Global Policy dialogue

The State of the World Economy in 2012

Jean-Michel Severino
Inspector general, French Ministry of Finance

Martin Wolf
Journalist, Financial Times

Professor David Held
Chair, University College, Durham
The shift and the shocks: prospects for the world economy

Martin Wolf, Associate Editor & Chief Economics Commentator, *Financial Times*

Global Policy Dialogue

23rd January

London School of Economics
The shift and the shocks

- Shift
- Shocks
- Prospects
1. The shift

- In the 19th century, there occurred the “great divergence”
- In the second half of the 20th century, convergence began, notably with Japan and the east Asian “tiger economies”
- In the late 20th and early 21st centuries convergence spread to the Asian giants
- Divergent growth is mirror image of converging incomes
1. The shift

EMERGING COUNTRIES OUTPERFORM HUGELY

GDP SINCE THE CRISIS

Source: IMF, WEO database

Advanced economies
Emerging and developing economies
China
India
1. The shift

DEVELOPED COUNTRIES FALL, ASIA RISES

SHARES IN WORLD OUTPUT
(at PPP, per cent)

Source: IMF WEO database, October 2011
1. The shift

- The “great convergence” has had powerful consequences:
  - An ongoing “labour-supply shock”, which lowered relative wages of the relatively unskilled in high-income countries;
  - Initially, a dis-inflationary shock, as China lowered world prices for manufactures;
  - An increase in the surplus of desired savings and so the rise of the global imbalances;
  - Then an inflationary shock, as demand for raw materials soared; and throughout
  - Ongoing shift in global economic activity
2. The shocks

• The economic collapse was large and enduring
• The rescue was also dramatic:
  – Liabilities of the core financial system were nationalised;
  – Monetary policy is unprecedented; and
  – Fiscal policy has been put on a war-time footing.
• This then is a “contained depression”.
• According to Carmen Reinhart and Kenneth Rogoff, *This Time is Different*, it could take three years, to return to “normality”. Given the scale of affected economies, it could be longer.
• Conventional fiscal and monetary firepower is used up.
2. The shocks: global

THE LEGACY OF THE DEBT EXPLOSION

Source: IMF WEO, September 2011

HOUSEHOLD DEBT TO INCOME RATIO

- United States
- Euro area
- United Kingdom
- Japan
2. The shocks: global

A LONG DEPRESSION

GDP IN THE GREAT RECESSION
2. The shocks: global

THE SOVEREIGN DEBT CRISIS

NET PUBLIC DEBT OVER GDP (per cent)

Source: IMF WEO, October 2011
2. The shocks: global

THE AGE OF PREMATURE RETRENCHMENT

STRUCTURAL FISCAL DEFICIT
(as per cent of GDP)
1. The shocks: global fiscal room? Yes

TEN-YEAR GOVERNMENT BOND YIELDS

2. The shocks: global
2. The shocks - eurozone

• The eurozone crisis is the world, in miniature
• The core of the eurozone financial crisis is not a fiscal crisis
• It is the interaction of balance of payments with financial crises, though huge debt stocks played a part in creating liquidity problems for sovereigns
2. The shocks - eurozone

• The difficulty is largely the result of the divergences accumulated in the years of excess
• What made everything seem so good was creating an acute long-term crisis
• The failure of a true union stands revealed: neither financing in a crisis nor workable adjustment mechanisms
• Too little, too confused and too late
• The crisis is potentially terminal for the eurozone
2. The shocks - eurozone

**EUROZONE IMBALANCES**

**CURRENT ACCOUNT BALANCES**
(per cent of GDP)

![Chart showing current account balances for eurozone countries from 1999-2007 and 2012. The chart uses bars to represent the balance for each country, with blue bars indicating the average from 1999-2007 and purple bars indicating the balance for 2012. The countries listed are: Finland, Netherlands, Belgium, Germany, Austria, France, Italy, Ireland, Spain, Greece, Portugal, and Estonia. The y-axis represents the balance in per cent of GDP, ranging from -12.0 to 10.0.]
2. The shocks - eurozone

ROAD TO THE EUROZONE FISCAL CRISIS

NET PUBLIC DEBT
(relative to GDP)
Source: World Economic Outlook database April 2011

Greece, Italy, Portugal, Ireland, Spain

Source: World Economic Outlook database April 2011
18

SPREADS OVER BUNDS

ROAD TO THE EUROZONE FISCAL CRISIS

2. The shocks - eurozone
2. The shocks – eurozone

ROAD TO THE EUROZONE FISCAL CRISIS

SPREADS OVER BUNDS

Greece
Ireland
Portugal
3. Prospects

• At the broadest level, we are watching the interaction of two huge events:
  – A secular shift in the location of economic activity; and
  – The collapse of a generational expansion in private and, to a lesser extent, public sector leverage in high-income countries
  – The eurozone crisis falls at the intersection of these processes
  – “Imbalances” are a vital symptom of economic stress

• So how might it all play out?
• We do not know. There are too many unknowns.
2. The prospects: global

GROWTH PROSPECTS DWINDLE FOR 2012

GROWTH FORECASTS FOR 2012

Spain, Italy, France, Germany, Eurozone, Japan, UK, US
2. The prospects: global

GROWTH PROSPECTS DWINDLE FOR 2012

GROWTH FORECASTS FOR 2012

- World
- Latin America
- Brazil
- Eastern Europe
- Russia
- Asia Pacific (without Japan)
- India
- China

Jun-11 vs Jan-12
3. Prospects: global

Here are salient elements of global challenges:

- Accelerating de-leveraging in the private sectors of overleveraged countries;
- Rebalancing the world economy, to give over-leveraged economies to enjoy export-led growth, necessary when their private sectors run huge financial surpluses;
- Reducing fiscal deficits in high-income countries, without killing the recovery; and
- Avoiding excesses in emerging countries, despite easy financial and monetary conditions.
3. Prospects: eurozone

• What is needed now in the eurozone are:
  – Financing while adjustment occurs, which will take at least 5 years and possibly 10 years, or more;
  – Adjustment via structural reforms and divergent inflation across the eurozone, with higher inflation in core countries and low inflation in vulnerable countries;
  – The big risk is a combination of premature fiscal tightening in the periphery and the absence of adjustment in the core;
  – That will lead to further deep recessions;
  – And a possible break-up.
3. Prospects

• Some guesses:
  – Growth in high countries will remain weak for many years, with a significant chance of a true depression;
  – Headline inflation rates will fall;
  – Short-term official interest rates will remain low;
  – Countries with their own central banks will have low long-term bond rates; many eurozone countries will not;
  – Eurozone break-up risk remains;
  – The US will be the fastest growing of big economies;
  – Emerging countries will grow quickly, but there is some chance of crises there, too.
Global Policy dialogue

The State of the World Economy in 2012

Jean-Michel Severino
Inspector general, French Ministry of Finance

Martin Wolf
Journalist, Financial Times

Professor David Held
Chair, University College, Durham

LSE events