The State of the Global Economy

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- Changing Patterns in the Global Economy
- The Chinese Economy in the Global Context
- The Near-Term Macroeconomic Outlook of the World Economy
- Concluding Remarks

Introduction

- The global economy has been in a state of turmoil since the outbreak of the global financial crisis in 2007, beginning with the sub-prime loan crisis in the United States, and followed by the bankruptcy of Lehman Brothers in September 2008.
- And just when the global economy appeared to stabilise in 2009, the European sovereign debt crisis broke out, first in Greece, and then spread to Ireland, Portugal, Italy and Spain. The Euro Zone economies went into a recession and global trade flows declined. It took a couple of years before the Euro Zone economies began to stabilise and confidence in the long-term survival of the Euro as a major international reserve currency was restored.

Introduction

- Recovery in the U.S. slowed in part because of the European sovereign debt crisis, which reduced European demand for U.S. exports, even as the U.S. rate of interest became super-low because of combined effects of flight of capital to safe haven (the U.S.) and the successive waves of "Quantitative Easing (QE)—I, II and III", launched by the U.S. Federal Reserve Board.
- Japan, which has been stagnating since its property price bubble burst in the early 1990s, launched its own version of QE in the form of Abenomics in December 2012.
- Throughout this crisis, however, the economies of the BRICS countries (Brazil, Russia, India, China and South Africa) did reasonably well. China, in particular, was able to maintain its average annual real rate of growth above 7.5%.

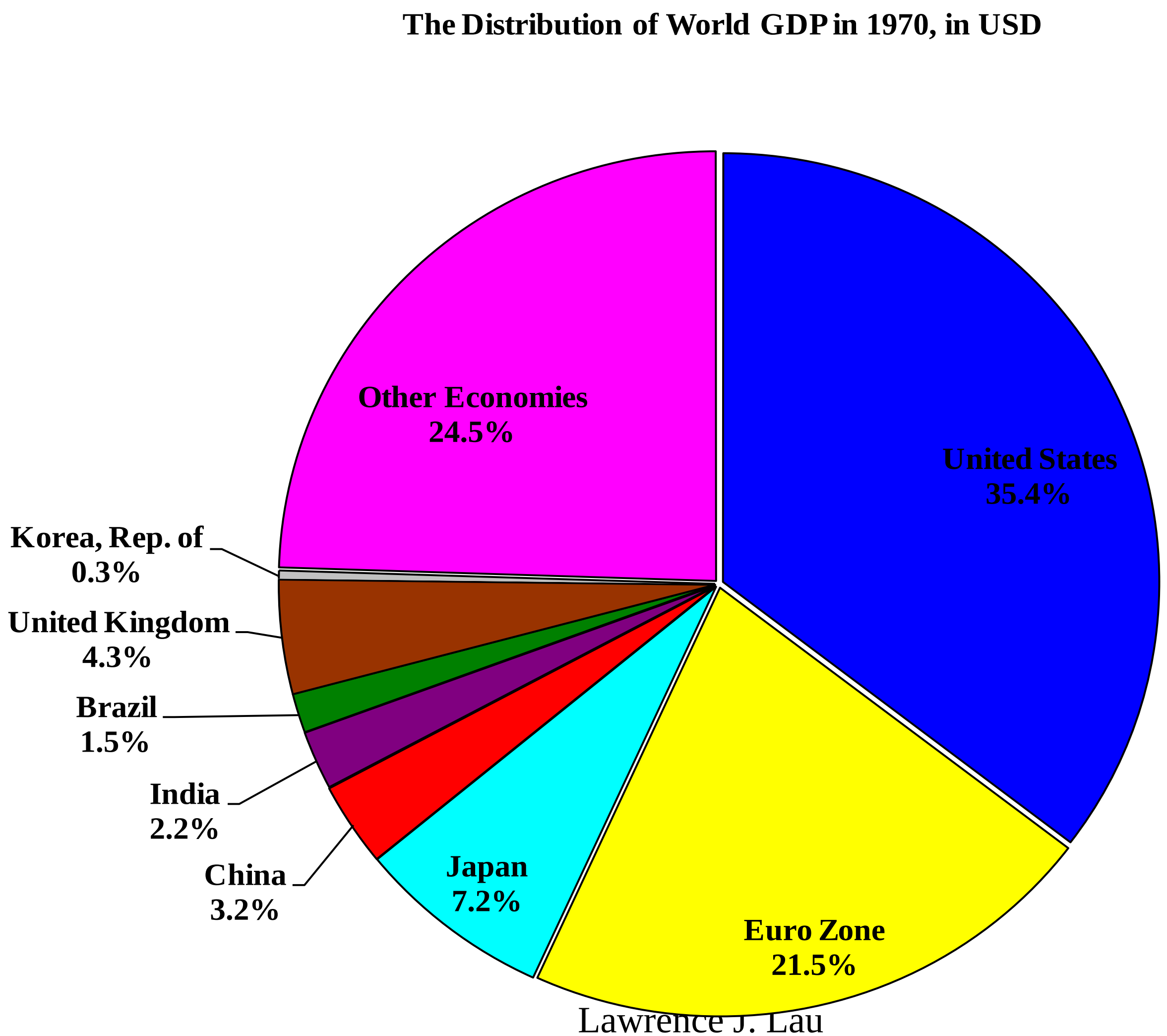
Changing Patterns in the Global Economy: The Shifting Centre of Gravity

- One important reason for the relative resilience of the Chinese and other East Asian economies is the shift, albeit gradual, of the centre of gravity of the global economy from the developed economies of North America and Europe to the economies of East Asia over the past three decades.
- This gradual shift in the centre of gravity of the global economy means that the East Asian economies have been steadily coming into their own and becoming less dependent on the developed economies, enabling a "partial de-coupling" of the East Asian economies from the developed economies of the West.
- The fact that the Chinese economy could continue to grow, albeit at a somewhat slower rate, even as the U.S. and European economies went into recession, lends credence to the "Partial De-Coupling Hypothesis".
- However, more recently, the other BRICS and East Asian economies have also begun to slow down because of the expectation of the end of QE on the part of the U.S.

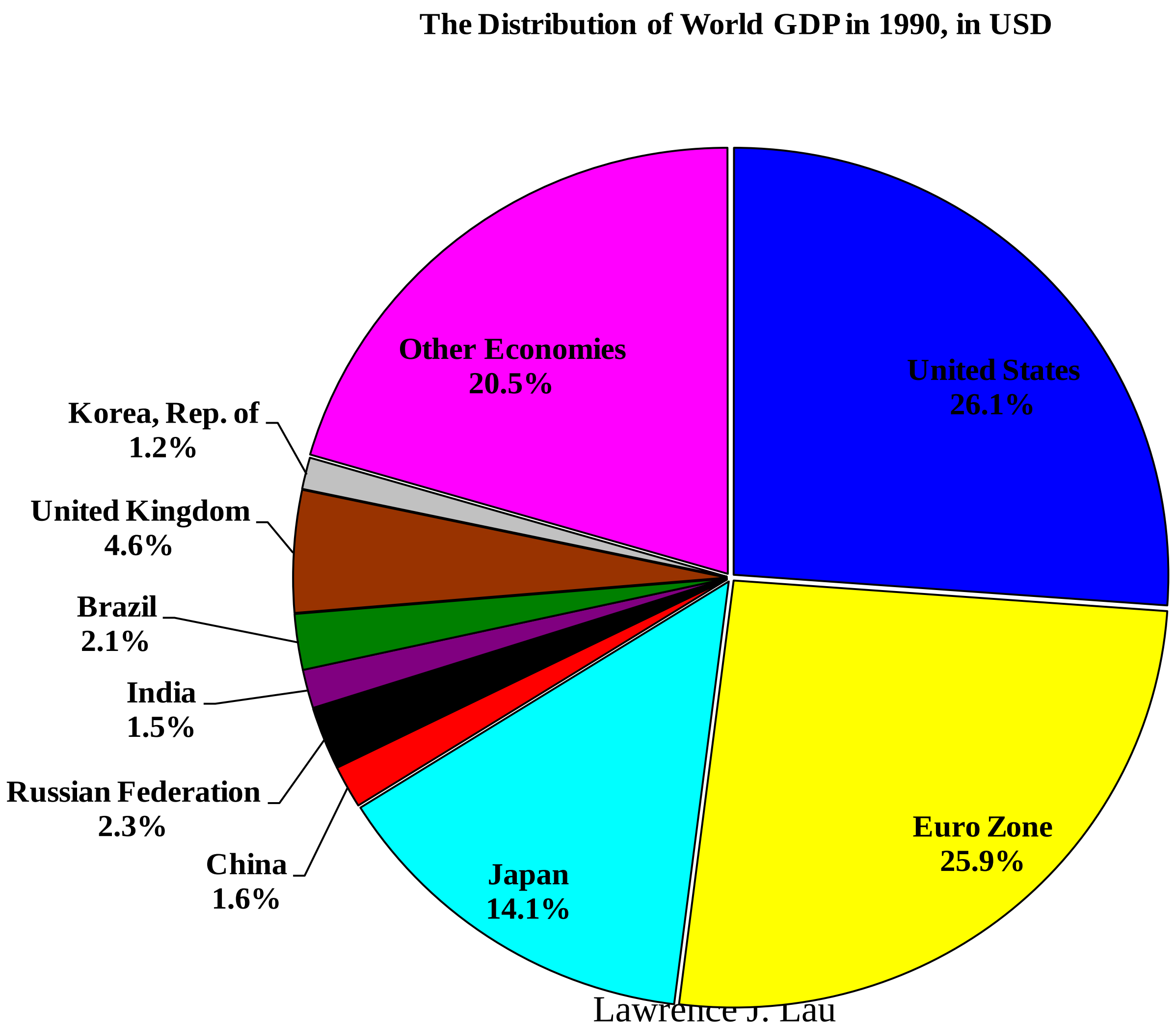
Changing Patterns in the Global Economy: GDP

- In 1970, the United States and Western Europe together accounted for over 60% of World GDP. By comparison, East Asia (defined as the 10 Association of Southeast Asian Nations (ASEAN)--Brunei, Indonesia, Cambodia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam--+ 3 (China, Japan and the Republic of Korea) and South Asia combined accounted for less than 15% of World GDP.
- In 1990, the United States and Western Europe together still accounted for over 55% of World GDP while East Asia and South Asia combined accounted for not quite 20% of World GDP.
- By 2012, the share of United States and Western Europe in World GDP has declined to approximately 45% whereas the share of East Asia and South Asia have risen to 30%.

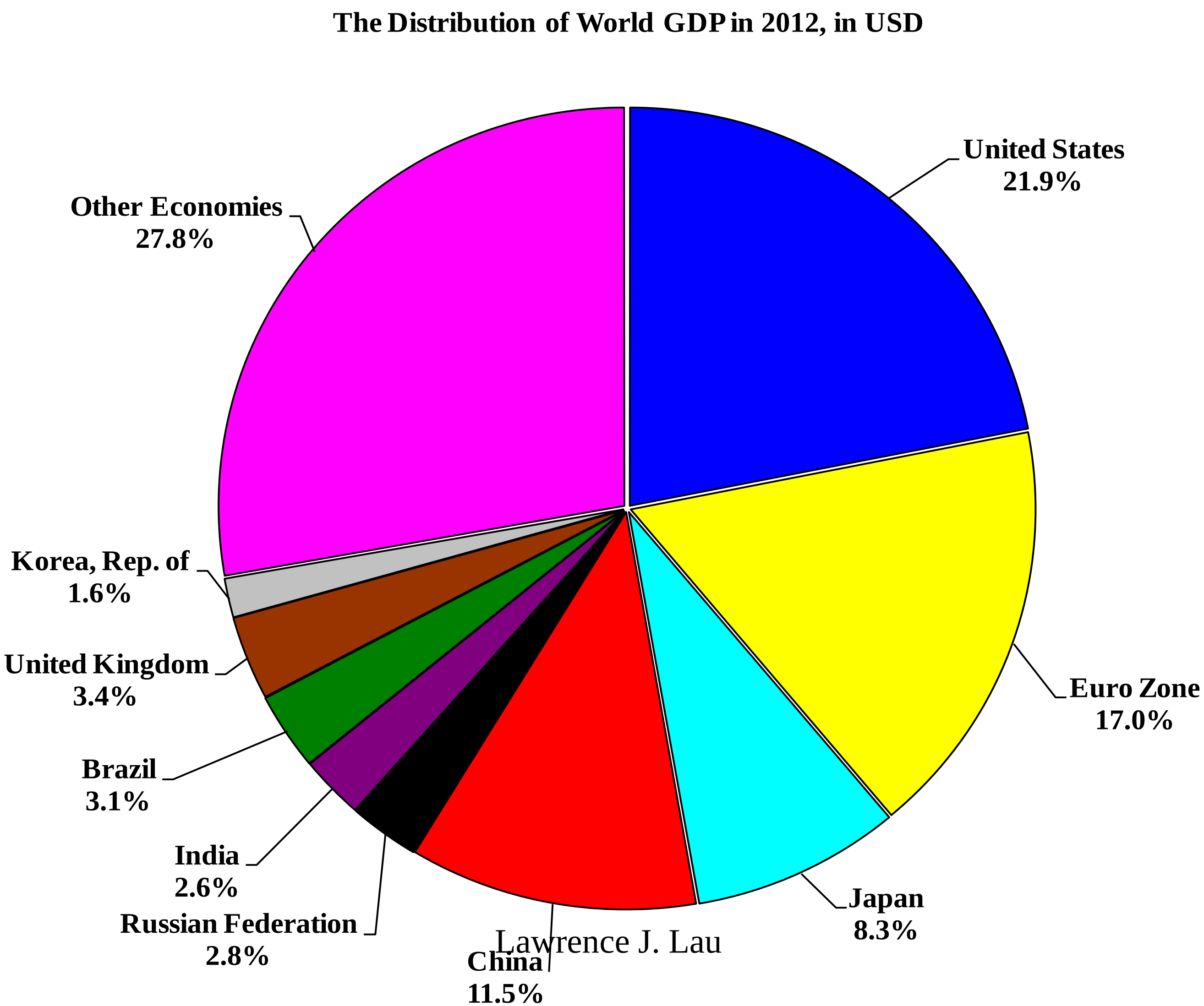
The Distribution of World GDP, 1970, US$



The Distribution of World GDP, 1990, US$



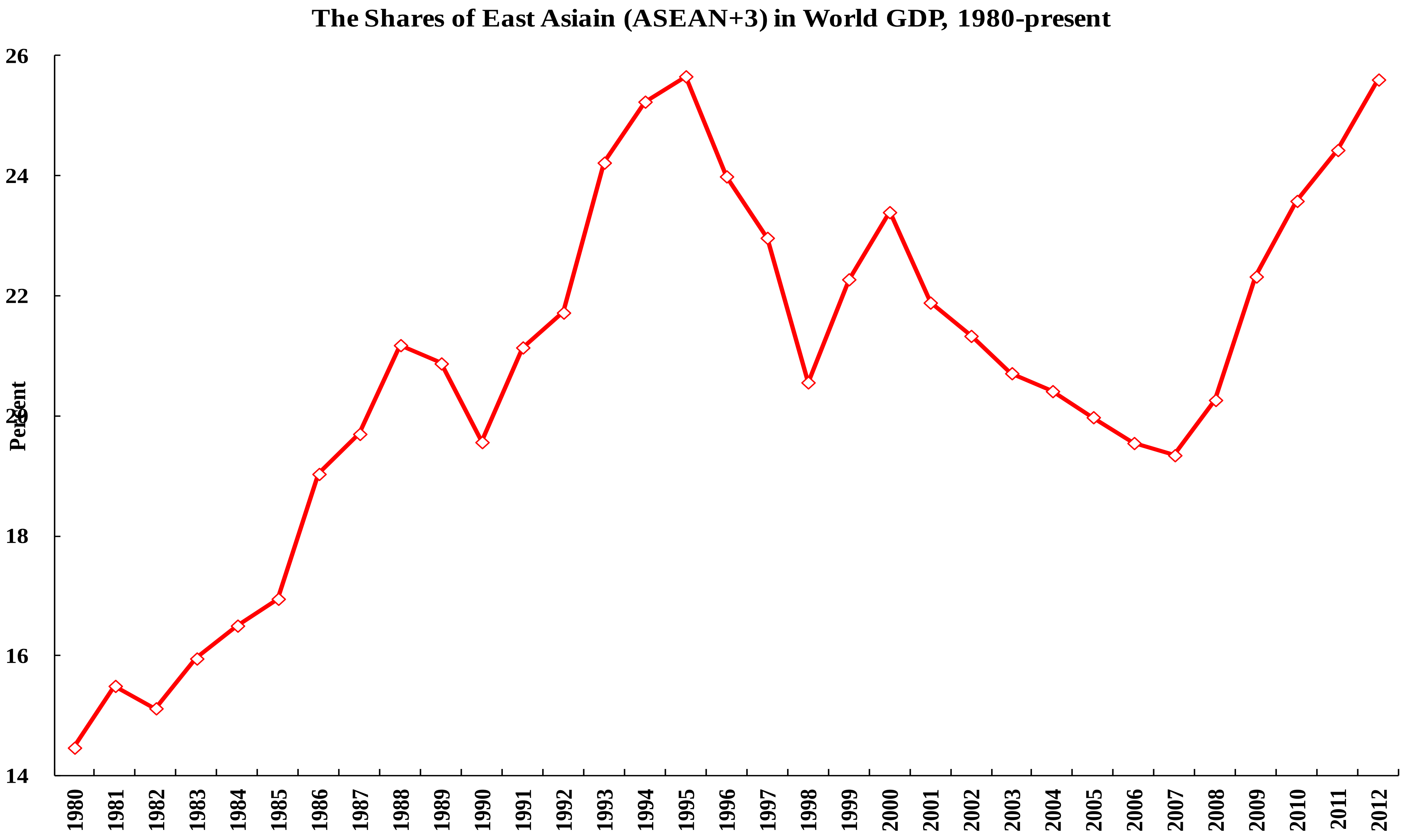
The Distribution of World GDP, 2012, US$



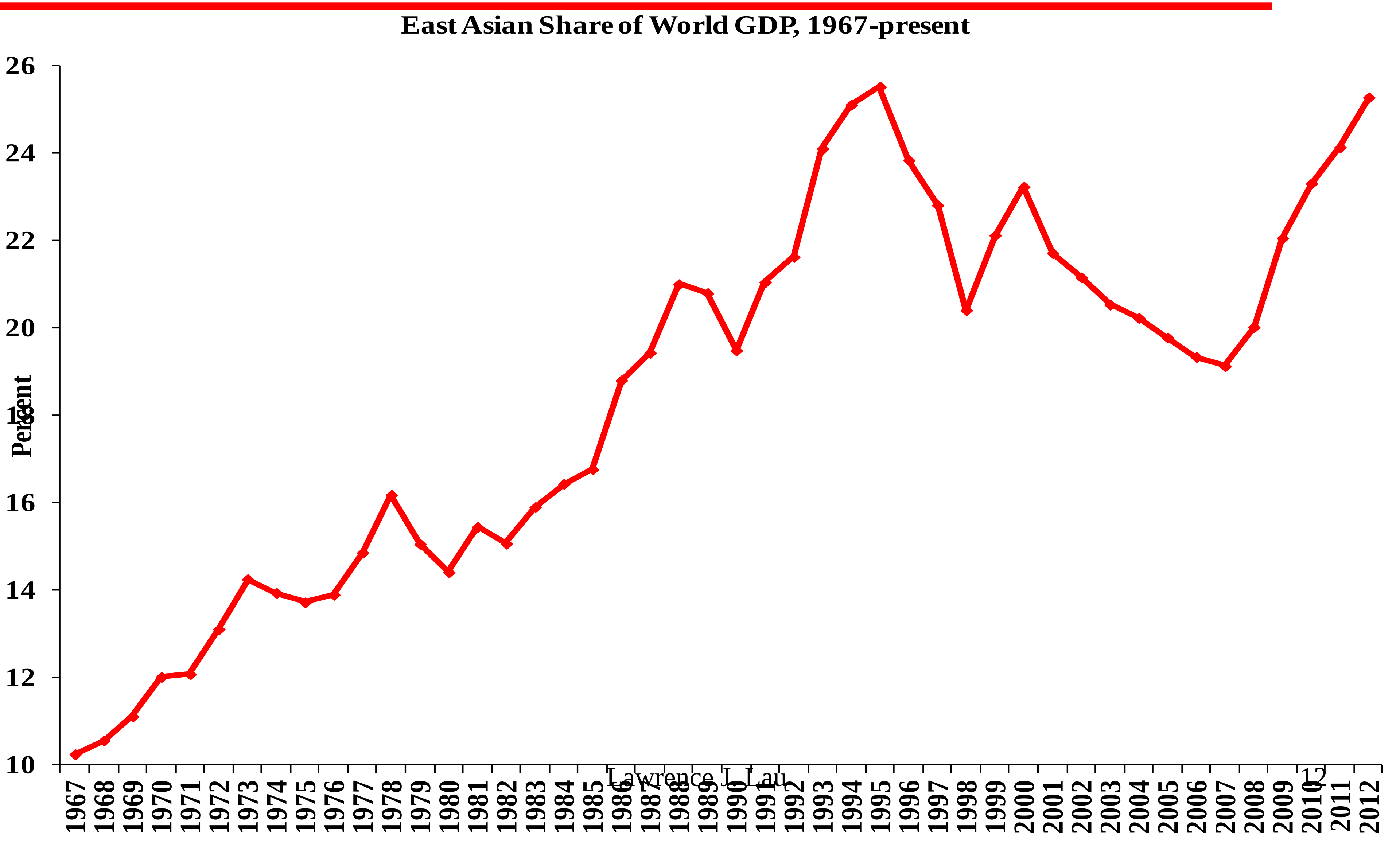
Changing Patterns in the Global Economy: GDP

- The East Asian (defined as the 10 Association of Southeast Asian Nations (ASEAN) + 3 (China, Japan and the Republic of Korea) share of World GDP rose from just above 10% in 1970 to approximately 25% in 2012.
- The Chinese share of World GDP alone rose from 3% in 1970 and only 4% in 2000 to over 11% in 2012.

East Asian (ASEAN+3) Share of World GDP, current prices, 1980-present

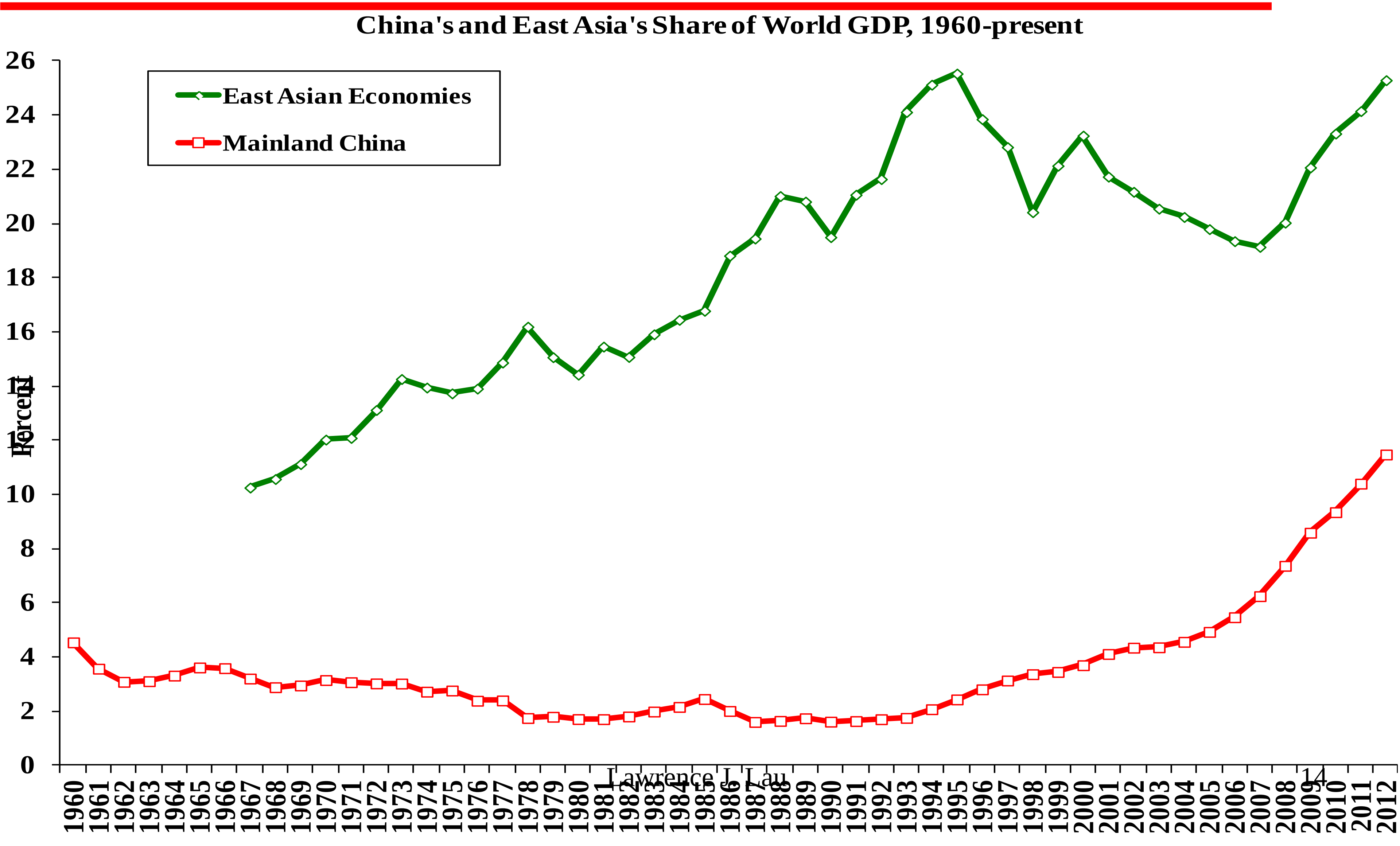


East Asian Share of World GDP, current prices, 1960-present



China's Share of World GDP, current prices, 1960-present

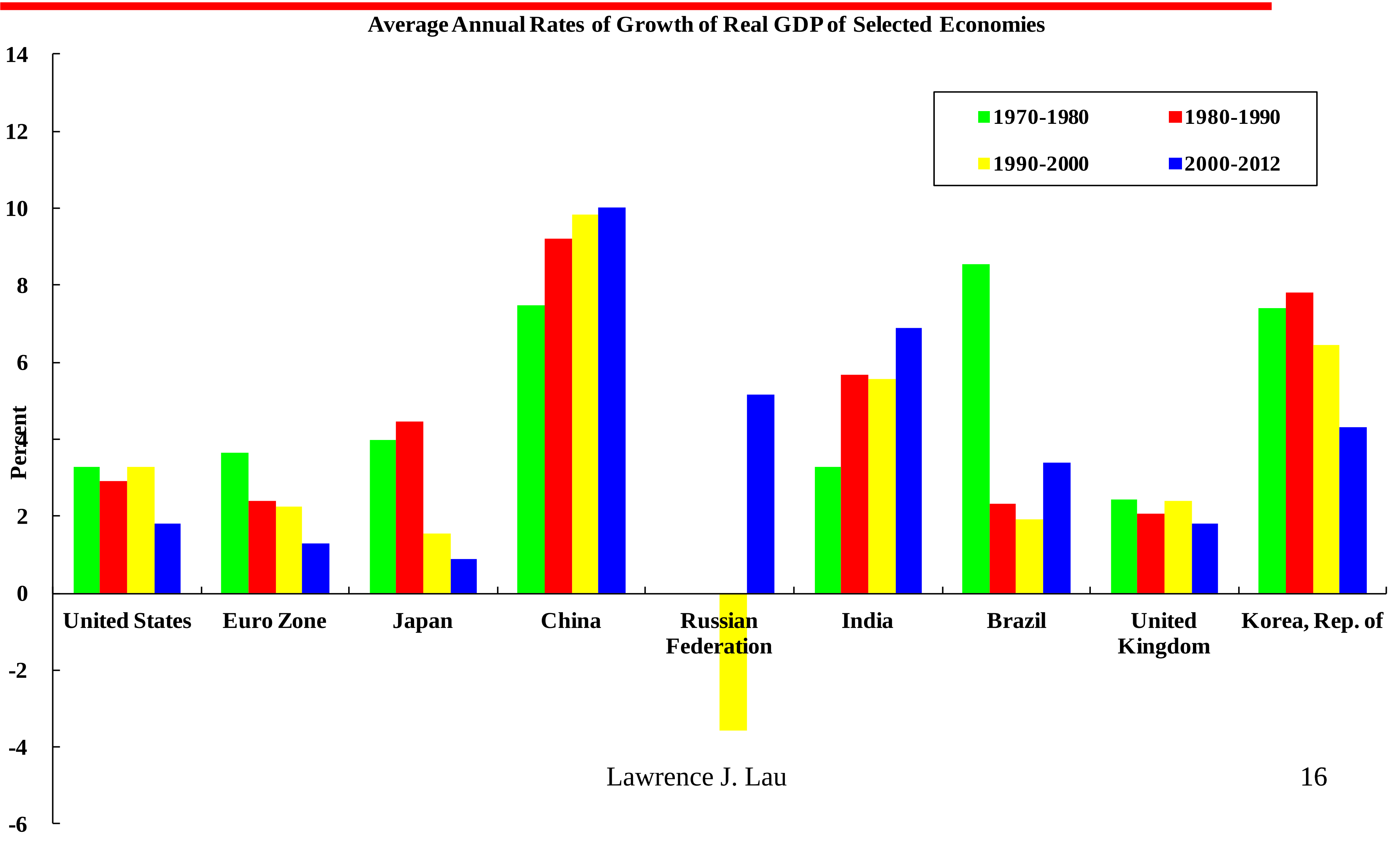
China and East Asia's Share of World GDP, 1960-present (Current Prices)



Changing Patterns in the Global Economy: Economic Growth

- China, India and South Korea are among the fastest growing economies during the past four decades.
- Russia has also grown at a very high rate during the past decade because of its significant oil production and high oil prices.
- Brazil has also grown very fast during the past decade because of the world natural resource boom.
- However, all the developed economies—the U.S., Euro Zone, Japan, and the U.K.—had relatively low and declining growth rates during the past decades. Even though there are now early signs of a steady economic recovery, the rates of growth have remained low by the historical standards of these economies.

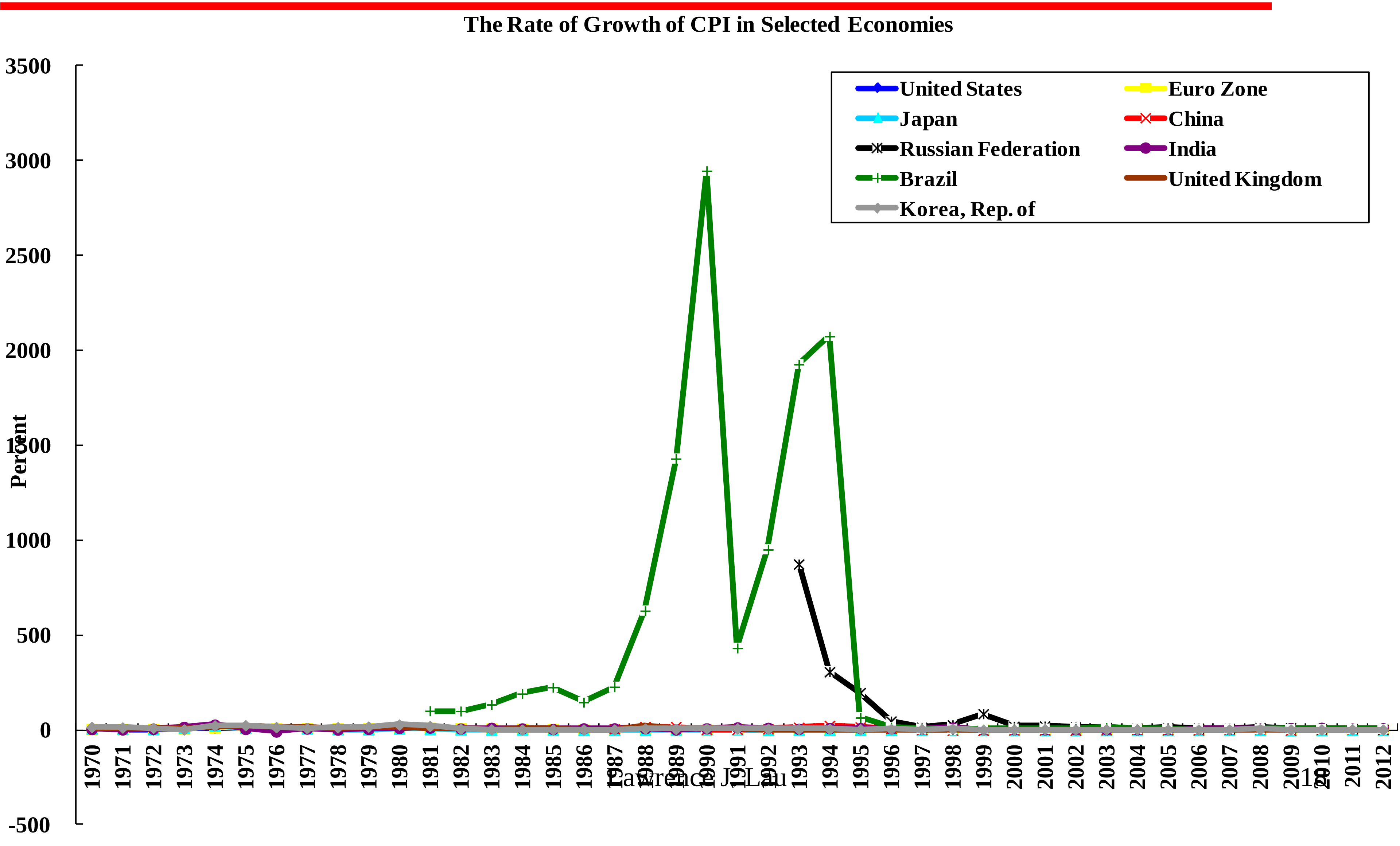
Average Annual Rates of Growth of Real GDP of Selected Economies



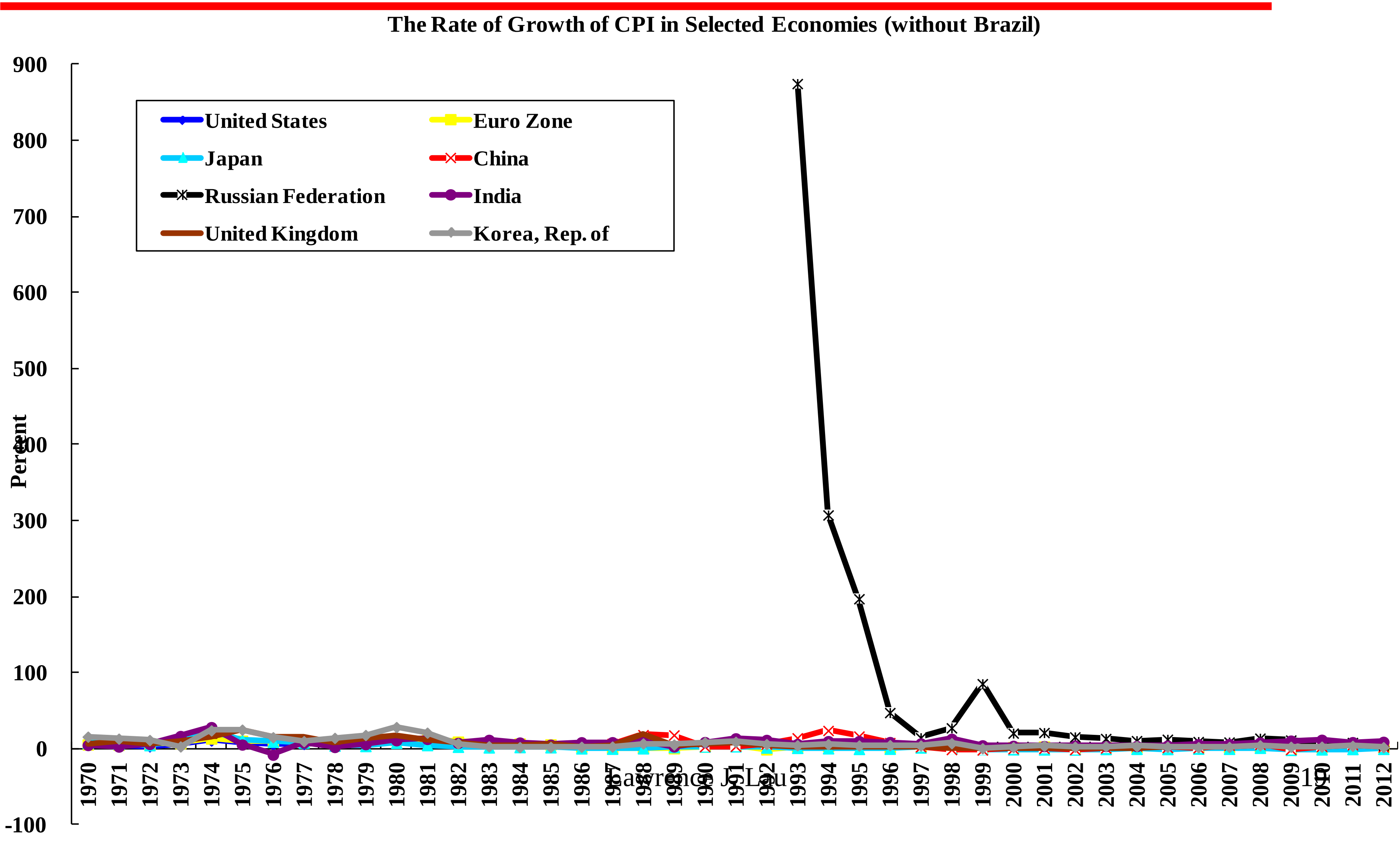
Changing Patterns in the Global Economy: Inflation

- The rate of global inflation has on the whole declined significantly over the past few years.
- Both Brazil and Russia experienced hyper-inflation of the order of 1,000% a year in the 1990s. Even China had a couple of years of double-digit inflation in the 1990s.
- The rate of inflation has come down for both major developed and developing economies in recent years, with the possible exception of India.

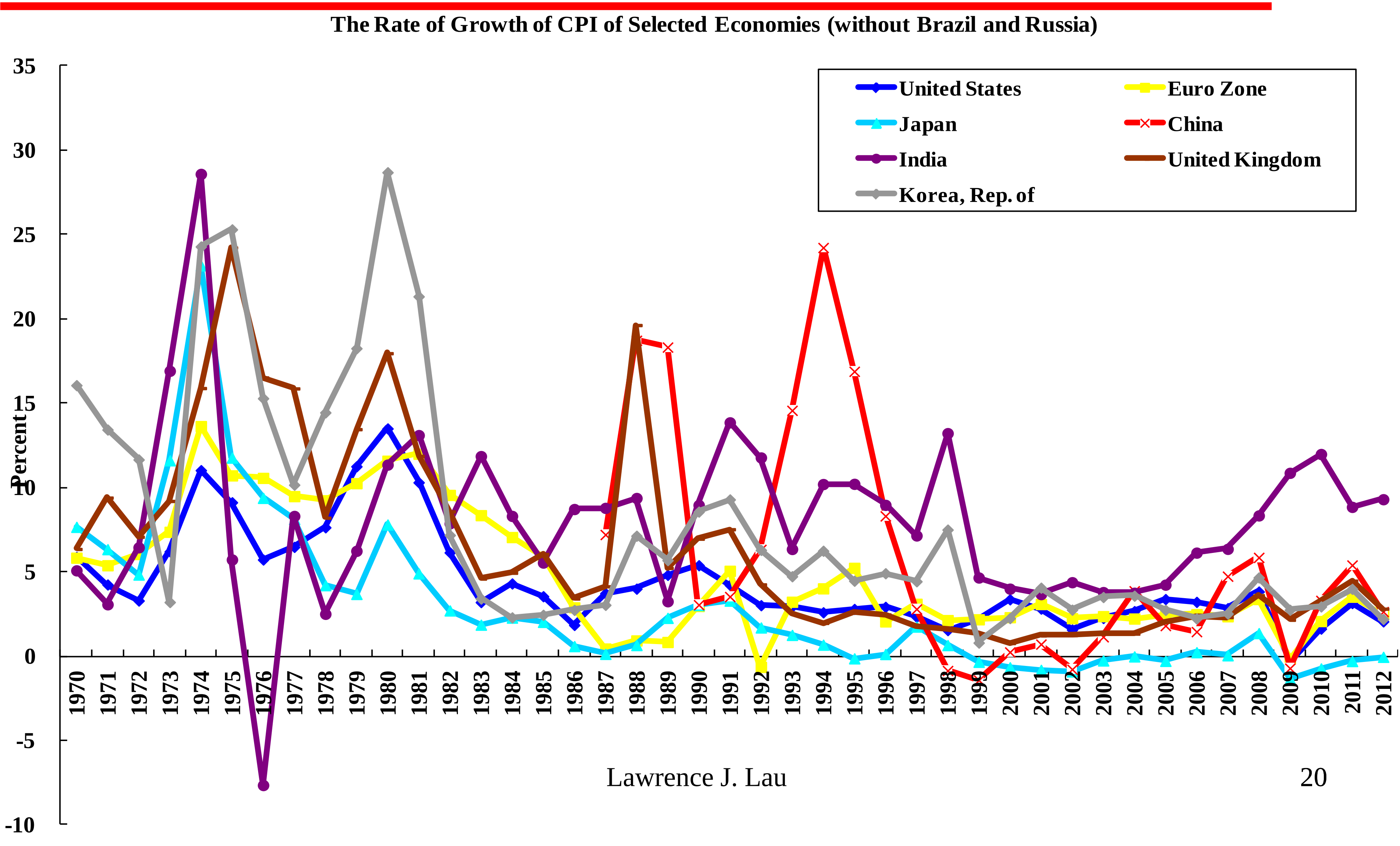
The Rate of Inflation in Selected Economies



The Rate of Inflation in Selected Economies (without Brazil)



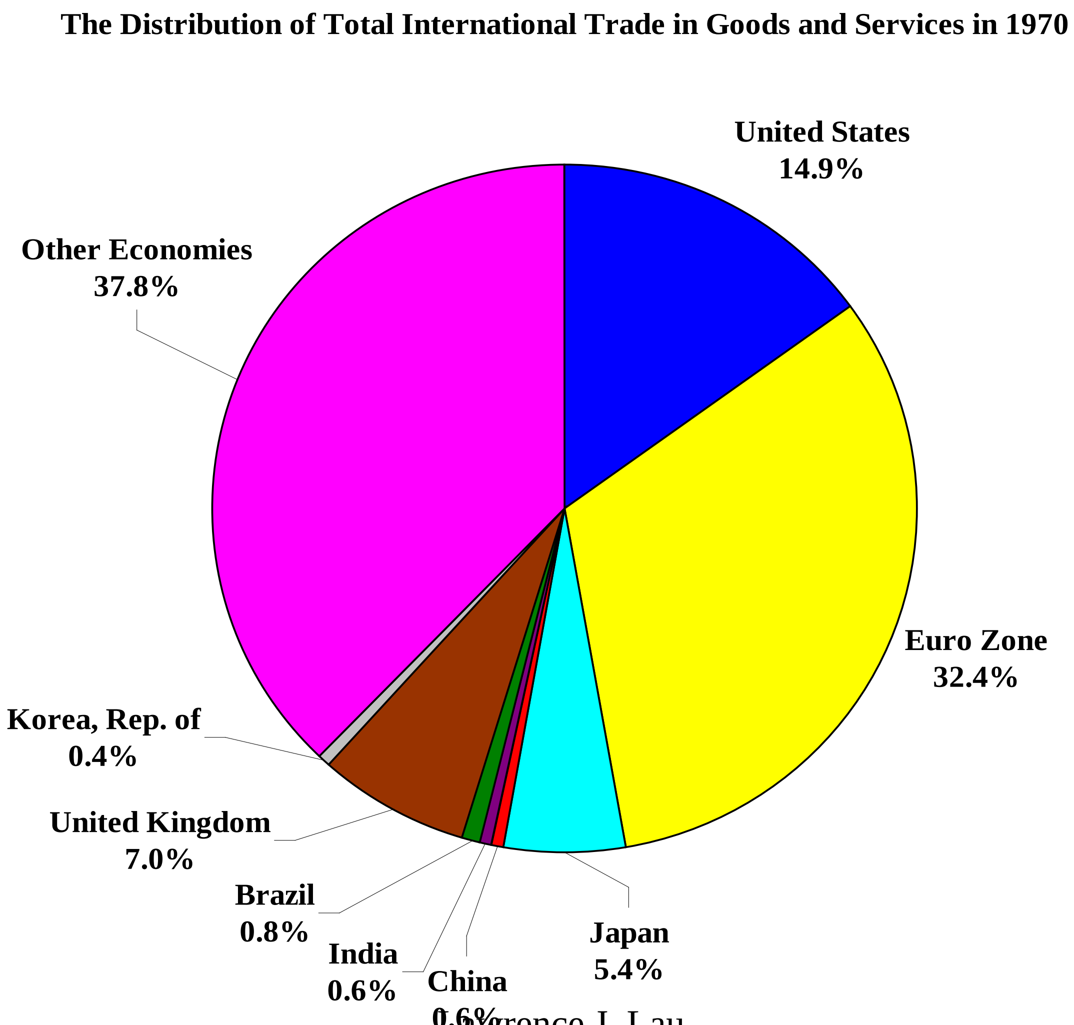
The Rate of Inflation in Selected Economies (without Brazil and Russia)



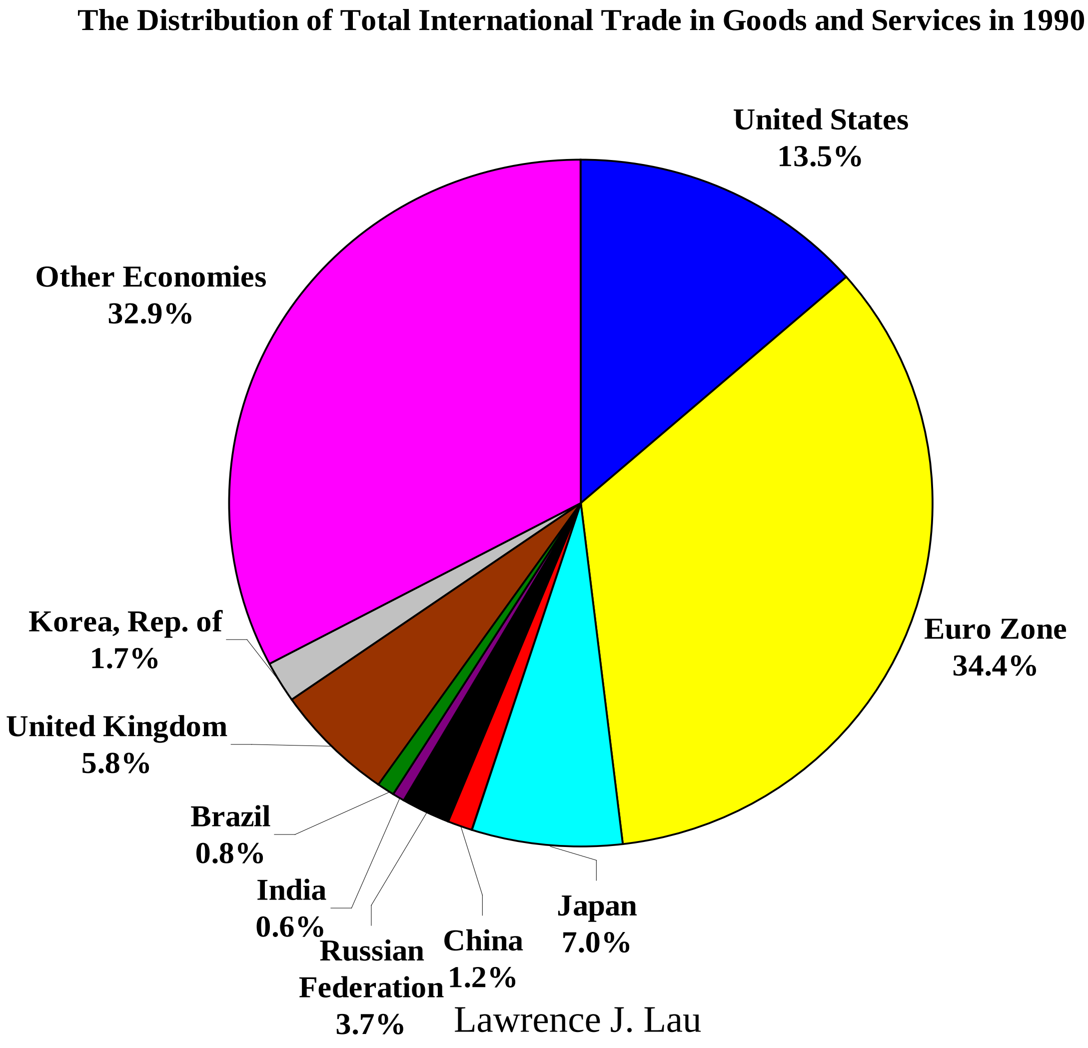
Changing Patterns in the Global Economy: International Trade

- In 1970, the United States and Western Europe together accounted for over 60% of World trade. By comparison, East Asia and South Asia combined accounted for less than 10% of World trade.
- In 1990, the United States and Western Europe together still accounted for approximately 55% of World trade while East Asia and South Asia combined accounted for just over 10% of World trade.
- By 2011, the share of United States and Western Europe in World trade has declined to below 45% whereas the share of East Asia and South Asia has risen to 30%.

The Distribution of Total International Trade in Goods and Services, 1970

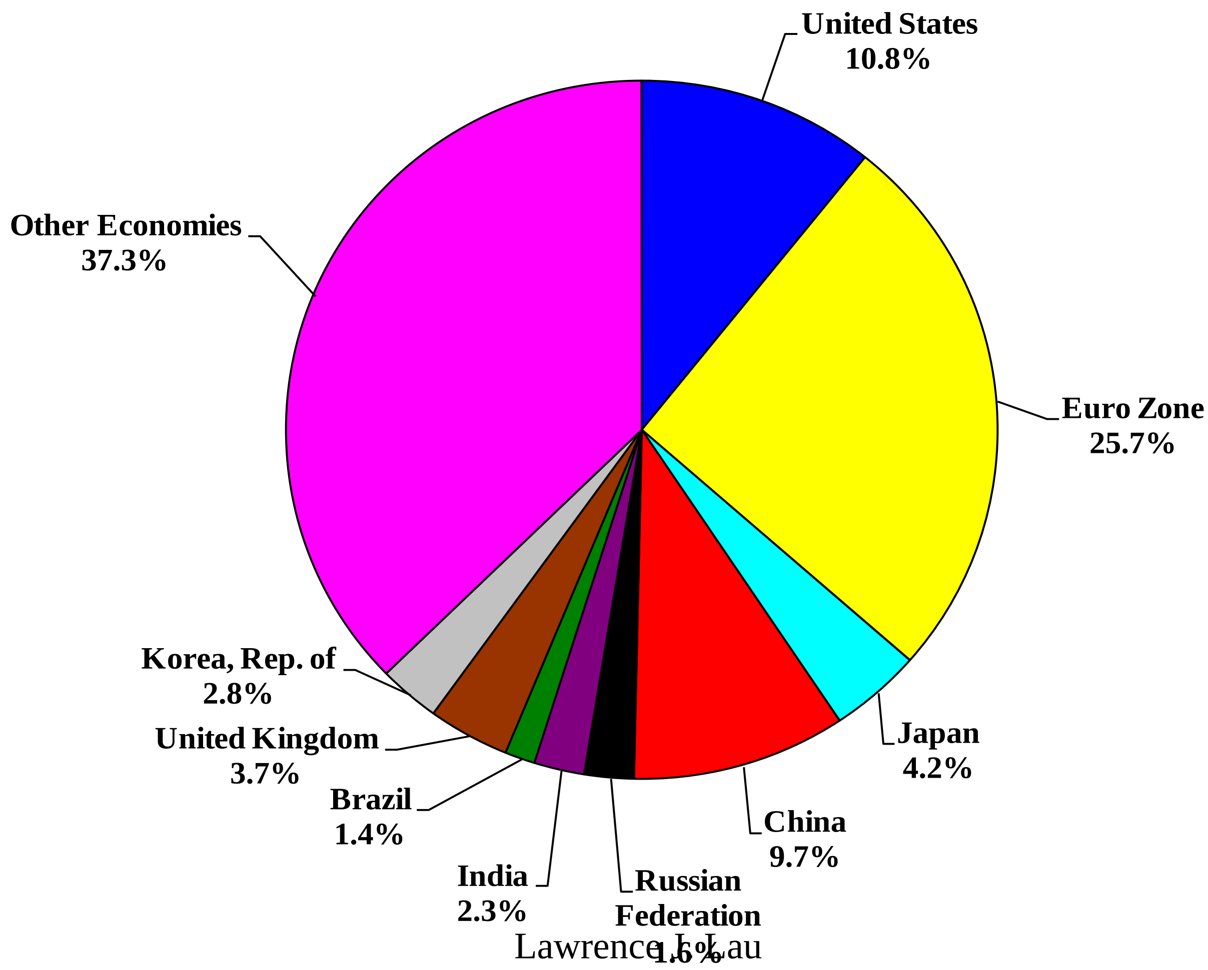


The Distribution of Total International Trade in Goods and Services, 1990



The Distribution of Total International Trade in Goods and Services, 2011

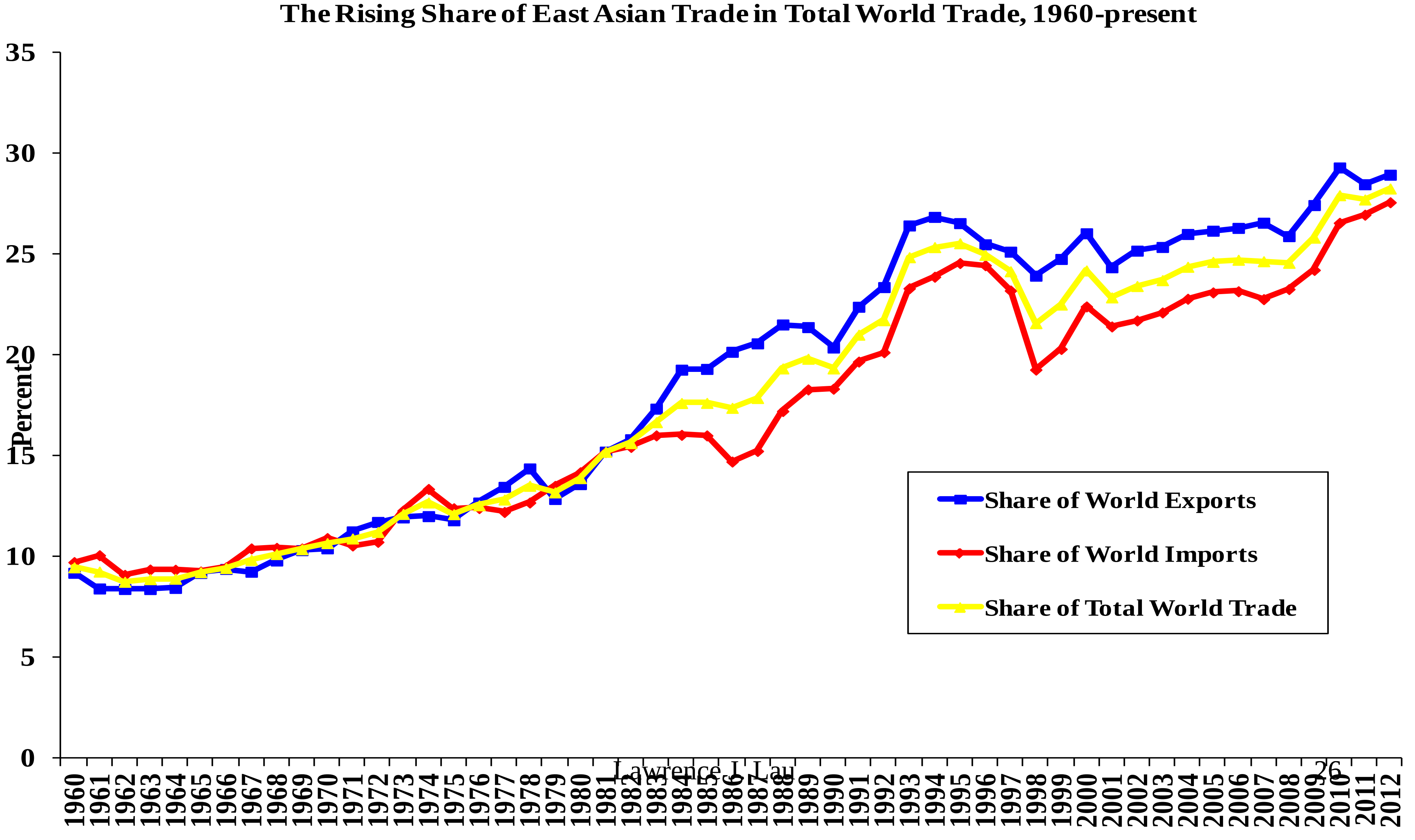
The Distribution of Total International Trade in Goods and Services in 2011



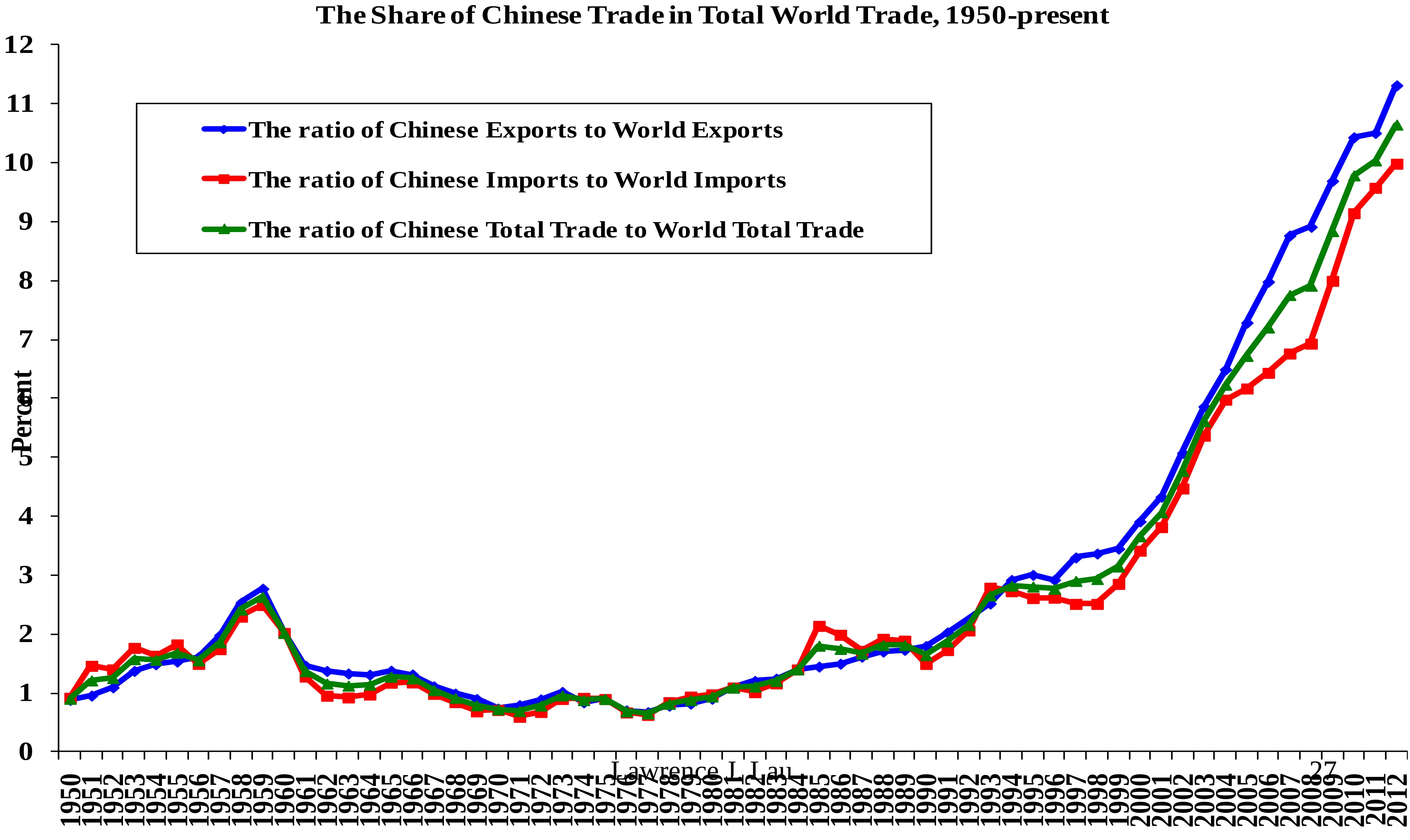
Changing Patterns in the Global Economy: International Trade

- The East Asian (defined as the 10 Association of Southeast Asian Nations (ASEAN) + 3 (China, Japan and the Republic of Korea) share of World trade rose from 9.9% in 1970 to 25.8% in 2012.
- The Chinese share of World trade rose from 0.7% in 1970 to 10.7% in 2012.
- Chinese international trade accounted for 41.2% of East Asian international trade in 2012.

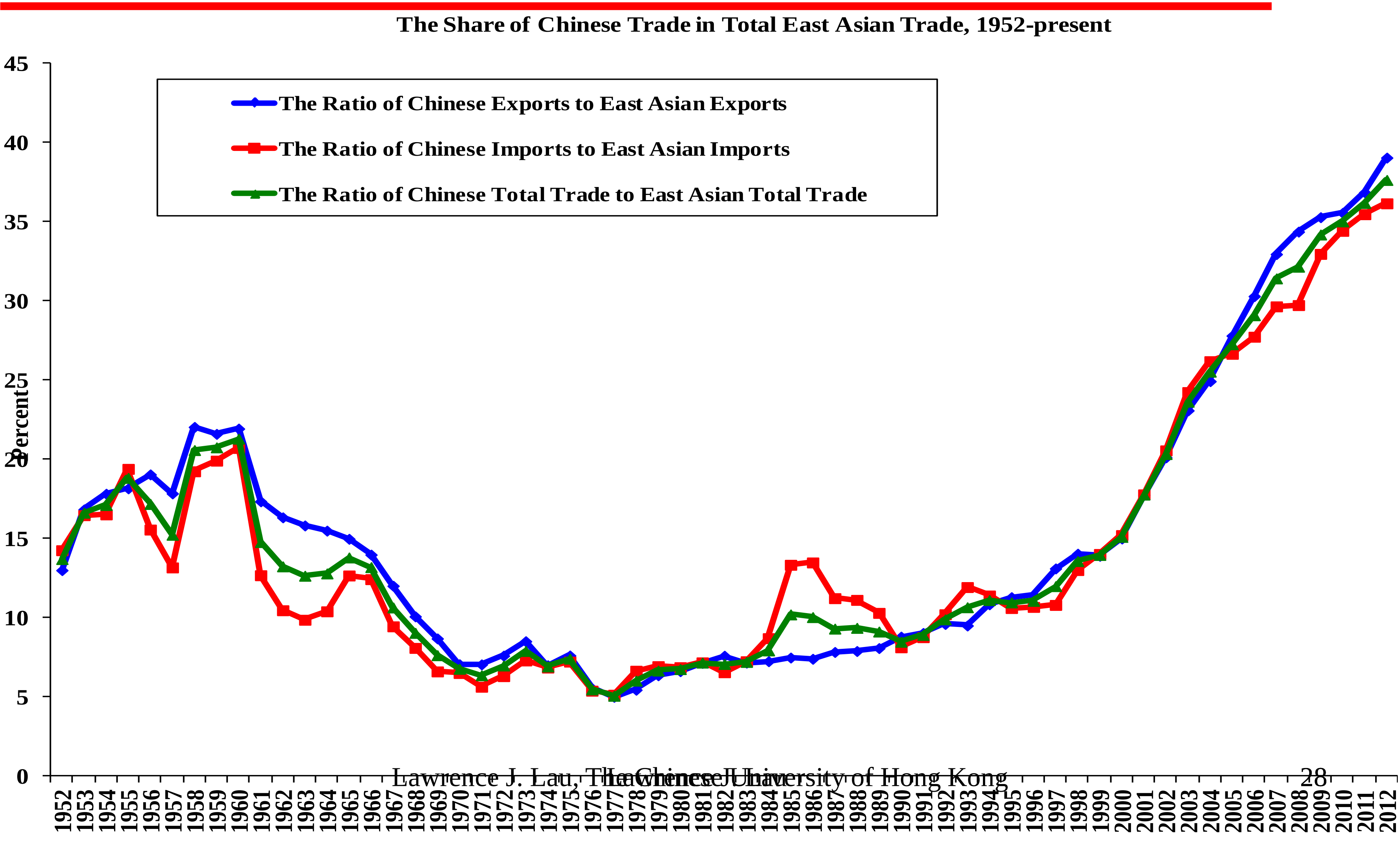
The Rising Share of East Asian Trade in Total World Trade, 1960-present



The Share of Chinese Trade in Total World Trade, 1950-present



The Share of Chinese Trade in Total East Asian Trade, 1952-present



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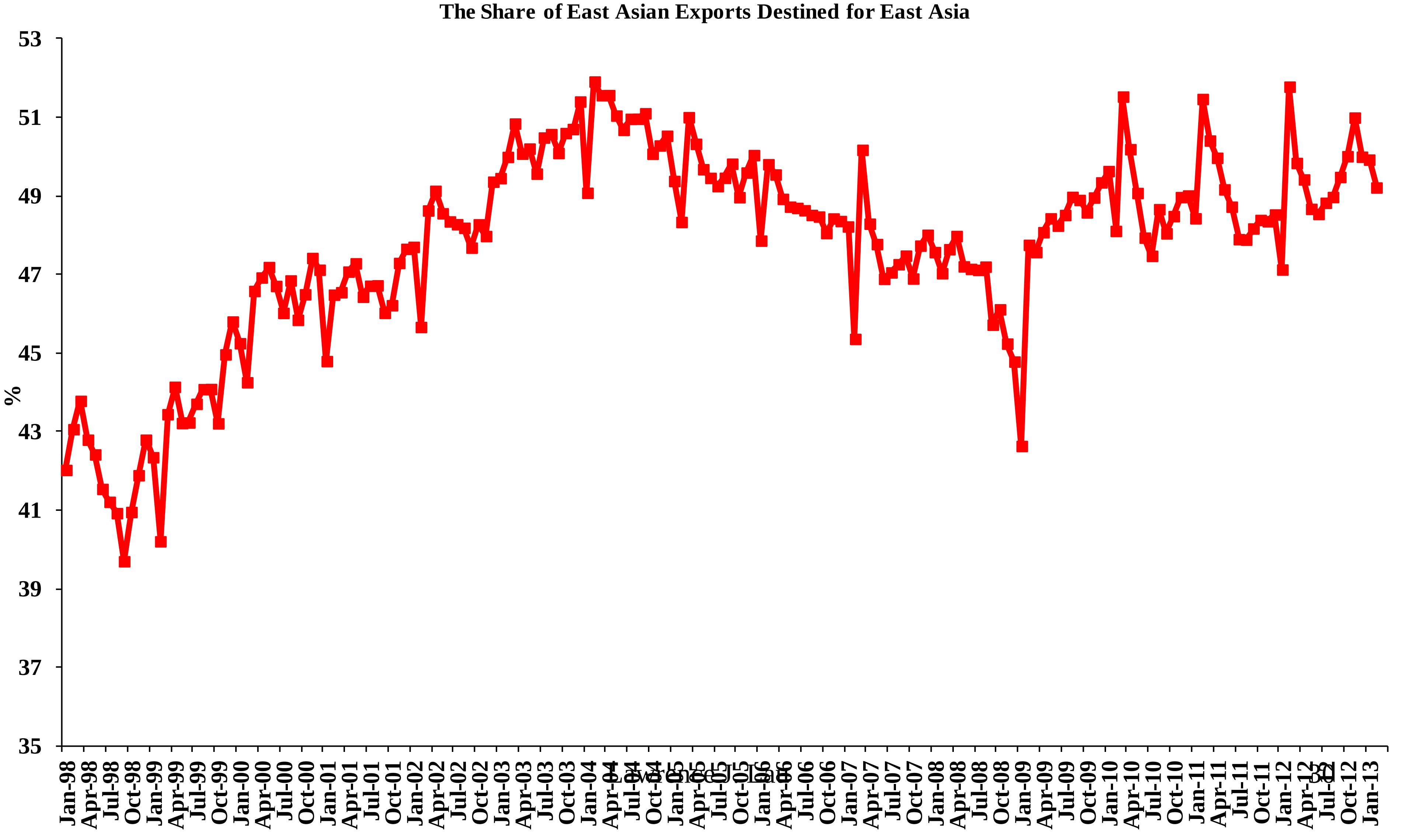
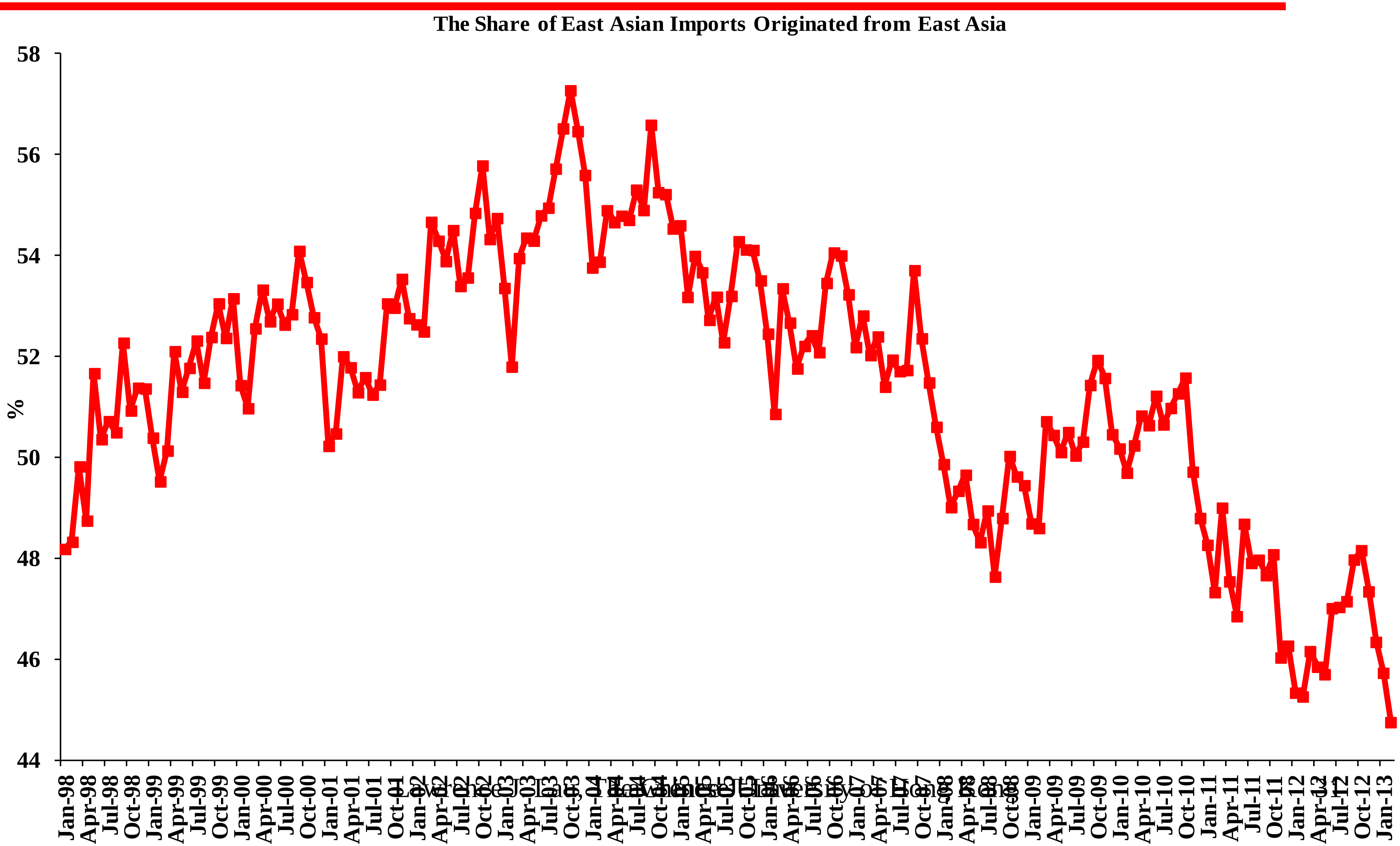
Changing Patterns in the Global Economy: International Trade

- A particularly interesting development is the rise in intra-East Asian international trade. The share of East Asian exports destined for East Asia has risen to over 50% in the past decade. This is a sea-change compared to 30 some years ago when most of the East Asian exports were destined for either the United States or Western Europe.
- Similarly, the share of East Asian imports originated from East Asia has remained above 45%.

The Share of East Asian Exports Destined for East Asia



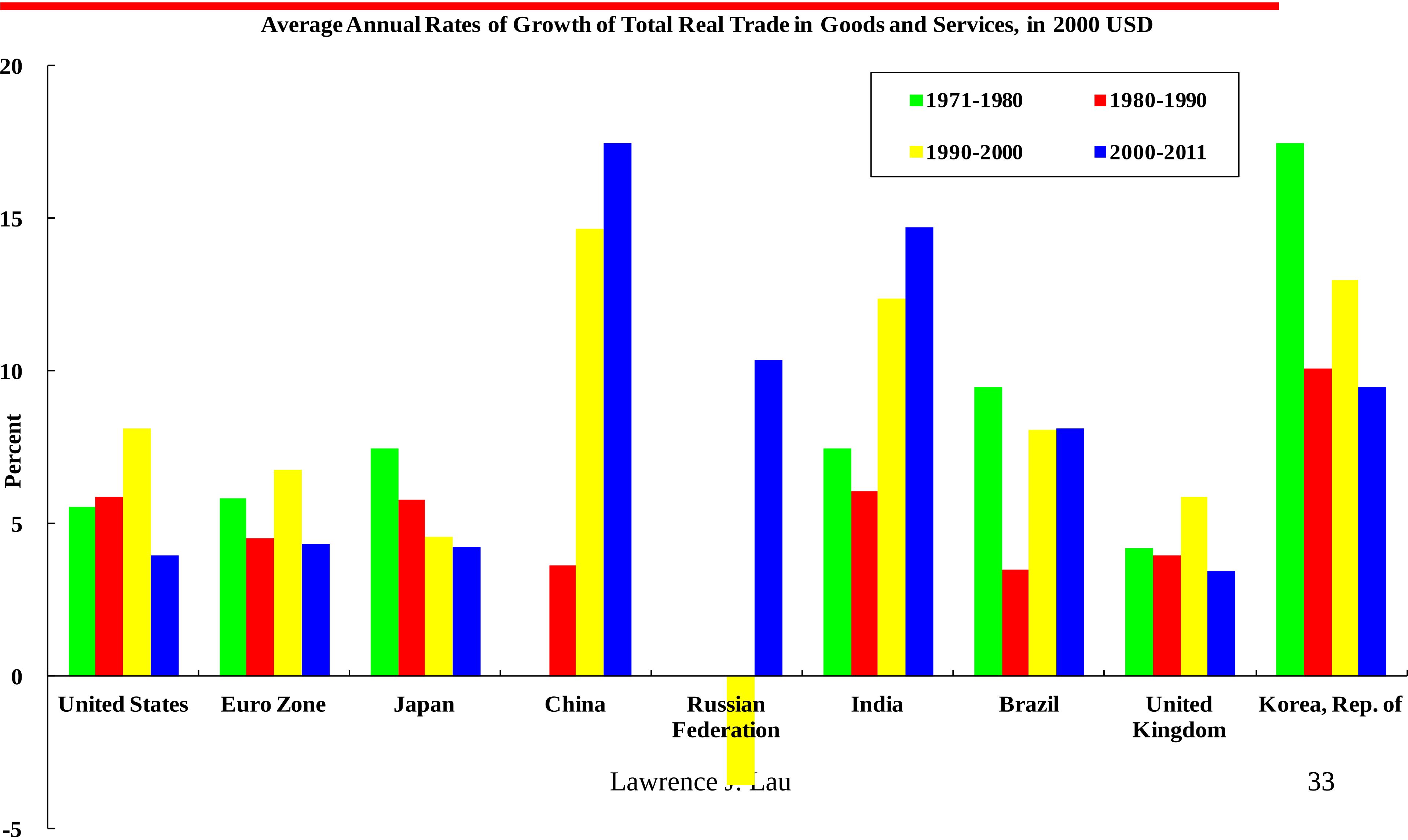
The Share of East Asian Imports Originated from East Asia



Changing Patterns in the Global Economy: Growth in International Trade

- South Korea, and more recently, China, India, Brazil and Russia, have had the highest rates of growth in international trade.
- Growth in Chinese international trade has been particularly rapid during the past decade because of its accession to the World Trade Organisation (WTO) and because of the expiration of the Multi-Fibre Agreement governing world trade in textiles.
- India, Russia and Brazil have also had exceptionally high growth in their international trade during the past decade.
- However, all the developed economies—the U.S., Euro Zone, Japan, and the U.K.—had relatively low and declining rates of growth of international trade during the past decades.

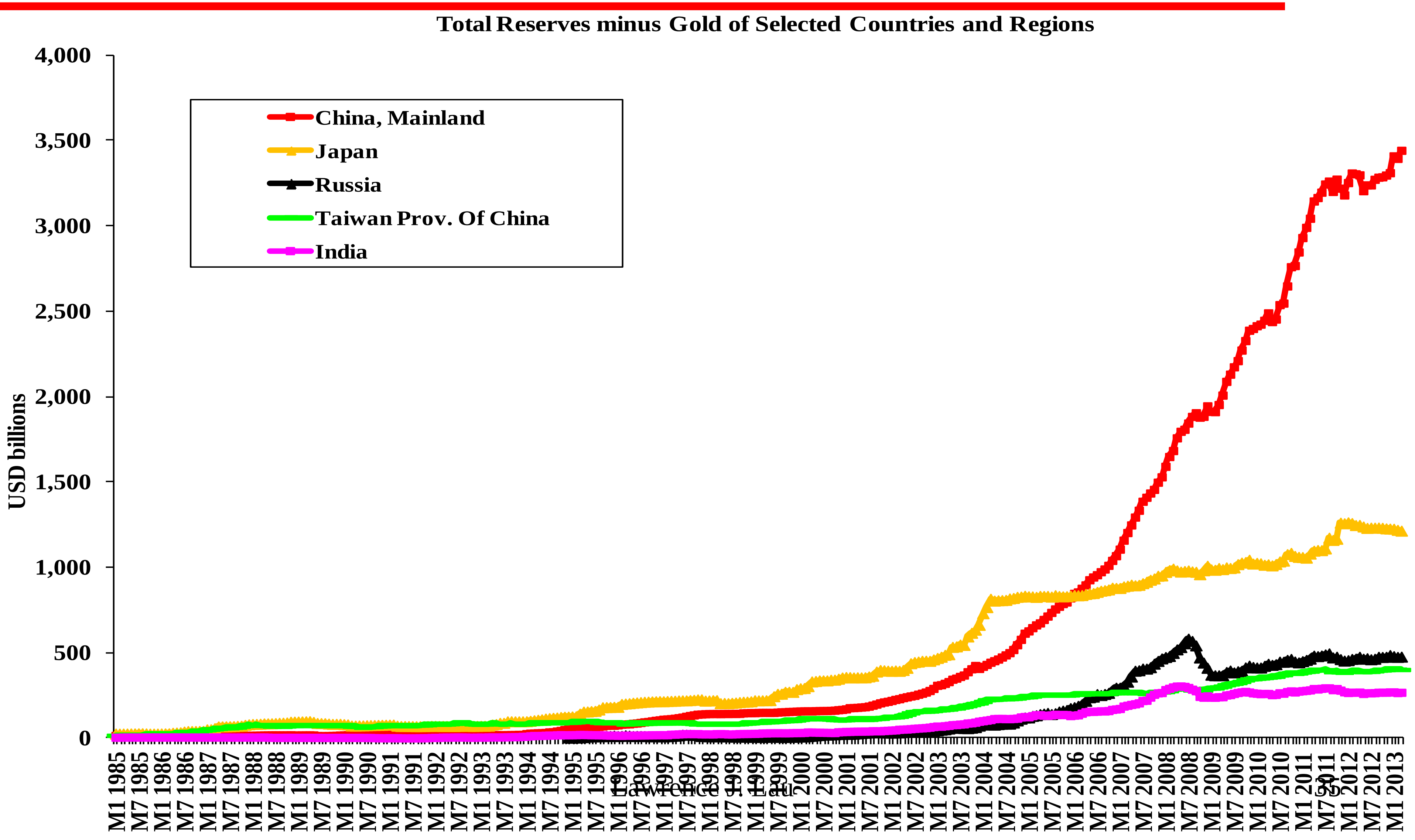
Average Annual Rate of Growth of Total International Trade in Goods and Services



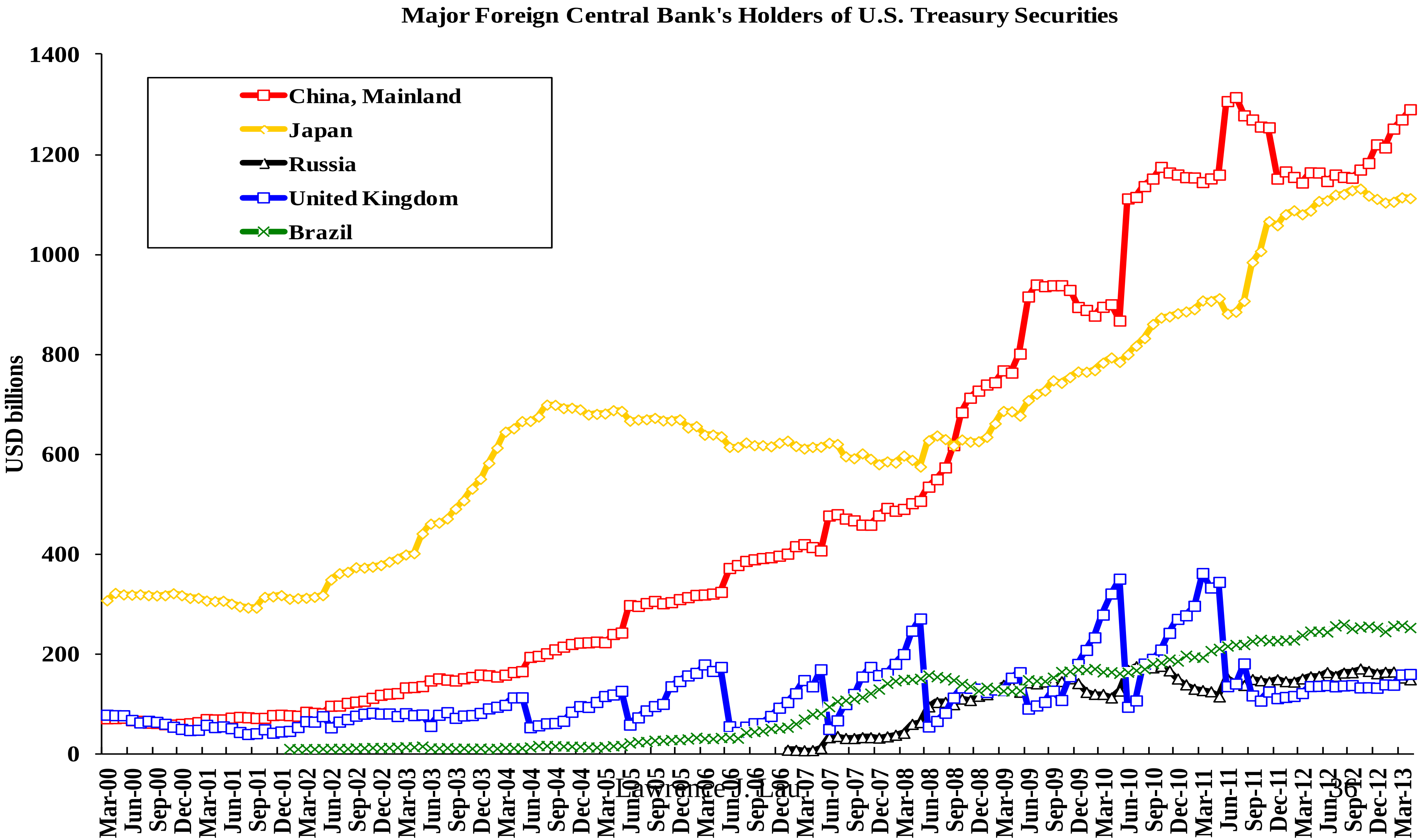
Changing Patterns in the Global Economy: Official Foreign Exchange Reserves

- The central banks of the East Asian and South Asian economies combined now hold huge foreign exchange reserves. China leads the pack with foreign exchange reserves of almost US$3.5 trillion as of mid-year 2013, almost all of which has been acquired during the past decade, followed by Japan with US$1.2 trillion.
- As of mid-year 2013, the People's Bank of China, China's central bank, is now the World's largest holder of U.S. Treasury securities, with not quite US$1.3 trillion, followed by the Bank of Japan, with almost US$1.1 trillion.

Total Foreign Exchange Reserves minus Gold, Selected Countries and Regions



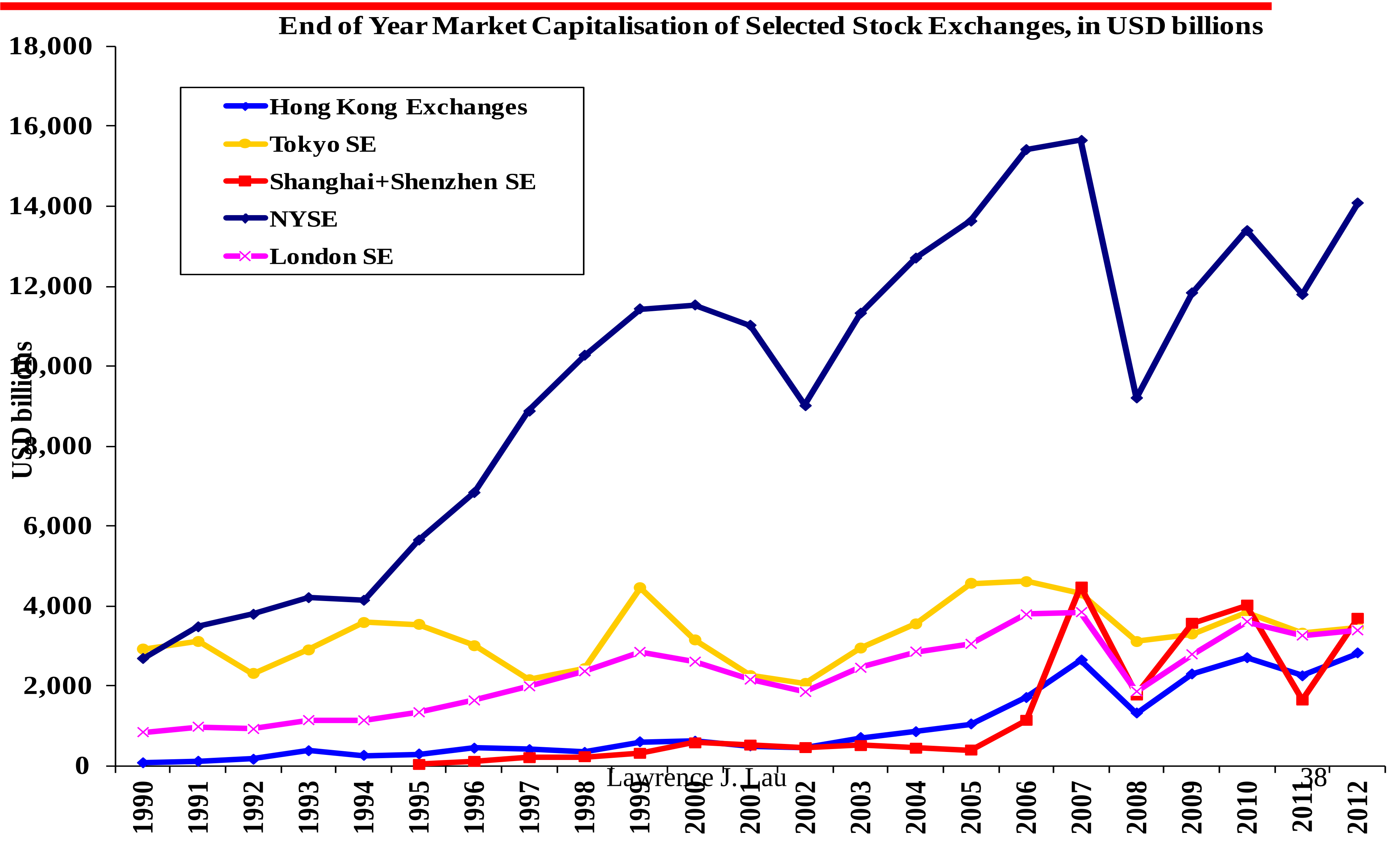
Major Foreign Central Banks' Holdings of U.S. Treasury Securities



Changing Patterns in the Global Economy: Capital Markets

- Over the years, the capital markets in East Asian economies have also grown. At year end 2012, the combined market capitalisation of all East Asian stock exchanges amounted to US$14.2 trillion, behind the market capitalisation of U. S. stock exchanges of US$18.7 trillion but ahead of the market capitalisation of all European stock exchanges combined of US$10.4 trillion.
- Again, this is a relatively recent phenomenon. For example, the Chinese stock exchanges at Shanghai and Shenzhen did not even get started until the mid-1990s.

End of Year Market Capitalisation of Selected Stock Exchanges



Market Capitalization of Stock Exchanges Year End 2012 (US$)

U.S.A.	18.7 trillion
Europe	10.4 trillion
East Asia	14.2 trillion

- Exchanges:
  - U.S.A.: NASDAQ and NYSE
  - Europe: Athens Exchange, BME Spanish Exchanges, Budapest SE, Cyprus SE, Deutsche Borse, Irish SE, London SE group, Luxembourg SE, NYSE Euronext (Europe), Oslo Bors, SIX Swiss Exchange
  - East Asia: Bursa Malaysia, Hong Kong Exchanges, Indonesia SE, Korea Exchange, Philippine SE, Shanghai SE, Shenzhen SE, Singapore Exchange, Taiwan SE, Thailand SE, Tokyo SE Group
- Data source: World Federation of Exchanges

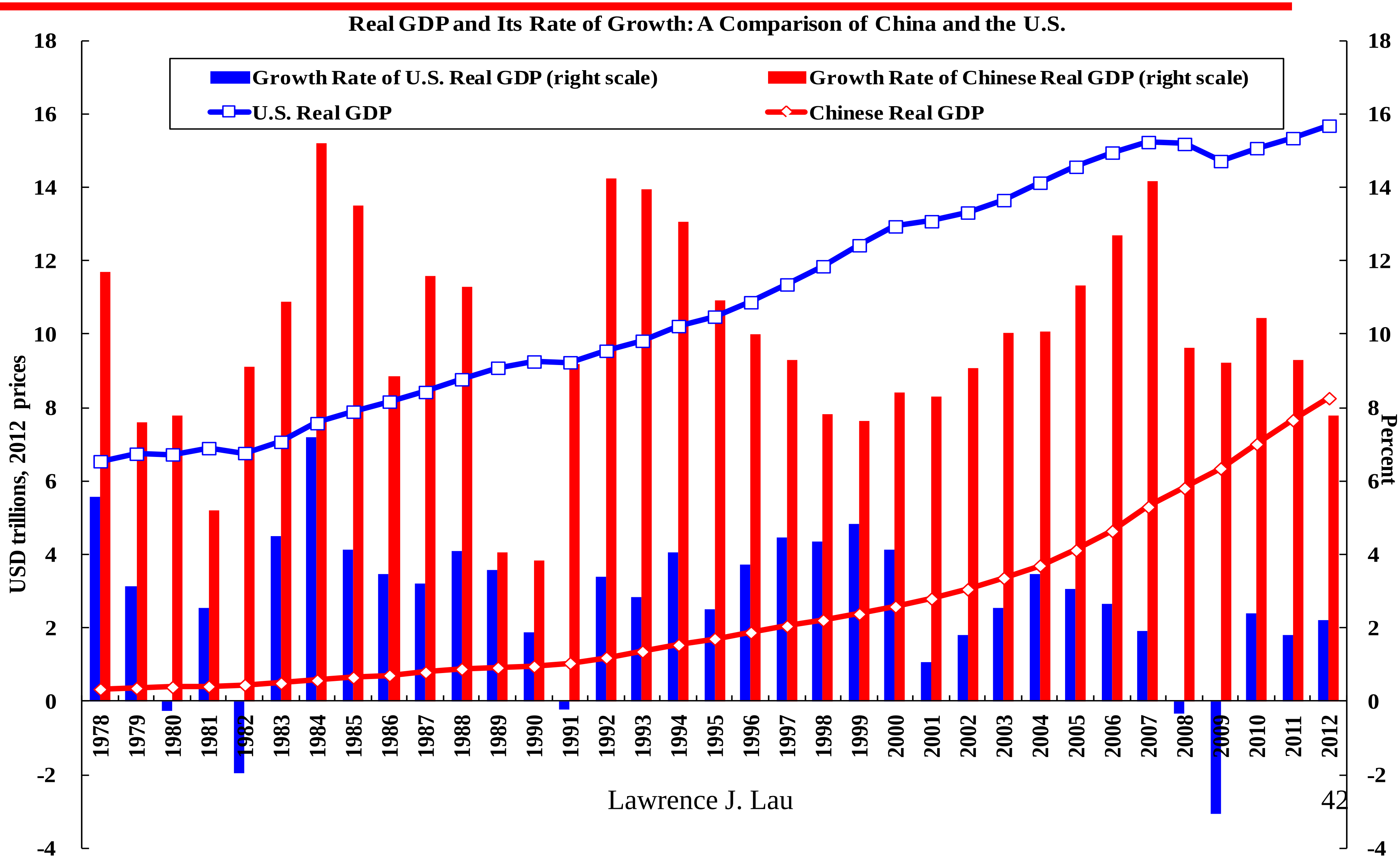
Changing Patterns in the Global Economy: The Shifting Centre of Gravity

- The strong performance of the Chinese, Indian and other East Asian economies except the Japanese during the 2007-2009 global financial crisis and the subsequent European sovereign debt crisis and up through 2012 provided convincing empirical evidence of the "Partial De-Coupling Hypothesis".
- However, the Chinese economy alone is not large enough to turn the World economy around. The idea of a G-2 group of countries consisting of China and the United States leading the World economy is premature.

The Chinese Economy in the Global Context

- China has made tremendous progress in its economic development since it began its economic reform and opened to the World in 1978. China is currently the fastest growing economy in the World, averaging 9.84% per annum over the past 34 years (1978-2012). It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- Between 1978 and 2012, Chinese real GDP grew almost 24 times, from US$340 billion to US$8.26 trillion (2012 prices) to become the second largest economy in the World, after the U.S.
- By comparison, the U.S. GDP (approx. US$15.7 trillion) was slightly less than 2 times Chinese GDP in 2012.

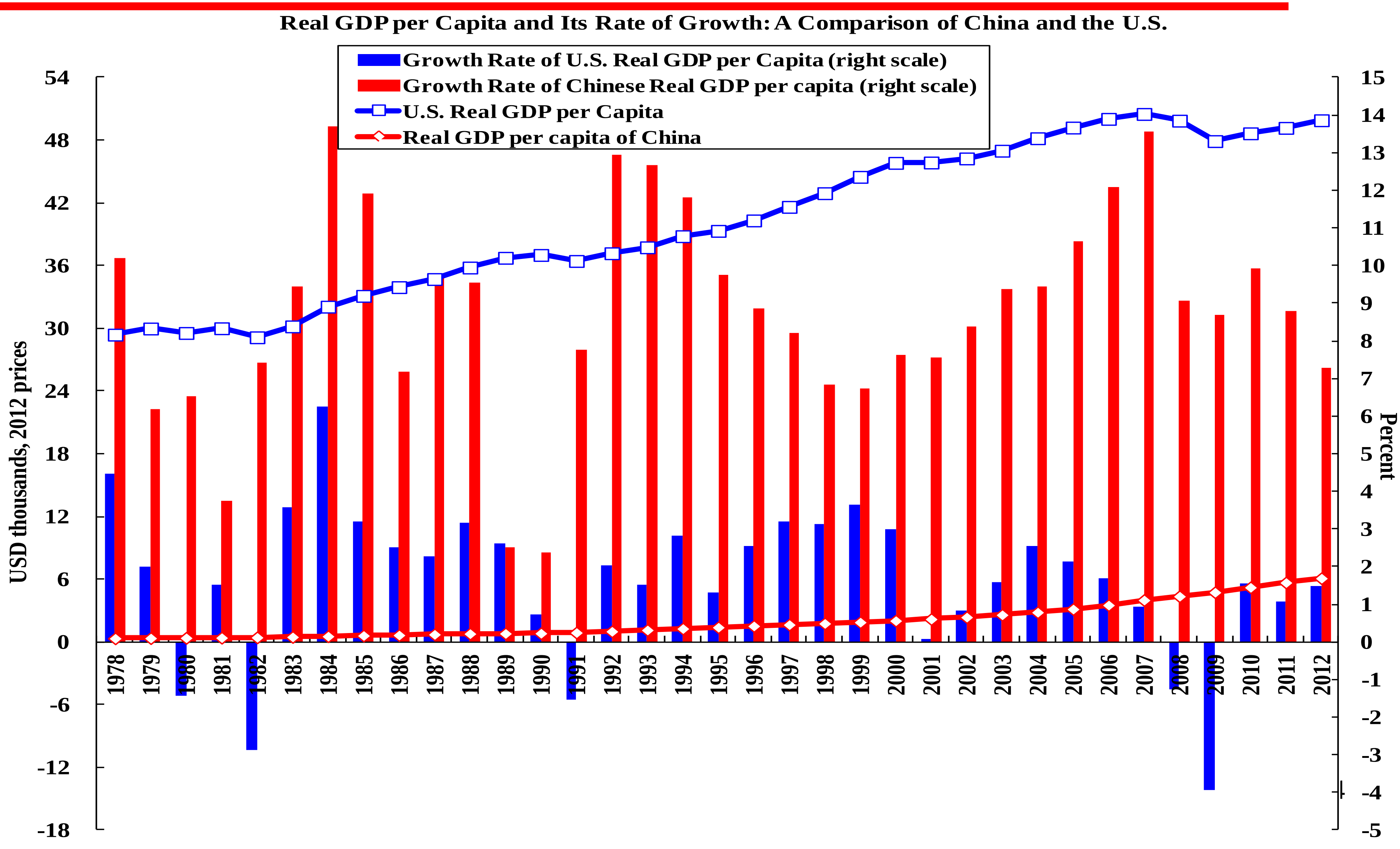
Real GDP and Its Rate of Growth: A Comparison of China and the U.S. (2012$)



The Chinese Economy in the Global Context

- Despite its rapid growth, in terms of its real GDP per capita, China is still a developing economy.
- Between 1978 and 2012, Chinese real GDP per capita grew 17 times, from US$354 to US$6,102 (in 2012 prices), but it is still below the global average per capita GDP of US$10,000.
- By comparison, the U.S. GDP per capita of US$49,907 was 8.2 times Chinese GDP per capita in 2012.

Real Chinese and U.S. GDP per Capita in US$ Since 1952 (2012 Prices)



The Chinese Economy in the Global Context

- While many problems have arisen in the Chinese economy within the past decade—for example, increasing income disparity (both inter-regional and intra-regional), uneven access to basic education and health care, environmental degradation, inadequate infrastructure and corruption—it is fair to say that every Chinese citizen has benefitted from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.

The Chinese Economy in the Global Context

- The Chinese Government leaders have also amply demonstrated their ability to confront important challenges and solve difficult problems over the past 34 years, surviving various economic and financial crises such as the 1997-1998 East Asian currency crisis, the 2007-2009 global financial crisis, the European sovereign debt crisis and more recently the anticipated tapering and winding down of QE3.
- China is one of the very few socialist countries that have managed to make a smooth transition from a centrally planned to a market economy without a massive decline in real GDP. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

The Chinese Economy in the Global Context

- The emergence of the Chinese economy on the global scene is probably the single most important development in the World economy during the past three decades.
- China has become not only the World's factory, but also has lately become the World's most important growth market, especially since Chinese economic growth has been gradually transitioning from export-driven to domestic-demand driven.
- The Chinese economy and its huge domestic demands are largely responsible for the partial de-coupling of the East Asian economies from North American and European economies.
- Finally, the internationalisation of the Renminbi and its resultant rising use in the clearing and settlement of international transactions will offer more options to exporters, importers, direct investors and long-term portfolio investors. Such a development will have a long-term impact on the international monetary system.

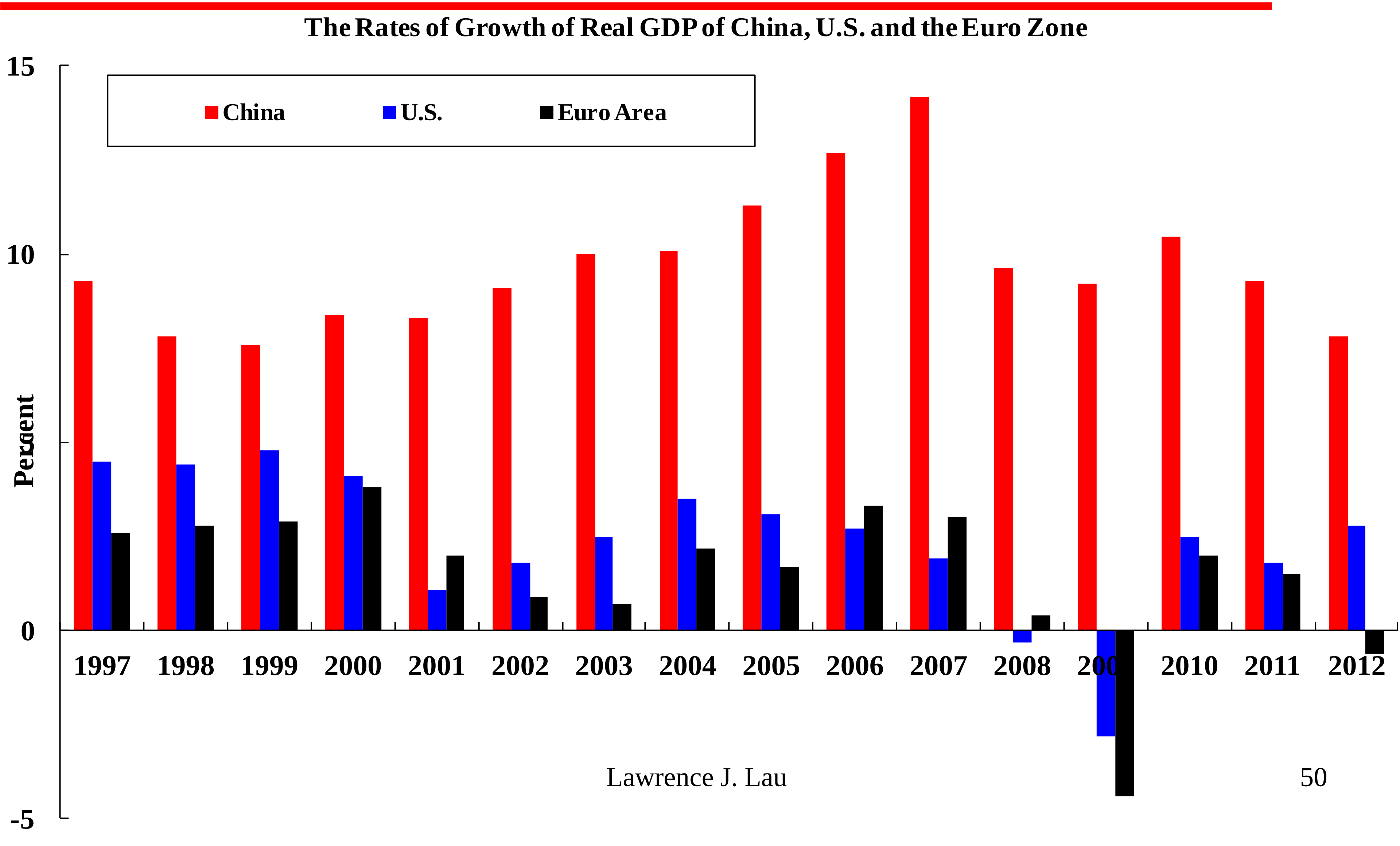
The Near-Term Macroeconomic Outlook of the World Economy

- The economic weakness in both the United States and the Euro Zone has reduced economic growth rates around the World, including those of China and India.
- The macroeconomic outlook of the World economy has turned slightly positive as the U.S. economy has continued to grow, albeit at relatively low rates. It has had positive rates of growth, year-over-year, for almost 50 consecutive months.
- Even the Euro Zone economies have turned around to show a small positive growth recently, as the Euro managed to survive as a major international reserve currency and the sovereign debt crisis began to be resolved gradually.

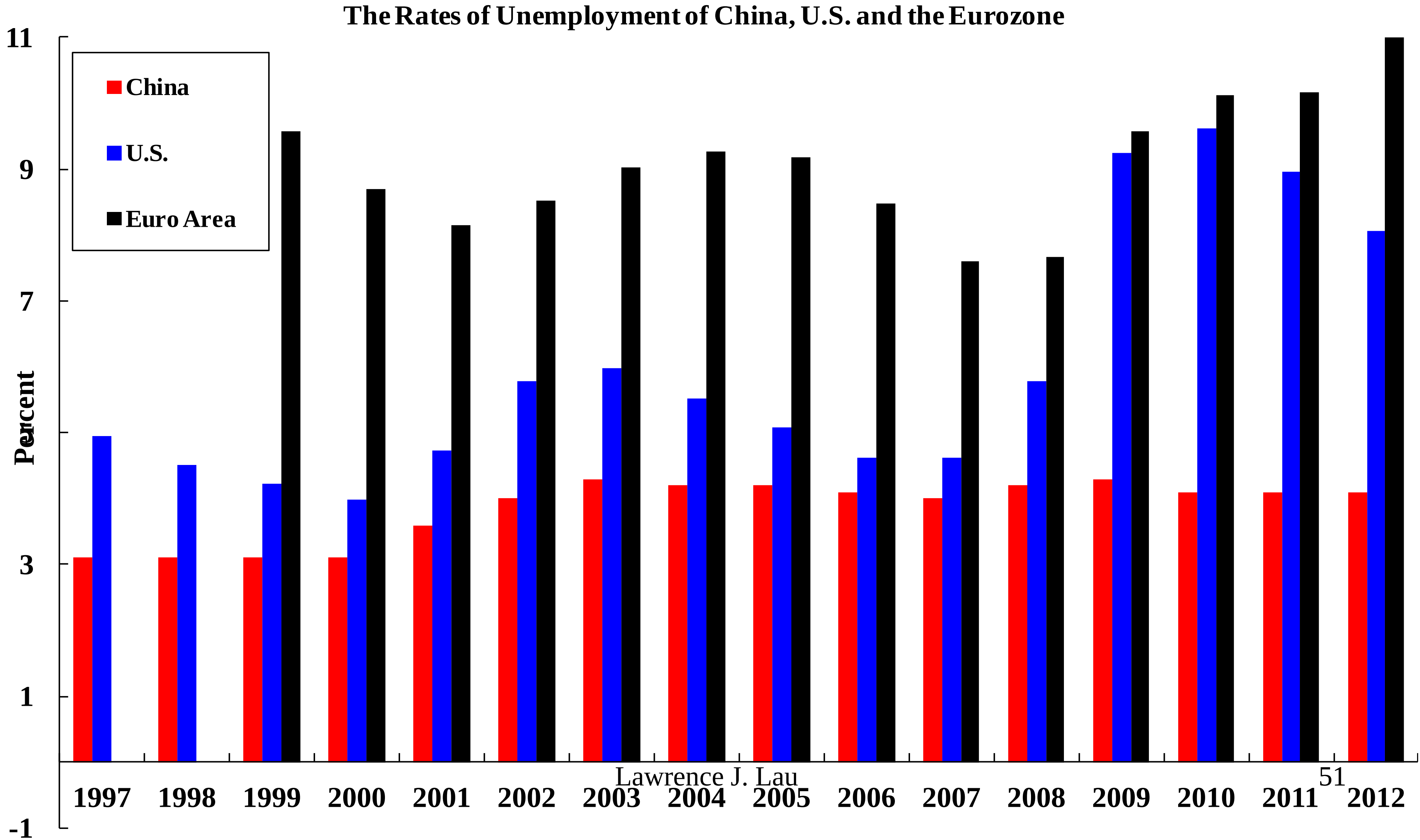
The Near-Term Macroeconomic Outlook of the World Economy

- The rates of unemployment have continued to be high for both the U.S. (7.4%) and the Euro Zone (12.1%) and are unlikely to decline significantly in the near term.
- Much of the recent decline of the unemployment rate in the U.S. may be attributed to discouraged workers withdrawing from the labour force. The unemployment rate is equal to (the number of job-seekers – employment) divided by the number of job-seekers and is in turn equal to 1 – employment/number of job-seekers. A decline in the number of job-seekers increases the employment/number of job-seekers ratio and hence decreases the unemployment rate.
- Fortunately, the rates of inflation have remained relatively subdued in the developed economies and in China, where the rate of inflation has begun to come down significantly.

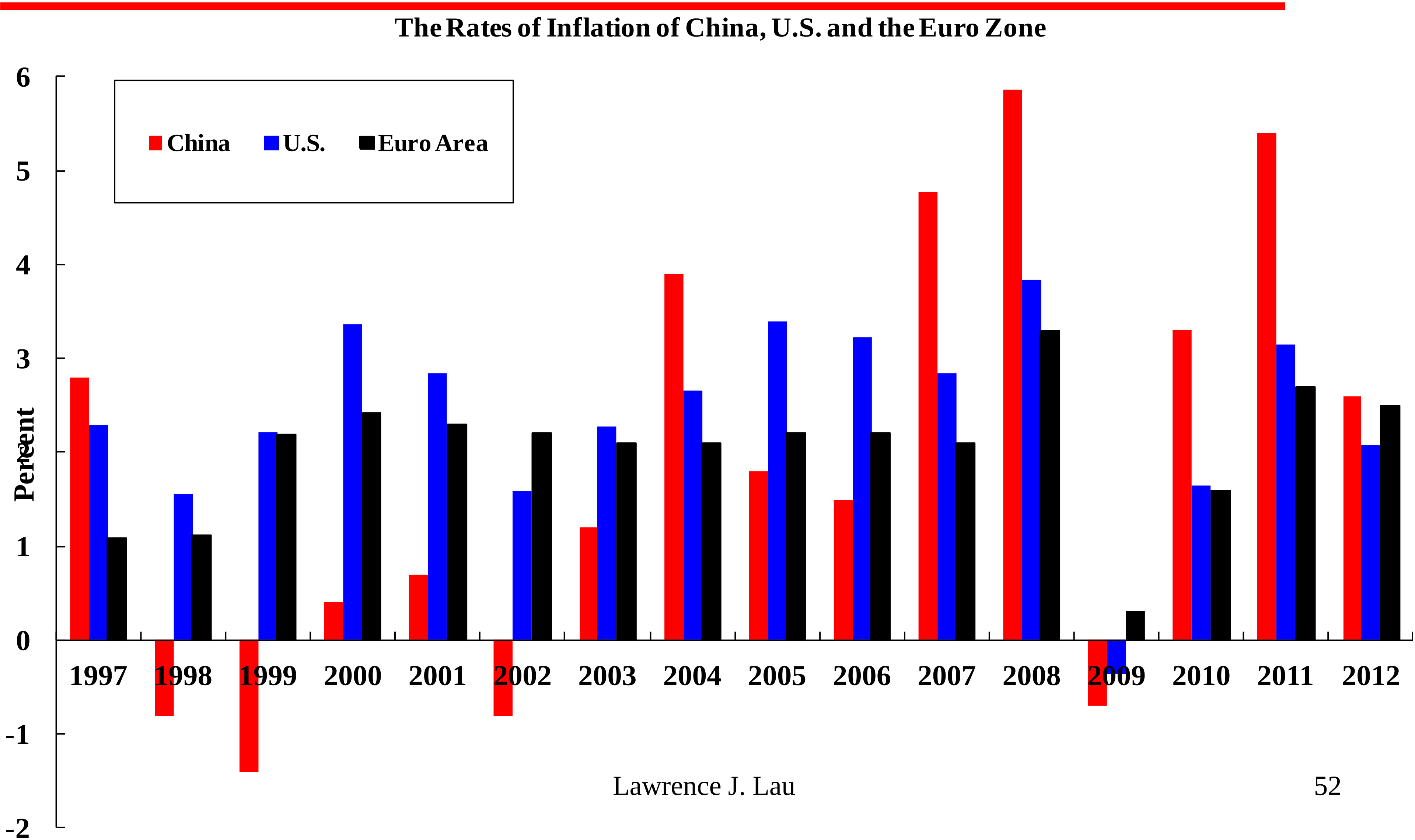
The Rates of Growth of Real GDP of China, U.S. and the Euro Zone



The Rates of Unemployment of China, U.S. and the Euro Zone



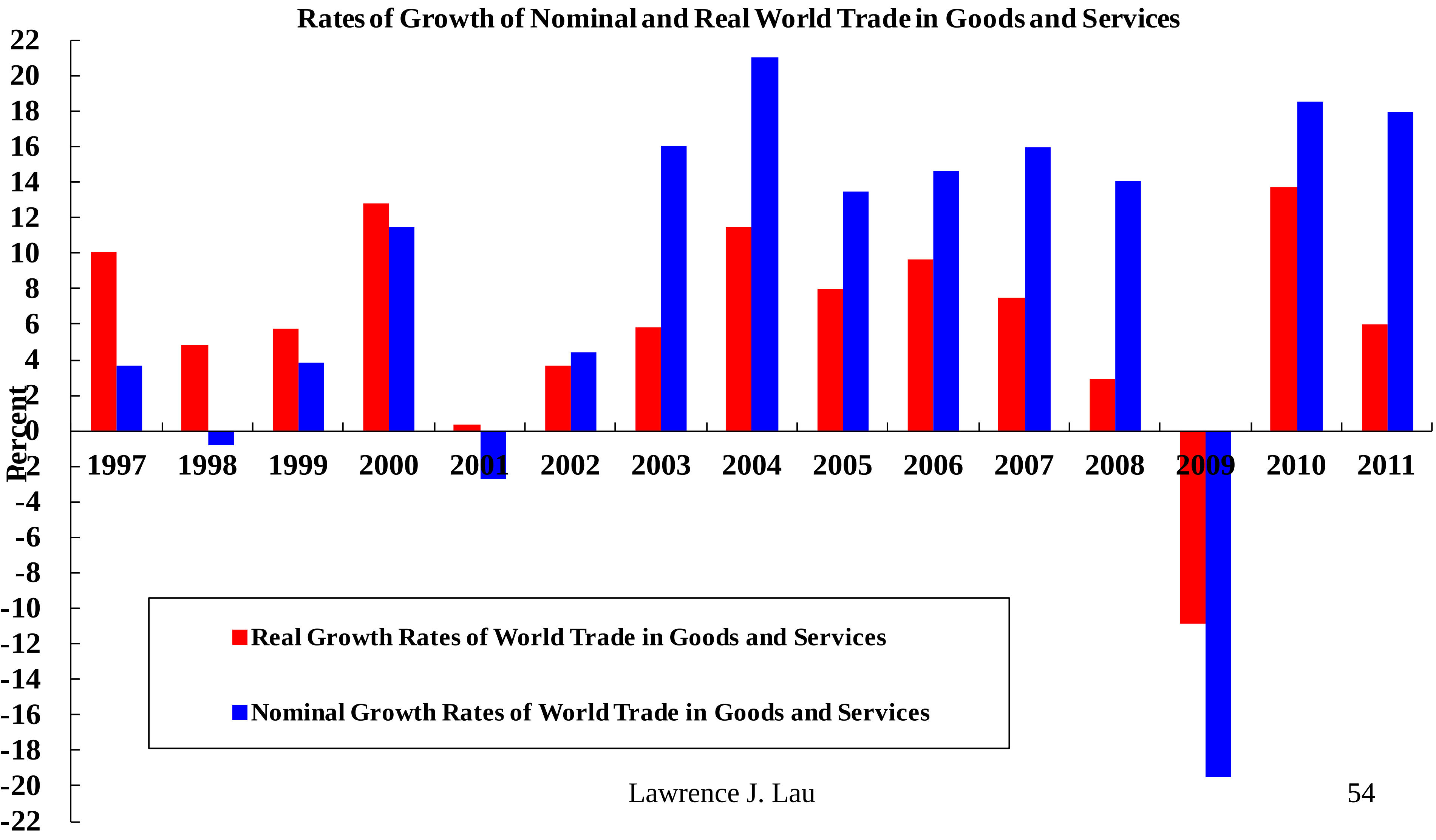
The Rates of Inflation of China, U.S. and the Euro Zone



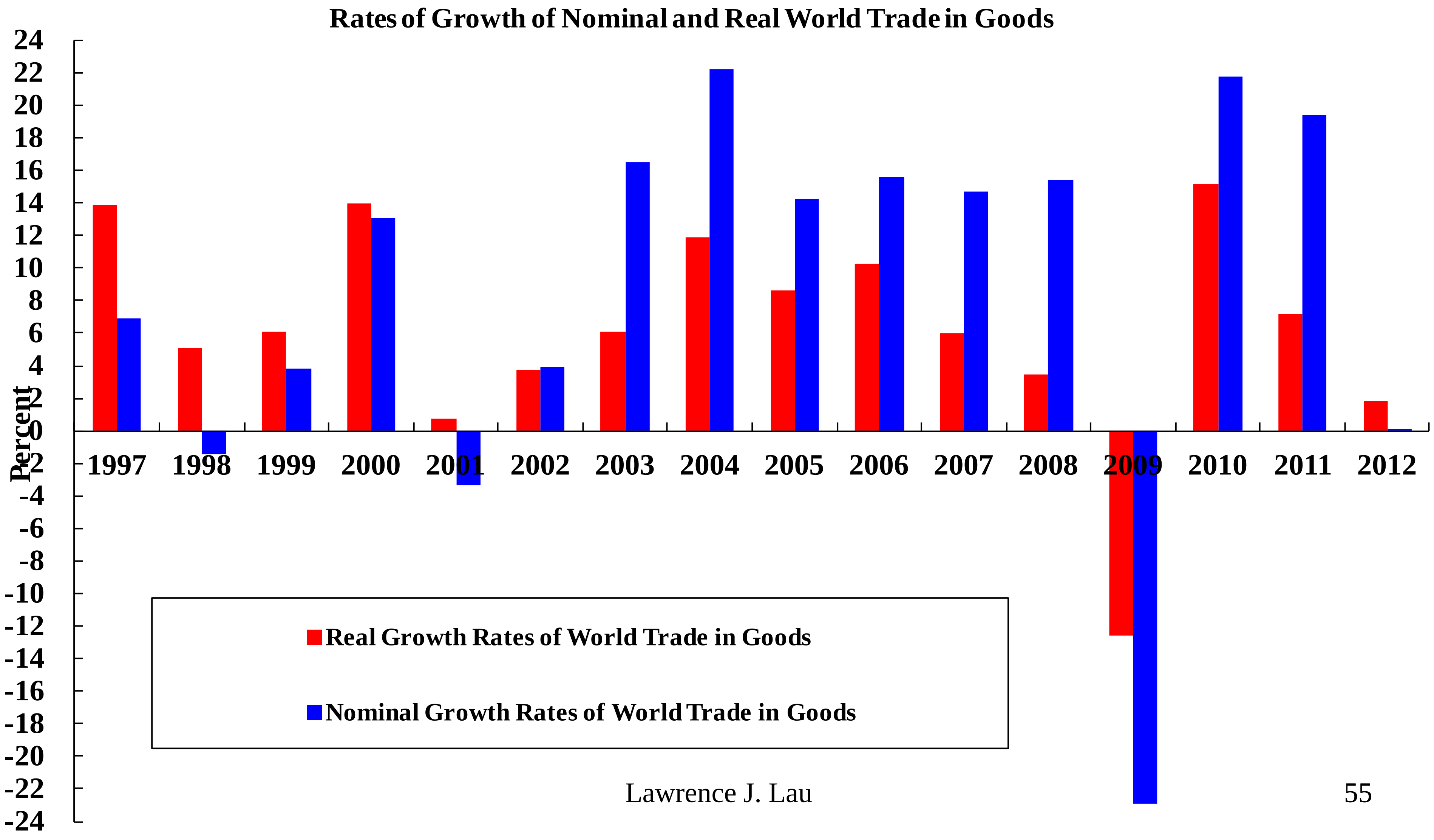
The Near-Term Macroeconomic Outlook of the World Economy

- The slow growth of the World economies has reduced aggregate demand and especially consumption in the developed economies and hence their demand for imports. In addition, their relative economic stagnation has also encouraged protectionist sentiments. Under these circumstances, inevitably, the real rate of growth of world trade, especially world trade in goods, has also declined significantly.

Nominal and Real Rates of Growth of World Trade in Goods and Services



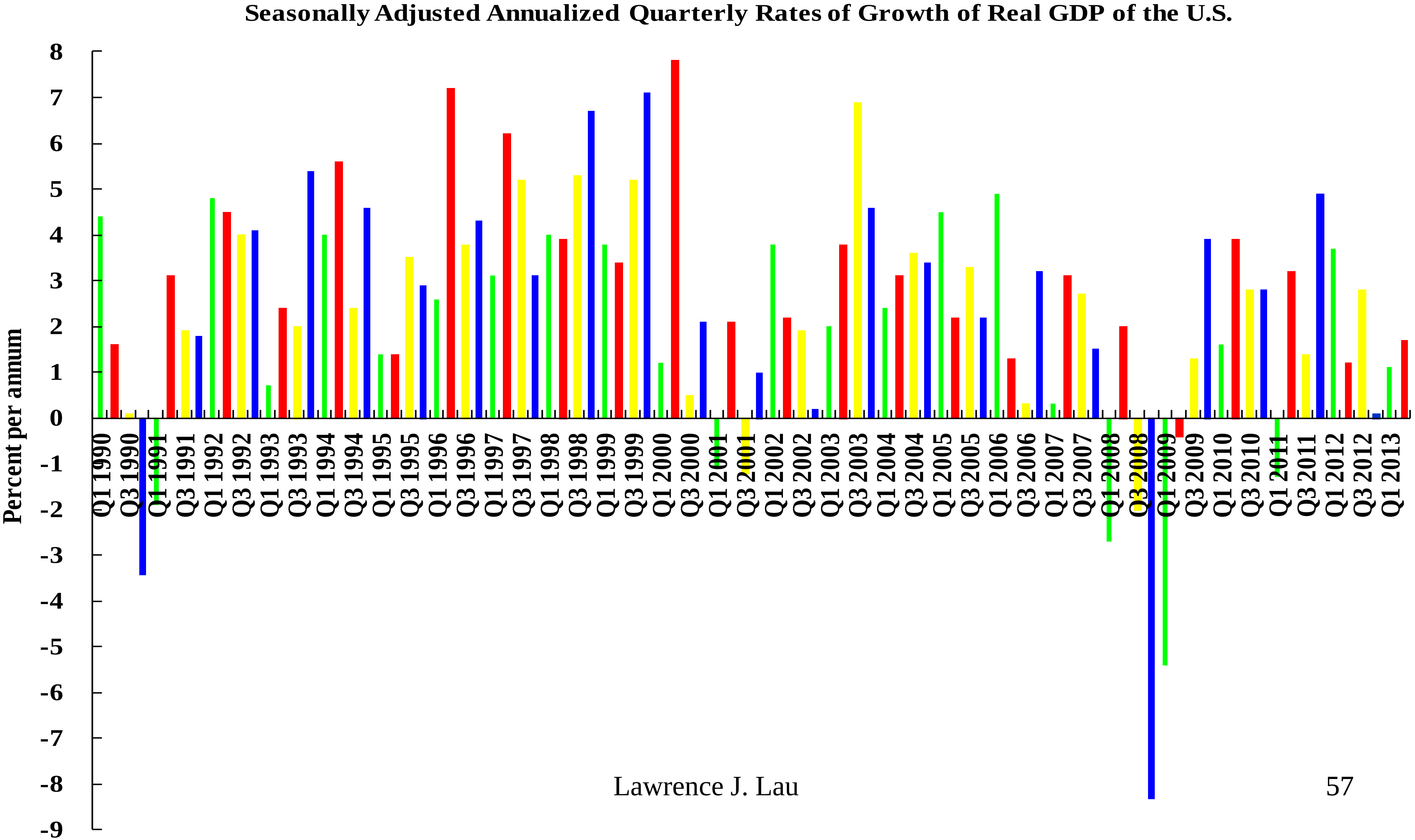
Nominal and Real Rates of Growth of World Trade in Goods



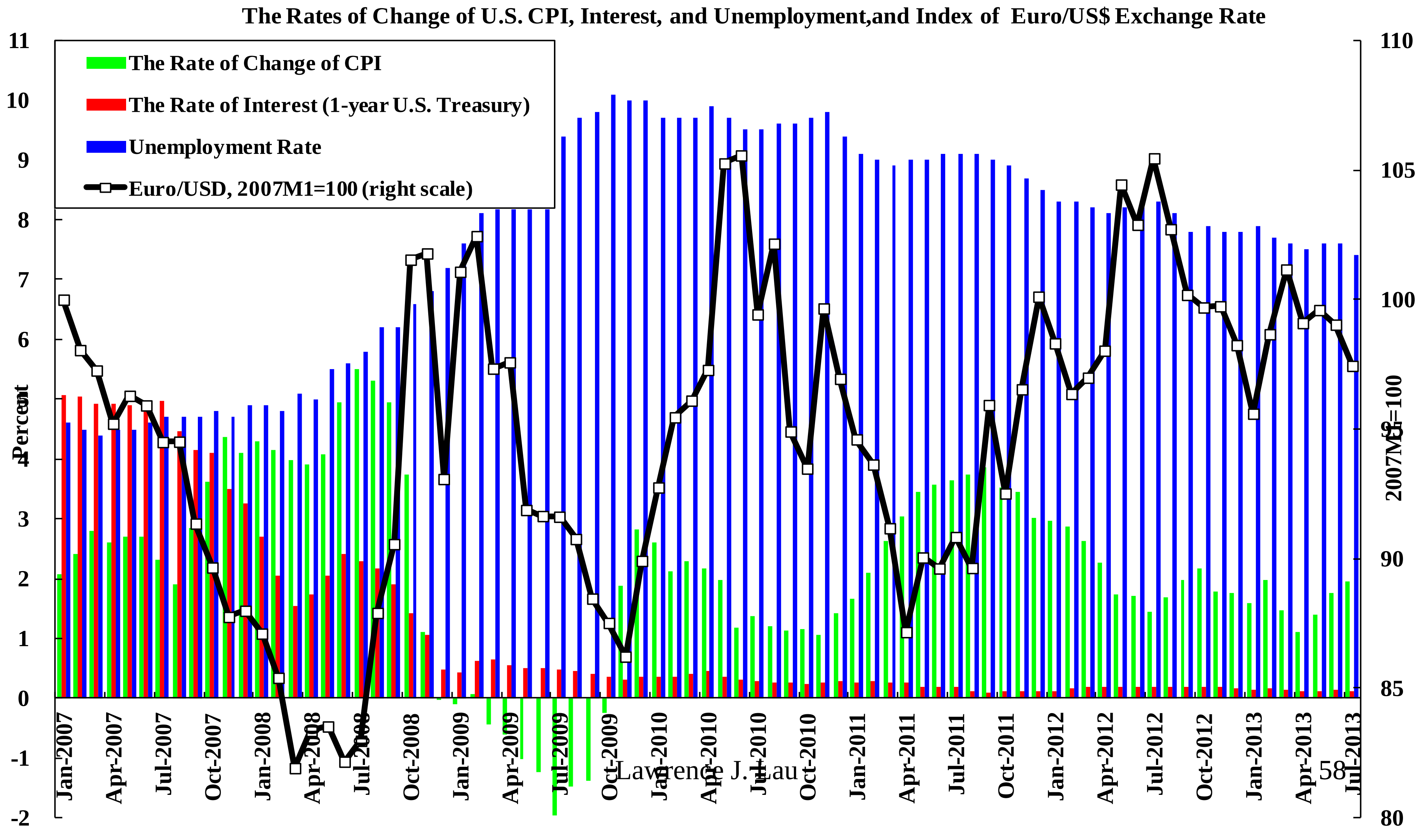
The Near-Term Macroeconomic Outlook: The U.S. Economy

- Economic recovery in the U.S. has remained slow, despite all the quantitative easing, affected internally by the failure to achieve a consensus on the government budget and externally by the European sovereign debt crisis and the resulting recession in the Euro Zone economies. It also appears likely that QE3 will come to an end by year-end 2013.
- The unemployment rate has stayed stubbornly high, above 7.4%, and is unlikely to fall significantly in the near term.
- The effectiveness of an easy monetary policy is in serious doubt. In fact, the real rate of interest, the difference between the nominal rate of interest and the rate of inflation (measured by the consumer price index (CPI)), has been negative since November 2009 (see the following Charts). The U.S. economy is in a classical "liquidity trap" situation.

Seasonally Adjusted Annualised Quarterly Rates of Growth of Real GDP of the U.S.



The Rates of Change of CPI, Interest, & Unemployment, & Index of Euro/US$ Exchange Rate



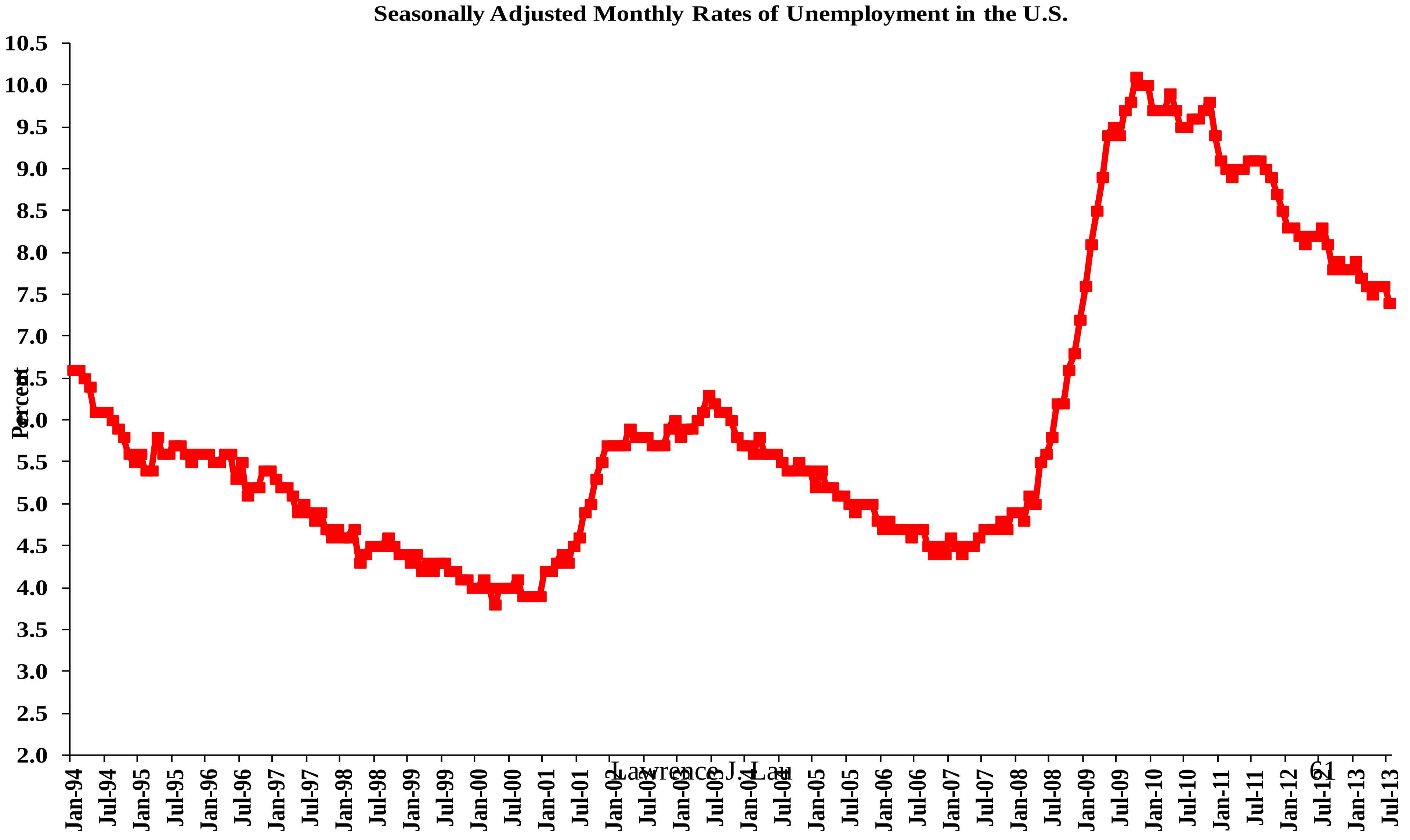
The Near-Term Macroeconomic Outlook: The U.S. Economy

- As is well known, one can pull on a string but not push on a string. Further lowering of the rate of interest and release of liquidity in the U.S. has not increased and is unlikely to increase domestic investment significantly.
- Despite the announcement by the Federal Reserve Board that interest rate would be kept low until 2015 and that as long as unemployment rate is above 6.5% (subsequently raised to 7%) and the inflation rate is below 2.5%, the long-term rate of interest, which is what is really relevant for new investment, has already begun to rise.
- While the unemployment rate is unlikely to fall below 6.5% by the end of 2013, the core rate of inflation, which is currently running at approximately 2% per annum, can easily and quickly rise to 2.5%.

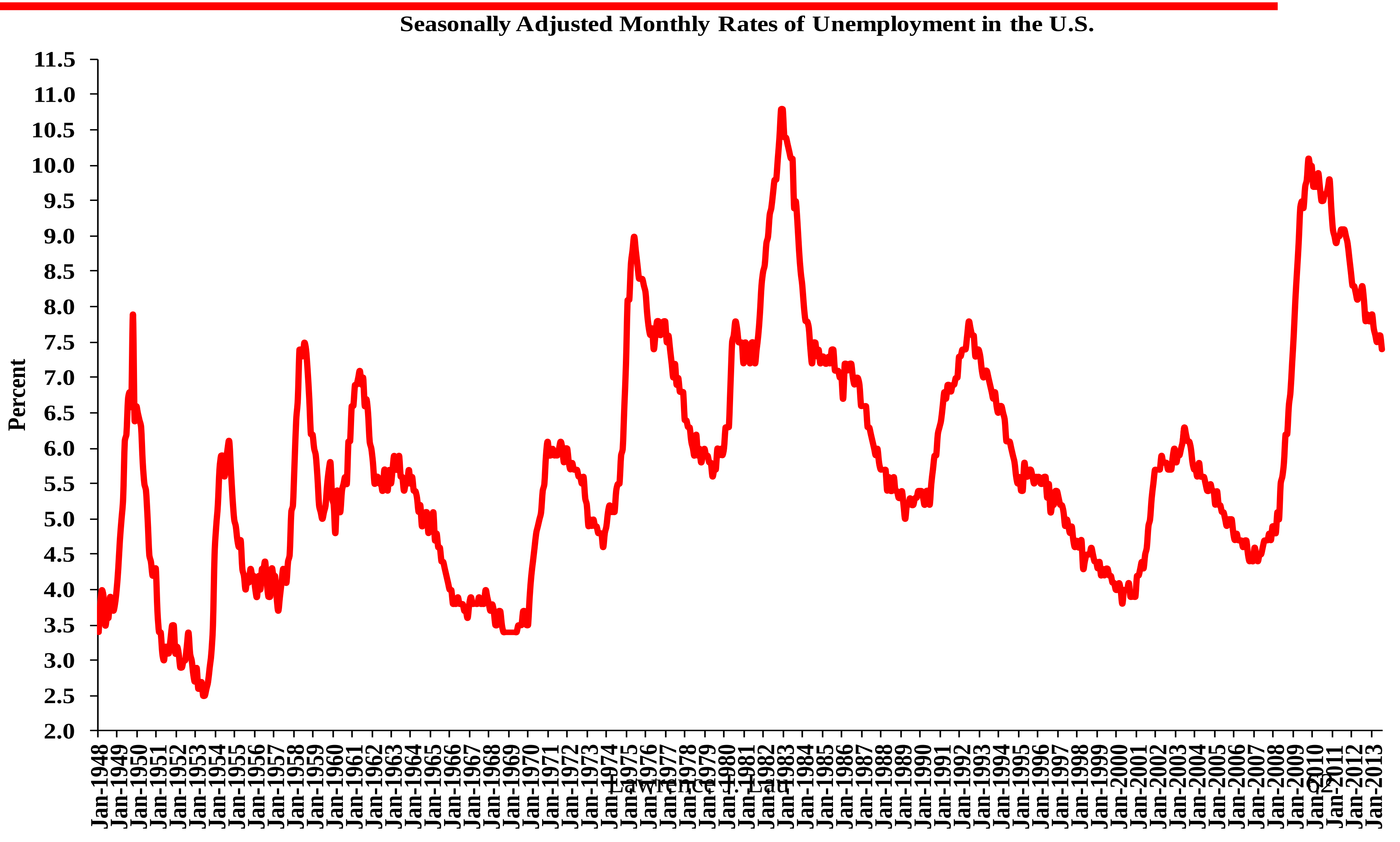
The Near-Term Macroeconomic Outlook: The U.S. Economy

- However, it does appear that the recovery is solid and real, and that with the resolution of the European sovereign debt crisis, the U.S. economy should be able to embark on a renewed path of steady, albeit relatively slow, growth.

Seasonally Adjusted Monthly Rates of Unemployment in the U.S.



Seasonally Adjusted Monthly Rates of Unemployment in the U.S.



The Near-Term Macroeconomic Outlook: The U.S. Economy

- One problem face by the U.S. economy is that expectations can be self-fulfilling in the absence of any clear signal of change. If firms and households expect the economy to do terribly and act accordingly by reducing investment and consumption respectively, the economy will indeed turn out to be terrible, fulfilling their expectations.
- This may lead them to expect a further worsening of the economy, and act accordingly, resulting in an even further decline of the economy, creating a self-perpetuating downward spiral in which negative expectations lead to declines and declines feed into even more negative expectations.
- This has been, unfortunately, the story of the Japanese economy since its property price bubble burst in 1990. In order for expectations to change, there must be some concrete action or development that can act as a signal to the firms and households that the economy will be improving soon. For the U.S., the rapid development of the shale gas and oil industry may have such an impact on the economy.

The Near-Term Macroeconomic Outlook: The U.S. Economy

- The World economy has already experienced "Quantitative Easing I (QE-I)", "Quantitative Easing II (QE-II)", and "Quantitative Easing III (QE-III)" operations by the U.S. Federal Reserve Board. However, almost five years later, these operations did not seem to have improved the U.S. real economy significantly. Much of the excess liquidity generated went overseas, driving up exchange rates and asset prices elsewhere. If the U.S. had some form of capital control, so that the excess liquidity had to be kept and used within the U.S., it might perhaps have driven up some U.S. asset prices and led to some additional domestic investment. However, that has not been the case.

The Near-Term Macroeconomic Outlook: The U.S. Economy

- At this point, only an expansion of real aggregate demand can serve as an effective signal for a change in expectations. However, it does not appear likely that the U.S. Congress will authorise a fiscal expansion, even though that is exactly what is needed.
- There is ample excess capacity in the U.S. economy, especially in the construction sector and the building materials sector. What the U.S. Government should undertake is an expansion in capital expenditures focused on public infrastructure on the one hand and a reduction in recurrent expenditures to match recurrent revenue on the other. It should be supporting growth and at the same time imposing austerity in terms of balancing recurrent revenue and recurrent expenditure in the medium term.

The Near-Term Macroeconomic Outlook: The U.S. Economy

- What have the QEs accomplished for the U.S. economy?
- First of all, the QEs have prevented the financial system in the U.S. from collapsing totally. The major banks and insurance companies have managed to survive, with government assistance. The QEs have released sufficient liquidity and have taken the bulk of the mortgage-backed securities off the balance sheet of the banks.
- A total collapse of the U.S. financial system would have led to a situation much worse than that experienced during the Great Depression of the 1930s not only for the U.S. but for the entire World economy.

The Near-Term Macroeconomic Outlook: The U.S. Economy

- Second, the QEs have enabled the U.S. Dollar to devalue significantly with respect to almost all of the major currencies in the World, with the possible exception of the Euro. This has helped increase U.S. exports and decrease U.S. imports, other things being equal. (As the U.S. is ideologically incapable of intervening directly in foreign exchange markets, the QEs are one of the very few feasible options for engineering a devaluation. "Jawboning" is another feasible, but probably less effective, option.)
- Japan, as part of its Abenomics initiatives, has countered with its own QE in December2012, and reversed the appreciation of the Japanese Yen vis-a-vis the U.S. Dollar.
- Moreover, in anticipation of the tapering and possible termination of the QEs, the exchange rates of many currencies have already begun to devalue with respect to the U.S. Dollar since May 2013.

The Near-Term Macroeconomic Outlook: The U.S. Economy

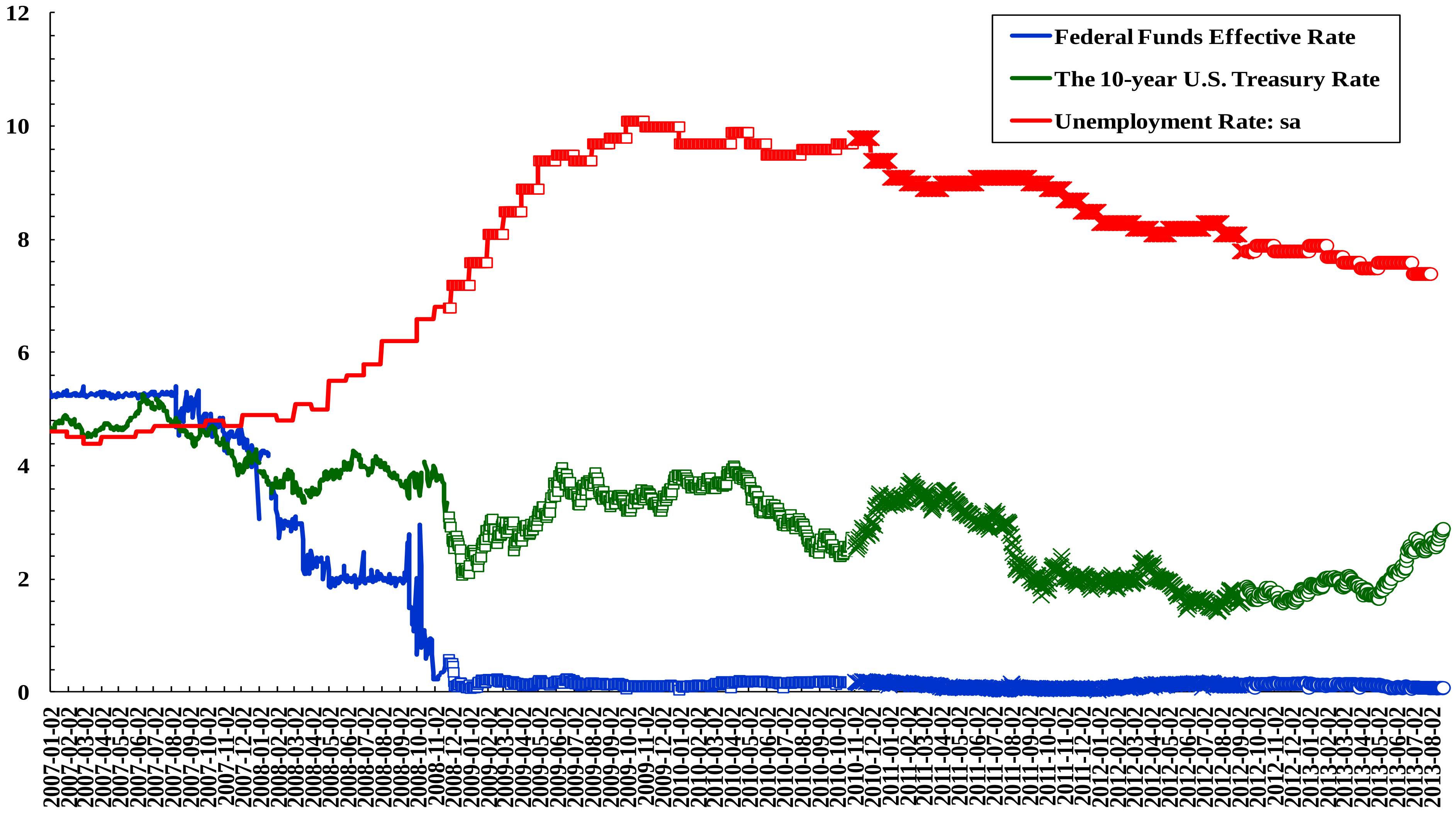
- Third, the QEs have enabled the U.S. long-term rate of interest to decline significantly and remain low until May 2013. The low long-term interest rate is meant to encourage domestic U.S. investment.
- The exceptionally low long-term interest rate has driven up the prices of securities and real assets, including housing. As a result, the housing market has shown signs of a revival, but with prices still significantly below its peak in 2006. The prices of financial assets—stocks and bonds—may have to undergo a significant adjustment as the long-term interest rate rises when the QE is finally terminated.

The Near-Term Macroeconomic Outlook: The U.S. Economy

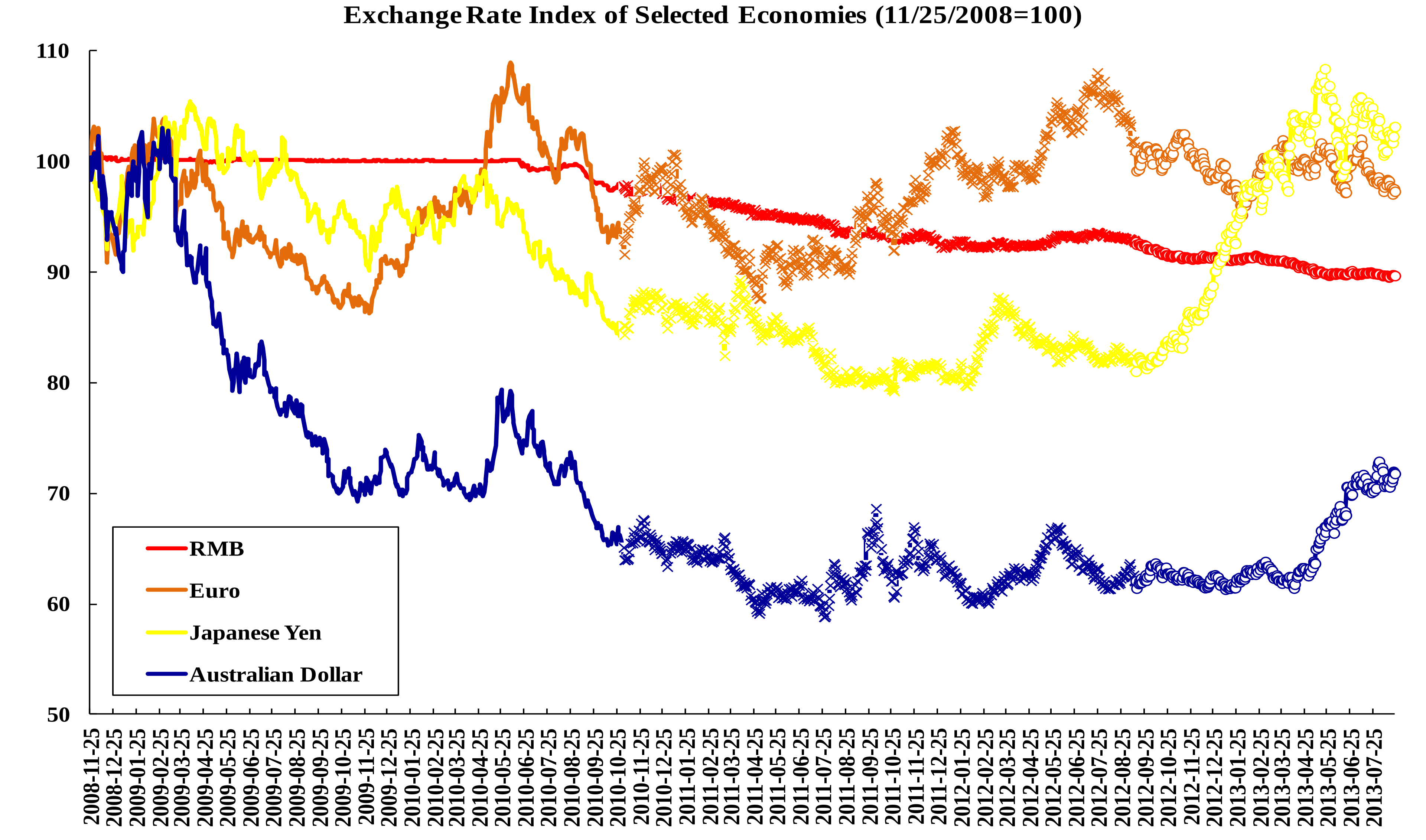
- Apart from the above, the QEs have not had much direct effect on the real economy. The low long-term interest rate does not seem to have induced many U.S. firms or federal or state governments to increase their domestic investments, which is the key to creating jobs. Hence it has not had a direct impact on U.S. aggregate demand or economic growth.

U.S. Federal Funds Rate, the 10-Year U.S. Treasury Rate, and Unemployment Rate

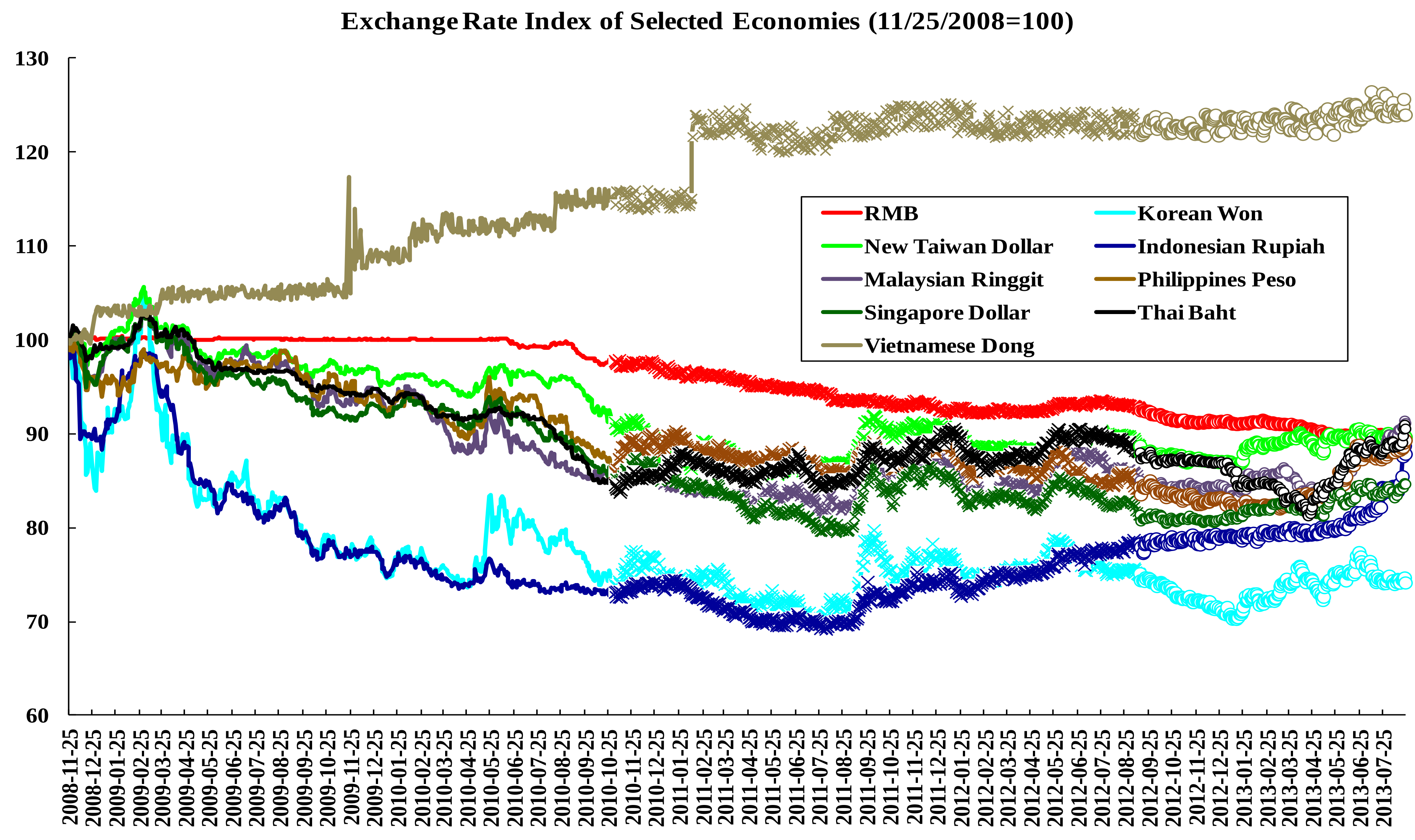
U.S. Federal Funds Rate, the 10-year U.S. Treasury Rate, and Unemployment Rate



Exchange Rate Index of Selected Economies since QEI (11/25/2008=100)



Exchange Rate Index of Selected Economies since QEI (11/25/2008=100)



The Exchange Rate Revaluations/Devaluations During QEI-III

The Exchange Rate Revaluation/devaluation during QE1

11/25/2008-8/23/2013

Currency	11/25/2008	8/23/2013	Revaluation/devaluation against USD
RMB	6.8245	6.1205	10.32%
Euro	0.76748	0.74675	2.70%
Japanese Yen	95.532	98.547	-3.16%
Australian Dollar	1.54135	1.1066	28.21%
Korean Won	1501.72	1113.9	25.83%
New Taiwan Dollar	33.349	29.906	10.32%
Indonesian Rupiah	12209	10729.6	12.12%
Malaysian Ringgit	3.6207	3.3014	8.82%
Philippines Peso	49.409	44.144	10.66%
Singapore Dollar	1.5108	1.2795	15.31%
Thai Baht	35.205	31.893	9.41%
Vietnamese Dong	16957	21030	-24.02%
Indian Rupee	49.894	63.229	-26.73%

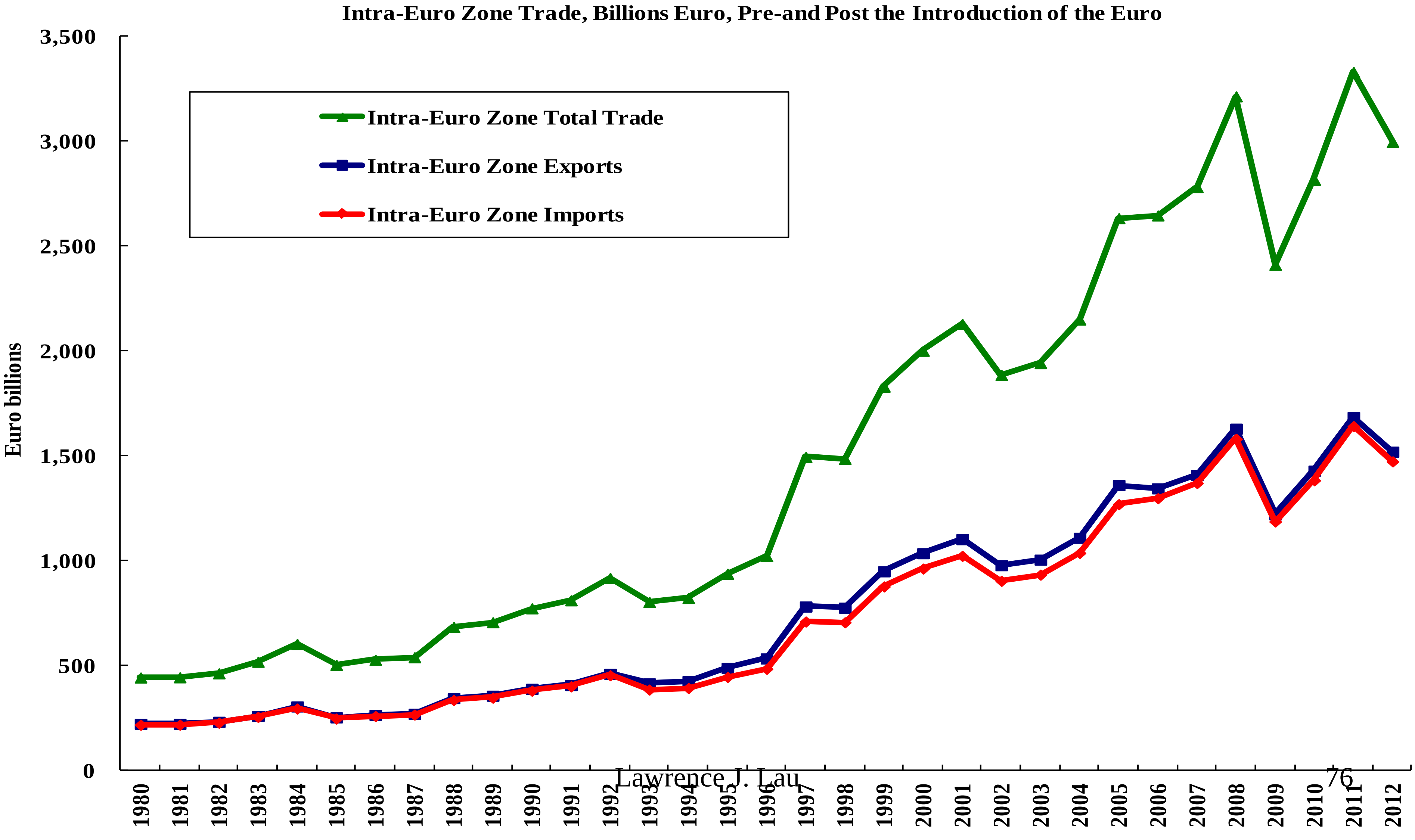
The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- The Euro Zone economies, including Germany, fell into recession as the European sovereign debt crisis was allowed to fester and spread to other Euro Zone economies from Greece.
- What is needed is some resolute action to reassure the World that the Euro Zone economies will do whatever it takes for the Euro to survive as a major international reserve currency. It does appear that the Euro Zone Governments have managed to convince the market that this is indeed the case. The Euro has finally begun to stabilise and the interest-rate spreads among Euro Zone economies have begun to narrow significantly.

The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- Stable relative exchange rates among economies can and do enhance the international trade and investment flows among them significantly, much more so than a free trade area or a common market among them.
- The introduction of the Euro as a single currency for countries in the Euro Zone is a good example—intra-Euro Zone trade tripled to approximately 3 trillion Euro (or US$4 trillion) after the introduction of the Euro in the late 1990s even though there had been no tariffs among the major countries in the Euro Zone since the 1960s.
- The benefits to the major Euro Zone economies such as France and Germany of maintaining the Euro far exceed the costs of doing so.

Intra-Euro Zone Trade, Billions Euro, Pre-and Post the Introduction of the Euro



What Caused the European Sovereign Debt Crisis?

- The source of the European sovereign debt crisis is the accumulation of public debt by a Euro Zone country, incurred to support a continuing series of government budget deficits, to a level that is beyond the servicing capacity of the individual country.
- Moreover, it is important to make a distinction between internal debt and external debt. Internal debt is debt owed by a country to its own citizens and firms. External debt is debt owed by a country to non-nationals. Debt repayments to a country's own citizens and firms stay in the country, not so debt repayments to non-nationals.

What Caused the European Sovereign Debt Crisis?

- If the public debt is mostly internal, as in Japan, where despite a public debt to GDP ratio of almost 250%, only 5% of the public debt is held by non-nationals, the problem is manageable.
- Internal debt is a little like debt within the same family. The son borrows from the father. When the father demands repayment from the son, the son goes to the mother and asks for money to repay the father. The mother asks the father for money. Father gives money to mother, mother gives money to son, and son repays the father. This completes the circle. This arrangement can continue more or less indefinitely, especially if the rate of interest is low, as long as the money stays within the family.
- However, if the debt is external to the family, this recycling breaks down. Debt repayment then becomes a real burden for the family.

What Caused the European Sovereign Debt Crisis?

- As long as the public debt is internal to a country, the government can issue new debt to its citizens and firms and repay the old debt with the proceeds from the new debt. This process can continue indefinitely if the domestic citizens and firms have confidence in the government's ability to repay, and especially if the nominal interest rate is low. (The government can also increase taxes and repay the old debt with the additional taxes collected.)
- However, this process breaks down if the debt is held externally, by non-nationals. In this case, net real resources must flow out of the country in order to repay the debt. And when a country fails to repay the debt, it is in default.

What Caused the European Sovereign Debt Crisis?

- Unfortunately, in the case of Greece, much of the debt is external. The situation is therefore not sustainable.
- The other option of solving the problem through printing more money is also not available to Greece, because it does not have the authority to issue Euros (unlike the United States and Japan, which can increase the supply of U.S. Dollars and Japanese Yen respectively at will).
- The solution for Greece is therefore limited to severe austerity or outright default (which implies exit from the Euro Zone).
- It does not help that there are many speculators speculating on an eventual Greek default. The indiscriminate sale of credit default swaps (CDSs) on Greek debt, and for that matter on the debts of other member countries of the Euro Zone, to speculators who do not own the underlying bonds, exacerbated an already bad situation.

What Caused the European Sovereign Debt Crisis?

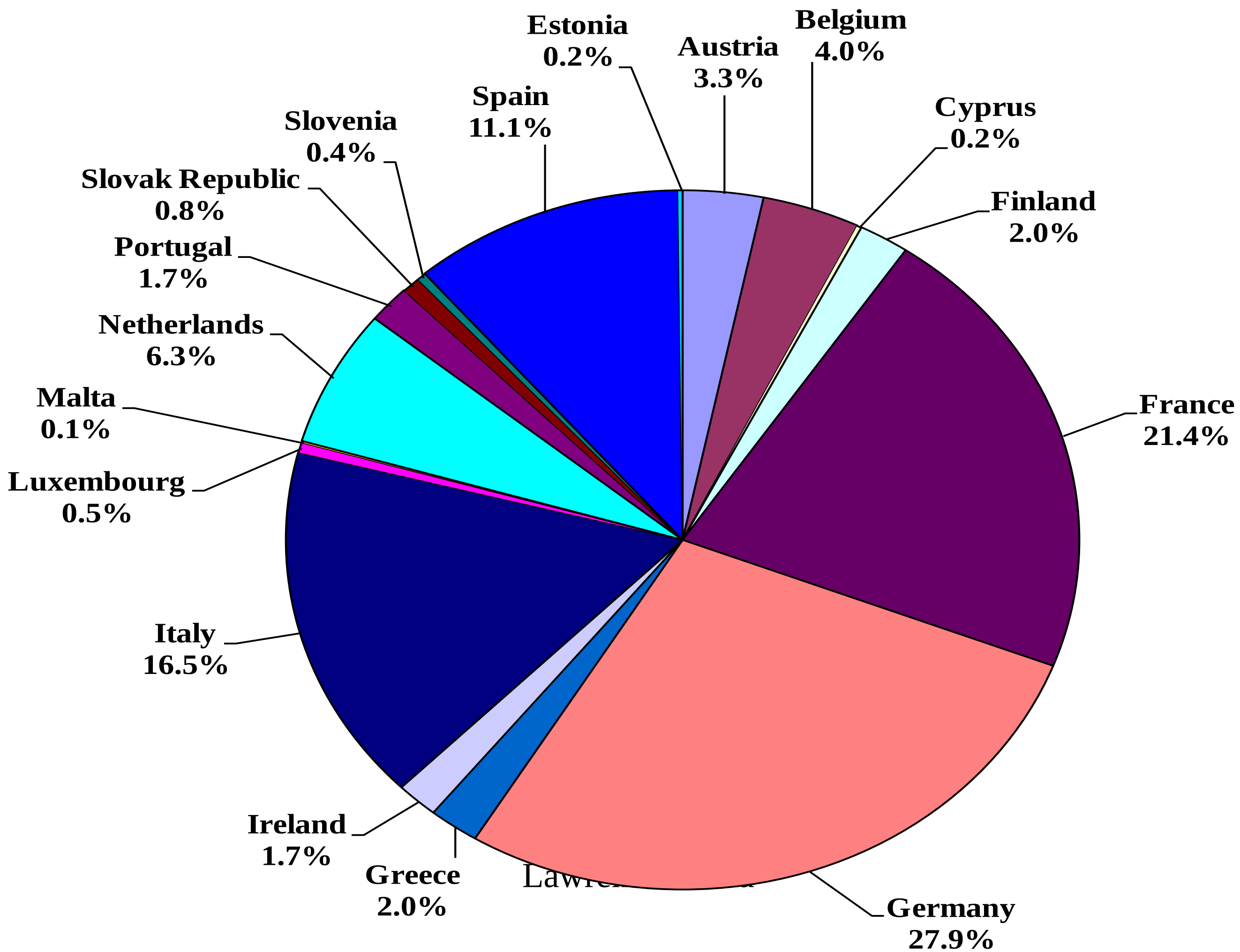
- Fiscal contraction at a time of recession feeds negative expectations about the future. It is better to have a short-term fiscal expansion in capital expenditures (but not recurrent expenditures) to promote the resumption of growth, coupled with a longer-term plan for achieving fiscal balance between recurrent expenditures and recurrent revenues in the long run.

The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- The Greek economy accounts for only 2% of the Euro Zone GDP. It is almost immaterial to the Euro Zone if Greece exits from the Euro Zone. And some Euro Zone countries may even welcome it.
- However, the costs to Greece will be much greater leaving the Euro Zone than staying. By leaving the Euro Zone, Greece will have to bring back its own currency, the drachma, which is certain to devalue sharply with respect to the Euro, resulting in a high rate of inflation in Greece for a while, even though it may promote some exports. Moreover, the problem of insufficient government revenue, whether in Euro or in drachma, will persist, necessitating a severe austerity programme either way. Thus, the painful adjustment by the government cannot be avoided.

The Distribution of the GDP of Euro Zone in 2012

The Distribution of the GDP of Euro Zone in 2012, in Euro billions



The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- What Greece should do is to reduce its recurrent government expenditures significantly to match its recurrent revenue based on actual collections, but at the same time undertake some capital projects, possibly with the support of other Euro Zone economies such as France and Germany, so as to maintain some economic growth and prevent unemployment from becoming too high. It must promote growth and impose austerity at the same time.

The Near-Term Macroeconomic Outlook: World Bank Global Economic Prospects

- The World Bank, in its Global Economic Prospects report published in June 2013, has forecast that the Global GDP, which grew 2.3% in 2012, will grow at 2.2% (down from the original forecast of 2.4%) in 2013, 3.0% (down from 3.1%) in 2014 and 3.3% in 2015. So there should be steady improvement in the World economy over time.
- The developed economies are forecast to grow a modest 1.2% in 2013, strengthening to 2.0% in 2014 and 2.3% in 2015, whereas the developing economies are forecast to grow at 5.1% in 2013, the same as in 2012, strengthening to 5.6 % and 5.7 % (down from 5.8%) in 2014 and 2015, respectively.
- China is forecast to grow 7.7% in 2013, strengthening to 8.0 and 7.9 % in 2014 and 2015 respectively.

Concluding Remarks

- The centre of gravity of the World economy is gradually shifting to Asia (East Asia and South Asia) from North America and Europe. The shift is still on-going.
- Despite the shift, China is still very much a developing economy in per capita terms.
- If current trends continue, it will probably take 15 years or so for Chinese real GDP to catch up to the level of the United States real GDP. In the meantime, the U.S. economy will still be the largest in the World.
- It will take another 30 years, until around 2060, for China to reach the same level of real GDP per capita as the United States (bear in mind that in the meantime, the U.S. economy will also continue to grow, albeit at rates significantly lower than those of the Chinese economy and that the Chinese population is likely to reach a plateau in 2045).

Concluding Remarks

- The partial de-coupling of East Asia is likely to accelerate the integration of the East Asian economies themselves as well as other multilateral initiatives such as the ASEAN Free Trade Area (+3—China, Japan and Korea, +6—Australia, New Zealand and the U.S.), Regional Comprehensive Economic Partnership (RCEP—ASEAN + 3 + Australia, New Zealand and India), and the Chiangmai Initiative.

Concluding Remarks

- The energy markets of the World, going forward, should shift in favour of consumers rather than producers as the anticipated additional supplies of unconventional sources of energy, including shale oil and gas, materialise, especially from the U.S.
- However, the possibility of another global financial crisis cannot be ruled out. Despite the implementation of the Basel III rules for the regulation of banks and the passage of the Dodd-Frank Act in the U.S., the regulation and supervision of financial institutions in the developed economies remain weak and can be further watered down by lobbyists for the financial institutions.

Concluding Remarks

- The long-term outlook for the U.S. economy is, however, quite positive. The innovative capacity of the U.S. economy is unmatched in the World—think of the internet, the micro-processor, the I-phone and the I-pad. The U.S. is also likely to become a net energy exporter within the next decade, taking advantage of its huge reserves of shale gas and oil and advanced hydraulic fracturing technology.
- It is in the interests of the Euro Zone authorities to step in decisively and forcefully as necessary to maintain confidence in the Euro and Euro Zone debt. Confidence, once lost, is extremely difficult and costly to restore.

Concluding Remarks

- Gong forward, Chinese economic growth will be driven by the growth of its own internal demand, consisting of both investment and consumption, rather than the growth of exports, and in time by innovation and technical progress in addition to growth in tangible inputs.
- China has also been gradually changing from its role as the World's factory to the World's new growth market. It is already the World's largest exporting country and is on its way to becoming the largest importing country in a couple of years.
- The Chinese trade surplus vis-a-vis the World has been declining and will continue to decline until Chinese international trade is approximately balanced.

Concluding Remarks

- The Renminbi has since 2009 been used in the clearing and settlement of Chinese international transactions. Currently, 16% of Chinese international trade (approximately US$330 billion) is settled in Renminbi. The use of the Renminbi for international settlement will continue to increase, especially in East Asia. The is a natural development, as settlement in own currencies reduces both transactions costs and exchange rate risks.
- The Renminbi has been current accounts convertible since 1994. It is likely to become capital accounts convertible within the next five years, perhaps with the imposition of a Tobin-like fee on conversion into and out of Renminbi to discourage short-term round-trip capital flows.