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## Decoupling and Recoupling: Global Links to the Business Cycle; Cattle Market Fundamentals

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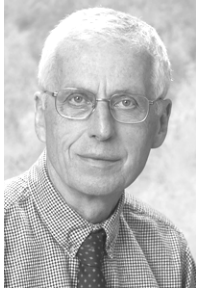


# ECONOMICS COMMENTATOR

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## DECOUPLING AND RECOUPLING: GLOBAL LINKS TO THE US BUSINESS CYCLE

by

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## CATTLE MARKET FUNDAMENTALS

by

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The Great Recession of 2007-2009 illustrates the brave new world of globalization has altered the scenario of events that evolve when a severe recession originates in the developed world. The old script holds that when the US economy sneezes, the rest of the world catches cold. Therefore, when the US housing bubble burst and its stock market plunged, it was expected that the other nations of the world would suffer at least equal economic shrinkage as their exports to the US fell precipitously. Note that the operative word here is “altered” – modified or revised, not radically changed.

### Decoupling

Decoupling is a relatively new concept which proposes that changes in the US economy (recession, boom) affect trading partners to a lesser extent today than was the case in the twentieth century. Decoupling affects all markets; both direct productive activity and financial. The theory of decoupling is based in large part on the changing structure of world economies, particularly emerging markets, but also developed European economies. Financial and output markets in emerging nations are becoming less susceptible to gyrations in the US economy because domestic consumption is growing faster than exports (and faster than consumption in the US as well) and a smaller percent of developing country exports are sold to the developed world and a larger percent to  
(Continued on page 2)

Cattle operations are common in South Dakota and they contribute to the agricultural economy. Relatively high input costs have kept cattle inventory levels contracting across the United States. The situation in South Dakota is similar, but subtle differences suggest slightly different responses to changing market conditions by cow-calf producers and feedlots.

### National Picture

At the national level producers continue to contract beef herd numbers resulting in lower inventory levels. In the *Cattle* report, the National Agricultural Statistics Service (NASS) reported that as of January 1, 2010 there were 93.7 million head of cattle in the U.S. The general trend of fewer cattle has not been mirrored in South Dakota. After several years of unchanged inventories the total number of cattle increased to 3.8 million head as of January 1.

Most states bordering South Dakota have smaller overall inventory levels and fewer beef cows. Most major cow-calf states had smaller beef herds as of January 1. Oklahoma was a notable exception. Thus, contraction is widespread and persistent. Based on slaughter data and on-feed statistics, analysts expected steady to fewer beef cows and fewer beef replacement heifers.  
(Continued on page 3)

*(The Continuing Case for .... Cont'd from p.1)*  
other developing nations. Also, as emerging economies and incomes grow, their securities are held by a broader cross-section of international investors – and, diversification of holdings over a broader investor base tends to reduce stock market volatility while raising share prices.

East Asian economies have adopted a cornerstone of classical economics; which focuses on capital accumulation via savings as the means of growing the wealth of nations. For instance, Singapore mandates that high wage employees/employers contribute more than 50% of a worker's gross pay to a fully-funded (not pay as you go) government program which invests the monies largely in domestic corporations, thereby helping to solidify a national savings rate in excess of 50%. This tight, positive correlation between national savings rates and economic growth provides a widely held cornerstone of developmental economics. In fact, Akerlof and Schiller (2009) view savings as a national exit route from poverty and underdevelopment.

Europe's hypothetical road to decoupling from the US economy is distinct from Asia's and hinges on structural differences and reform initiatives. First, liberalization of labor markets and business regulations would encourage employment, profitability, and economic growth. Concurrently, relatively high social welfare safety nets would be able to sustain consumption and modulate any decline in recession-induced production. In Japan, a reformed, sounder bank system, heightened consumption, and reduced reliance on export-led growth would help separate her from the constricting US economy.

### **Recoupling**

Advocates of the decoupling theory controlled the playing field until the last quarter of 2008, when they were put to rout by the grinding halt of the global economy. Prior to the halt, some economists were of the mind that emerging economies had transformed into the engine of growth for the global economy (FT.com, 08/10/09). Surging demand and positive economic growth in developing nations would offset the recession and indebtedness, negative GDP growth, and reduced import demand in the US and the rest of the developed world.

After the meltdown of Lehman Brothers in September 2008, international capital flows were reduced, trade finance became more difficult and emerging economies felt the full brunt of the now-global recession. Asset values and national output began falling more precipitously in developing economies than in the industrialized world. Recoupling replaced decoupling in the railroad yards of international commerce, and the recession in industrialized nations spread quickly and deeply into emerging markets. "Two thousand and eight will be the year of "recoupling," stated Peter Berezin, an economist at Goldman Sachs in attempting to clarify his firm's 180 degree change of course. "What began as a US specific shock is morphing into a global shock." (Bloomberg.com, 12/7/08).

### **Changed Relationship of US v. ROW**

When the US economy quickly slipped into recession in the second half of 2007, other world economies, developed and less developed, maintained positive economic growth. The fallout from the housing market bubble was largely contained within the US. Within a year, this rosy scenario had changed. Other developed nations, mainly the EU, began economic shrinkage. Emerging economies, once above the fray, experienced declining or negative economic growth as well as plunging stock markets. In 2008, the US mortgage loan-generated crisis spread globally and virtually no economy was immune to its negative effects.

In the past, a US economic slump became immediately contagious abroad. This time, US recessionary effects were transmitted with roughly a year's lag. It should be noted that the US economy remains the dominant world economy. US consumption exceeds that of the entire Asian economy, while US imports alone are roughly equal to the GDP of China. The US stock market constitutes about 45% of global market capitalization, down from 55% a decade ago. But the reality is that emerging markets are growing much faster than the US economy and the US share of global output and market valuation has been diminishing.

The Dallas Fed notes that the proliferation of international economic linkages reduces nations' *immediate* economic dependence on the demand of US consumers to absorb their excess production, but it does not necessarily alter longer term dependence; e.g. China may sell more consumer products to the European Union and perhaps less to the US. However, depressed recessionary demand in the US for European output may ultimately restrict the EU's imports from China. The global economy simply cannot ignore the effects of recession in the US; 25% of world output (and a larger percent of world consumption) will ultimately affect global demand and incomes. What globalization has achieved is a delay of the negative global impacts of US recession.

The Dallas Fed tracked US cyclical movements in moving windows of 80 quarters from 1960 to 2007, using variations in real GDP as the variable metric, against fluctuations experienced by 11 other countries including: Canada, Japan, Belgium, Denmark, Netherlands, Korea and Spain. Data restrictions precluded similar comparisons for Mexico and China. The correlation, in the immediate run, between US cyclical fluctuations and the business cycles of EU members, has been decreasing over time (1960-2007). Also, the direct impact of US cyclical fluctuations on non-EU members (Canada, India, Japan, and South Korea) has also been diminishing over time, particularly since 2000. The demise of the Bretton Woods fixed exchange rate system, oil price shocks, trade liberalization and technological advance have all contributed to globalization, which lessened the immediate effects of changes in the US economy on global economic welfare. (Economic Letter, Dallas Fed., Nov. 2008).

However, the same Fed study indicates that the impact abroad of US economic changes may actually be building – over the longer run. That is, it takes longer for fluctuations in the US economy to affect other economies, but the effects may be deeper than prior to 1980. Globalization means that economies are more open to economic shocks today and that those shocks, reverberating among trading partners, may become stronger – while the full impact takes longer to arrive. The appearance of decoupling is transitory, while the transmission mechanism for economic shocks has become more sophisticated – affecting economies from different directions.

## **Investment Impacts**

It stands that the decoupling process is an incomplete one and that swings in the US business cycle still affect foreign economies, both developed and developing. However, globalization has altered the timing of impacts and, likely, their severity as well. Some emerging economies, notably Brazil, China and India have exited the current financial crisis and afford investors greater medium-term growth than industrialized (actually, post-industrial) economies. Consequently, select emerging markets are currently likely to offer investors a better risk-return tradeoff via less downside risk and more upside return because of their V-shaped recovery from the current global recession (F.T.com, Aug. 10, 2009).

## **Reference**

Akerlof, George A. and Robert J. Shiller. *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*. Princeton, NJ: Princeton University Press, 2009.

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(*Cattle Market Fundamentals ....Cont'd from p. 1*)

The *Cattle* report confirmed analysts' expectations. The slightly smaller cow herd will be partially offset by the slight increase of heifers expected to calve in 2010. However, replacements overall are 2% lower than last year. Smaller calf crops are thus expected for 2010 and 2011, ultimately reducing the potential supply of beef in 2011 and 2012.

The short run price situation is mixed. Nationally there are fewer cattle currently on feed, and slightly fewer feeder cattle outside of feedlots. However, there are more feeder cattle grazing southern wheat pastures. Generally once those feeder cattle are placed on full feed they have larger frames and finish at relatively higher weights.

## **South Dakota Differences**

The overall higher South Dakota cattle inventory level masks some subtle changes compared to other states. In South Dakota the number of beef cows has fallen slightly for four consecutive years. The beef replacement heifers, calf crops and on feed levels have been steady.

The increase in total inventory is driven by feeder cattle outside of feedlots. This group is the sum of calves, steers and other (non-replacement) heifers minus the number of cattle on feed. This group reflects the flexibility South Dakota producers have. A late crop harvest may have resulted in more feedstuffs and generally delayed some cattle sales until 2010.

Additional replacement heifers could be developed from this reserve inventory. The lighter animals could be grazed on summer pasture in South Dakota or in neighboring states. Some substitution of yearlings for stock cows is thus possible in 2010. Because the neighboring states did not expand their inventories, there could be surplus grazing available. The heavier animals could be placed on full feed using any excess feedstuffs from the late crop harvest.

The on-feed situation also reveals some trends specific to South Dakota. At the national level there are 13.6 million head on feed, down 2% from 2009. The January *Cattle on Feed* report showed the same absolute decrease among feedlots with more than 1,000 head, suggesting smaller feedlots across the U.S. have the same number on feed. The state-level breakdowns reveal that the largest feedlot states have smaller inventories as do most of the very small feedlot states. In contrast several states in the upper Midwest, specifically Iowa, Minnesota, Michigan and

South Dakota, have a larger number on feed this year. The long-run trend on cattle feeding in South Dakota continues to show a strong seasonal pattern in monthly placements and a relatively smooth pattern in monthly marketings. Average monthly placements are three times higher during the peak month of October than during the trough month of July.

The prospects for the remainder of 2010 will depend on how the different market forces come together. Cattle profits will likely improve because of a smaller national cattle supply, lower hay prices, and stabilized grazing fees. The short-run feedlot situation continues to be tenuous, but the second half of 2010 should be profitable because of tighter supply. There should be higher demand for grass cattle this summer (and thus higher prices). By fall the smaller expected calf crop should result in higher calf prices than observed in 2008 and 2009. Finally, backgrounded cattle held into 2011 should also command higher prices (though returns will be dependent on corn prices).

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