

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

Global Policy Dialogue

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London School of Economics

# The shift and the shocks

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- Shift
- Shocks
- Prospects

# 1. The shift

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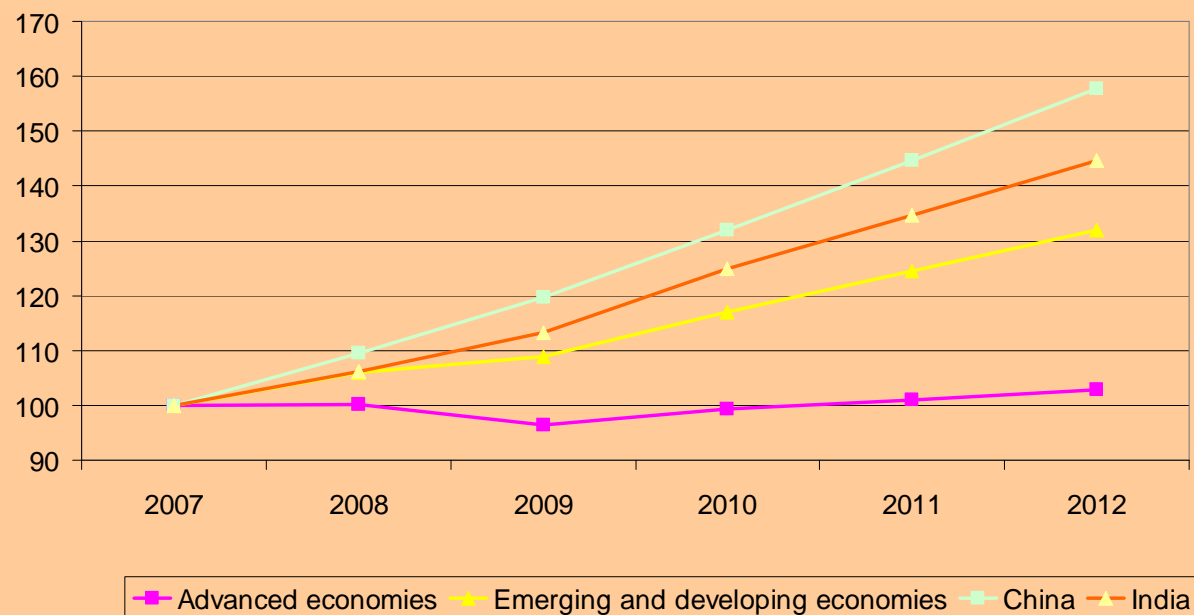
- In the 19<sup>th</sup> century, there occurred the “great divergence”
- In the second half of the 20<sup>th</sup> century, convergence began, notably with Japan and the east Asian “tiger economies”
- In the late 20<sup>th</sup> and early 21<sup>st</sup> centuries convergence spread to the Asian giants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

# 1. The shift

## EMERGING COUNTRIES OUTPERFORM HUGELY

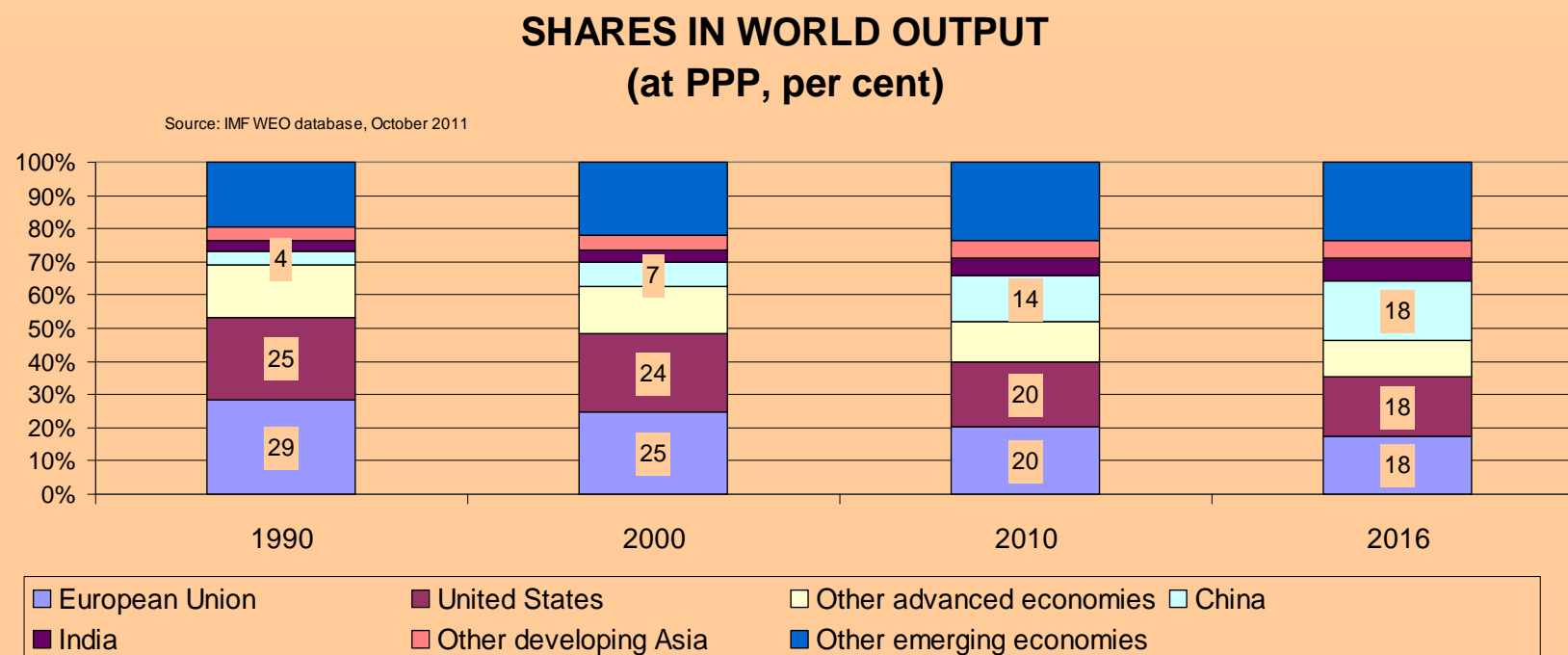
Source: IMF, WEO database

### GDP SINCE THE CRISIS



# 1. The shift

## DEVELOPED COUNTRIES FALL, ASIA RISES



# 1. The shift

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- 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

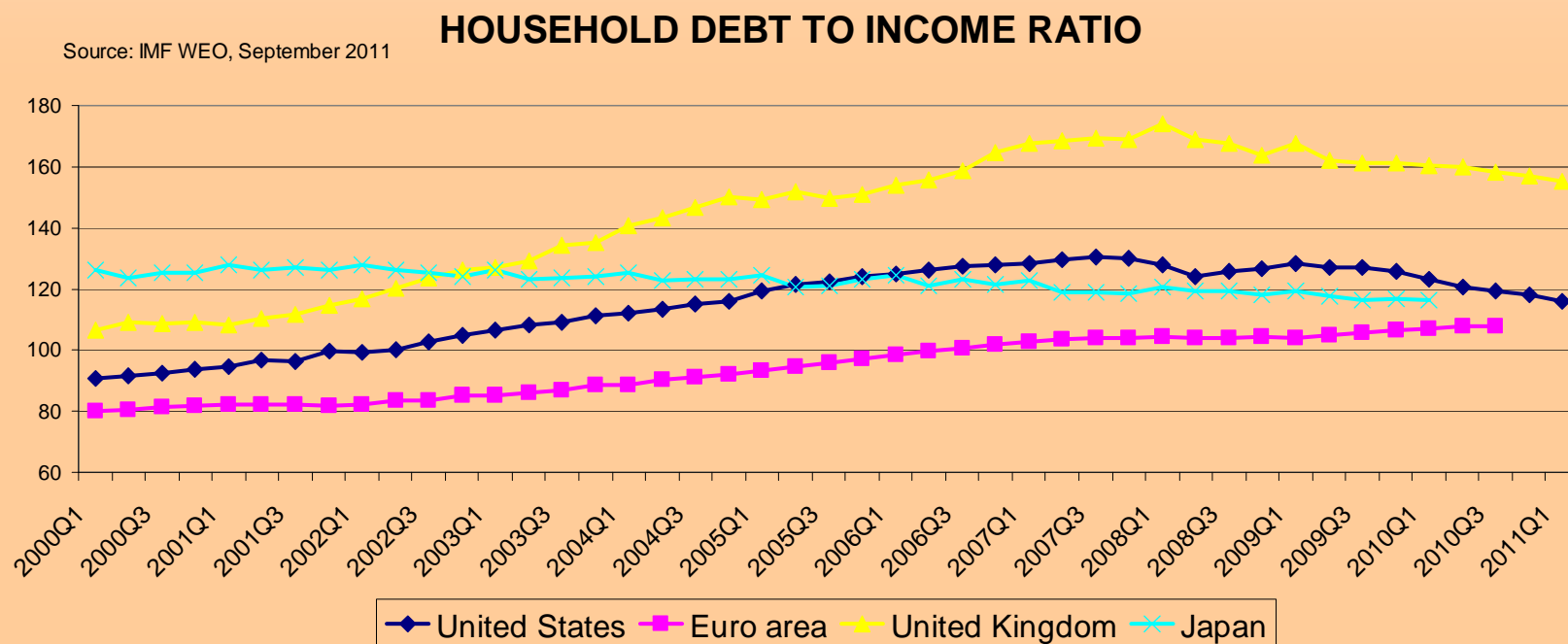
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- The economic collapse was large and enduring
- The rescue was also dramatic:
  - Liabilities of the core financial system were nationalised;
  - Monetary policy is unprecedented; and
  - Fiscal policy has been put on a war-time footing.
- This then 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

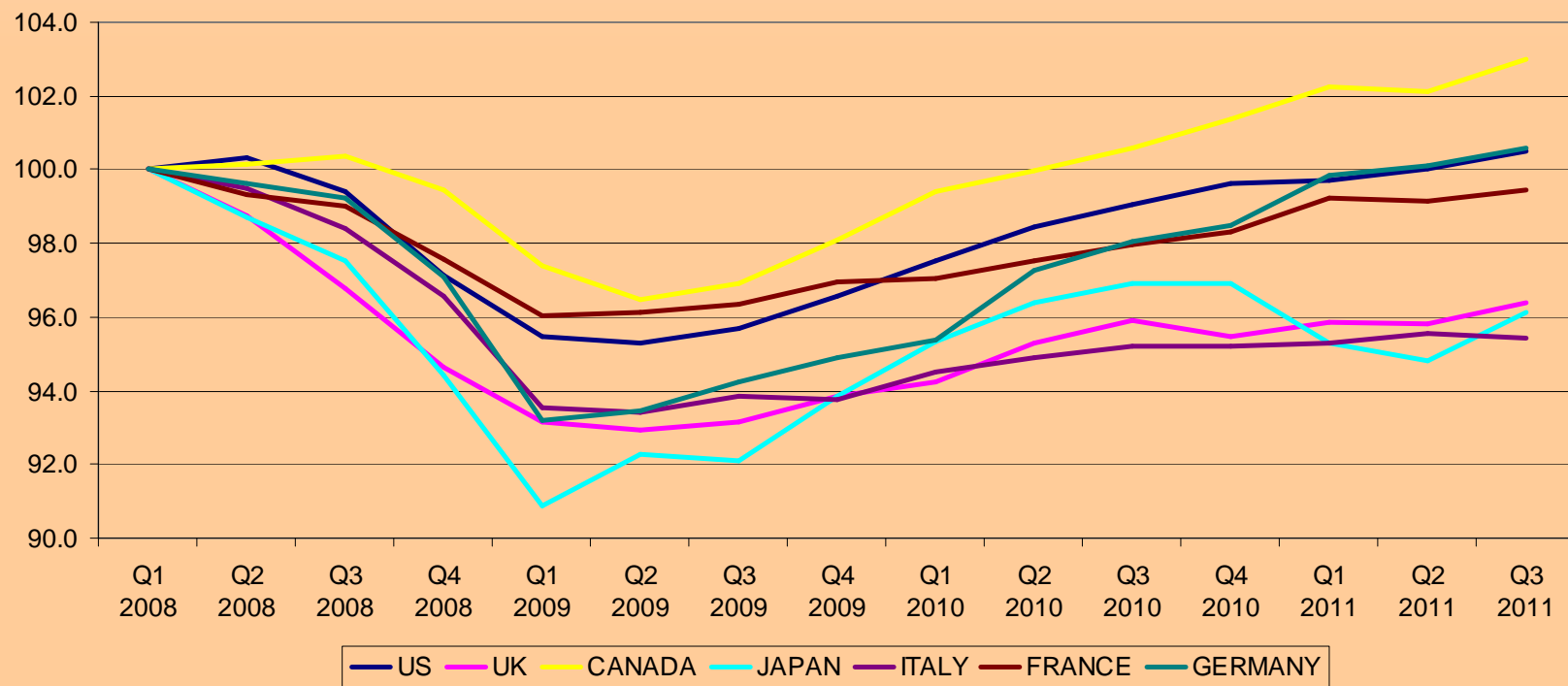
### THE LEGACY OF THE DEBT EXPLOSION



## 2. The shocks: global

### A LONG DEPRESSION

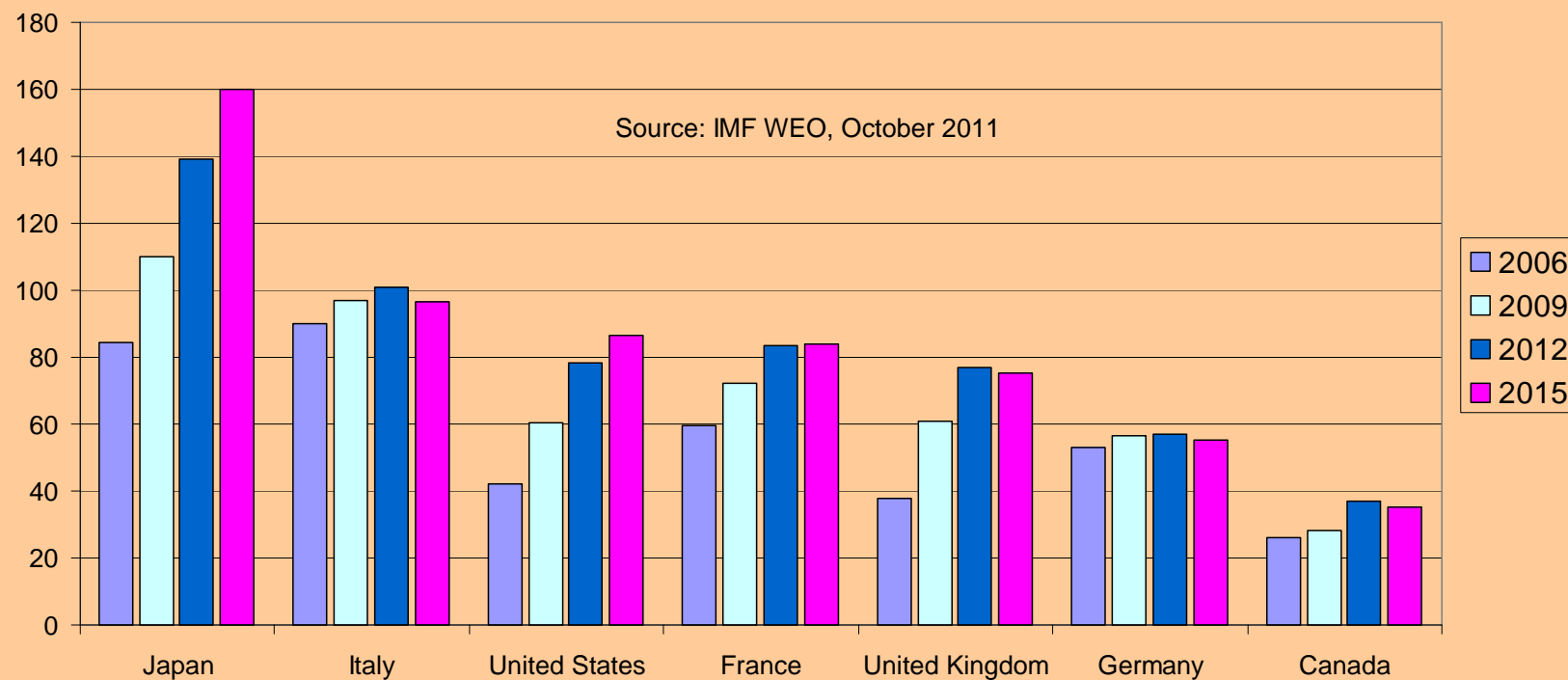
GDP IN THE GREAT RECESSION



## 2. The shocks: global

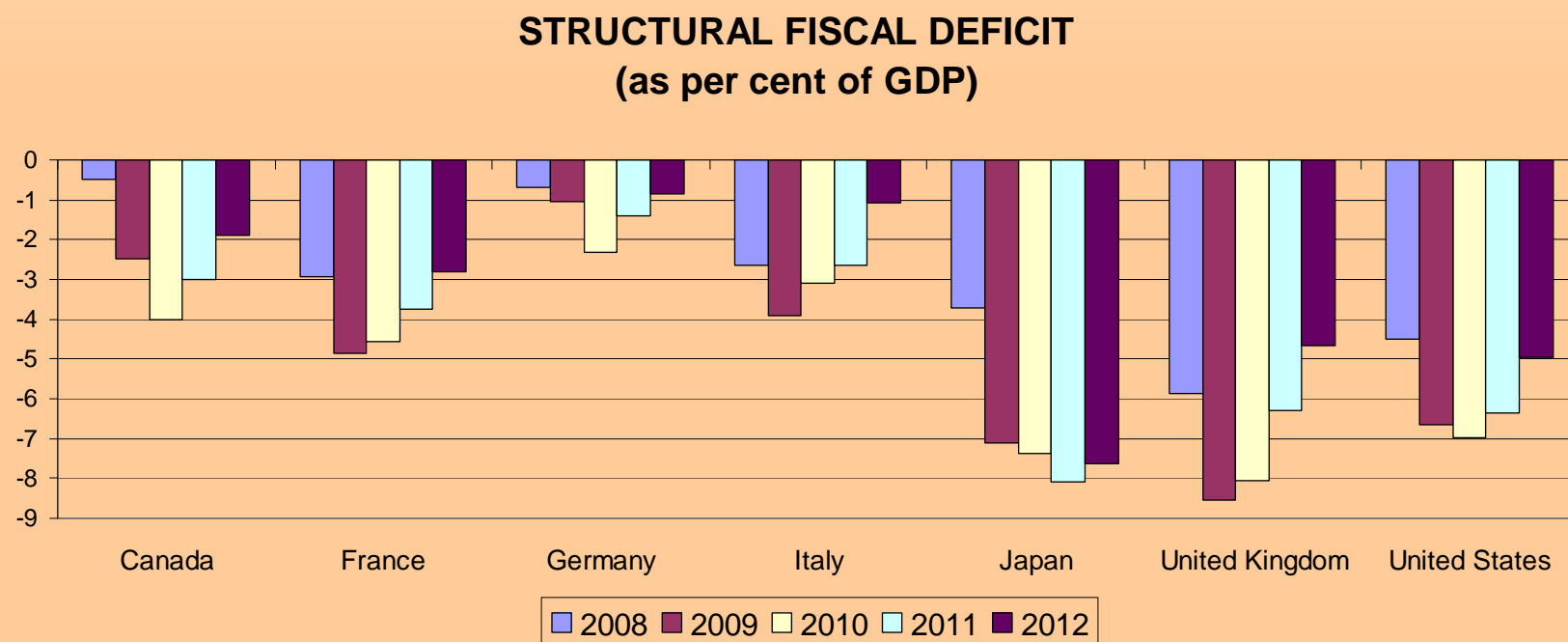
### THE SOVEREIGN DEBT CRISIS

NET PUBLIC DEBT OVER GDP (per cent)



## 2. The shocks: global

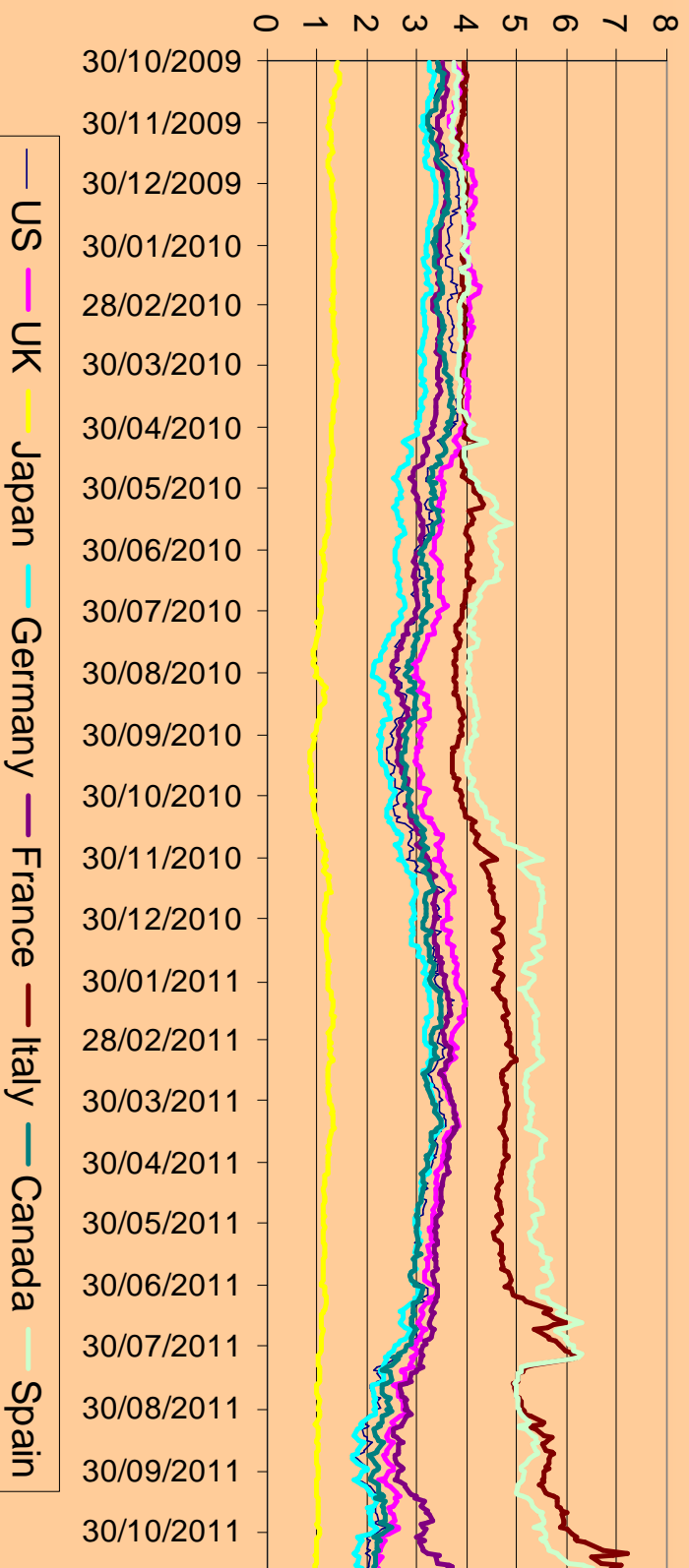
### THE AGE OF PREMATURE RETRENCHMENT



## 2. The shocks: global

### FISCAL ROOM? YES

#### TEN-YEAR GOVERNMENT BOND YIELDS



## 2. The shocks - eurozone

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- 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

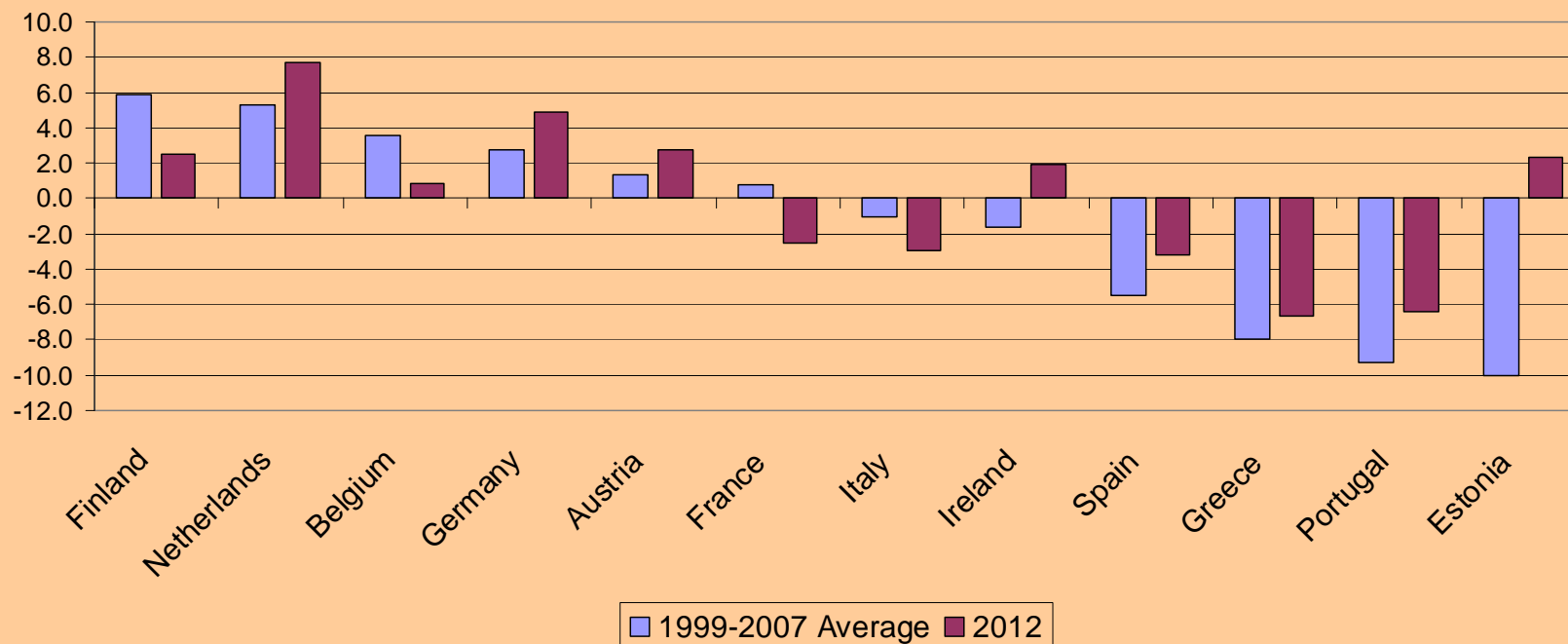
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- The difficulty is largely the result of the divergences accumulated in the years of excess
- What made everything seem so good was creating an acute long-term crisis
- The failure of a true union stands revealed: neither financing in a crisis nor 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)



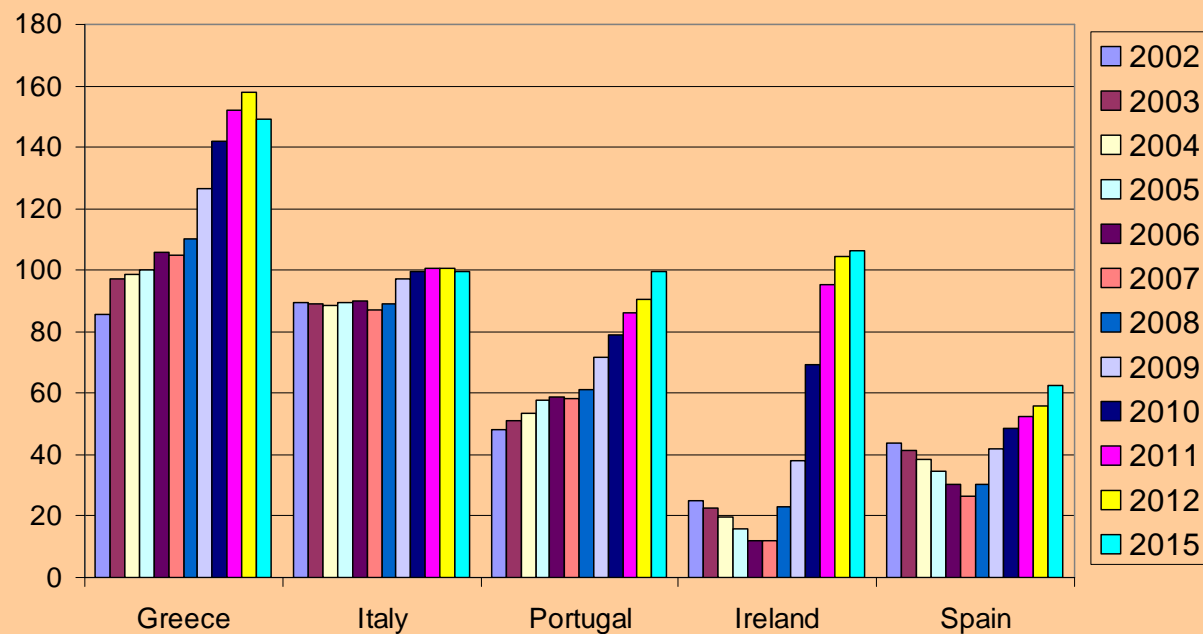


## 2. The shocks - eurozone

### ROAD TO THE EUROZONE FISCAL CRISES

#### NET PUBLIC DEBT (relative to GDP)

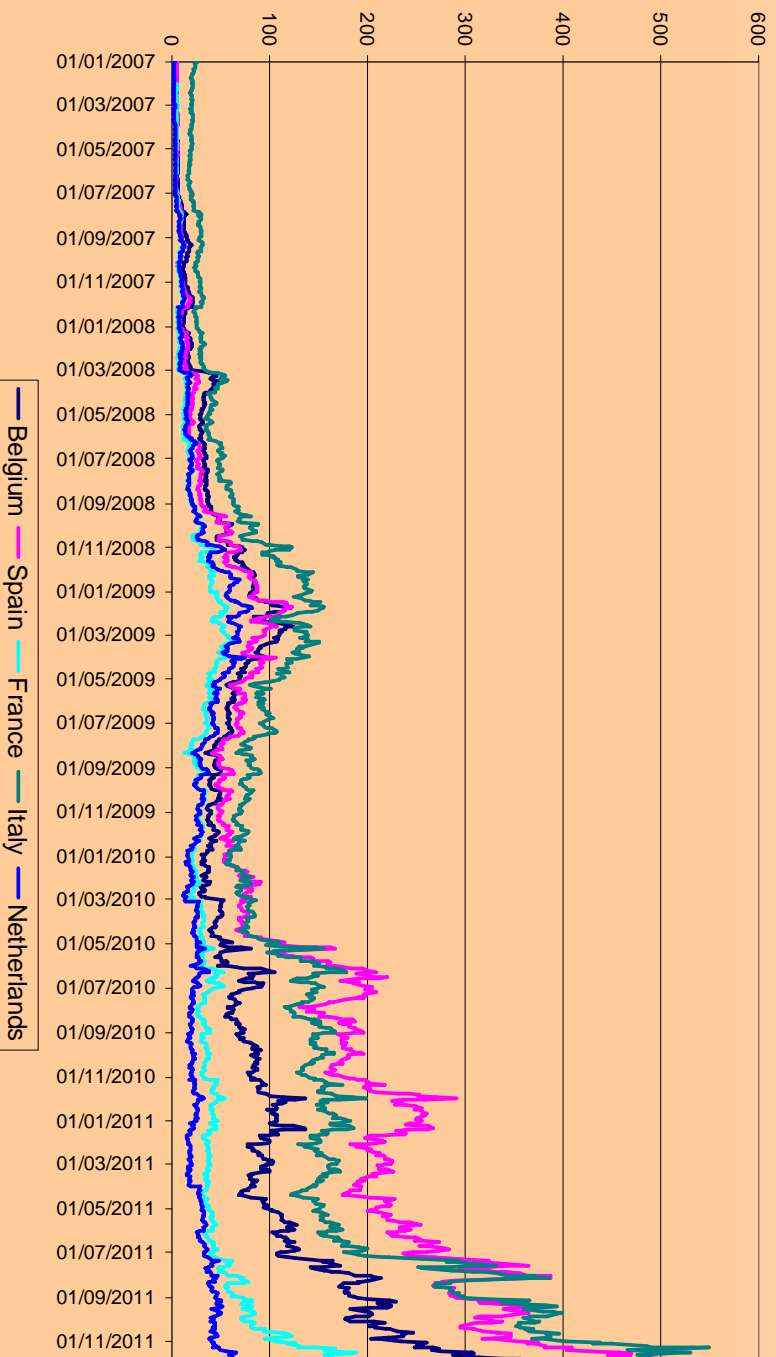
Source: World Economic Outlook database April 2011



## 2. The shocks - eurozone

### ROAD TO THE EUROZONE FISCAL CRISES

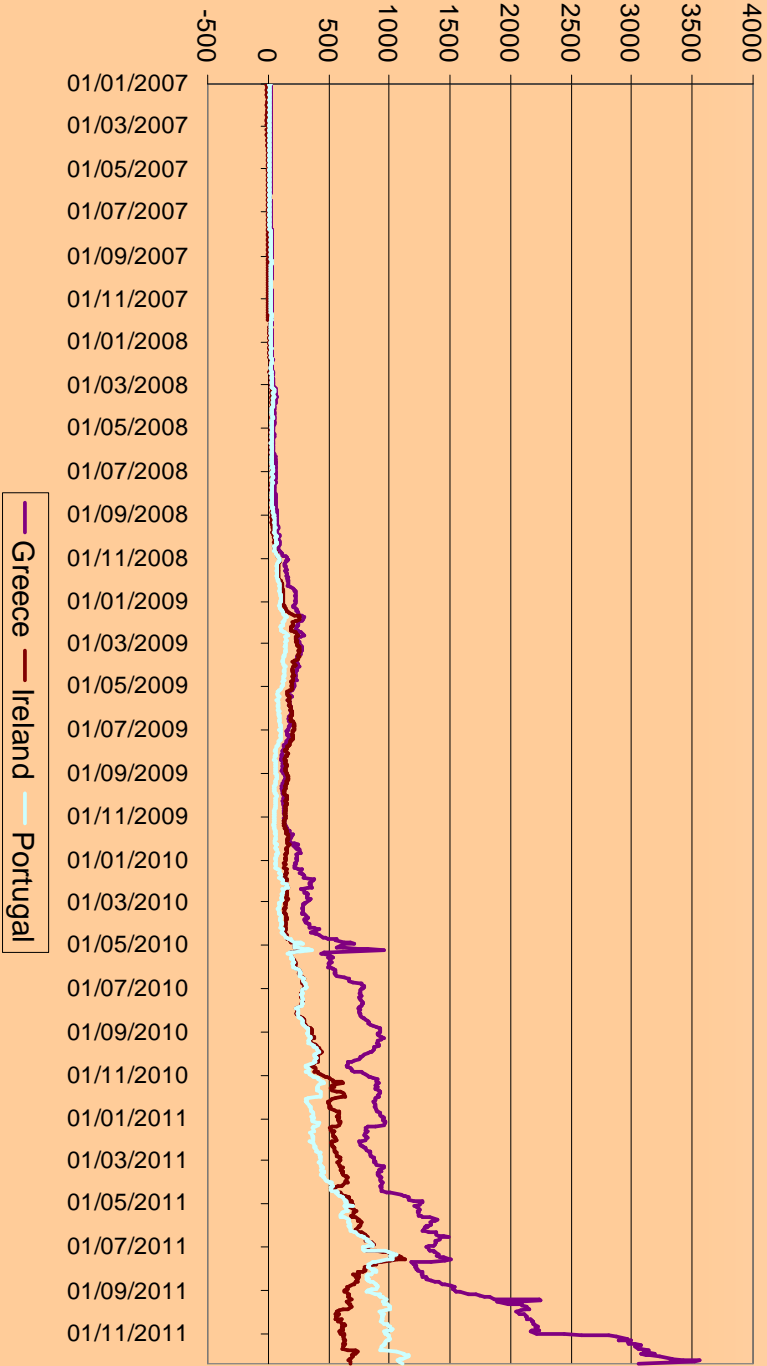
SPREADS OVER BUNDS



# 2. The shocks - eurozone

## ROAD TO THE EUROZONE FISCAL CRISES

### SPREADS OVER BUNDS



### 3. Prospects

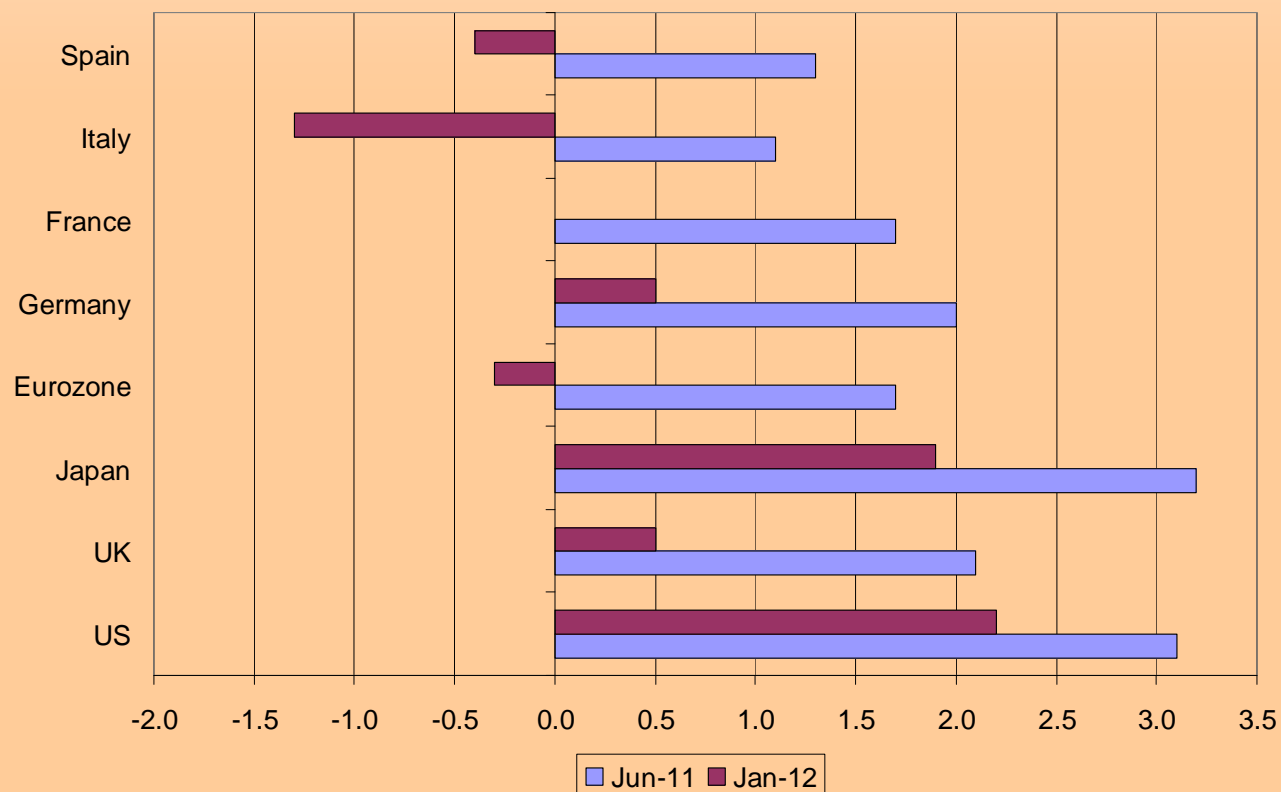
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- At the broadest level, we are watching the interaction of two huge events:
  - A secular shift in the location of economic activity; and
  - The collapse of a generational expansion in private and, to a lesser extent, public sector leverage in high-income 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

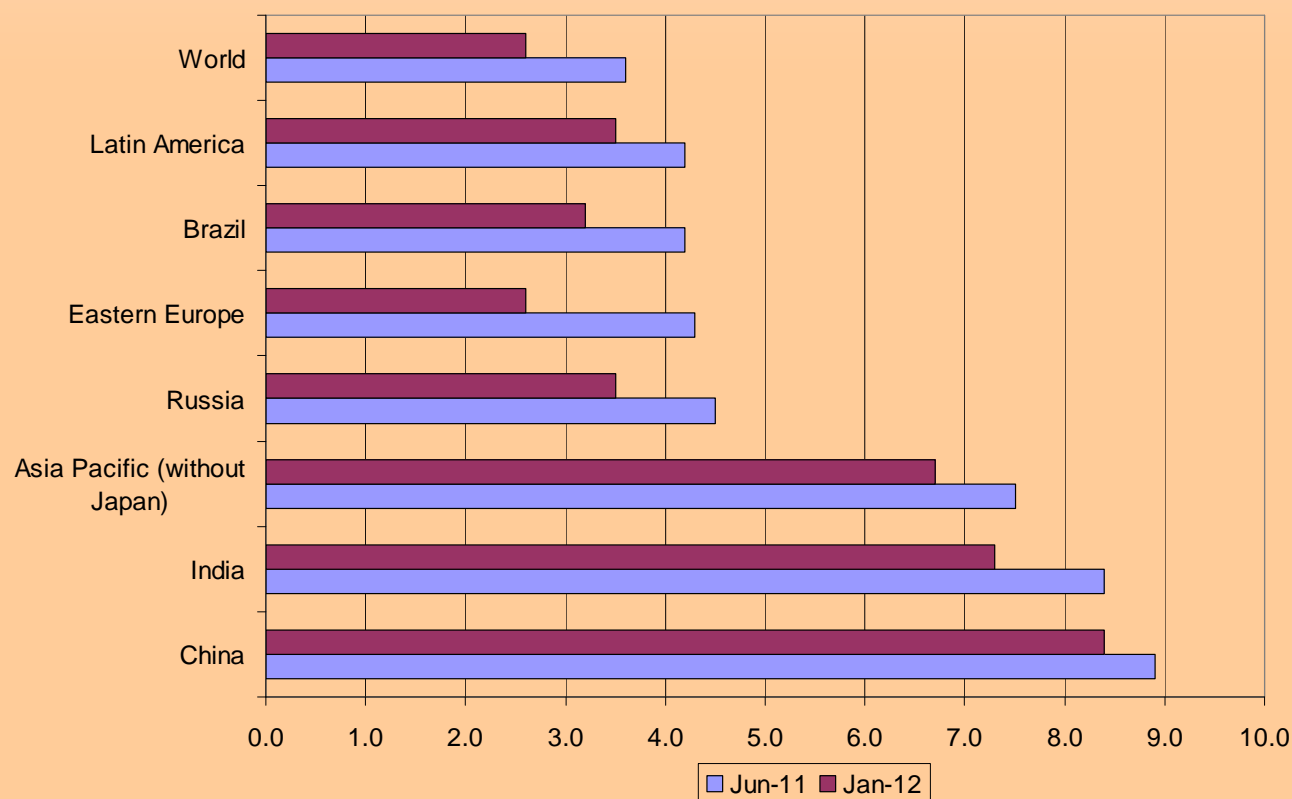
#### GROWTH FORECASTS FOR 2012



## 2. The prospects: global

### GROWTH PROSPECTS DWINDLE FOR 2012

GROWTH FORECASTS FOR 2012



### 3. Prospects: global

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- 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

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- 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

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- 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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