

Global Policy dialogue

The State of the World Economy in 2012

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LSE events





**The shift and the shocks:
prospects for the world economy**
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Global Policy Dialogue

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The shift and the shocks

- Shift
- Shocks
- Prospects

1. The shift

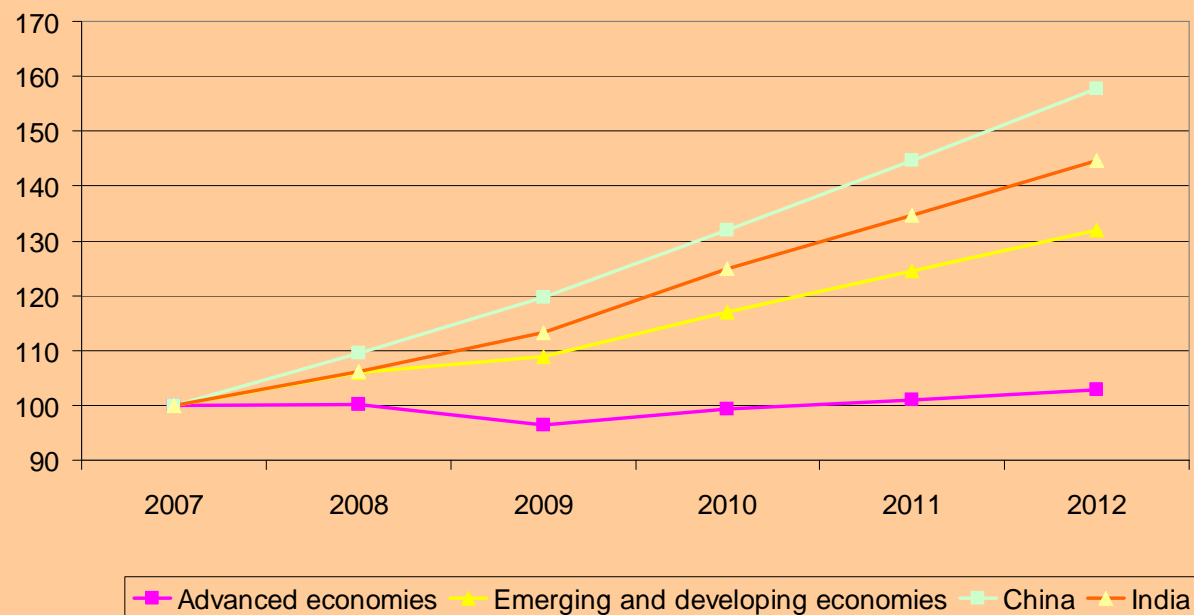
- In the 19th century, there occurred the “great divergence”
- In the second half of the 20th century, convergence began, notably with Japan and the east Asian “tiger economies”
- In the late 20th and early 21st centuries convergence spread to the Asian giants
- Divergent growth is mirror image of converging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

1. The shift

EMERGING COUNTRIES OUTPERFORM HUGELY

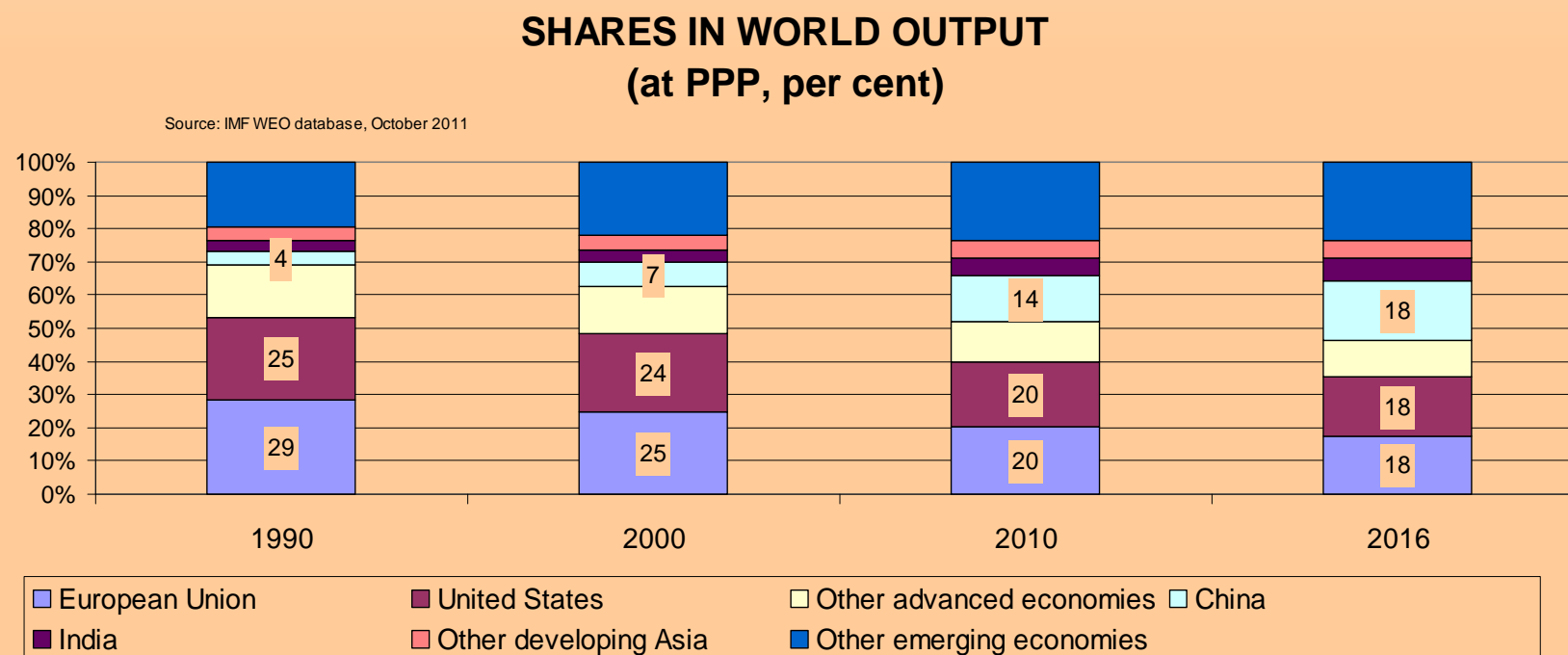
Source: IMF, WEO database

GDP SINCE THE CRISIS



1. The shift

DEVELOPED COUNTRIES FALL, ASIA RISES



1. The shift

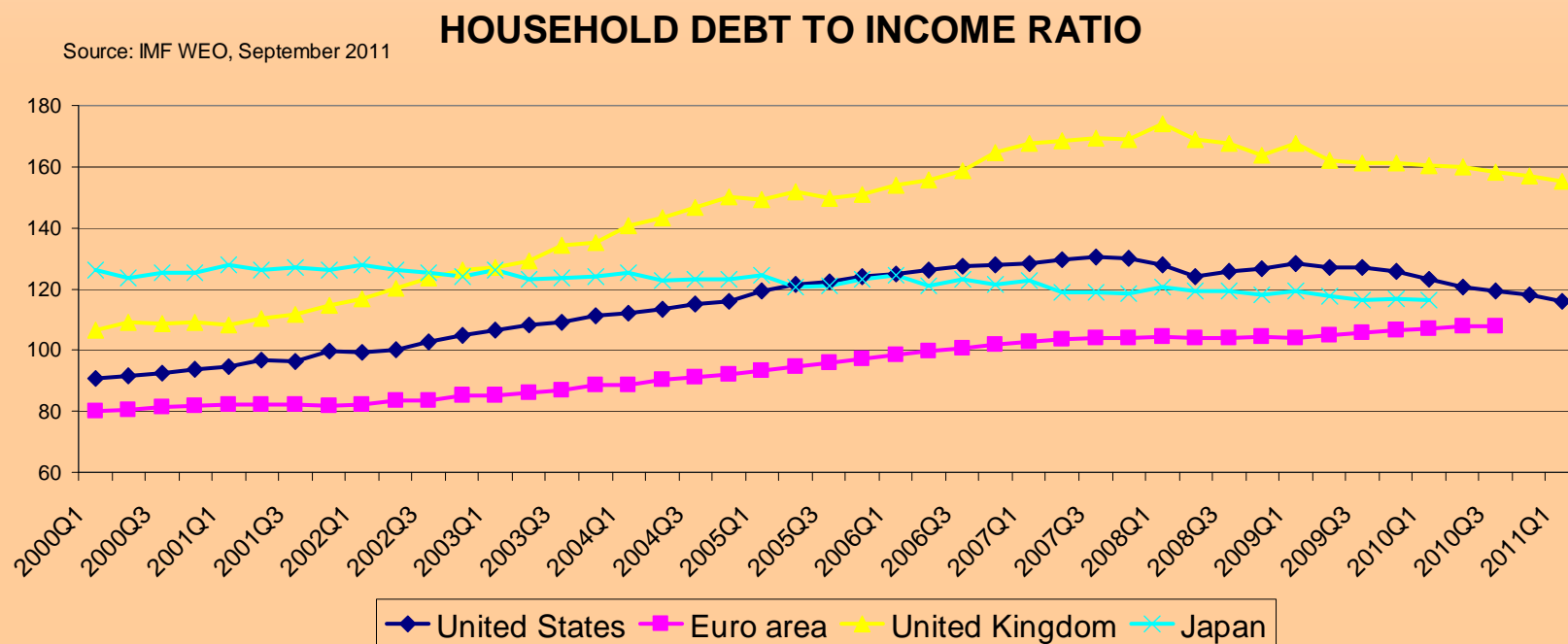
- The “great convergence” has had powerful consequences:
 - An ongoing “labour-supply shock”, which lowered relative wages of the relatively unskilled in high-income countries;
 - Initially, a dis-inflationary shock, as China lowered world prices for manufactures;
 - An increase in the surplus of desired 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

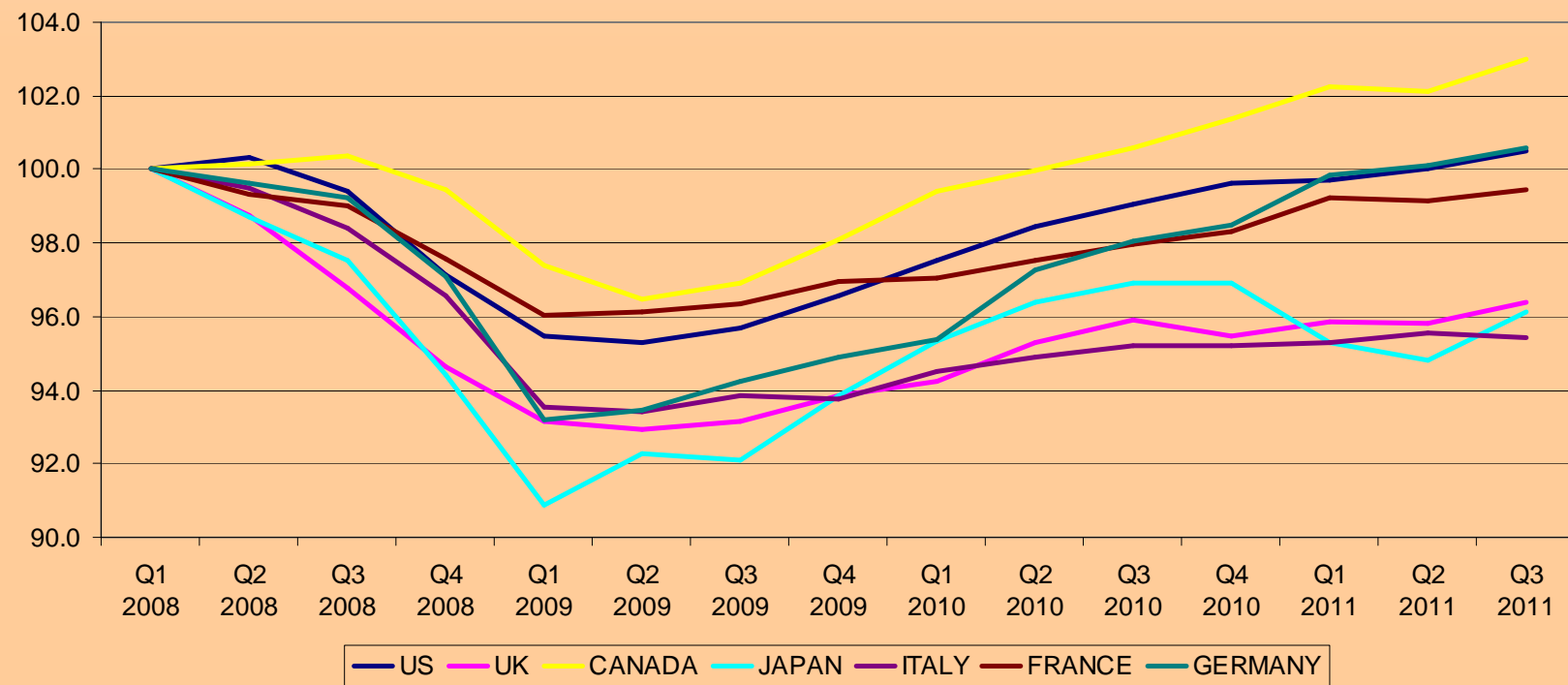
THE LEGACY OF THE DEBT EXPLOSION



2. The shocks: global

A LONG DEPRESSION

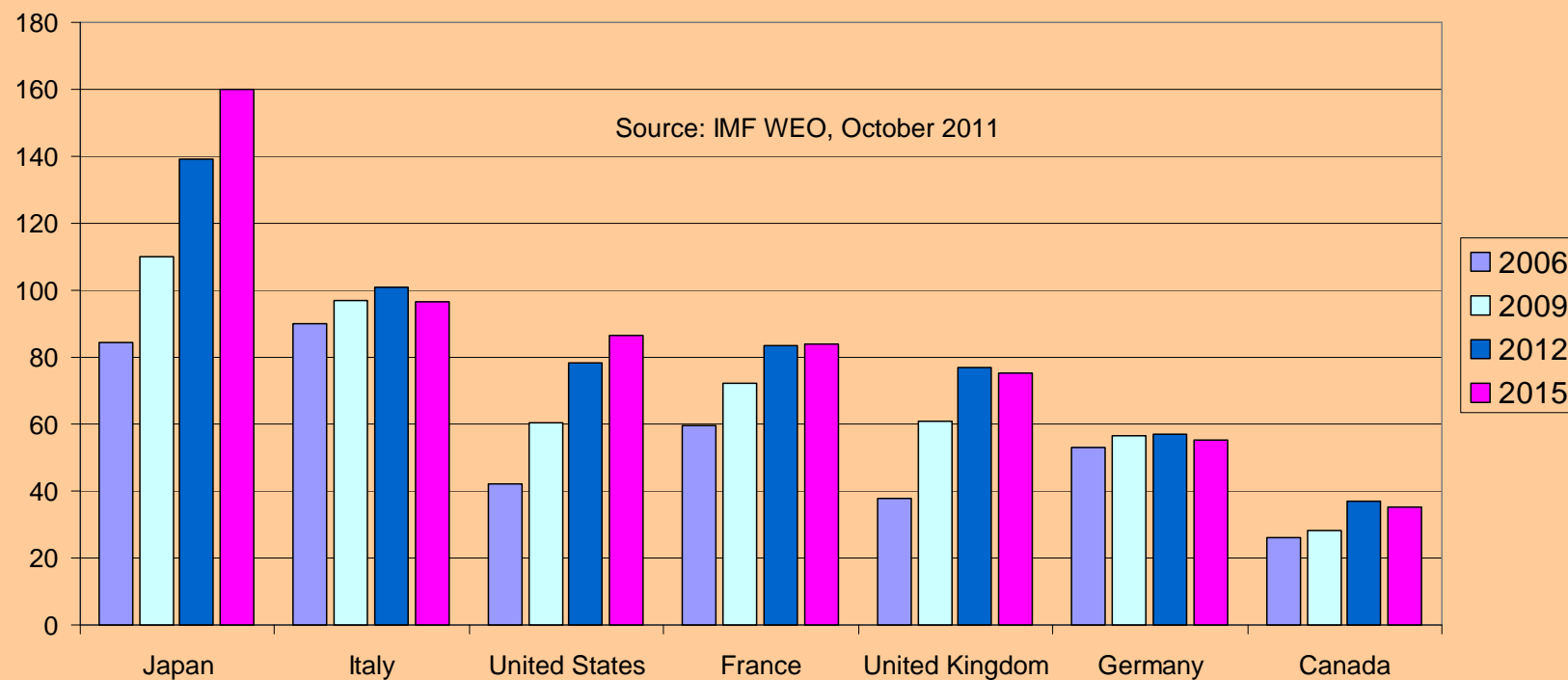
GDP IN THE GREAT RECESSION



2. The shocks: global

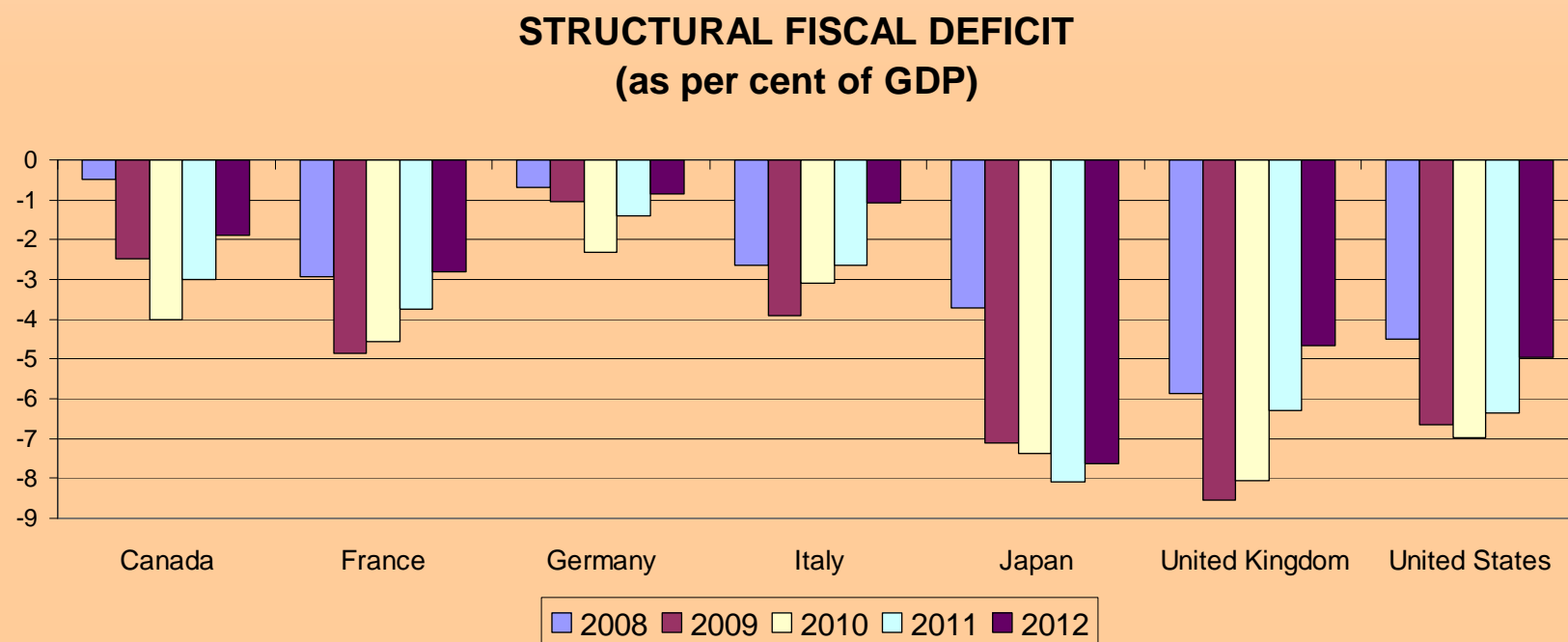
THE SOVEREIGN DEBT CRISIS

NET PUBLIC DEBT OVER GDP (per cent)



2. The shocks: global

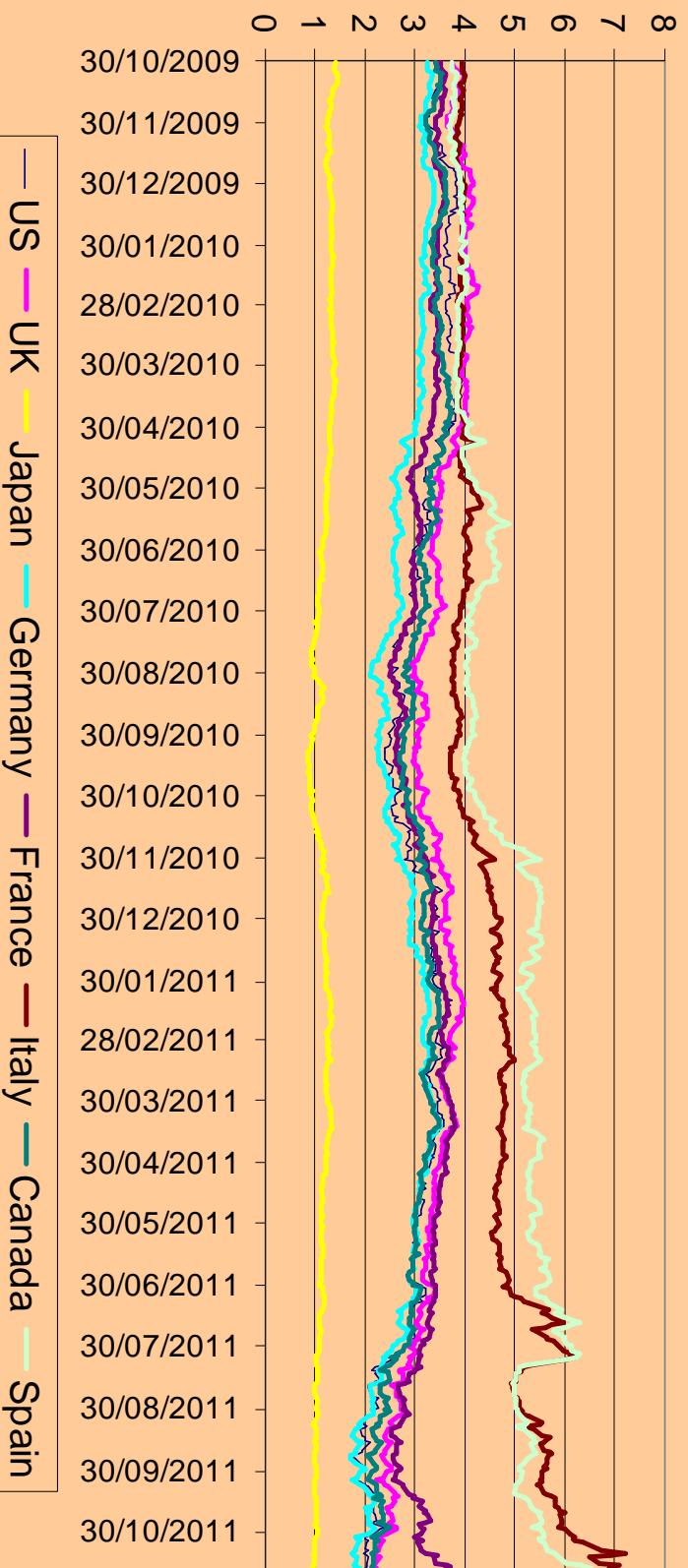
THE AGE OF PREMATURE RETRENCHMENT



2. The shocks: global

FISCAL ROOM? YES

TEN-YEAR GOVERNMENT BOND YIELDS



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

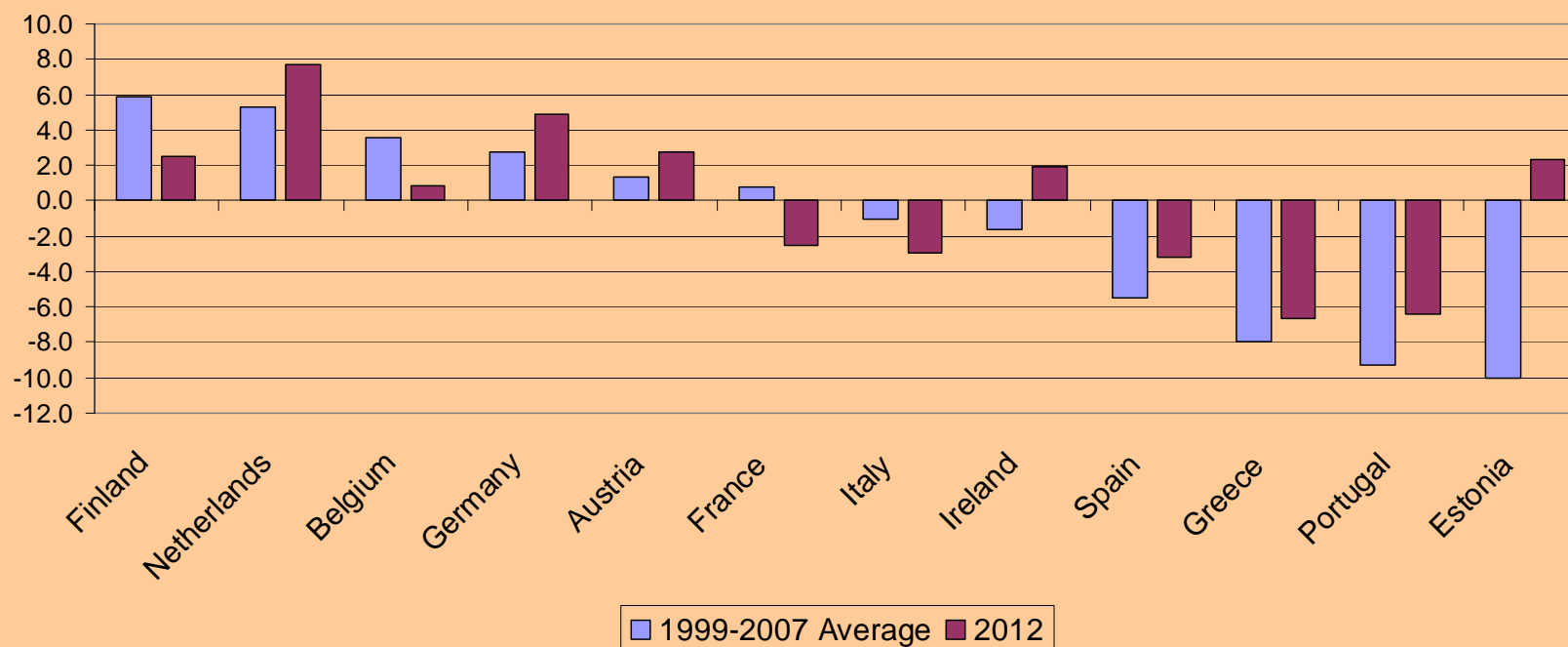
2. The shocks - eurozone

- 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)

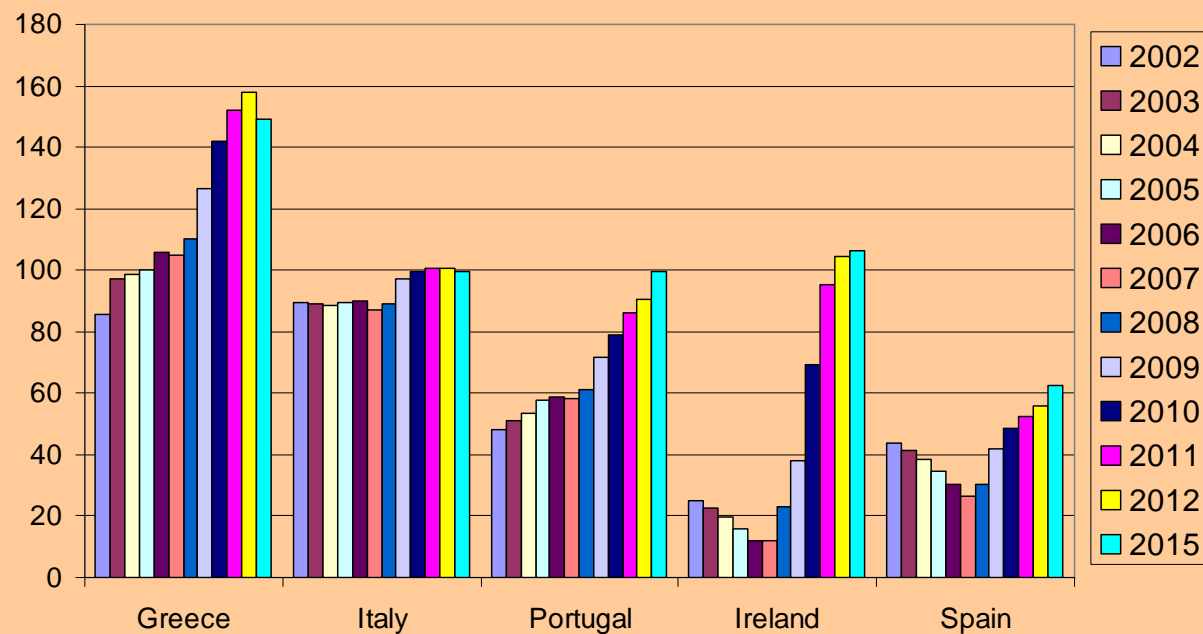


2. The shocks - eurozone

ROAD TO THE EUROZONE FISCAL CRISES

NET PUBLIC DEBT (relative to GDP)

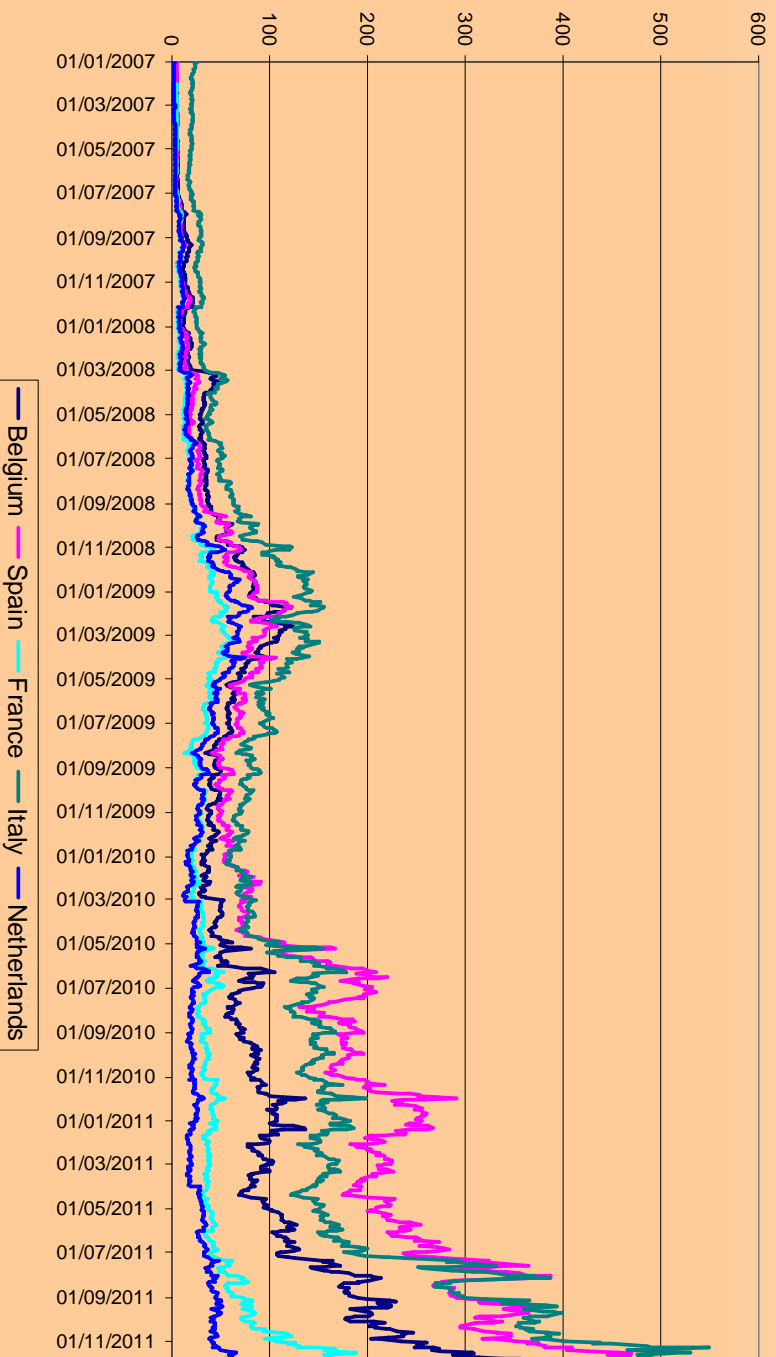
Source: World Economic Outlook database April 2011



2. The shocks - eurozone

ROAD TO THE EUROZONE FISCAL CRISES

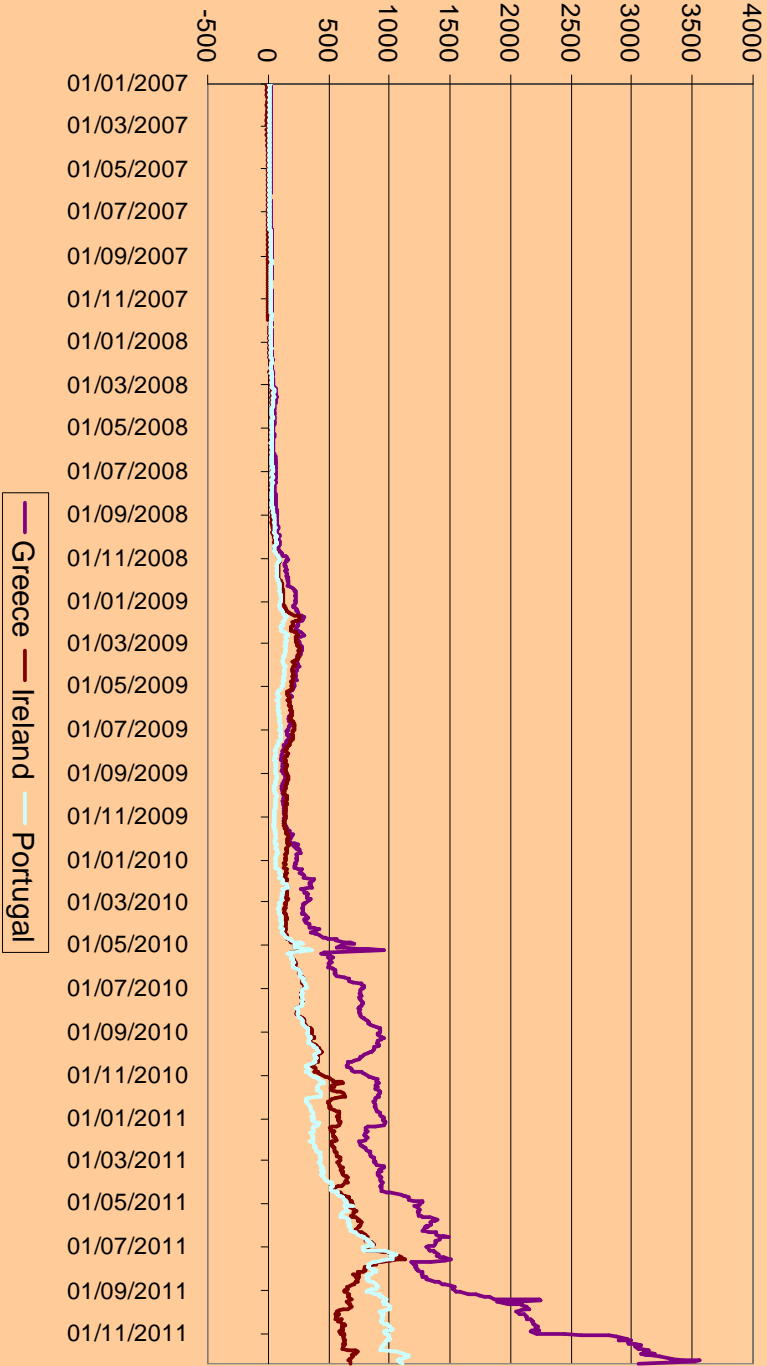
SPREADS OVER BUNDS



2. The shocks - eurozone

ROAD TO THE EUROZONE FISCAL CRISES

SPREADS OVER BUNDS



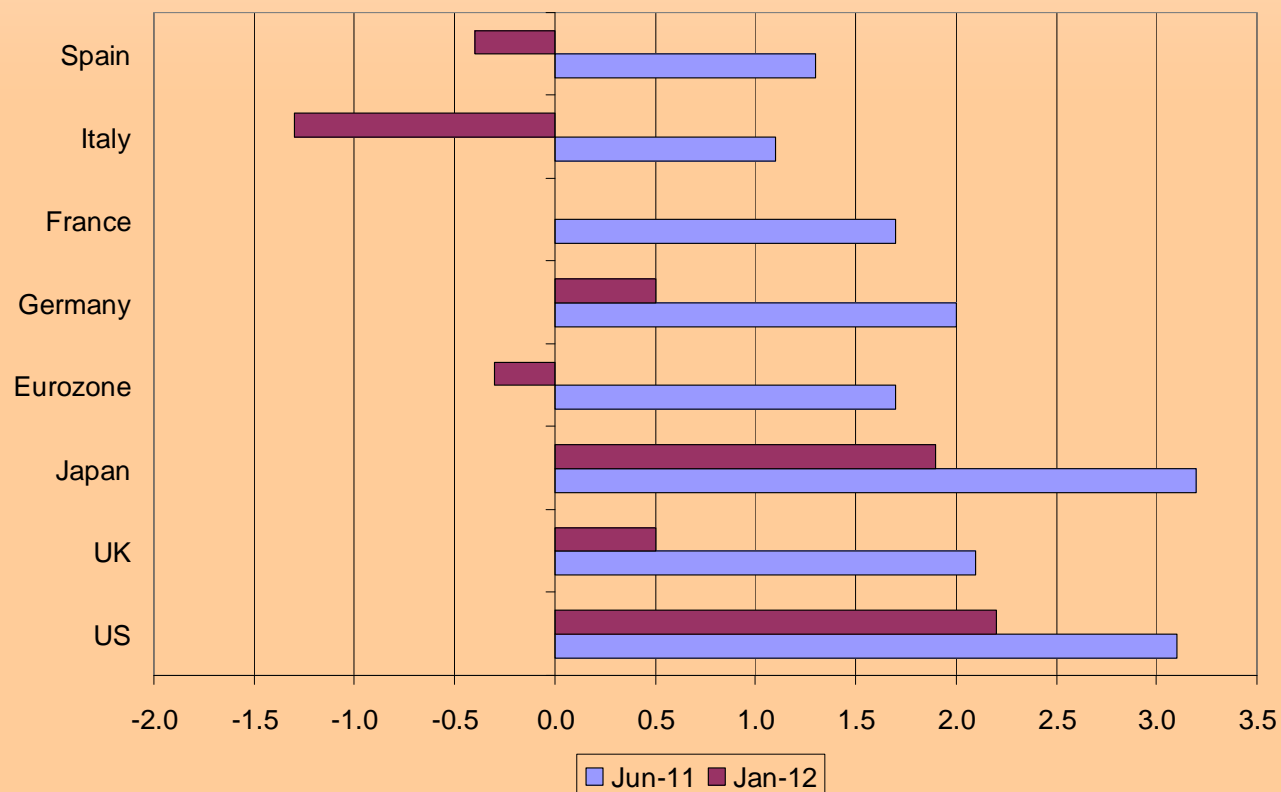
3. Prospects

- 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

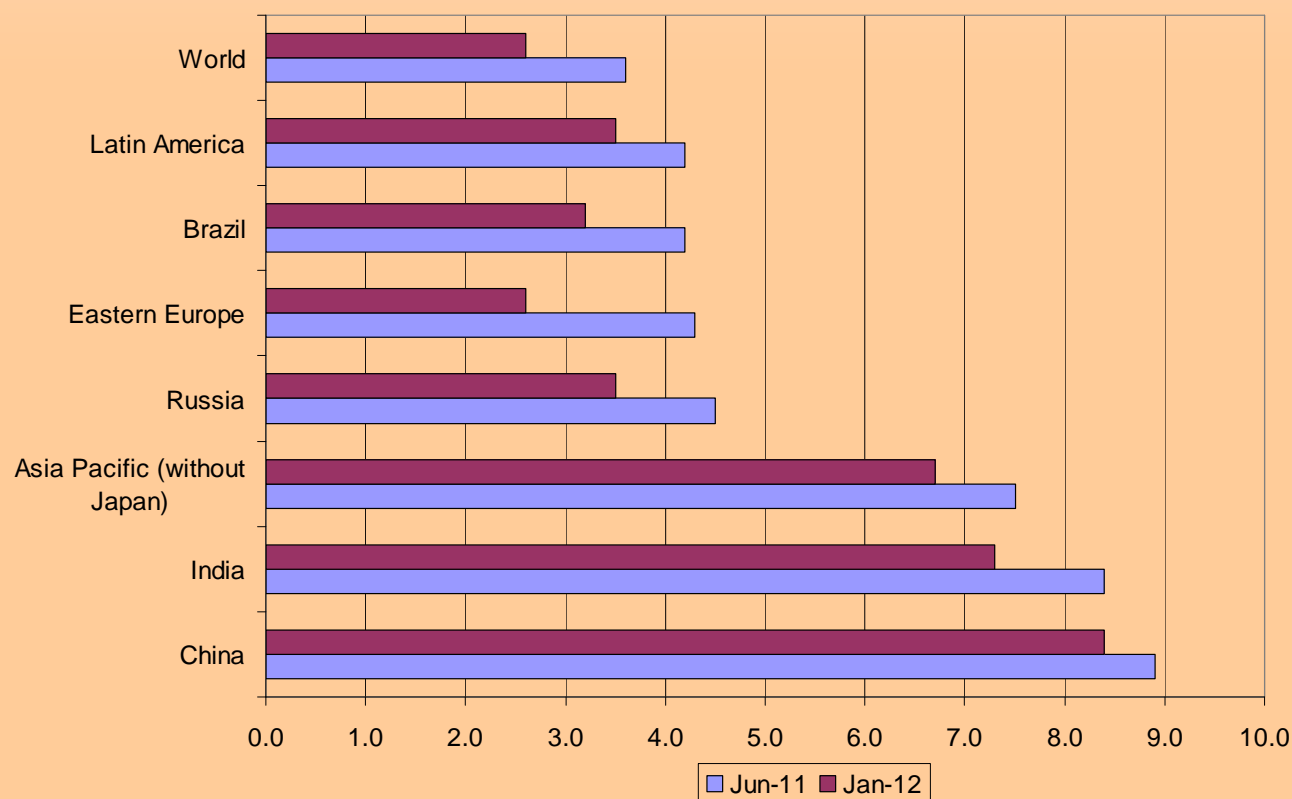
GROWTH FORECASTS FOR 2012



2. The prospects: global

GROWTH PROSPECTS DWINDLE FOR 2012

GROWTH FORECASTS FOR 2012



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.

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