Is “decoupling” bad?

BHI Perspective on the implications of evolving U.S.-China rift

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The trend towards greater global integration has been so dominant over the last few decades that the specter of “decoupling” understandably inspires fear among business leaders and investors alike. If China leaves the orbit of a U.S.-centric world economy, seeking to build its own ecosystem of alliances, institutions, and norms, the benefits of integration seem at risk. Decoupling also seems inexorable – the current administration has accelerated that trend, not caused it, and a new one would likely not reverse the dynamic.

Yet, the risks for firms and economies from decoupling are neither linear or clear. It’s tempting to think that unwinding a system that has delivered growth and profits for decades must mean the end of those benefits as well. But global integration always fell short of its aspirations and as the architecture of a bipolar world is still in the early stages of being written it’s too early to survey the damage. “Decoupling” will offer both risks and opportunities for firms and economies, and overall losses are not a foregone conclusion.

The benefits and limits of global integration

Conversations about decoupling tend to cut straight to dark future outcomes, but it is worth pausing and reflecting on what the proper benchmark is – what are we afraid of losing?

The long stretch of global integration has unquestionably brought many benefits. From a business perspective, two are worth singling out: tremendous growth in foreign profits has been a tailwind to corporate profitability as global value chains have proliferated. Meanwhile, those value chains have also provided a structural disinflationary impulse for many economies around the world, contributing to low inflation and high equity valuations.

However, the idea of global convergence was much more comprehensive than corporate profits, cheap goods, or valuations and we can sketch its shortfalls against its original ideals across three broad dimensions:

Geopolitical alignment. In the geopolitical arena the hope was the end of geostrategic competition and great power rivalry, as the universal adoption of liberal market practices would propel development and liberal democracy. However tempting the idea about the symbiotic relationship of liberal markets and liberal democracy, it failed to deliver (and was not even on a path to do so). In fact, the failure of the liberal order has weakened the grip on power of those interested in global integration as well as the claim of superiority of the liberal democratic model.

Global financial integration. In the arena of finance, the expectation of open capital markets moving savings to their most productive place (implicitly from rich countries with large capital stocks to poor countries with limited ones) never happened. In fact, the reverse was true, as the globalized world delivered significant and sustained financial imbalances where savings moved from poor to rich nations. This was also a key facilitator of the Global Financial Crisis – another factor that weakened the champions of integration.

Economic integration. For the global real economy, widespread growth and development was predicted and if there is one place where the highest ambitions of integration are most realized, it’s here. Beyond the

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tailwinds to corporate profits mentioned above there are also the laudatory falls in severe poverty. However, growth was often imbalanced and debt-driven, and was delivered with sharp rises in inequality within nations – each adding to the challenges for future growth, on top of other headwinds such as weakening demographics. That too has undermined the champions of integration.

Even the aspirations of integration had weaknesses

But even if a less flawed version of global integration had come to pass, there would still be at least two structural downsides or limitations.

First, any integration carries a substantial, often overlooked, risk – that of correlation. In the world of finance that is quite intuitive: highly correlated asset classes pose a significant risk to investors, whereas weakly or uncorrelated asset classes offer diversification and thus protection. Translated to the firm level, a synchronized global expansion is certainly attractive for globally operating businesses, but a synchronized downturn is not. It even poses a systemic threat.

Though correlation risks don't feature in today's debates about decoupling, they have in the past. In 2007, the year before the Global Financial Crisis, as the U.S. economy looked vulnerable and a risk to the global expansion, many hoped for a "decoupling" of the Chinese and U.S. economies, so as to avoid a concerted global downturn. While today "decoupling" refers to a broader set of themes, not just growth, the risk advantages of a decoupled world were broadly understood and emphasized then.

Another structural limitation of "integration" is that it ultimately describes a unipolar system: the world economy resembles a solar system where the U.S. economy is orbited by other economies in its gravitational realm. Structurally, such a system can be mutually beneficial for a long time, but as orbiting economies gain mass the gravitational system can reach its limits. "Global integration" sounds neutral but was effectively anchored on U.S. geopolitical hegemony, on the USD as a reserve currency, and U.S. institutional leadership. As others rise the system was always going to struggle to exhibit the flexibility to adapt to a changing global reality.

The architecture of decoupling is not yet written, and neither is the impact on firms

Decoupling is still uncertain and immature with respect to degree, manner, and impact. As it will play out across the geopolitical, financial, and real economic dimensions to varying degrees, multiple futures with various combinations of changes are plausible. In a field where the only certainty is uncertainty, how to capture the main fault lines?

One theme that runs across all dimensions of decoupling is the nature of "alignment" as the U.S. and China drift further apart. Will the rest of the world be subjected to "forced alignment" – the necessity to choose a side – or will this be a bipolar world tolerant of "non-alignment"? Today the opportunities for interaction are much greater than during the Cold War when choosing sides was a necessity for all but a small group who had either the clout or insignificance to afford nonalignment.

No matter the future fault lines, decoupling doesn't necessarily mean its nature is malignant. Across each dimension – geopolitical, financial, and real (as well as their subdimensions) – there are relatively benign versions of a decoupled world. Geopolitically, this is classically illustrated by the difference between a cold and hot war between bitter rivals; in the financial arena, a bipolar order could help reduce global imbalances of recent decades; and in the real economy dimension, the fault lines could be porous or integration and scale may be significant within the separate poles.

Building the architecture of a decoupled world will be an evolution, probably playing out over decades and at varying speeds. It could include temporary reversals and allow for continued integration in some dimensions. The clearest sign of the new architecture taking shape will be the emergence of new institutions that codify and govern the emerging changes.

As a consequence, economies and the business environment in which firms operate will be forced to struggle with more uncertainty. This points towards building greater resilience to manage in a less predictable global landscape. As firms increasingly trade efficiency for resilience (building optionality will have cost but will prepare firms for multiple futures), economies could become more resilient too. Additionally, a decoupled world, if it spawns competition between more distinct operations, may spur innovation. The tailwind of global integration has stopped but it has not been replaced by a simple headwind – rather by crosswinds demanding vigilance.

Business strategy will have to adapt to protracted systemic uncertainty

So, is decoupling bad for firms? In one way it certainty is – decoupling will bring systemic uncertainty that in all likelihood will be protracted and deliver episodic bouts of volatility and stress. Yet, uncertain outcomes also mean losers and winners are not predestined and that many firms will have a chance to reposition and shape their futures as uncoupling plays out.

For example, even in the aggressive non-alignment version of decoupling, those who can position themselves to work within each ecosystem while angering neither will not necessarily face a downgraded future (even if cost may be higher, they can still benefit from scale and integration). In the forced alignment view of the future, challenging choices arise. They could include how to divide assets that no longer can be in the same firm and how to choose which side to align. But even there, outcomes are not predestined as market shares would be reassigned and competitive forces change.

Irrespective of the U.S. election outcome, firms are facing a future where a concerted strategy for a decoupled world will be required. The various dimension of decoupling, as well as the uncertainty in each, will require agility and flexibility. Successful preparation will be about envisaging multiple futures and having the ability to execute flexibly and adapt. Those who think in these terms need not assume the worst about a decoupled future.

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