regression. The charts then report the percentage point deviation of the logged level of real GDP of the foreign economy relative to their linear trend vis-à-vis the level of U.S. real GDP. When the level of GDP in these economies is above this long-run relationship with the U.S., they are outperforming and vice versa.

[2] All statistical relationships are not created equal, with some showing a closer fit over time than others. It should be noted then that the measure for closeness-of-fit between economic growth in the U.S. and each economy shown is above 0.90 (with 1.0 being a perfect relationship) in every case except Japan and Russia, with each of these reporting a result of 0.80. This should not imply that these analyses are fool-proof, an accurate representation of future developments, nor without their limitations, but they do seem to be fairly descriptive of past developments.

[3] To be mathematically precise, the levels of GDP reported in this chart should be shown in logs to correct for relative changes over time. For the purposes of this chart, the patterns and relationships are little changed so they are shown here as is to make them easier to understand. The other charts which show deviations of GDP growth from the U.S. are, however, based on logged values.

[4] Revisions are underway by the World Bank and IMF which will lower these figures. These revisions will reduce the relative economic size of developing countries, especially China and India, and increase slightly the size of some advanced economies. This is a statistical revision of the relative prices used to convert nominal domestic GDP in local currency into real measures in one common currency. This does not change the story of rapid growth in emerging markets, but will reduce their estimated share of global economic output and give more weight to GDP growth rates in advanced nations when computing a global figure.