Coupling or Decoupling?

The Indian stock markets had crashed in 2008 along with deepening of recession in the United States. This seems to indicate that fate of the Indian economy follows the fortunes of the American economy. But this relationship appears to have reversed in the last five months of this year. The stock markets of developed countries have crashed while those of developing countries are rising. The US markets are down by 6 percent and those of UK and France by 1 percent. On the other hand markets in India have risen by 48 percent, China by 45 percent and Brazil by 30 percent. Will the fortunes of India rise and fall with the American economy as has happened in 2008; or they will rise while the American economy declines as has been happening in 2009?

True, American economic crisis matters as it affects the global economy. The main reason is that wages of American workers are much higher than similar workers in India. General Motors is closing its plants in America while increasing production in its plants in India and China. It plans to import more cars from these countries into the United States. Less production in America is leading to less employment. American workers have less income. They are not able to buy goods like garments and Basmati rice exported from India. This is also causing loss to Indian exporters.

There is a similar negative impact on Indian stock markets. Western investors have been hurt badly and have clammed up like a turtle. They are unwilling to take risks of investing in emerging markets like that of India. Instead, they have resorted to large scale sales in India in the last year because they needed to raise money to make up for the losses incurred in America. They remitted large amounts to their headquarters which led to decline in the value of the rupee and crash in Indian stock markets. The decline of America was being transmitted to India in these ways. Thus it was held that Indian and American economies are coupled.

Of late this relationship has undergone a fundamental change. The decline of America has now become a gain for India because there are other indirect effects that will slowly manifest. Reduction of production in America will lead to increase in production in India and China. That will lead to increase in purchasing power of Indian and Chinese workers. This tendency is likely to persist in the long run. The negative impact from curtailment of exports and reduced inflow of foreign investment will be more than made up by increase in productive activities in the country. Indian economy may grow much faster in the coming years once the overhang of American connection is loosened.

Foreign investment follows a similar pattern. There has been a reduction in foreign capital inflows in 2008. But foreign investors have returned in 2009. The investors have now assessed that the decline of the US economy is likely to continue in the long run. They have started pulling out of the dollar. They are looking for alternate avenues of investment. For example, Arab oil-exporting countries were investing their incomes in the US dollar till recently. They are likely to look elsewhere now. And, that 'elsewhere' may well be India and China.

The rise of Indian stock markets and value of rupee between 2003 and 2007 reflects the long term upward tendency. The decline in 2008 was a short run tendency created by sudden exit of foreign investors from the country. This tendency has come to an end now and Indian economy is back on the long term upward swing. The decline of America and rise of India are likely to go hand-in-hand in the coming years. Indian economy is coupled with the American economy in the short run but decoupled in the long run. □□□

[Contributed]

Frontier, Vol. 42 : No. 32, February 21-27, 2010