The Global Economy and the Global Financial Crisis

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Outline

- The World Economic Situation
- The U.S. and European Debt Crises
- Concluding Remarks

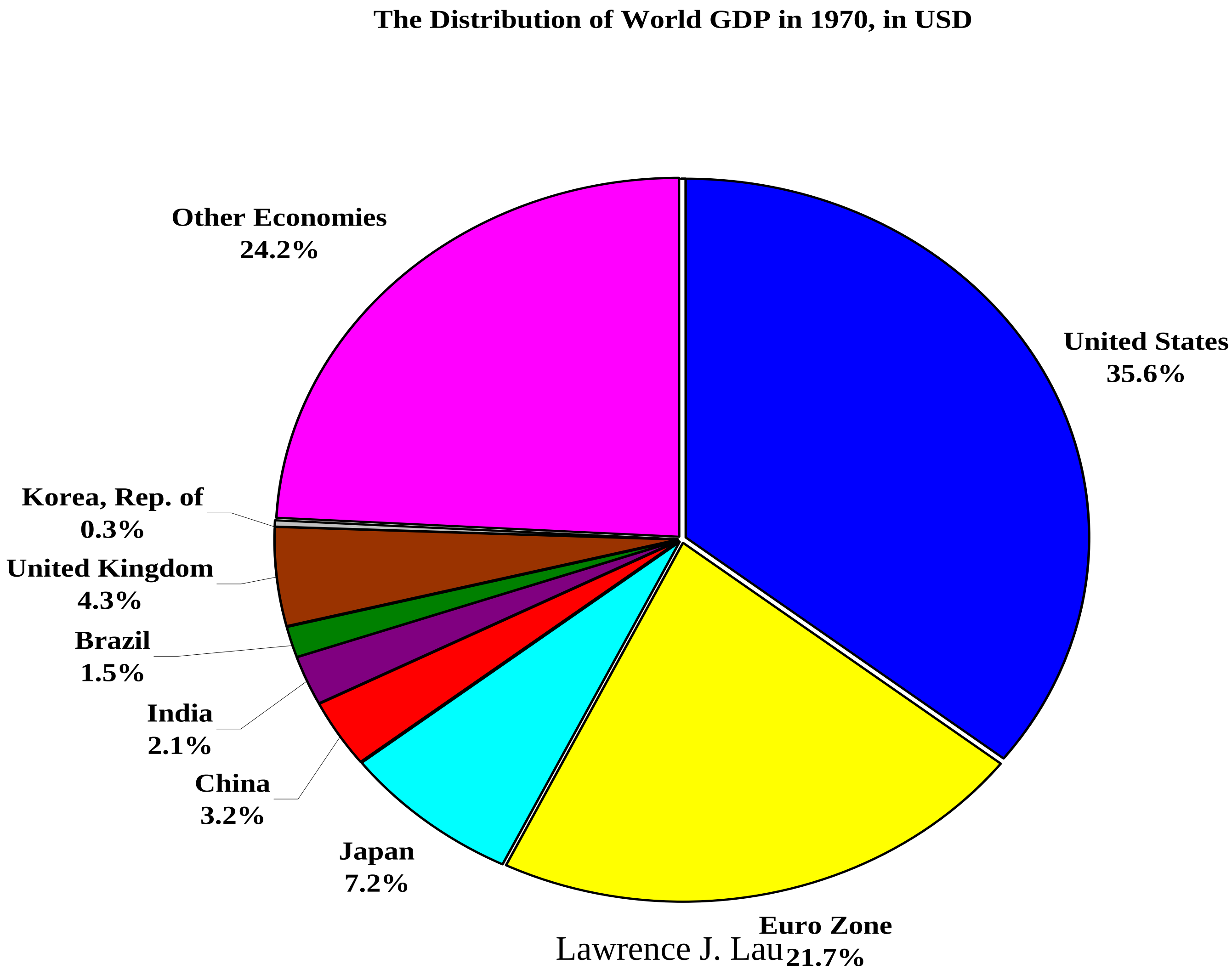
The World Economic Situation

- The centre of gravity of the World economy has been gradually shifting from the United States and Europe to Asia, including both East Asia and South Asia.
- The East Asian economies are partially de-coupled from the rest of the World economy, as evidenced by the continuing rapid growth of China and other East Asian economies except Japan during the 2007-2009 global financial crisis.
- However, the Chinese and East Asian economies are not large enough to turn the World around. The idea of a G-2 consisting of the United States and China dominating the World economy is premature.

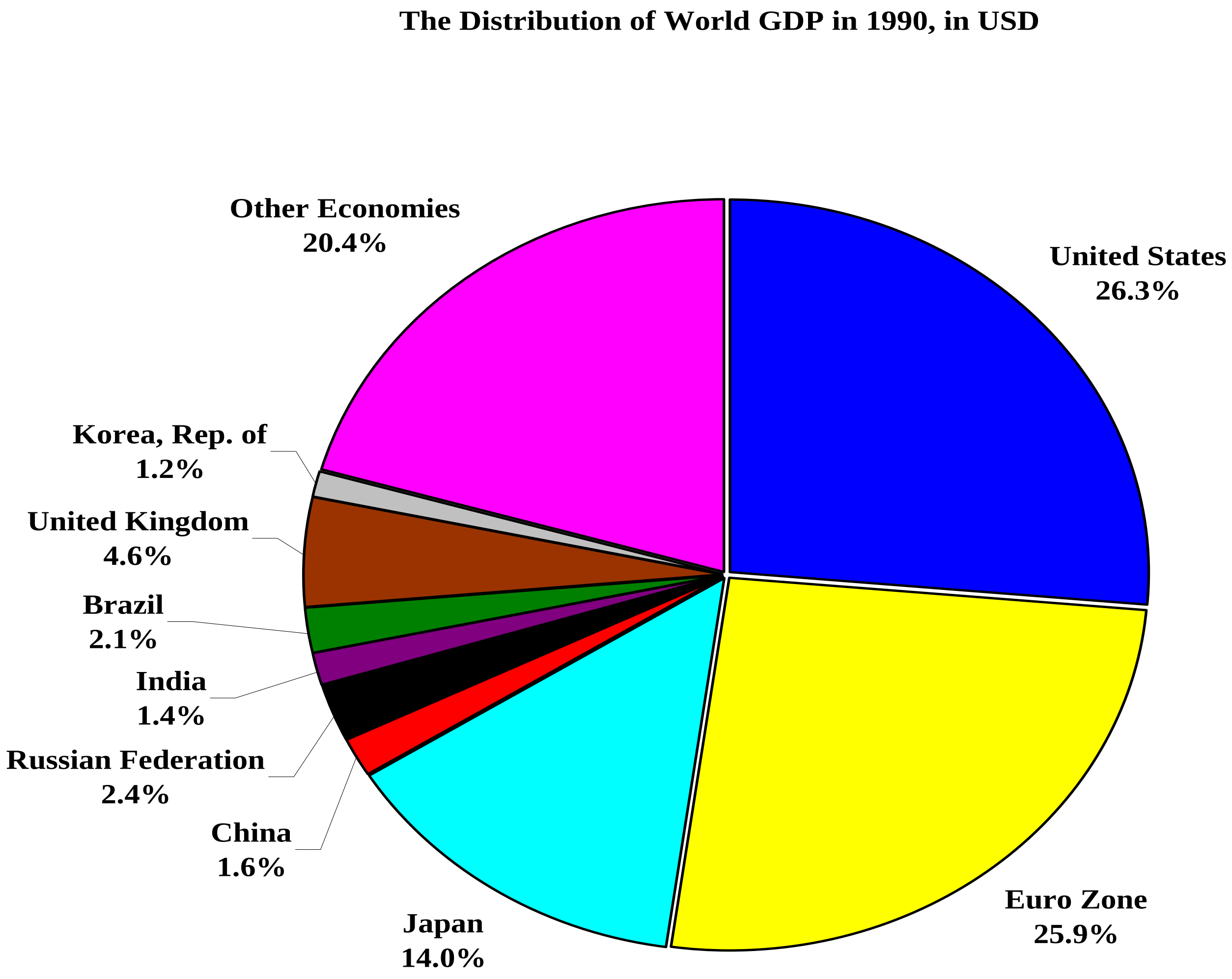
The World Economic Situation: The Shifting Centre of Gravity

- The U.S. share of World GDP, in current U.S.$, has fallen from 35.6% in 1970 to 26.3% in 1990 to 23.1% in 2010.
- During the same period, the Chinese share of World GDP, in current U.S.$, started at 3.2% in 1970, fell to 1.6% in 1990 and then rose to 9.3% in 2010.
- Also during the same period, the Japanese share of World GDP, in current U.S.$, started at 7.2% in 1970, rose to 14.0% in 1990 and then fell to 8.7% in 2010.
- The U.S. and Western Europe accounted for more than 70% of World GDP in 1970 but less than 50% in 2010.
- The BRICS countries (Brazil, Russia, India, China and South Africa) together accounted for some 18% of World GDP in 2010.

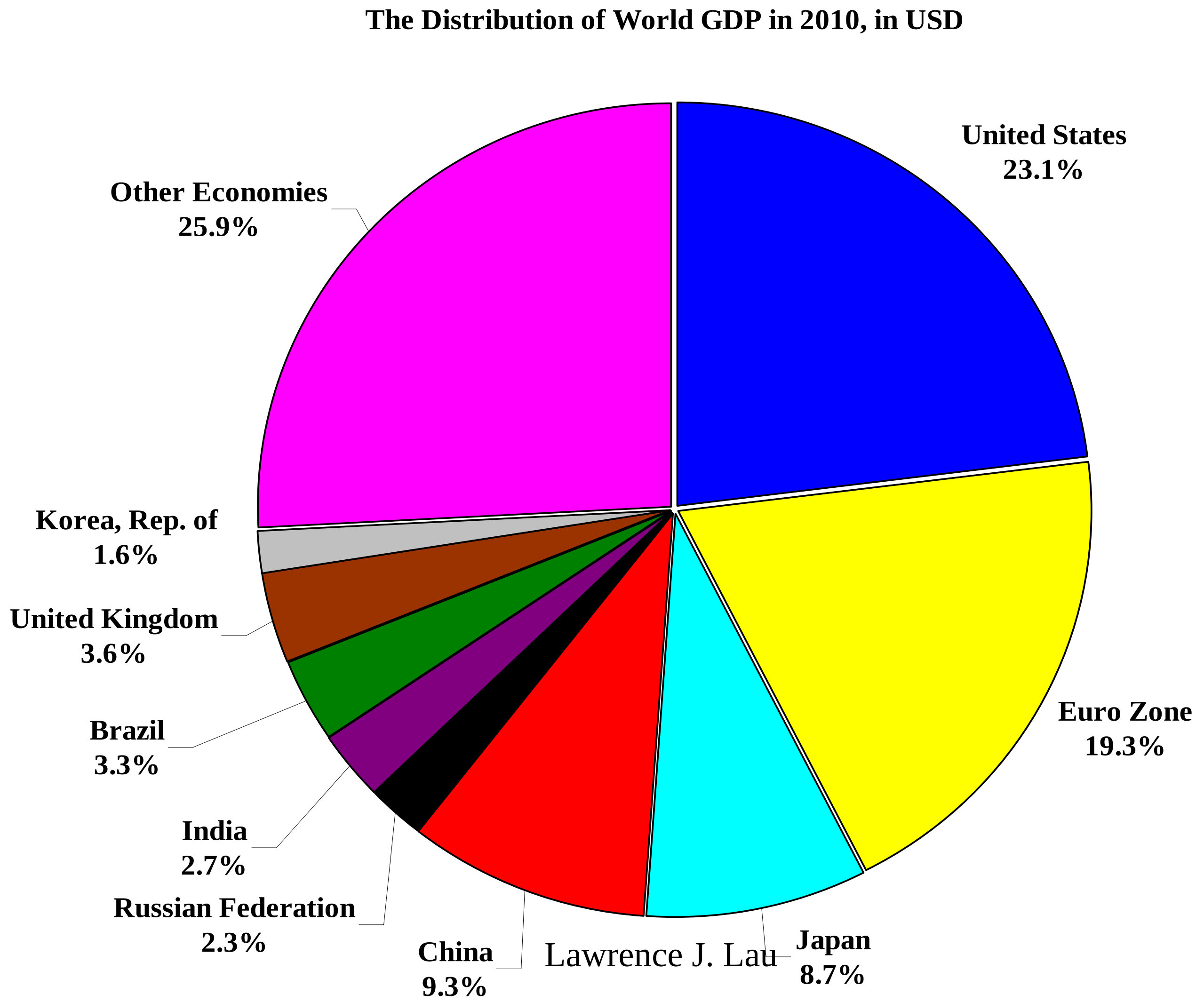
The Distribution of World GDP, 1970, US$



The Distribution of World GDP, 1990, US$



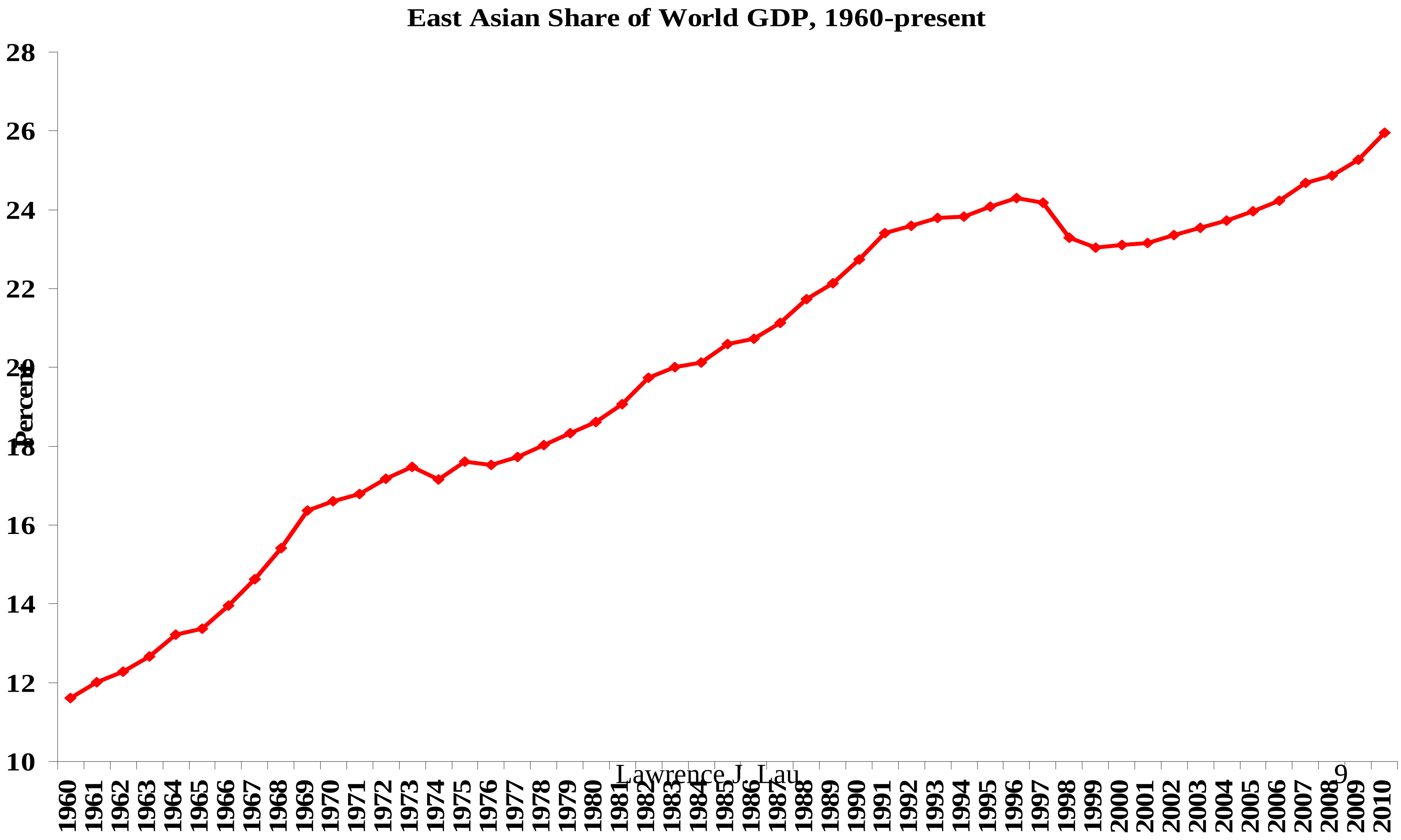
The Distribution of World GDP, 2010, US$



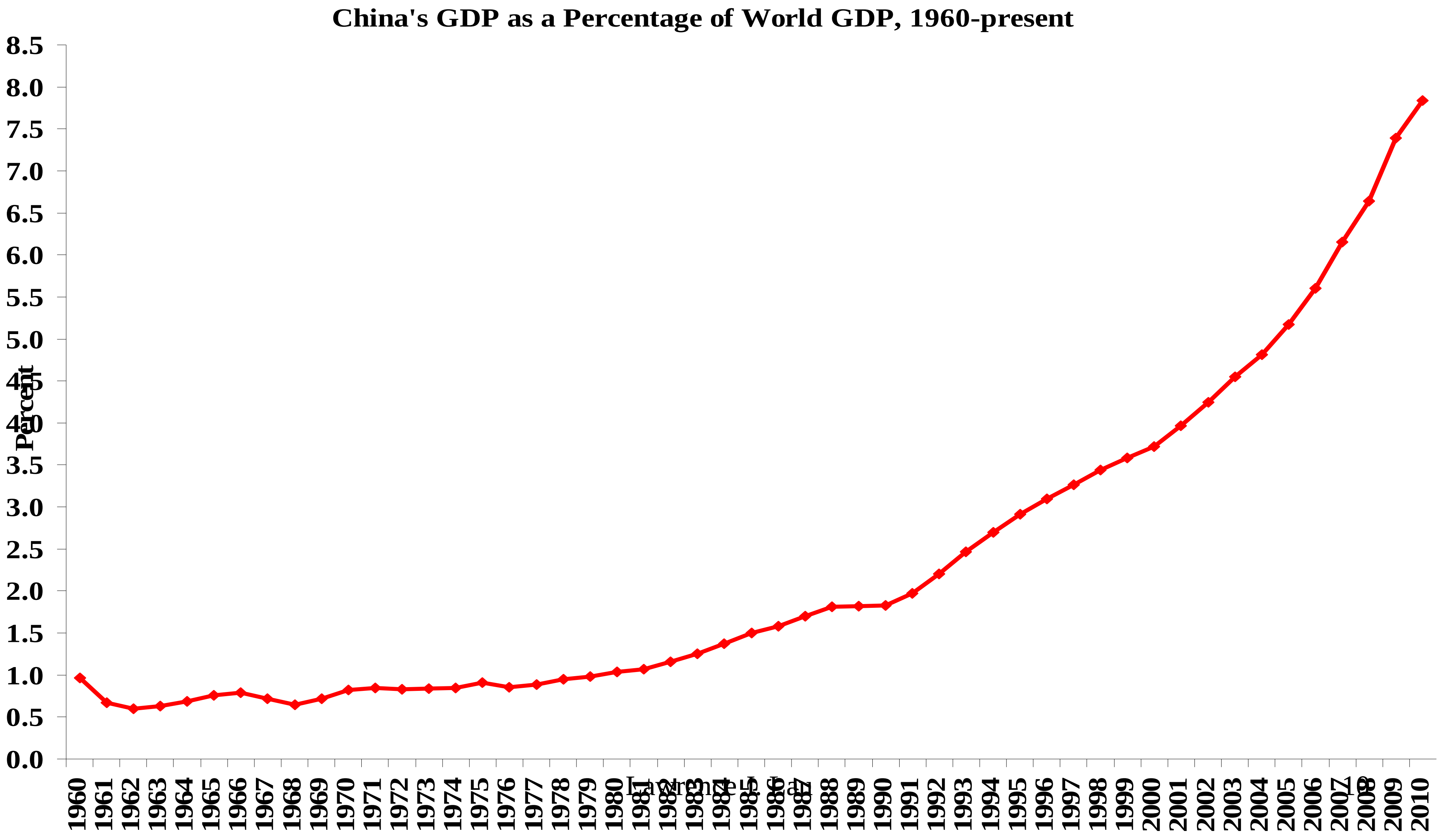
The World Economic Situation: The Shifting Centre of Gravity

- East Asia as used in this lecture is taken to mean the 10 ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (including Hong Kong, Macao and Taiwan), Japan, and South Korea), that is, approximately, all the territories in Asia east of Bangladesh and west of the Pacific Ocean.
- The share of World GDP of East Asia has risen from 16% in 1970 to 26% in 2010, larger than those of the U.S. and the Euro Zone.
- In the following charts, East Asian and Chinese GDPs as percentages of World GDP since 1960 are respectively presented. Both percentages show very strong trends of growth over the past half a century.

East Asian Share of World GDP, 1960-Present, in 2010 US$



China’s Share of World GDP, 1960-Present, in 2010 US$

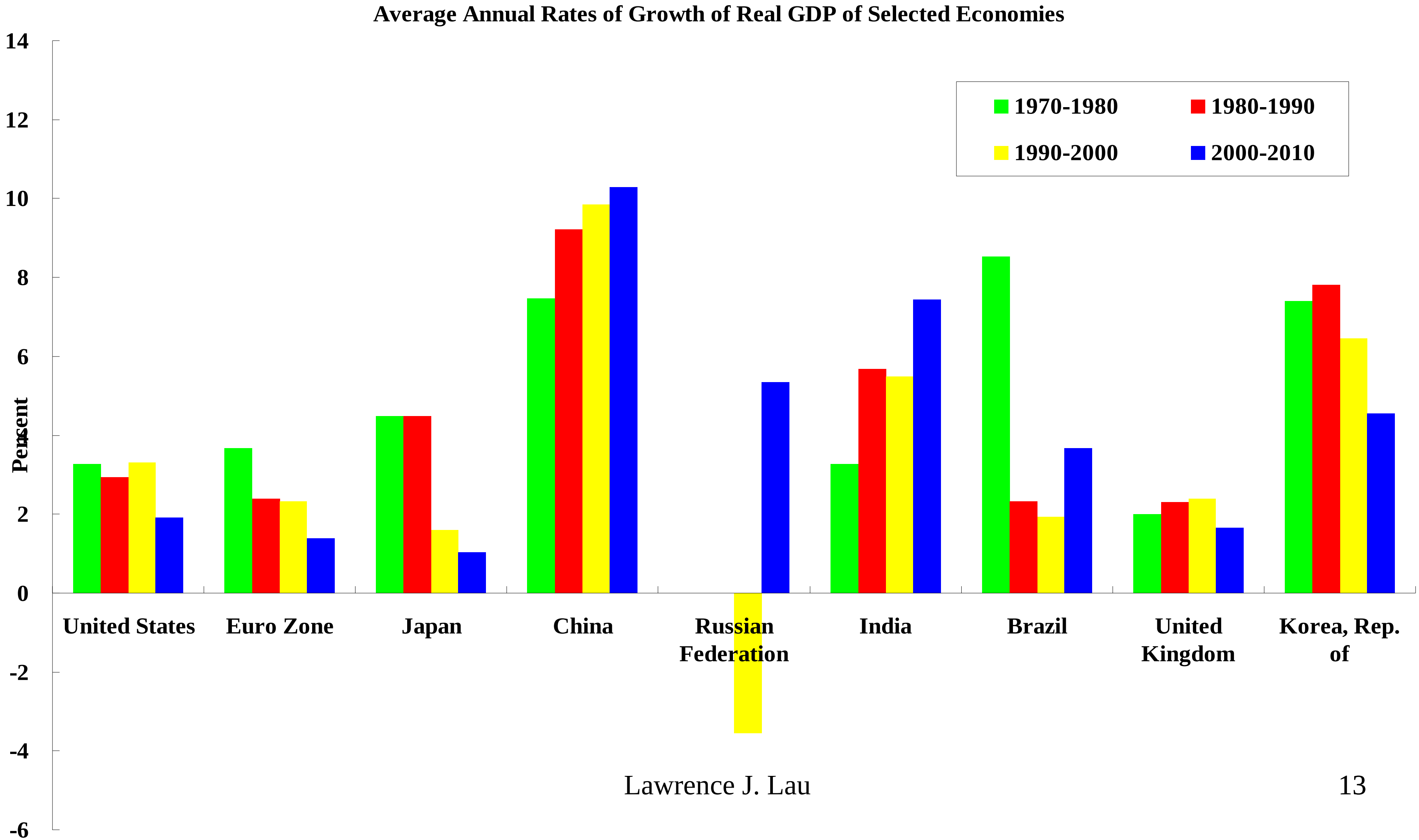


China’s Share of World GDP, 1960-present, in Current US$

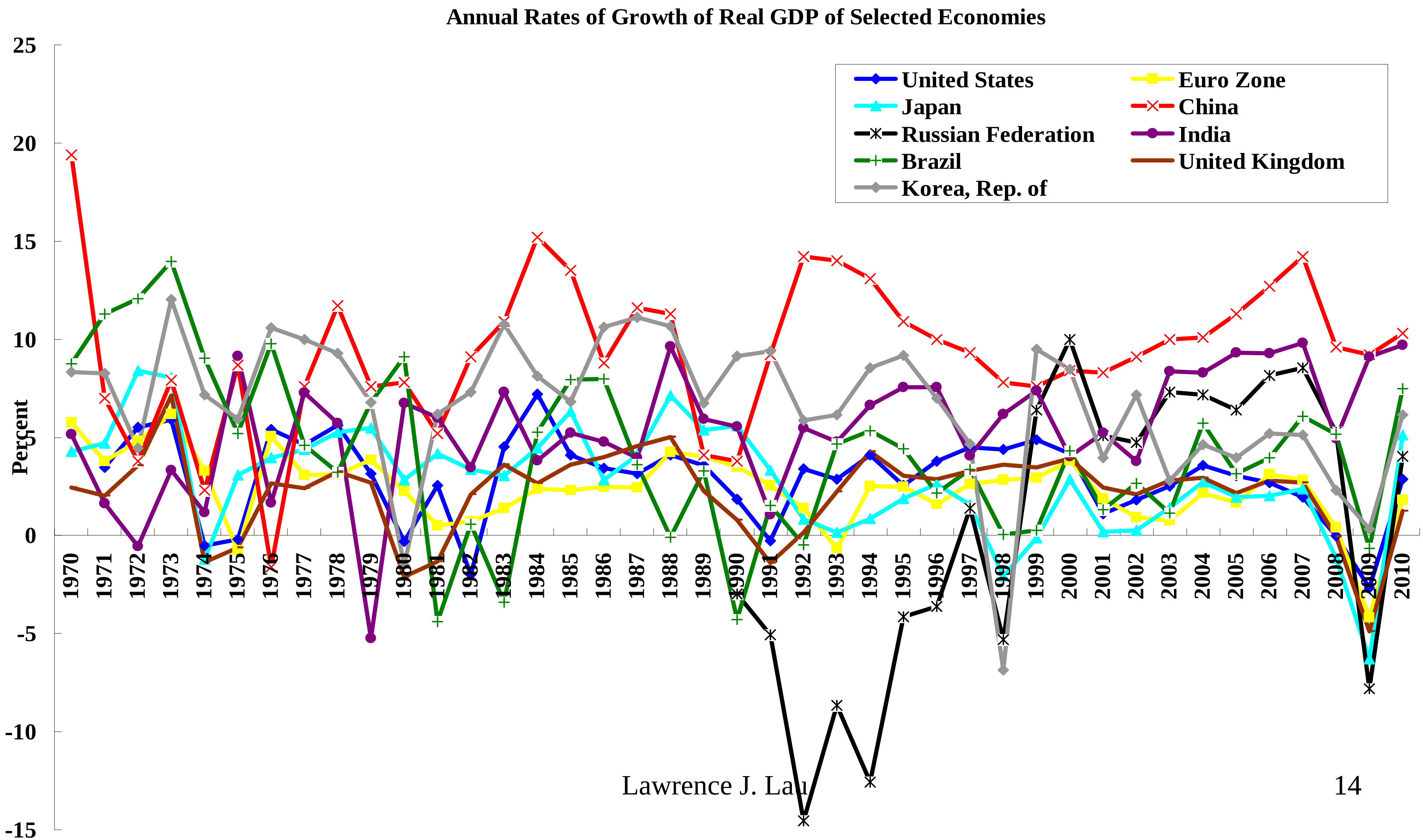
The World Economic Situation: The Differentials in Real Growth Rates

- On the whole, the BRICS countries as well as the East Asian economies (except Japan) have been growing much faster than the developed economies (U.S., Europe and Japan).
- Moreover, the rates of growth of the developed economies have been falling significantly over time.
- China, as well as other East Asian economies except Japan, have been able to continue to grow during the 2007-2009 global financial crisis, lending empirical support to the "Partial De-Coupling Hypothesis," which says that while East Asia is not immune from the effects of the economic recession in the United States and Europe, it can nevertheless continue growing, albeit at somewhat lower rates, even with economic contraction in the U.S. and Europe.

Average Annual Rates of Growth of Real GDP of Selected Economies



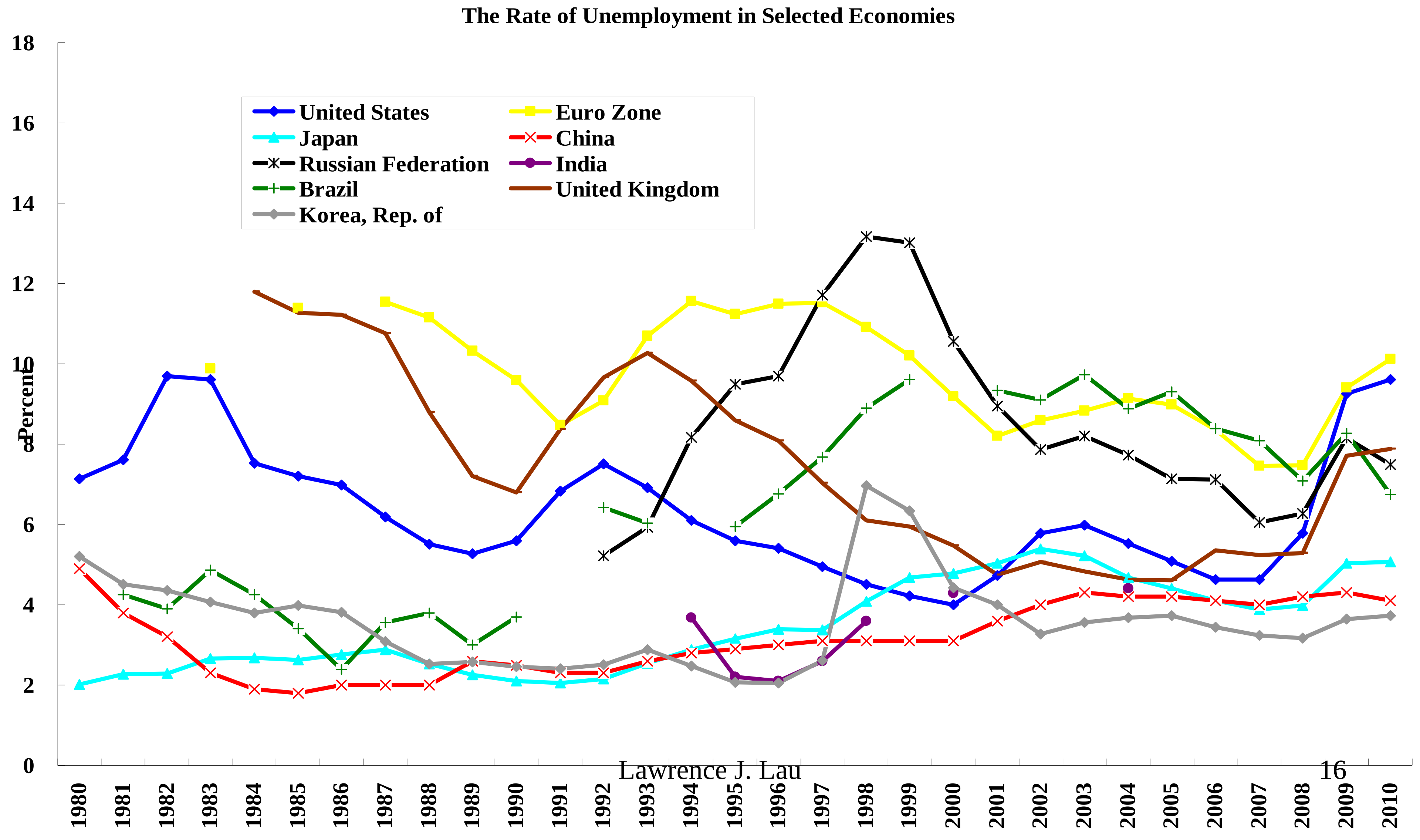
Annual Rates of Growth of Real GDP of Selected Economies



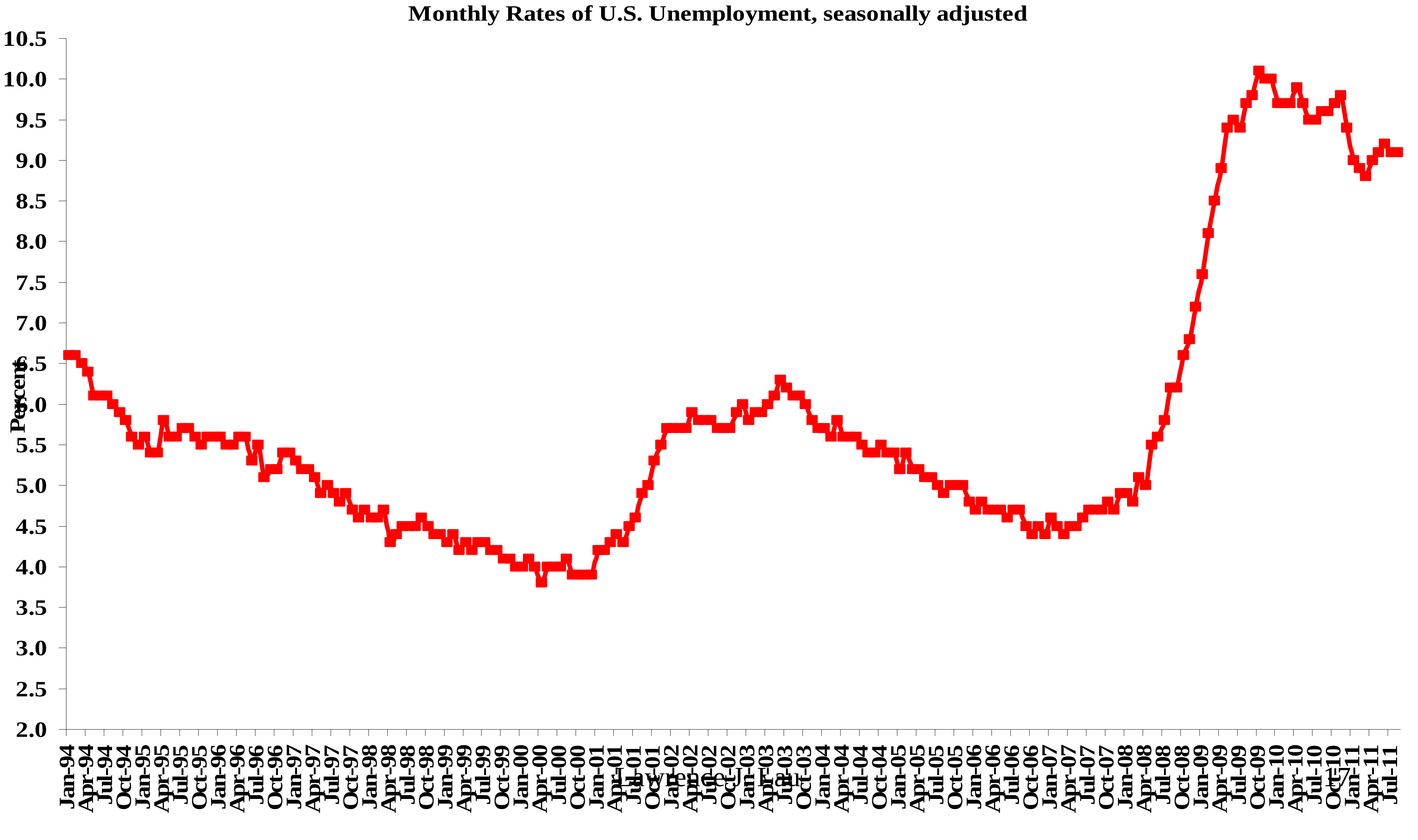
The World Economic Situation: The Differentials in Unemployment Rates

- The unemployment rates have remained stubbornly high in the United States and Europe in the aftermath of the 2007-2009 global financial crisis.

The Rate of Unemployment in Selected Economies



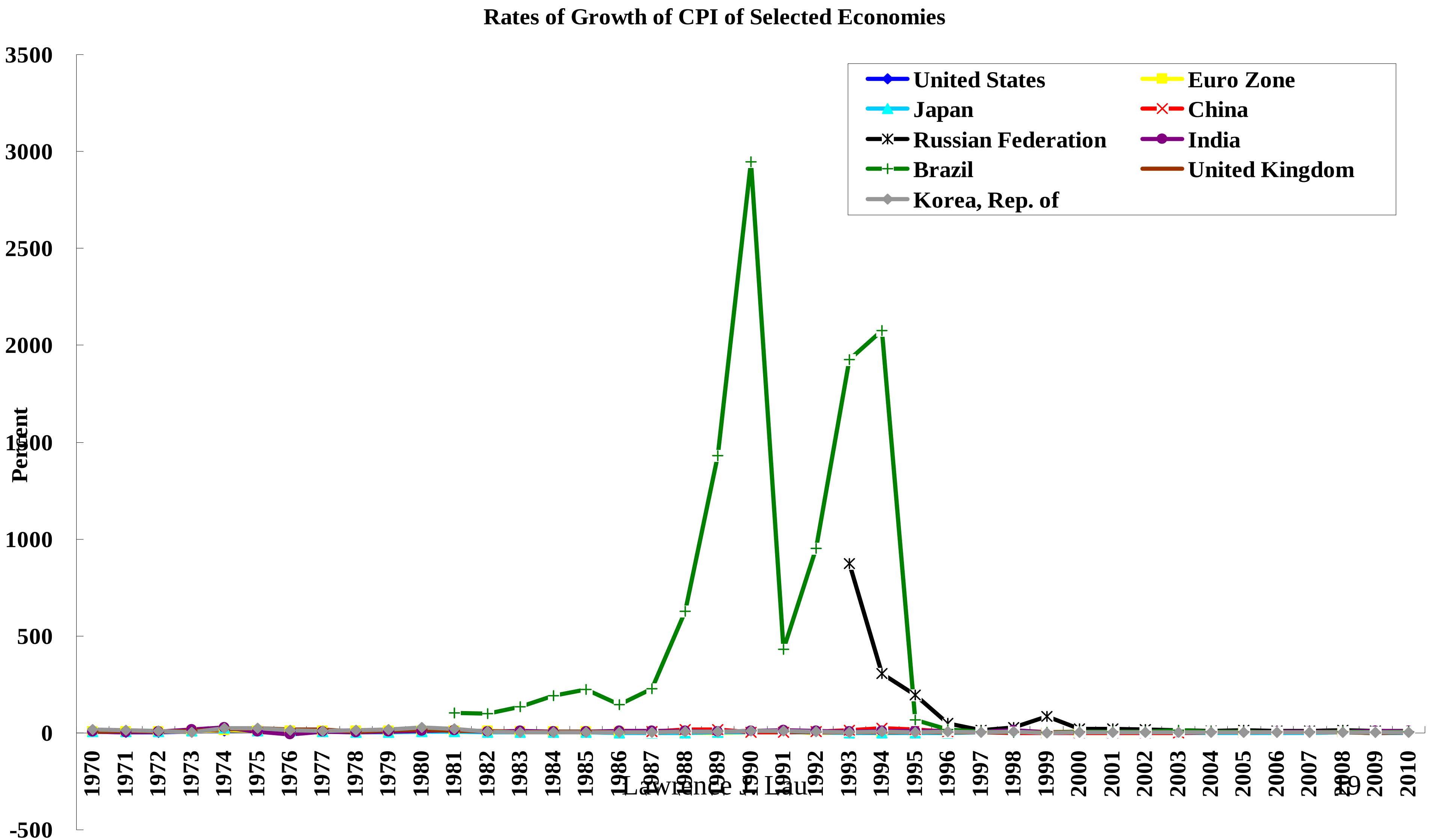
U.S. Unemployment Rate
Seasonally Adjusted



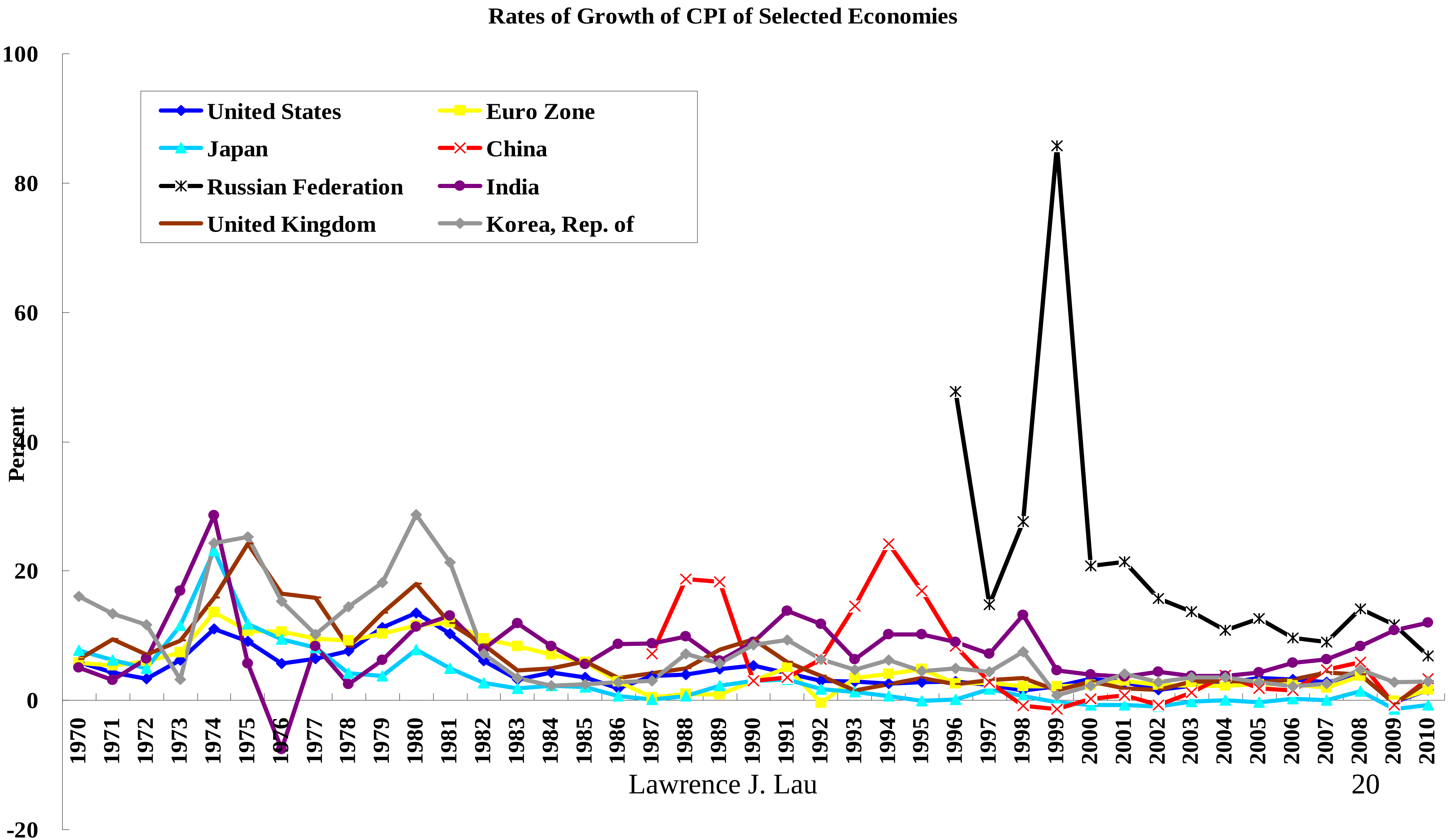
The World Economic Situation: The Differential Rates of Inflation

- The rates of inflation worldwide has remained relatively tame with the exceptions of Brazil, Russia and India.

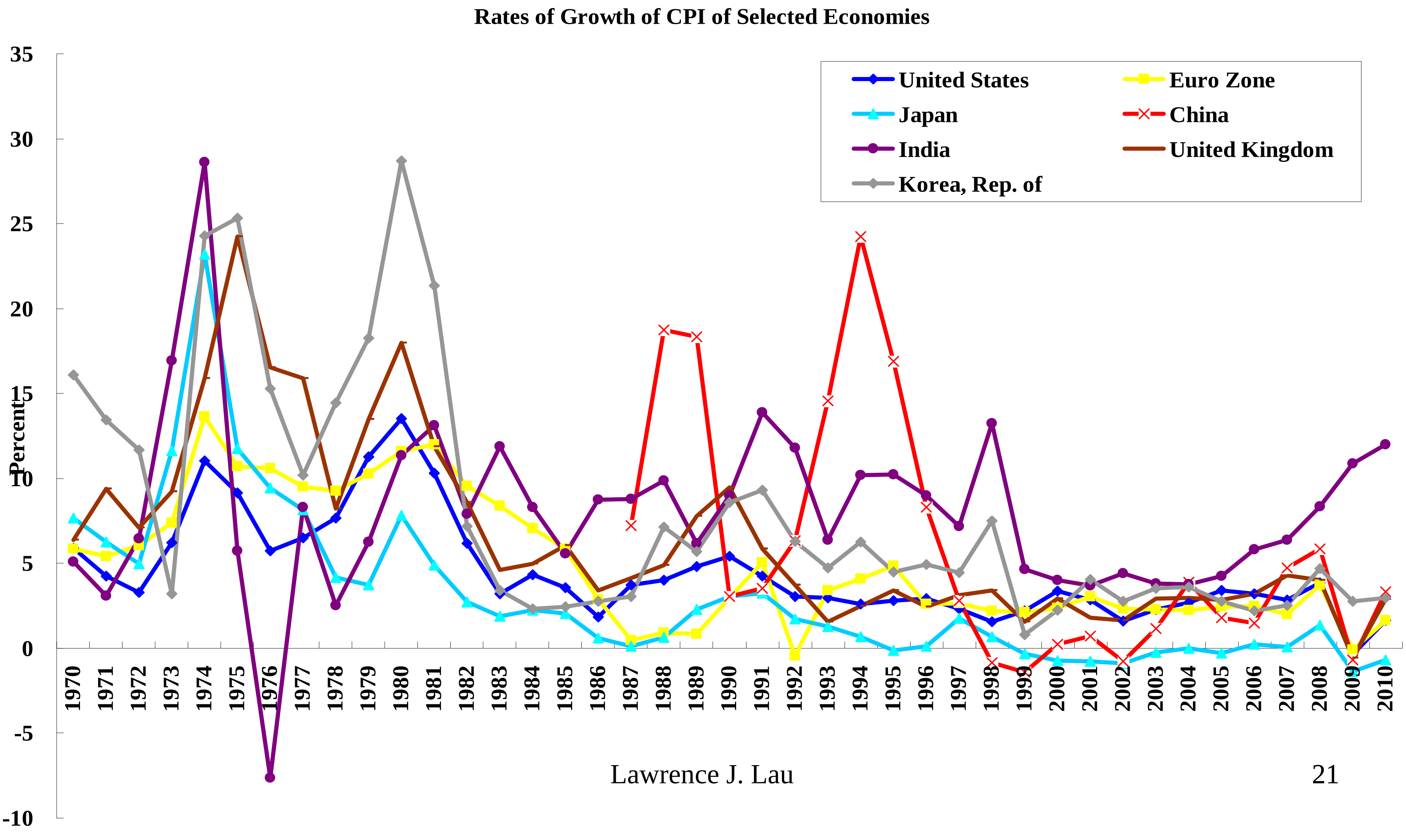
The Rate of Inflation in Selected Economies



The Rate of Inflation in Selected Economies (without Brazil)



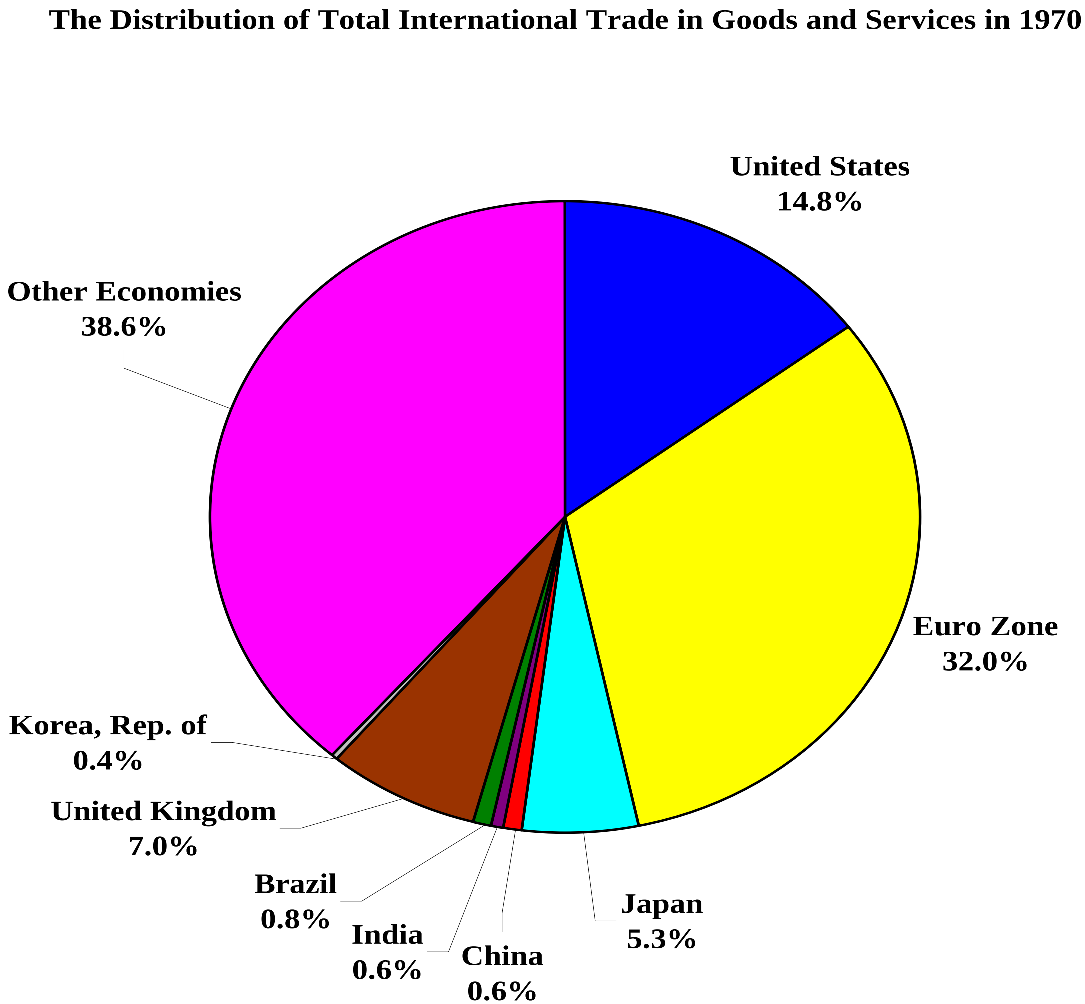
The Rate of Inflation in Selected Economies (without Brazil and Russia)



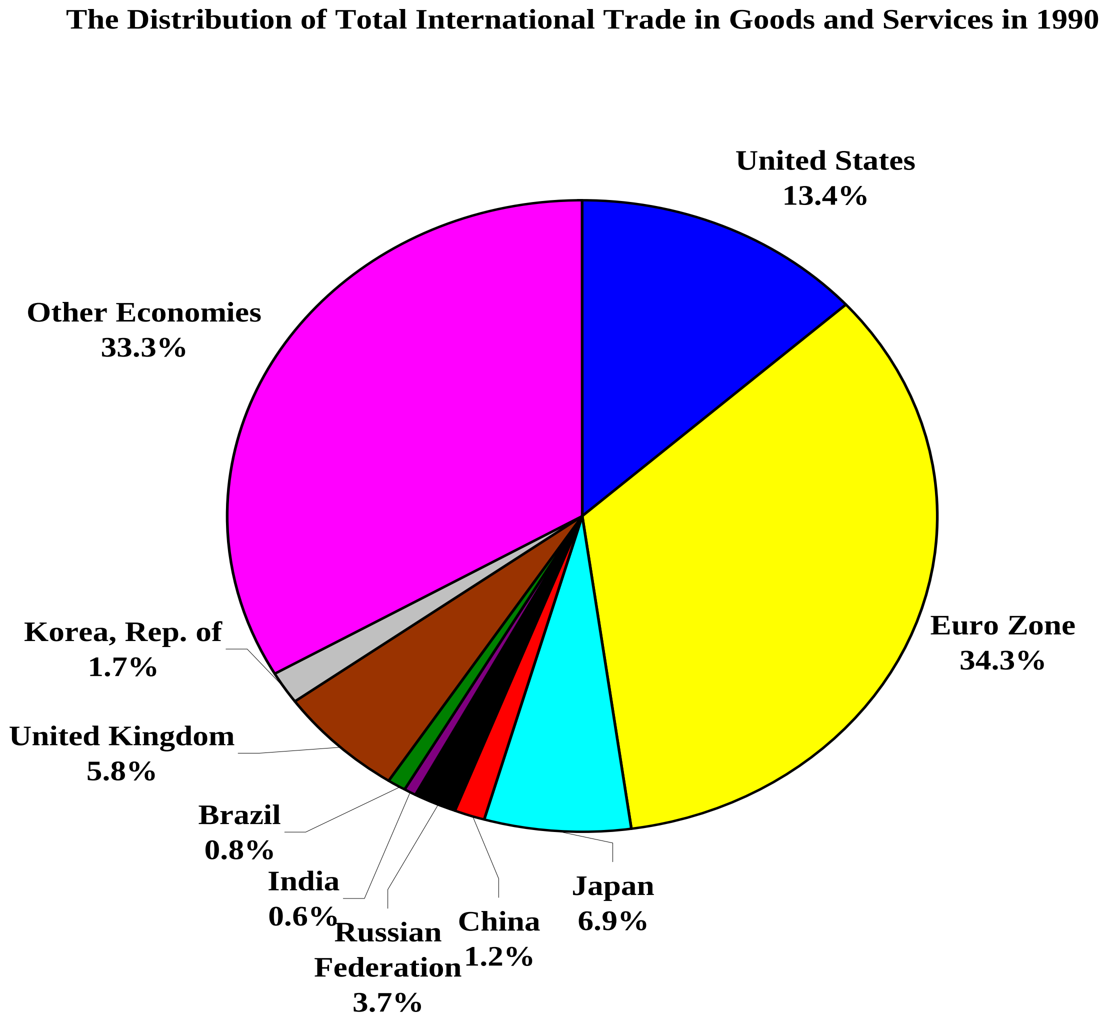
The World Economic Situation: The Changing Pattern of International Trade

- The U.S. share of World trade, in current U.S.$, has fallen from 14.8% in 1970 to 13.4% in 1990 to 11.3% in 2010, but still remains the largest in the World.
- During the same period, the Chinese share of World trade, in current U.S.$, rose from 0.6% in 1970 to 1.2% in 1990 and 7.8% in 2010.
- Also during the same period, the Japanese share of World trade, in current U.S.$, started at 5.3% in 1970, rose to 6.9% in 1990 and then fell to 4.0% in 2010.
- The U.S. and Western Europe accounted for more than 54% of World trade in 1970 but less than 44% in 2010.
- The BRICS countries (Brazil, Russia, India, China and South Africa) together accounted for more than 12% of World trade in 2010. However, there is a great deal of room for the international trade of Brazil, India and South Africa to grow.

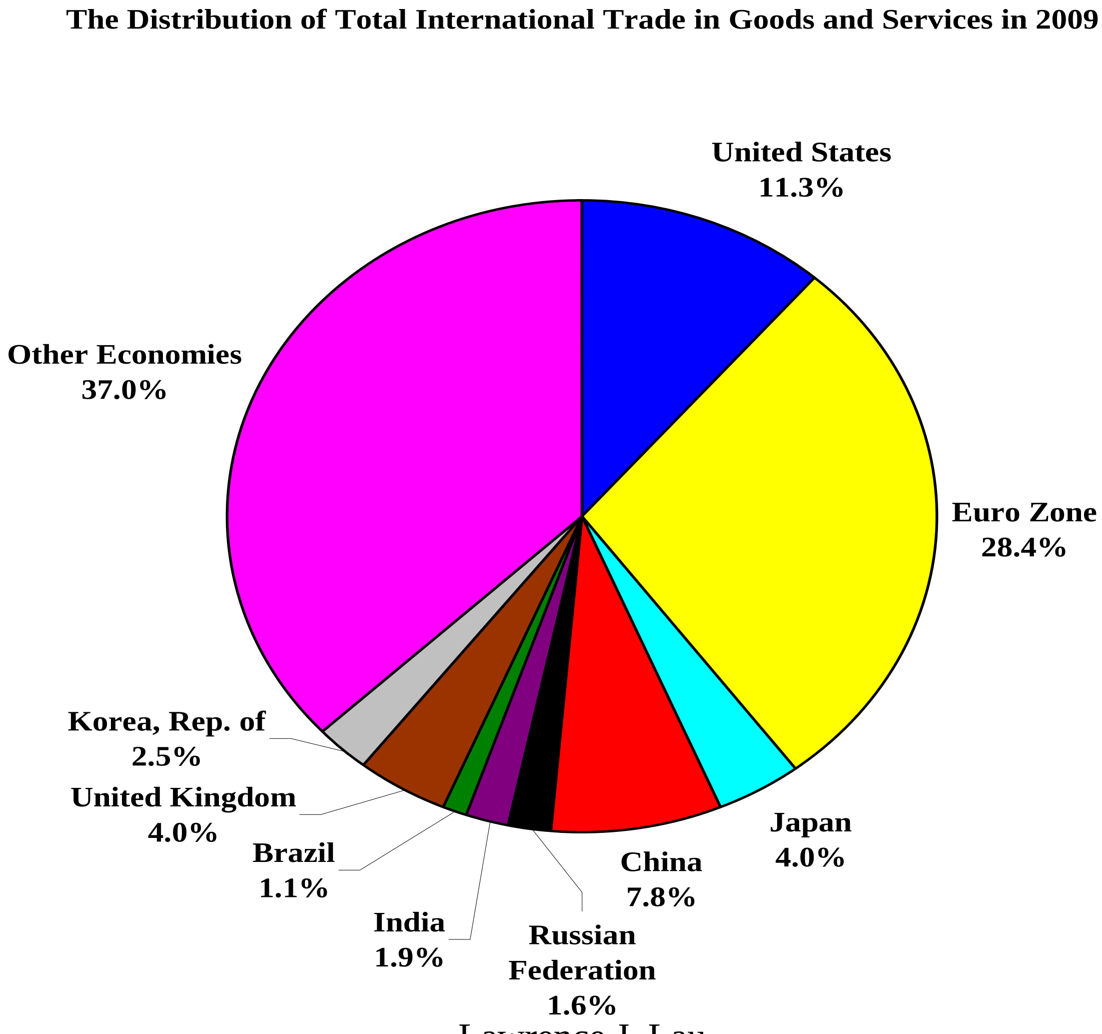
The Distribution of Total International Trade in Goods and Services, 1970



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



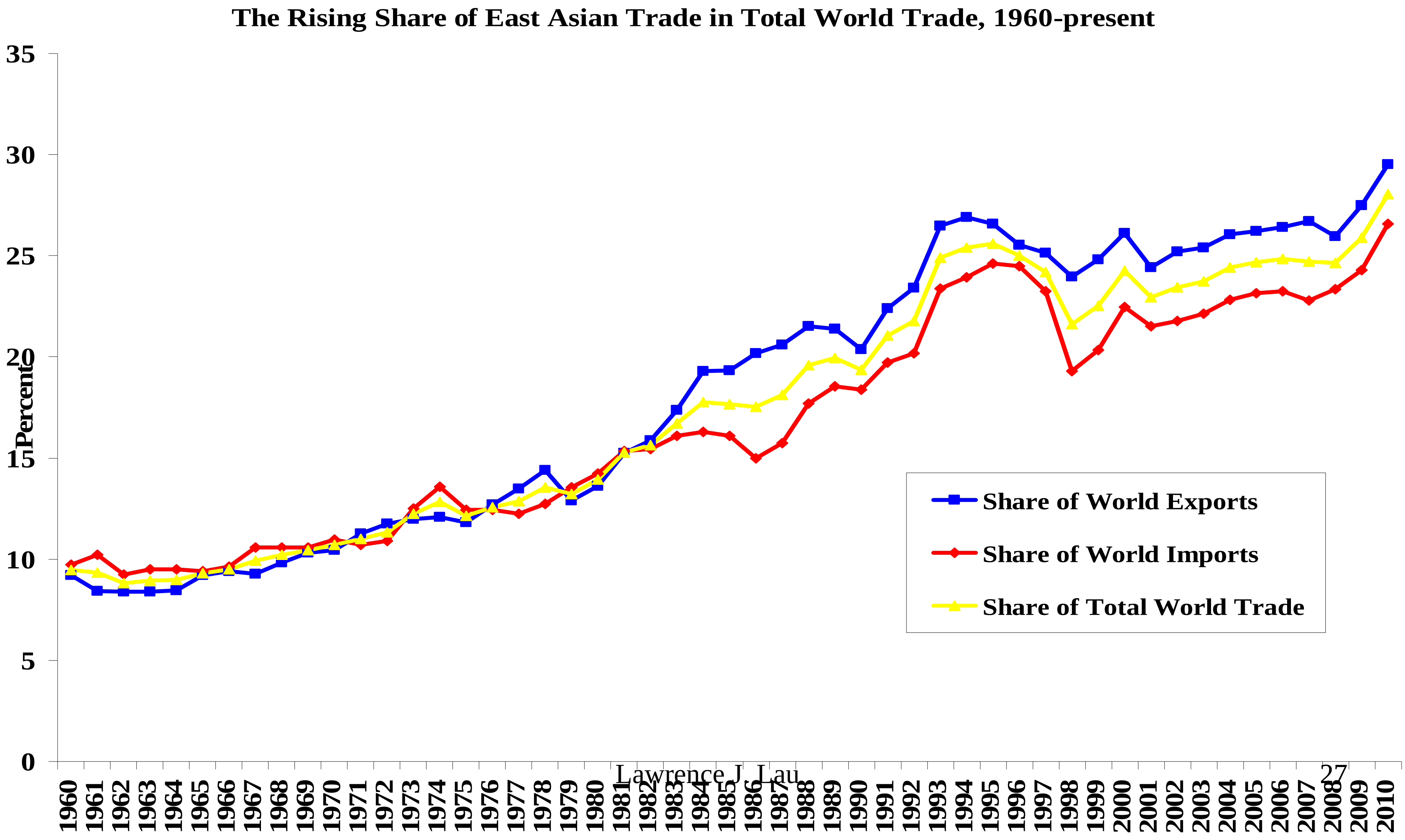
The Distribution of Total International Trade in Goods and Services, 2009



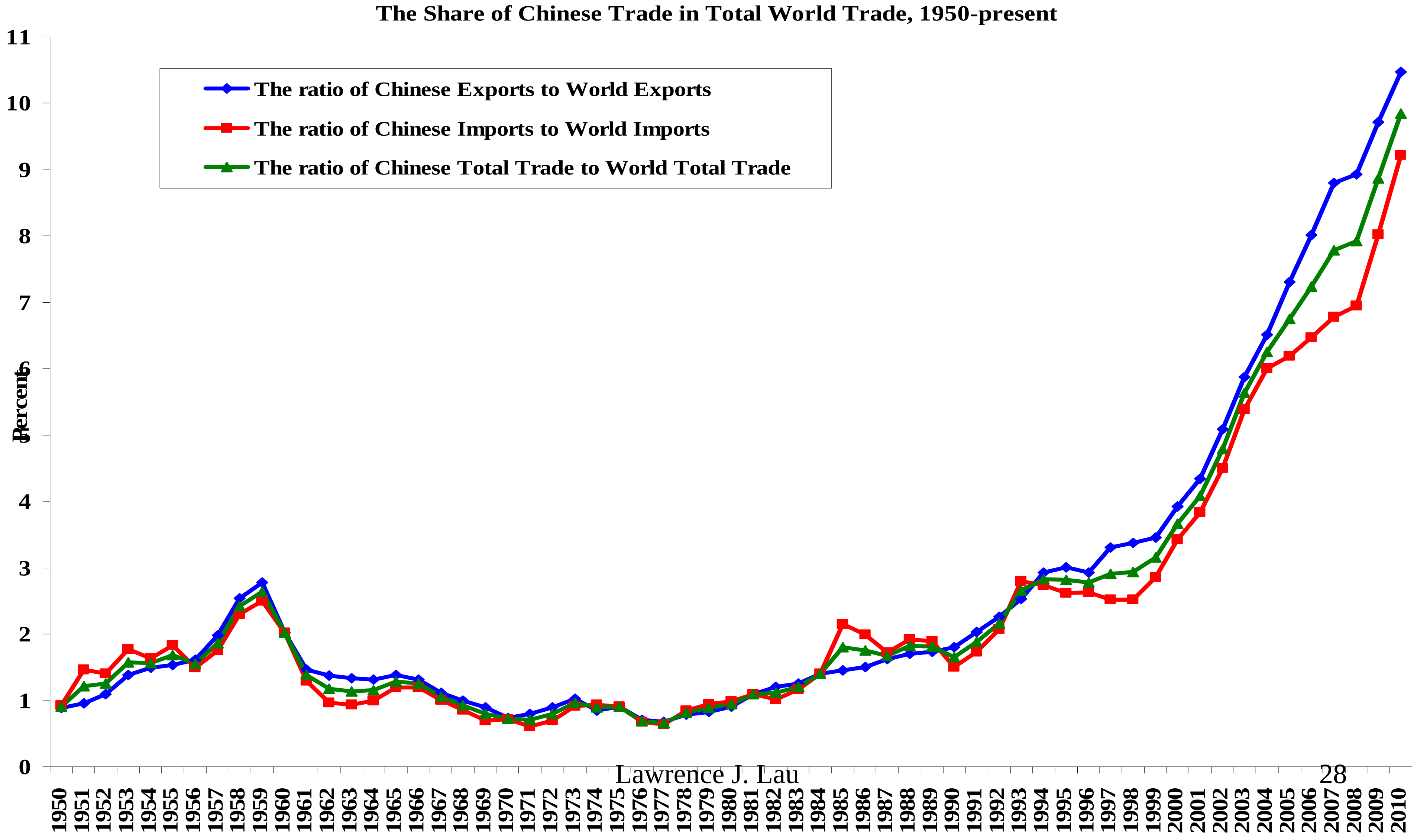
The World Economic Situation: East Asian and Chinese Shares of World Trade

- East Asian shares of World exports, imports, and international trade have also grown from approximately 10% in 1960 to a little below 30% in 2010, paralleling the growth of East Asian share of World GDP (see the following chart).
- The emergence of the Chinese economy on the global market was the single most significant new development during the past three decades. Chinese shares of World exports, imports and international trade have also grown rapidly. Chinese exports and imports have risen from approximately 1% of World exports and imports in 1960 to approximately 10% of World exports and imports in 2010.
- China has become the second largest trading country in the World, after the United States. China accounts for 35% of East Asian international trade today. China has also replaced Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.

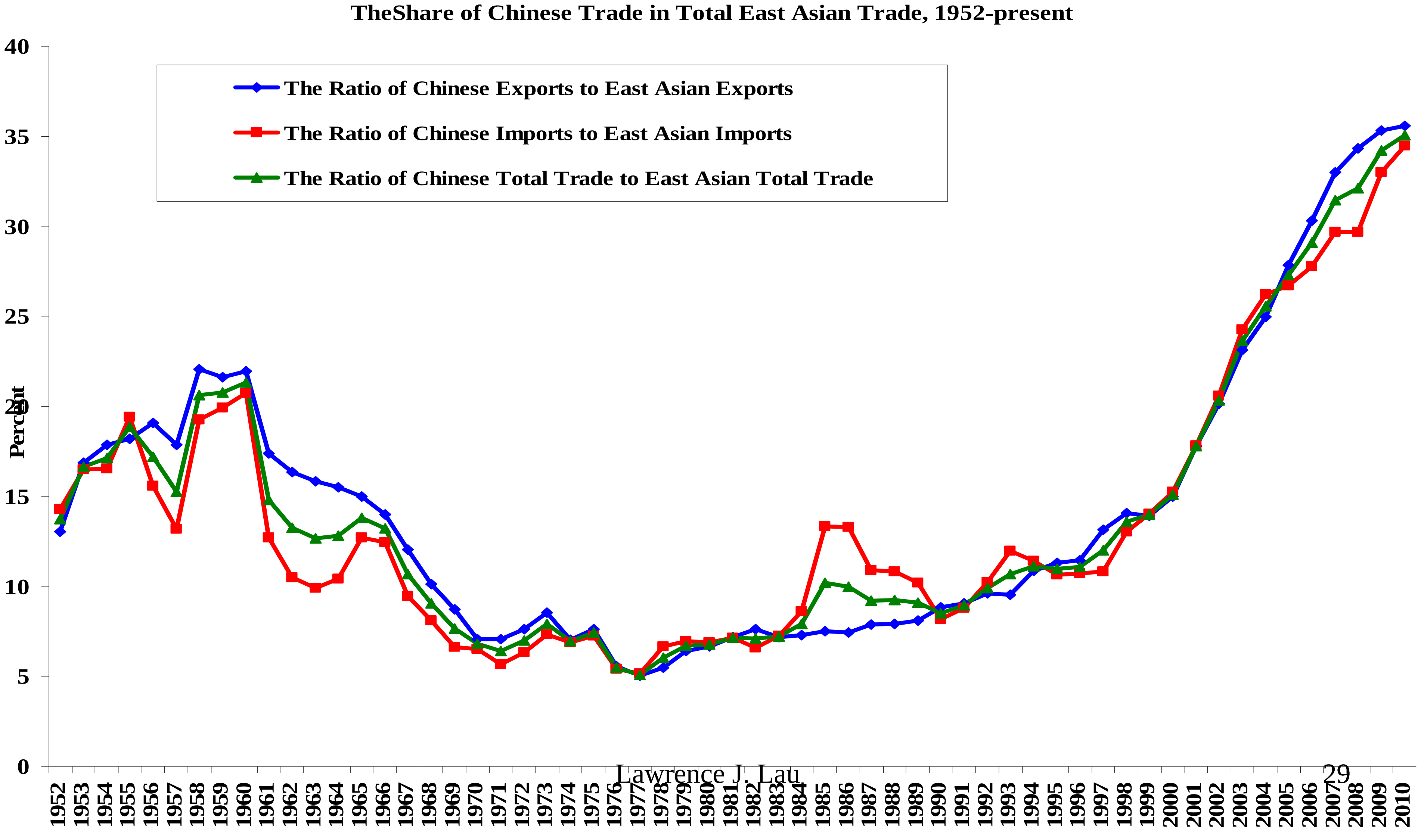
The Rising Share of East Asian Trade in Total World Trade, 1960-Present



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



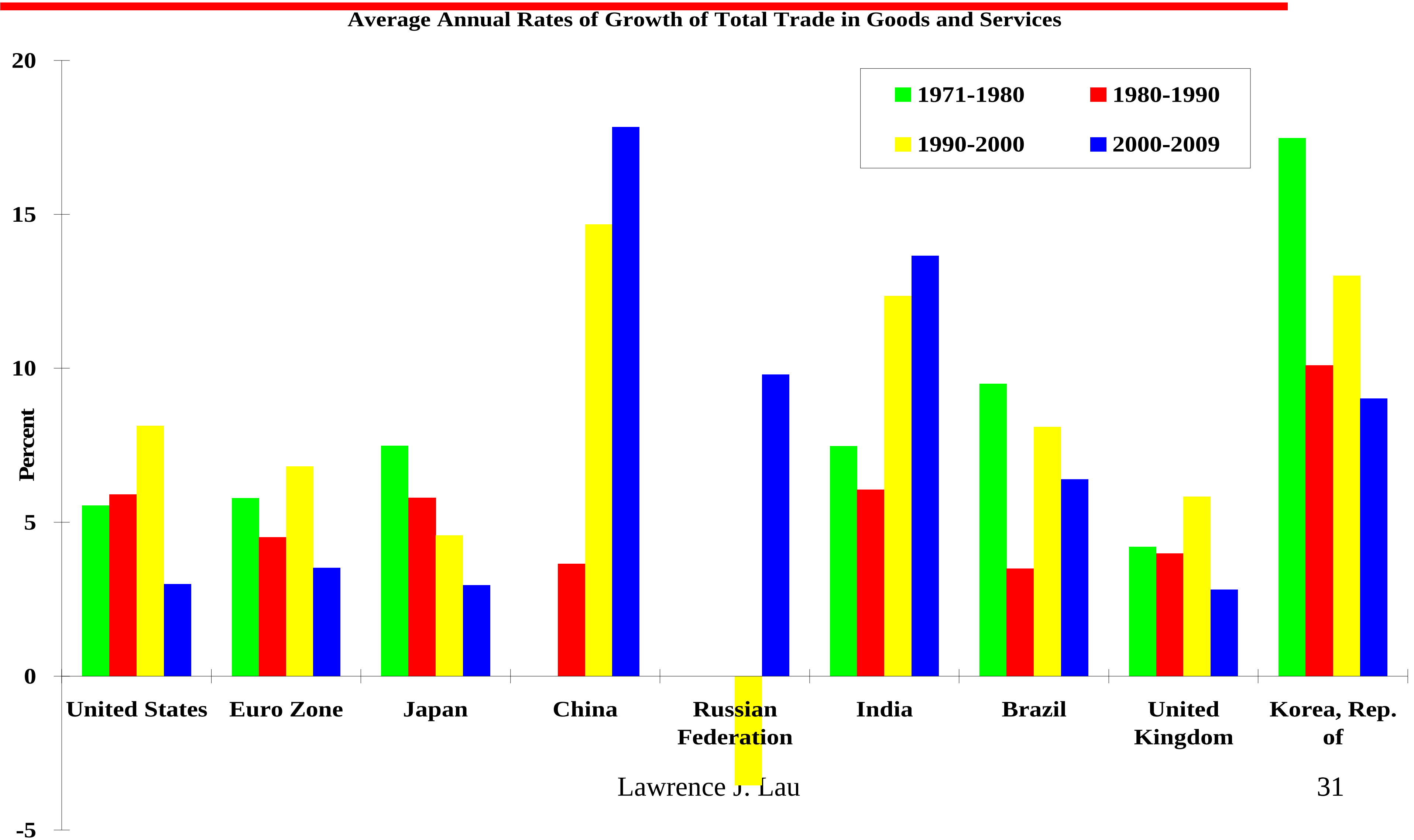
The Share of Chinese Trade in Total East Asian Trade, 1952-Present



The World Economic Situation: The Growth in World Trade

- The rates of growth of international trade in the BRICS and East Asian economies (except Japan) have far outstripped the rates of growth of the developed economies of United States, Europe and Japan.

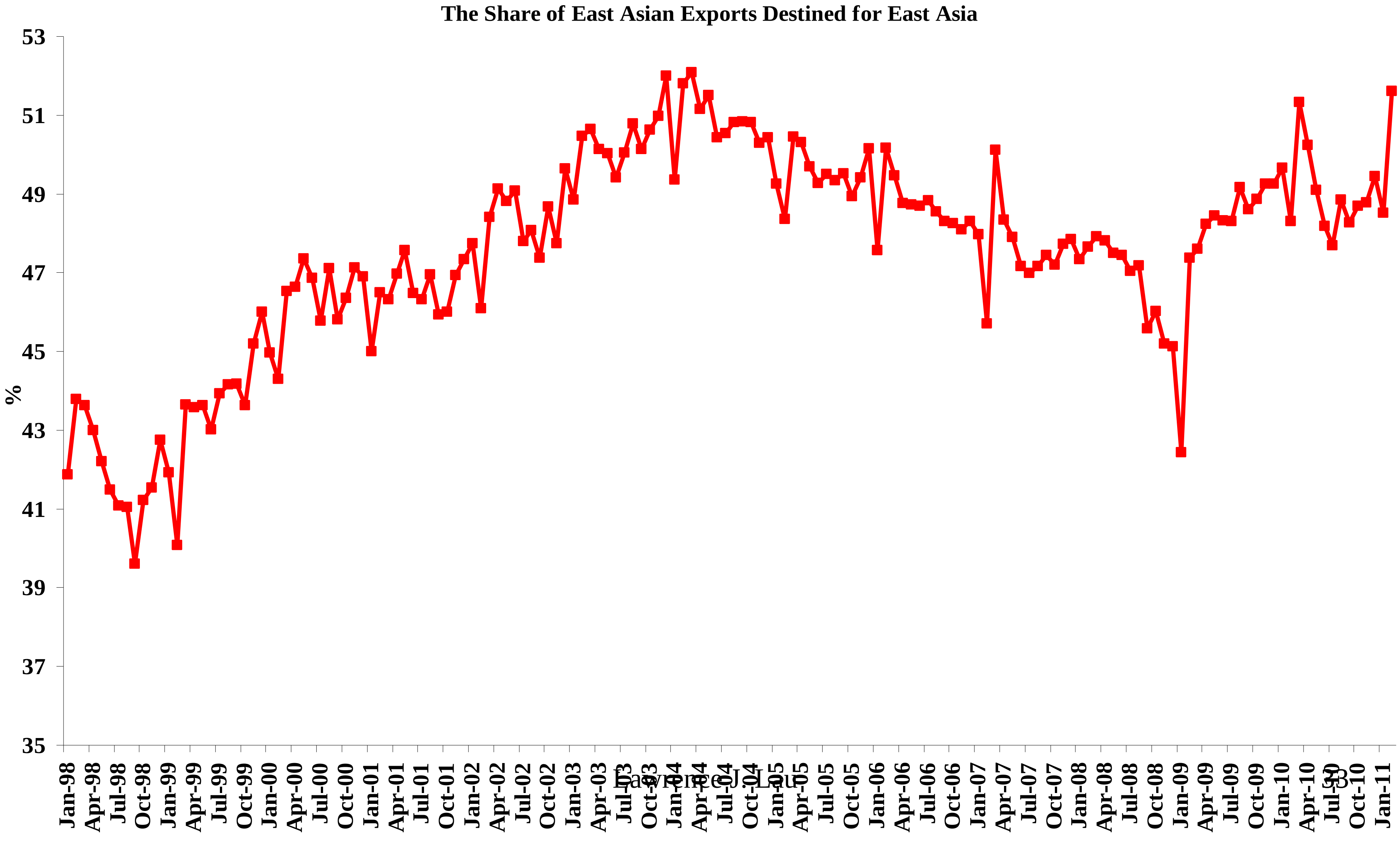
Average Annual Rate of Growth of Total International Trade in Goods and Services



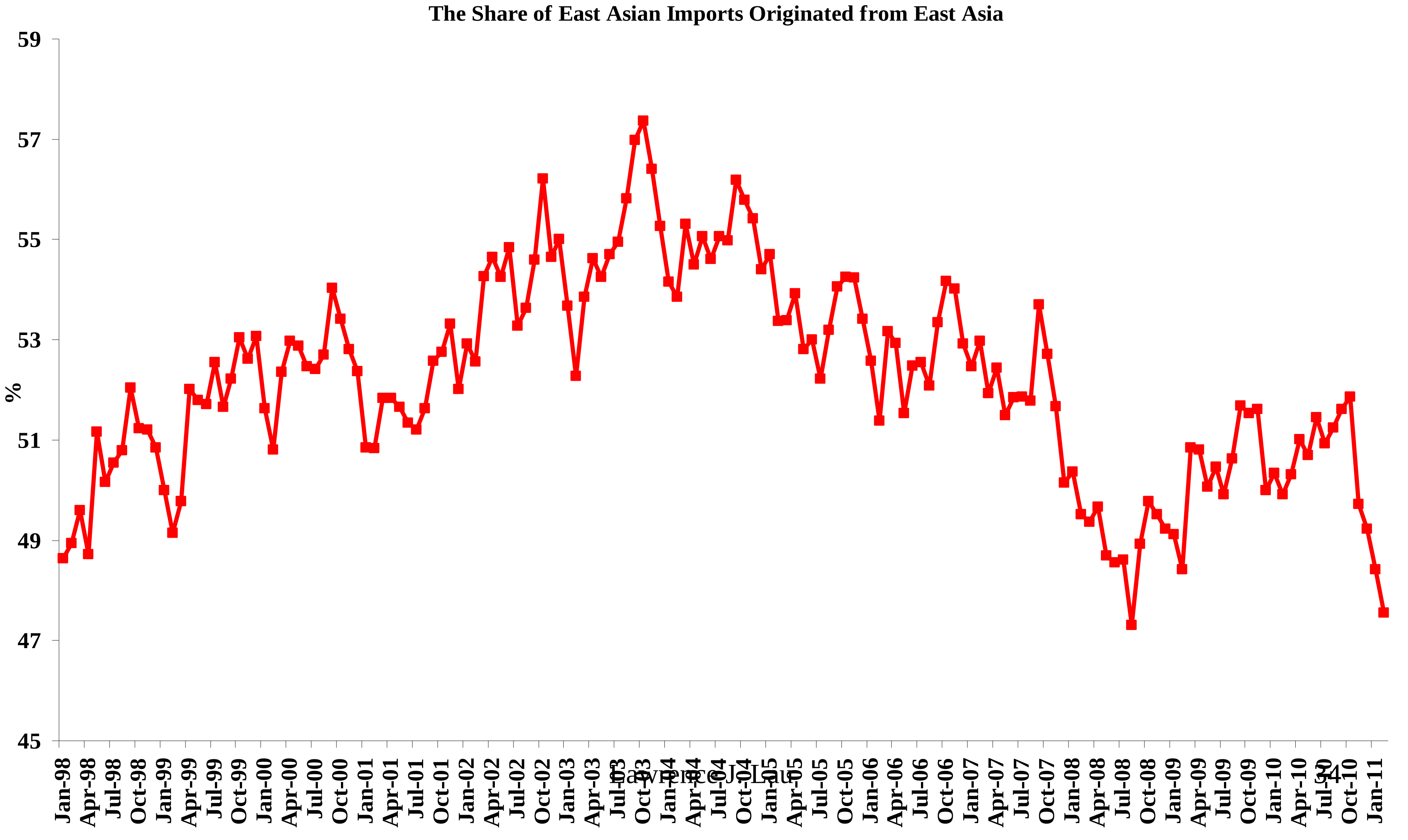
The World Economic Situation: The Changing Pattern of International Trade

- Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. By the late 1990s, approximately half of East Asian trade is among East Asian economies (see the following charts).
- And while much of the trade consists of raw materials, components, and semi-finished goods which are further processed for exports to developed economies ultimately, much of it has also found itself into the final demands of the domestic markets of the East Asian economies.
- This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe and not within East Asia itself.

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia



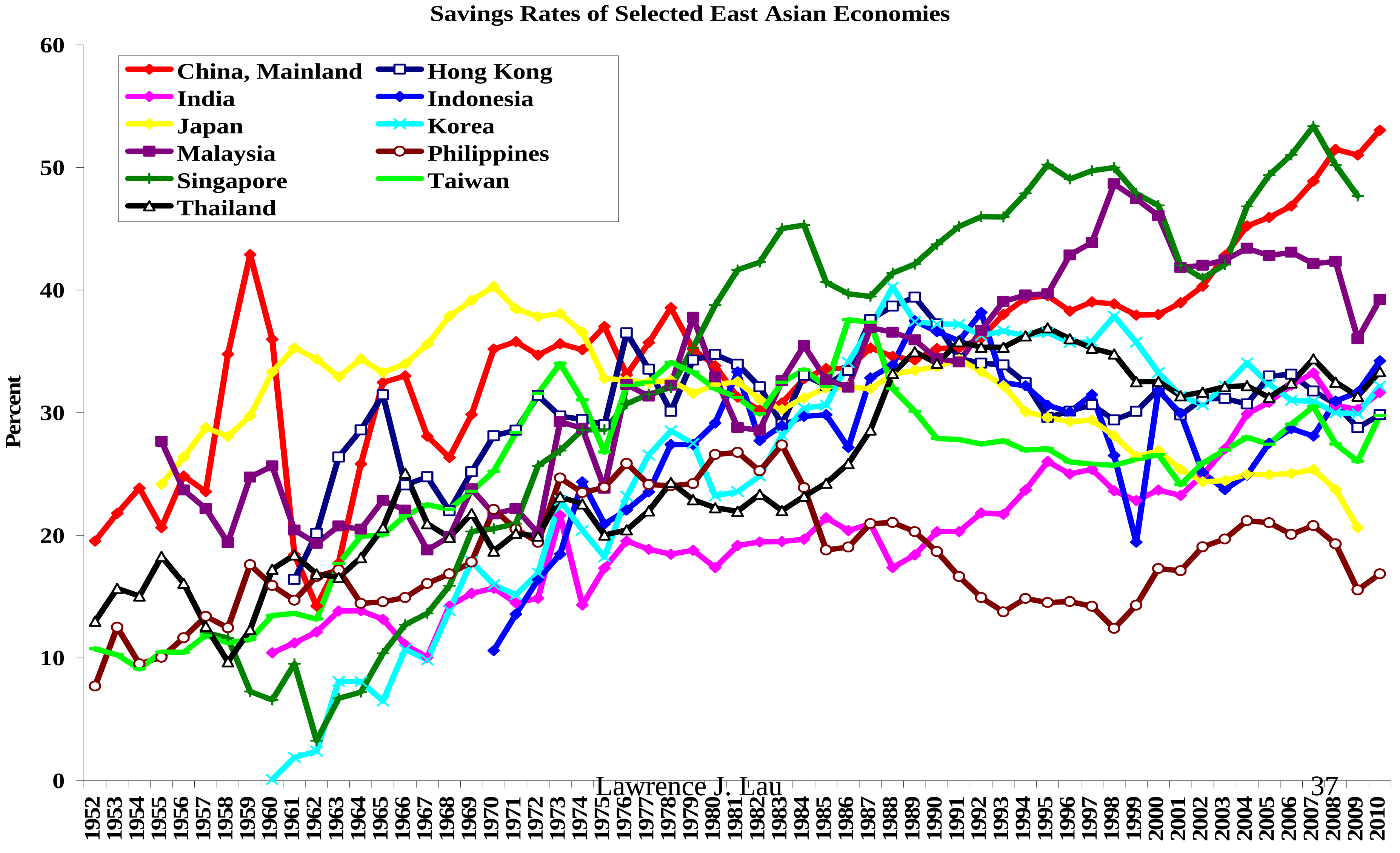
The World Economic Situation: Rising Economic Independence in East Asia

- As a result, interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined.
- Interdependence of the East Asian economies will rise even further within the next five to ten years as East Asia becomes the only region with a high rate of real economic growth and as the ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) become increasingly realities.
- There is also the more recently concluded Indo-ASEAN Free Trade Agreement which also testifies to the possibility of significant demand growth outside of the United States and Europe.

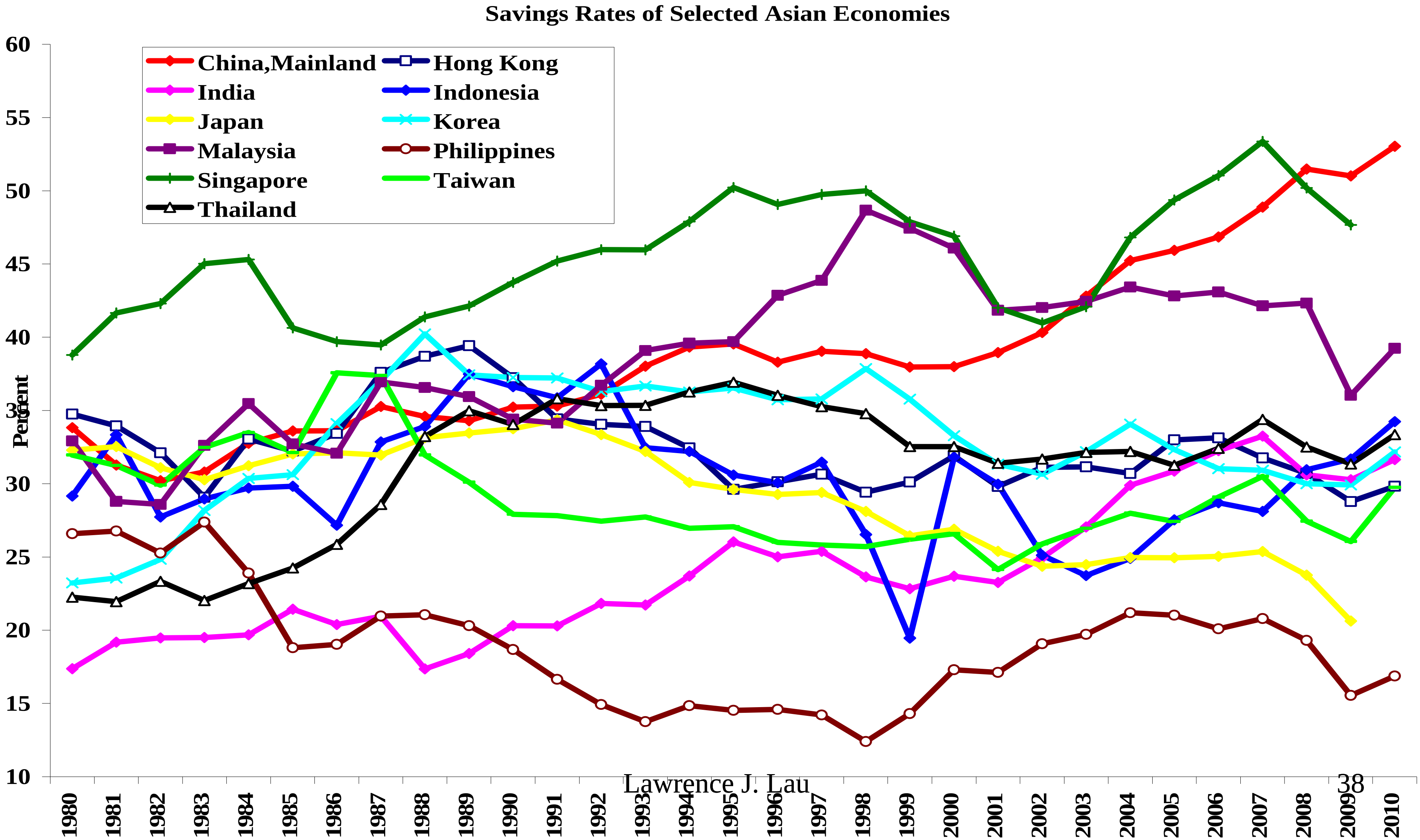
The World Economic Situation: Savings Self-Sufficiency in East Asia

- Almost all East Asian economies, with the possible exception of Philippines, have high national savings rates. What this means is that the domestic savings in each economy are sufficient to meet the domestic investment needs for sustained economic growth without relying on inbound foreign direct or portfolio investment or foreign loans.

Savings Rates of Selected Asian Economies (1952-present)



Savings Rates of Selected Asian Economies (1980-present)



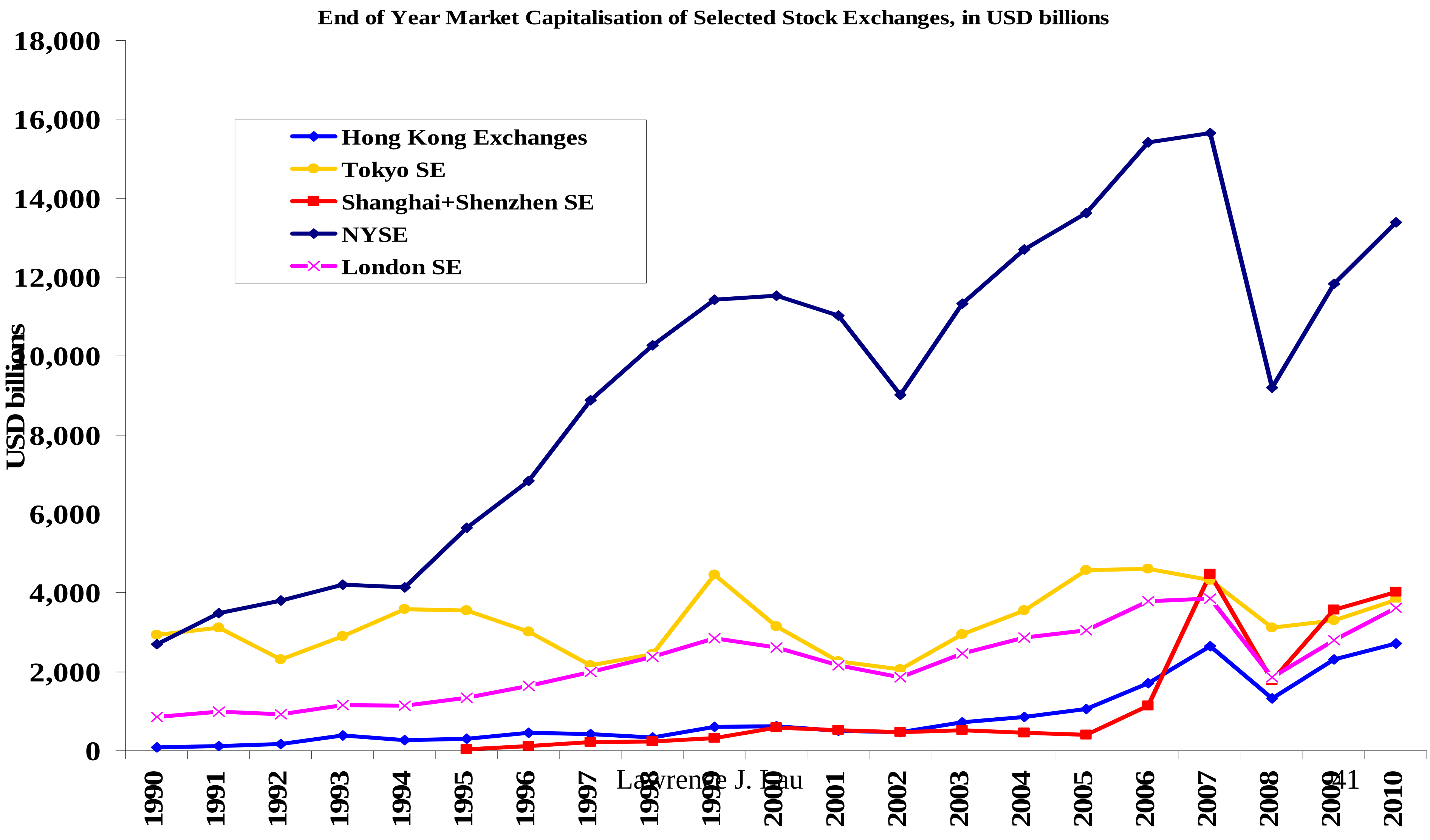
The World Economic Situation: Savings Self-Sufficiency in East Asia

- A country with a high national savings rate does not need to rely on foreign savings—does not need to borrow abroad and bear the potential risks of a large, and often interruptible, foreign-currency denominated debt.
- With new resources being made available each year from new savings, enabling new investments to be made, the necessity of restructuring and redeploying existing fixed assets is greatly diminished (thus making it more possible to avoid potentially politically divisive issues).

Market Capitalization of East Asian Stock Exchanges, Year End 2010 (US$)

- At year end 2010, the market capitalisation of all **East Asia**n stock exchanges combined was **US$14.6 trillion,** compared to **US$17.3 trillion** for **U.S.** stock exchanges combined and **US$10.9 trillion** for all **Europe**an stock exchanges combined.
- Thus, the East Asian stock exchanges have also come into their own, with a market capitalisation larger than that of all European stock exchanges combined and equal to 80 percent of that of all U.S. stock exchanges combined.
- Since East Asia is itself a major source of savings, it is expected that the market capitalisation of the East Asian stock exchanges will continue to grow rapidly and will exceed the U.S. stock exchanges in another decade.

End of Year Market Capitalisation of Selected Stock Exchanges



Market Capitalization of Stock Exchanges Year End 2010 (US$)

- The data on the market capitalisation of stock exchanges include the following:
  - U.S.A.: NASDAQ and NYSE
  - Europe: Athens Exchange, BME Spanish Exchanges, Borsa Italiana, Budapest SE, Cyprus SE, Deutsche Borse, Irish SE, London SE, Luxembourg SE, NYSE Euronext (Europe), Oslo Bors, SIX Swiss Exchange
  - East Asia: Bursa Malaysia, Hong Kong Exchanges, Indonesia SE, Osaka SE, Korea Exchange, Philippine SE, Shanghai SE, Shenzhen SE, Singapore Exchange, Taiwan SE, Thailand SE, Tokyo SE Group
- Data source: World Federation of Exchanges

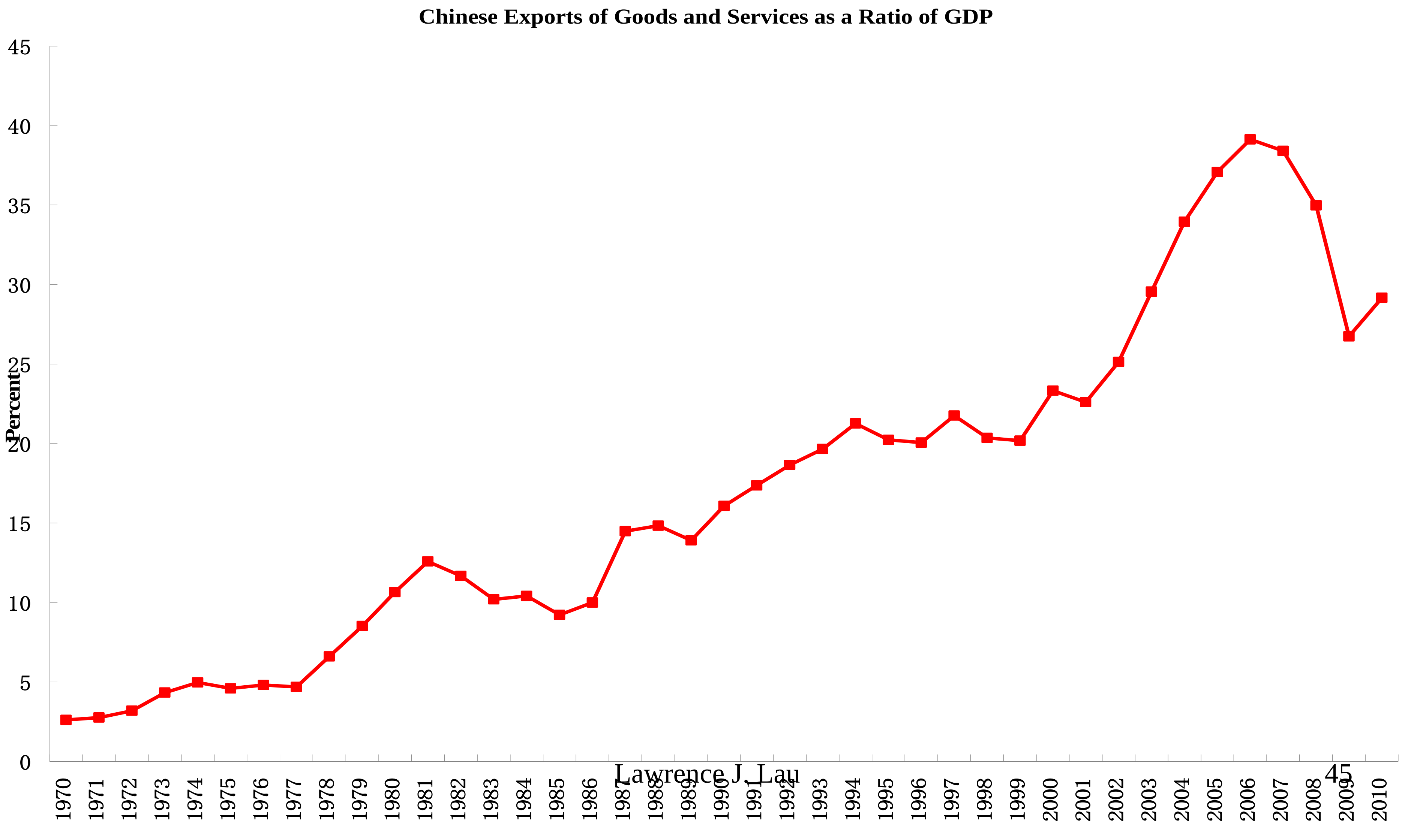
The World Economic Situation: The Partial De-Coupling Hypothesis

- Partial de-coupling is a consequence of the economic centre of gravity of the World gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China (but the shifts are still continuing).
- It is this shifting economic centre of gravity, and the rising interdependence of the East Asian economies as well as the national (regional) self-sufficiency in savings that in combination give credence to the idea of “partial de-coupling” of the World economies—that the Chinese and East Asian economies can continue to do reasonably well despite the economic problems in the U.S. and Europe.

Chinese Economic Growth Does not Depend Critically on Exports

- Chinese exports as a proportion of GDP rose steadily beginning in 1978 and reached a peak of almost 40 percent in 2006 and then began to decline to between 25 and 30.
- While this ratio appears large, it is not when compared to Hong Kong, Singapore, South Korea and Taiwan, where exports are more than 100 percent of the respective GDPs.
- And the Chinese Exports/GDP ratio actually exaggerates the importance of exports in the Chinese economy because it fails to take into account the low domestic value-added content of Chinese exports.

Chinese Exports of Goods and Services as a Percent of GDP, 1970-present



Chinese Economic Growth Does not Depend Critically on Exports

- The domestic value-added content of Chinese exports is no more than 30 percent, that is: for every dollar of goods exported, less than 30 cents, on average, consist of domestic value-added—the rest consists of imported raw materials, intermediate goods, components, parts, semi-finished goods, etc.
- The domestic value-added percentage is even less for the so-called “Processing and Assembly” exports which at one time constituted more than half of Chinese exports.
- If we multiply the Exports/GDP ratio of say 40 percent (it is currently much lower) to the domestic value-added content of 30 percent, we obtain 12 percent, which is the upper bound for the percentage of Chinese GDP (value-added) generated by exports.

Chinese Economic Growth Does not Depend Critically on Exports

- Now, 12 percent of GDP is a large number, and no economy can afford to lose 12 percent of its GDP overnight. However, if 12 percent of GDP does not grow, or even declines by 25 percent, as long as the other 88 percent of the economy continues to grow, the economy as a whole should do all right, especially if appropriate compensatory economic stimulus measures are taken by the government.

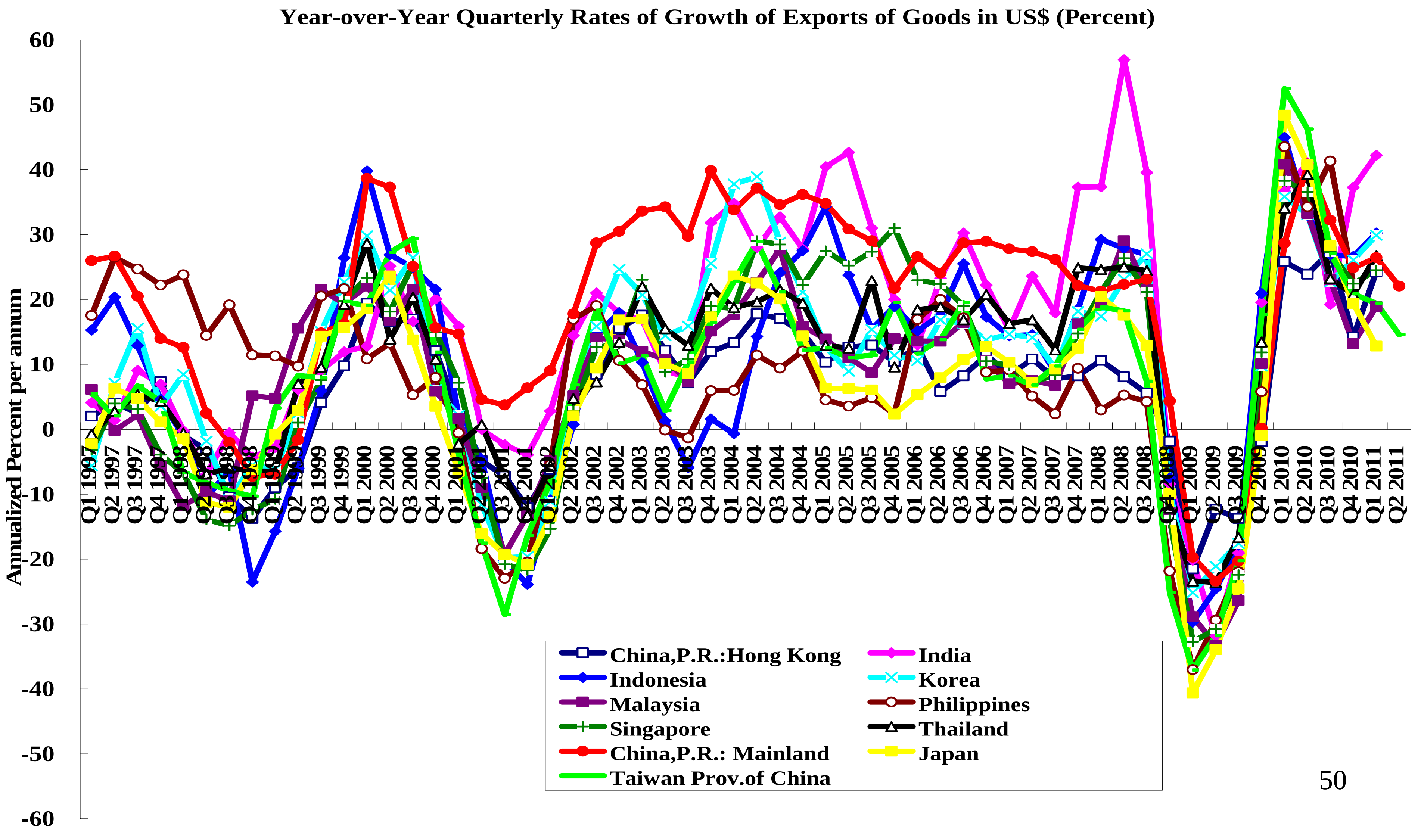
Chinese Economic Growth Does not Depend Critically on Exports

- A 25-percent decline in Chinese exports should result in a 25 percent times 12 percent or 3 percent maximum decline in Chinese GDP, other things being equal. Thus, the reduction in exports caused by the 2007-2009 global financial crisis should be expected to reduce the rate of real Chinese economic growth from 9 percent in 2008 by a maximum of 3 percentage points to no less than 6 percent in 2009, other things being equal.
- However, the 2-year, 4-trillion Yuan (equivalent to approximately 8 percent of GDP per year) economic stimulus programme launched by the Chinese Government in November 2008 helped make up the short-fall in aggregate demand caused by the decline in exports.
- This provides the explanation for the high rates of Chinese economic growth in 2009 (8.7%) and 2010 (9.3%).

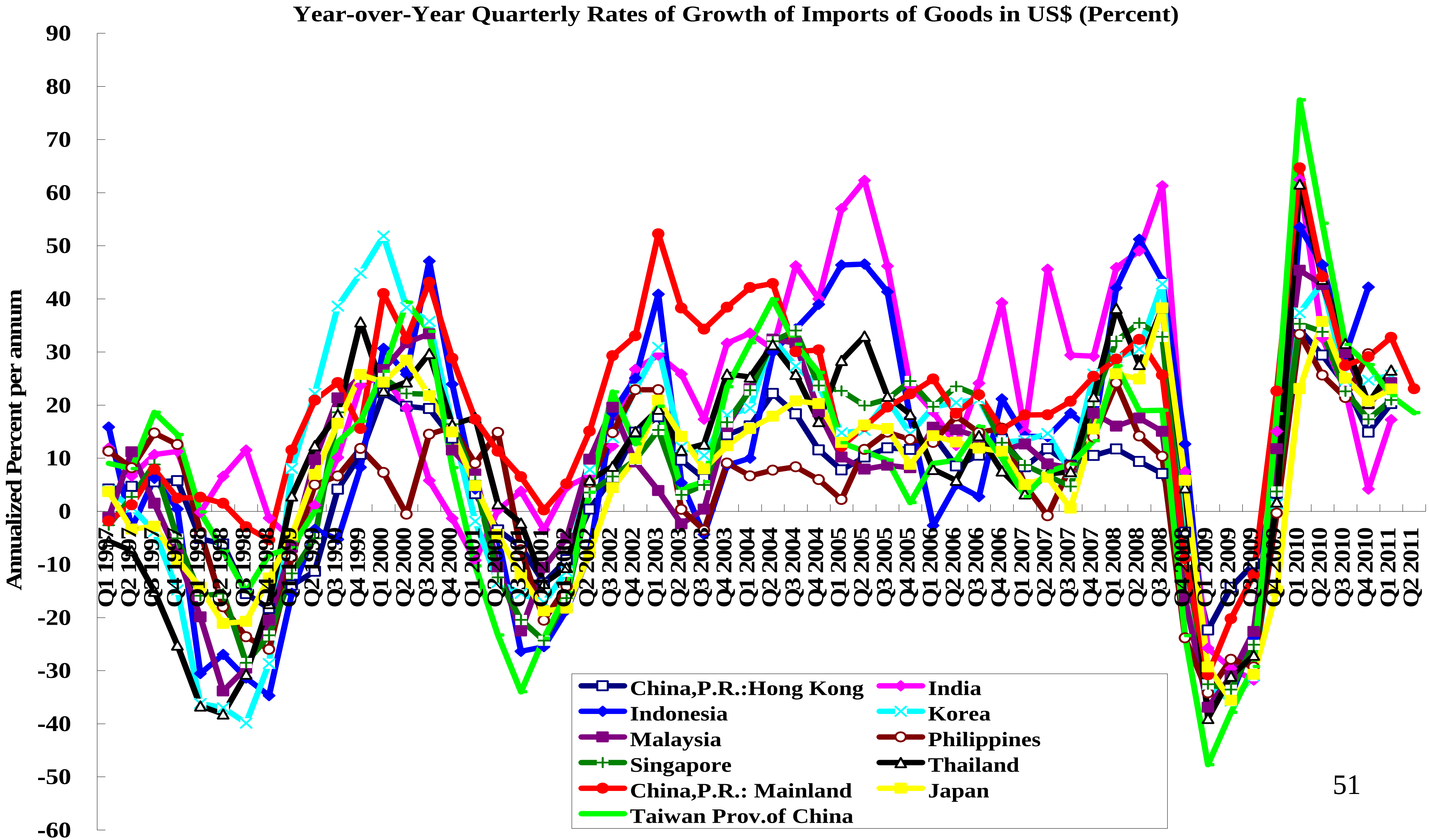
Chinese Economic Growth Does not Depend Critically on Exports

- An important implication of the relatively low export dependence of the Chinese economy is that the rate of growth of Chinese real GDP is relatively stable even as Chinese exports (and imports) fluctuate as widely as the exports and imports of other East Asian economies. (See the following charts on the rates of growth of the exports, imports and real GDP of East Asian economies).

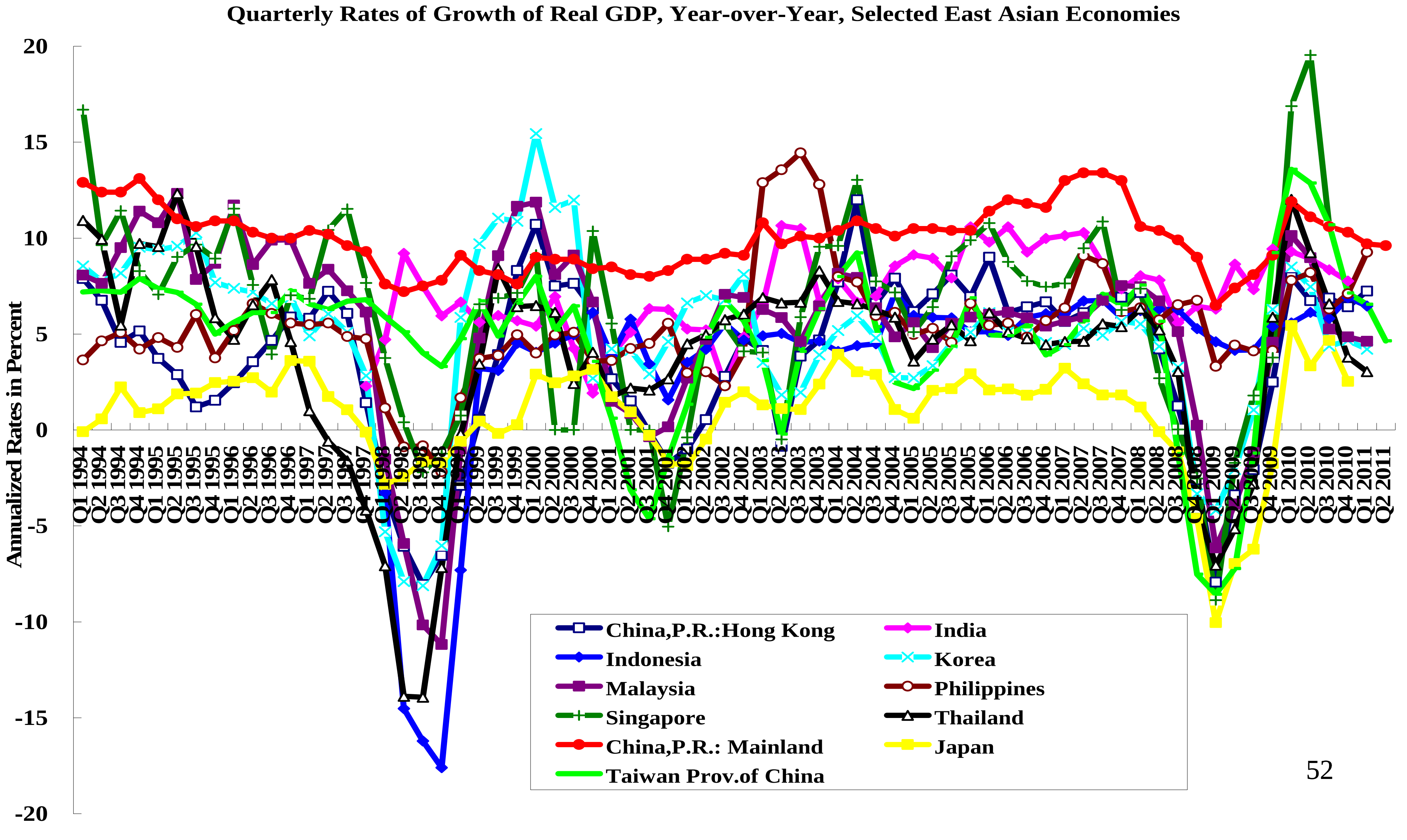
Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies



Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies



Quarterly Rates of Growth of Real GDP, Y-o-Y: Selected East Asian Economies



Chinese Economic Growth Does not Depend Critically on Exports

- Large continental economies, such as the United States, are mostly driven by their internal demands, and not by international trade. Exports have never been very important to the U.S. economy, and the U.S. economy has never been dependent on international trade, except perhaps in the 19th Century.
- For the Chinese economy it is the same—Chinese economic growth in the future decades will mostly depend on internal demand rather than exports.

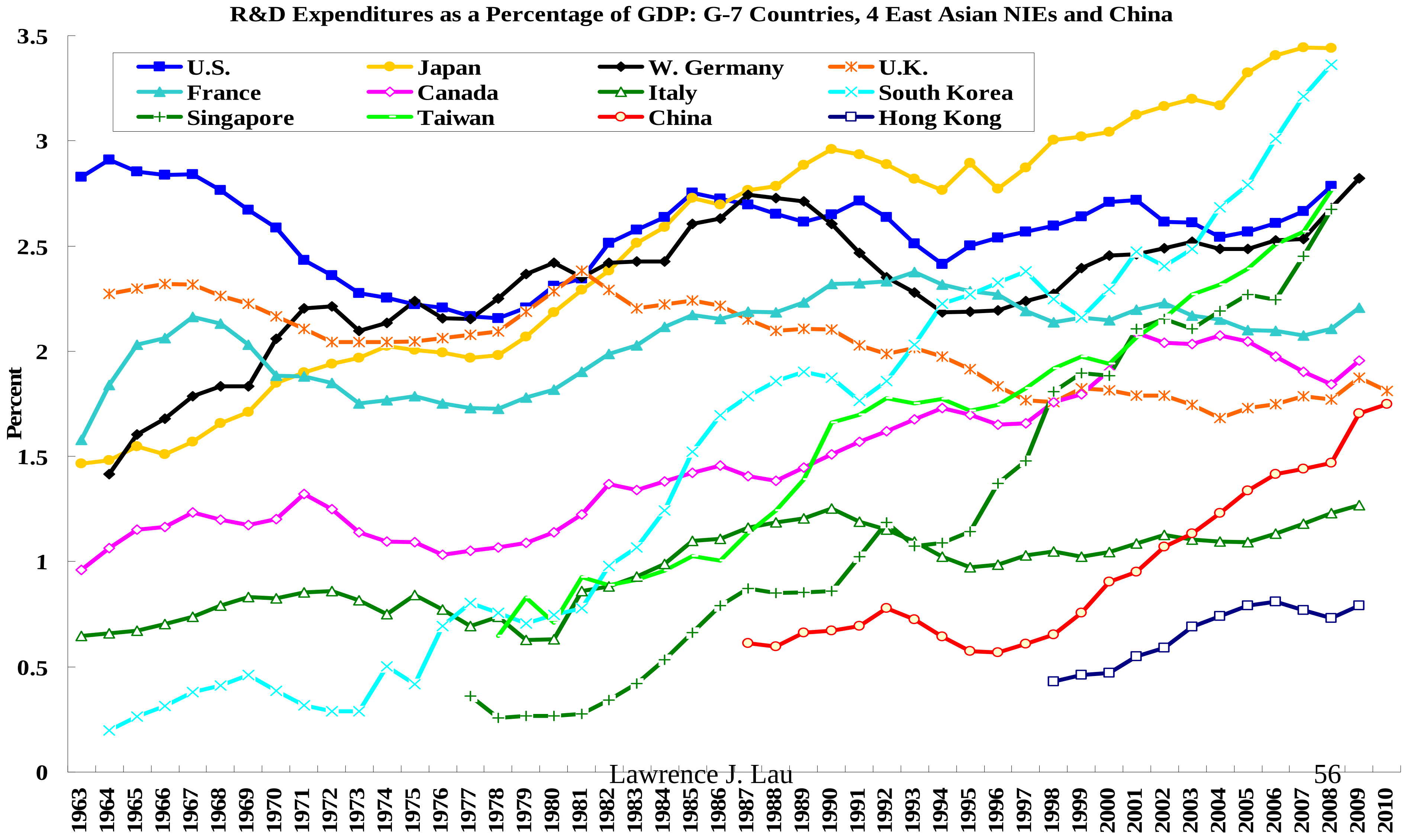
The World Economic Situation: Innovative Capacity

- Another measure of economic strength across economies is innovative capacity.
- U.S. economic growth has been mostly due to technical progress whereas Chinese economic growth during the past thirty years has been mostly due to growth in the primary inputs—capital and labour.
- The U.S. lead in technical progress is attributable to its past and present investment in research and development (R&D). China has begun to invest in R&D in recent years. However, even though Chinese R&D expenditure has been rising rapidly, both in absolute value and as a percentage of GDP, it still lags far behind that of the many of the developed and newly industrialised economies by a whole order of magnitude.

The World Economic Situation: Innovative Capacity

- The Chinese R&D Expenditure/GDP ratio, 1.8% in 2010, is targeted to reach 2.2% in 2015, still below the historical average for the U.S. of approximately 2.5% since the late 1950s.
- By comparison, both Japan and South Korea invest more than 3% of their GDPs in R&D annually.

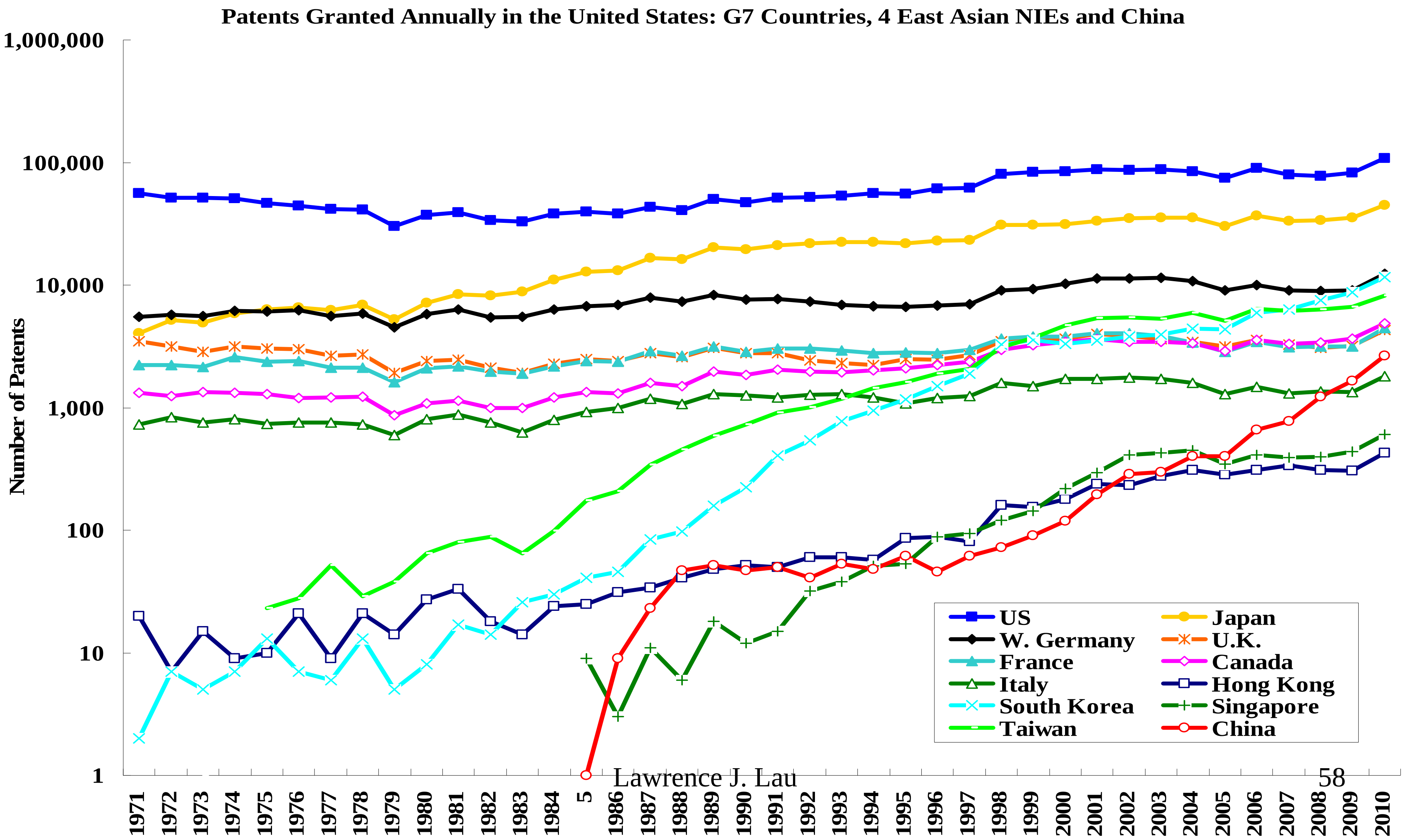
R&D Expenditures as a Share of GDP:G-7 Countries, 4 East Asian NIES & China



The World Economic Situation: Innovative Capacity

- One indicator of the potential for technical progress (national innovative capacity) is the number of patents obtained each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented.
- The U.S. is the undisputed champion over the past forty years, with more than 100,000 patents granted in 2010, followed by Japan, with approximately 45,000.
- Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries, the comparison across them should be fair.

Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China



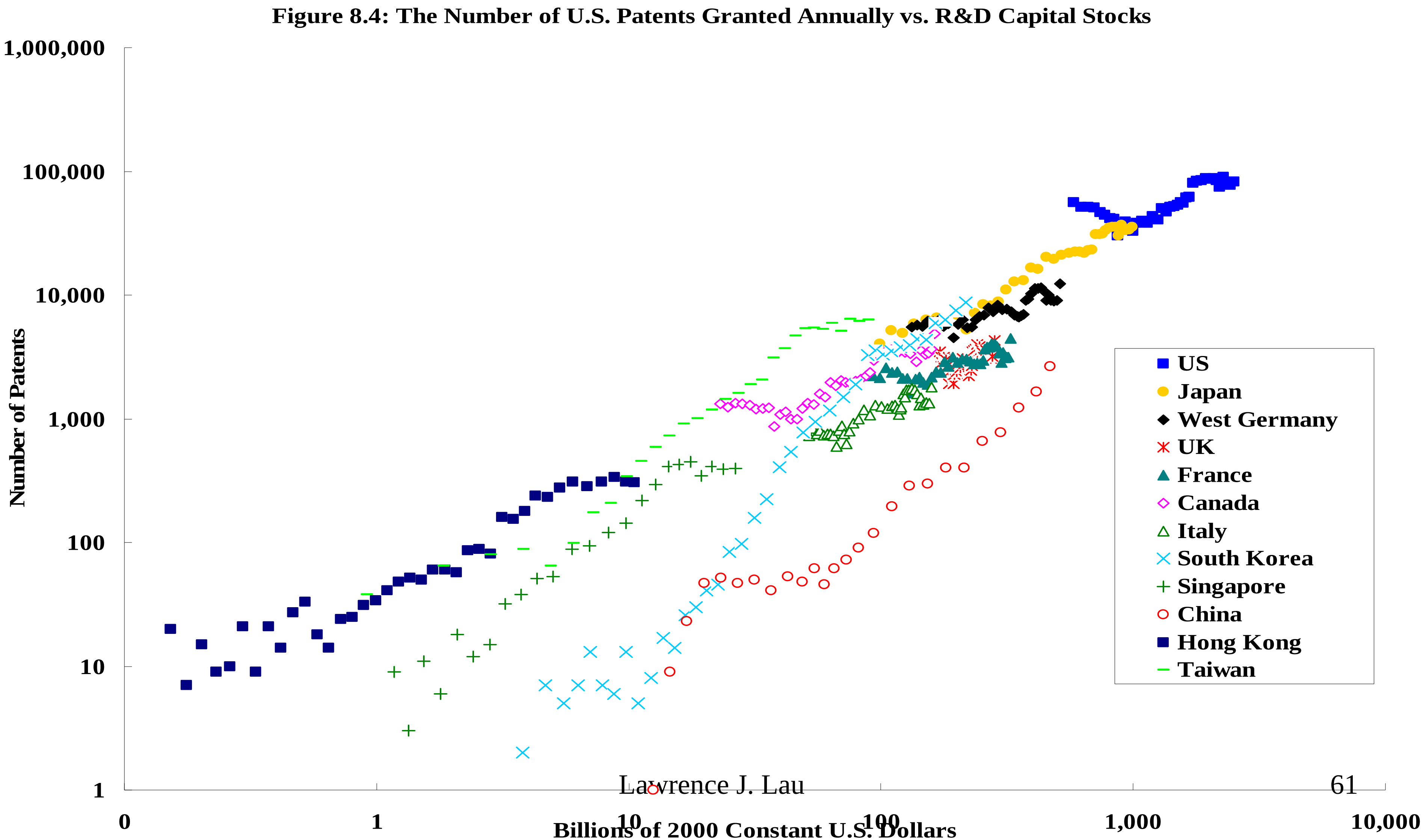
Innovation and Investment in Intangible Capital

- The number of patents granted to Chinese applicants each year has increased from 1 in 1985 to 2,657 patents in 2010.
- South Korea and Taiwan are still ahead of China in terms of the number of patents granted in the U.S., with 11,671 and 8,238 patents in 2010 respectively.

The World Economic Situation: Innovative Capacity

- The stock of R&D capital, defined as the cumulative past real expenditure on R&D less depreciation of 10% per year, can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the number of patents granted is plotted against the R&D capital stock for each country and each year).
- The causal relationship between the stock of R&D capital and the number of patents granted is unmistakable. However, there are variations in the ability and efficiency of obtaining patents in the U.S., given the same level of R&D capital stock. For example, at the same level of R&D capital stock, China obtains far fewer patents than the other countries and regions.

Patents Granted in the United States and R&D Capital Stocks, Selected Economies



The U.S. and European Debt Crises

- The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor
- The European Debt Crisis

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- First of all, the downgrade definitely does not mean that the U.S. is more likely to default on its sovereign debt after the downgrading compared to before. In fact, the probability of a U.S. default was higher before the U.S. Congress raised the debt ceiling limit than afterwards and before the downgrading. The downgrade in and of itself therefore has little new information content—it conveys nothing new that we do not know already but it creates unnecessary and irrational panic.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- Credit ratings should not be taken too seriously anyway—I have often argued that if the credit rating agencies are really good at discriminating among the creditworthiness of debt securities a priori, they should be out there managing large investment portfolios and earning large fees rather than rating. No one should be overly concerned by a marginal down-grade issued by a credit-rating agency with a questionable track record of both over-rating (for example, sub-prime mortgage-loan backed securities and Icelandic banks) and under-rating (Chinese sovereign debt) in the recent past, except asset managers who are restricted to purchase and to hold only debt securities of certain ratings.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- The probability of a U.S. default of its sovereign debt remains close to nil, notwithstanding the credit rating downgrade. Thus, there is no need to panic and rush out to sell U.S. Government debt securities.
- The downgrade itself may have some psychological impact on consumers and investors but should have little lasting effect on the real economy.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- Second, in the short-term, with or without the downgrade, the U.S. Federal Reserve Board will do its best to keep the short-term interest rate low in the U.S. However, in the medium and long term, it is probably inevitable that the rate of interest will rise in the U.S., and that the foreign holdings of U.S. sovereign debt will begin to decline, albeit gradually. This may, however, be coupled with an increased domestic U.S. holdings of U.S. debt, as the result of a flight to safety (from equities).
- But the fact remains that there are very few alternatives to U.S. sovereign debt at the moment and that a massive sell-off of U.S. sovereign debt by foreign central banks is definitely not in their own interests, so that it is most unlikely to occur. The U.S. is "too big to fail," and too big a debtor to be allowed to fail.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- Third, the real threat to the U.S. economy is the possibility of stagflation. It is for this reason that I believe it may be a mistake for the U.S. Government to focus solely on the reduction of the U.S. Government deficit, important that it is, at this time. The primary goal of the U.S. Government should be to restore economic growth and reduce unemployment as soon as possible.
- If the economic pie can be made bigger, deficit reduction will be made that much easier. What the U.S. Government needs to do is to try to change the expectations of U.S. households and firms about the future of the U.S. economy, and this it can do only through an unanticipated exogenous increase in real aggregate demand, with monetary policy having exhausted its effectiveness.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

- Unfortunately, additional fiscal stimulus at the Federal level at this time appears unlikely, giving the inclinations of the U.S. Congress. What the Federal Reserve Board may wish to consider doing, instead of buying U.S. Treasury securities, is to buy long-term (possibly zero-coupon) state bonds, for example, in proportion to each state's population, with the requirement that the proceeds must be used for new infrastructural projects within each of the states. This will increase both real aggregate demand (and hence real GDP) and employment rather quickly and help to change expectations about the future in a positive direction.

The Downgrade of U.S. Sovereign Debt Credit Rating by Standard and Poor

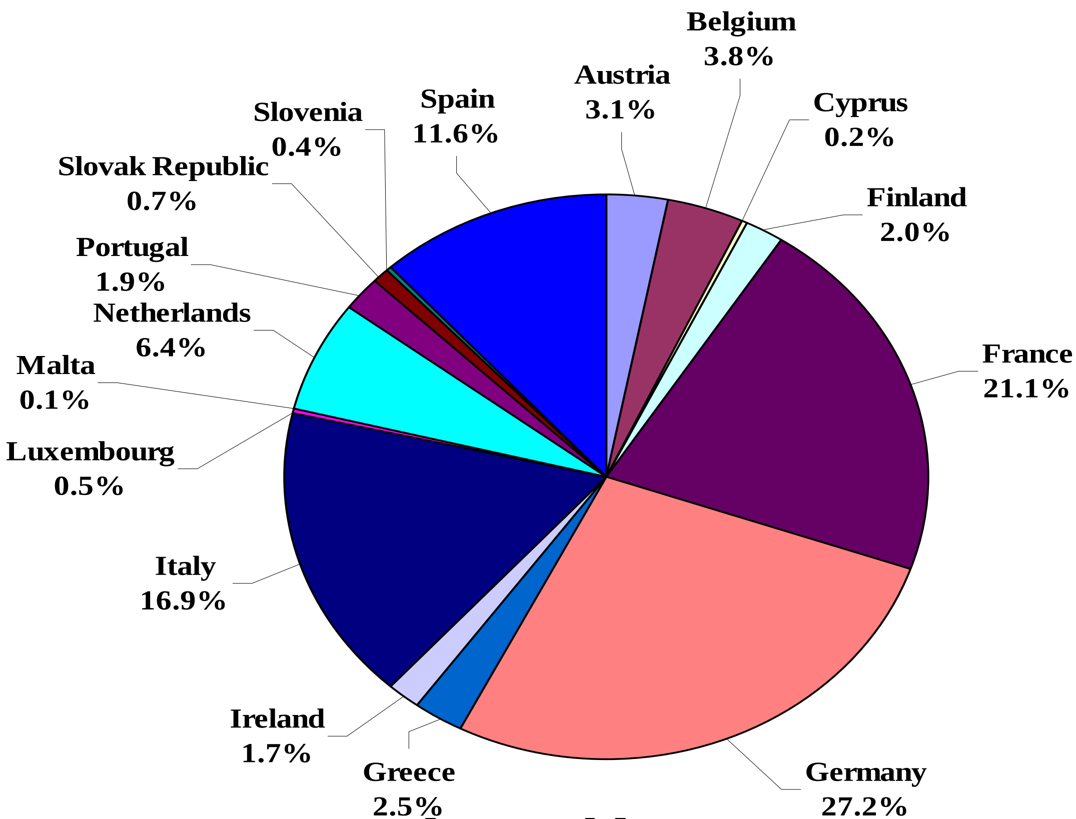
- Fourth, the downgrade may actually have the unintended but, in my opinion, beneficial effect of cooling down the speculative fervour in the World financial markets today. The less bubbly the World is, the better it is for the real economy. Softening of commodity prices, including the price of oil, should be regarded as a positive development for the World economy.

The European Debt Crisis

- First, it is important to put the European debt crisis in perspective. Greece accounts for only 2.5% of the GDP of the Euro Zone.
- Of the other so-called PIGS countries (Portugal, 1.9%; Ireland,1.7%; Spain, 11.6%), only Spain has a sufficiently large share of the Euro Zone GDP to matter.
- While some countries have relatively large public debt to GDP ratios, they are, with the exception of Greece, mostly internal debt, which is much more easily manageable.
- Germany and France, the two major countries in the Euro Zone, remain economically healthy and stable despite the 2007-2009 global financial crisis.

The Distribution of the GDP of Euro Zone in 2009

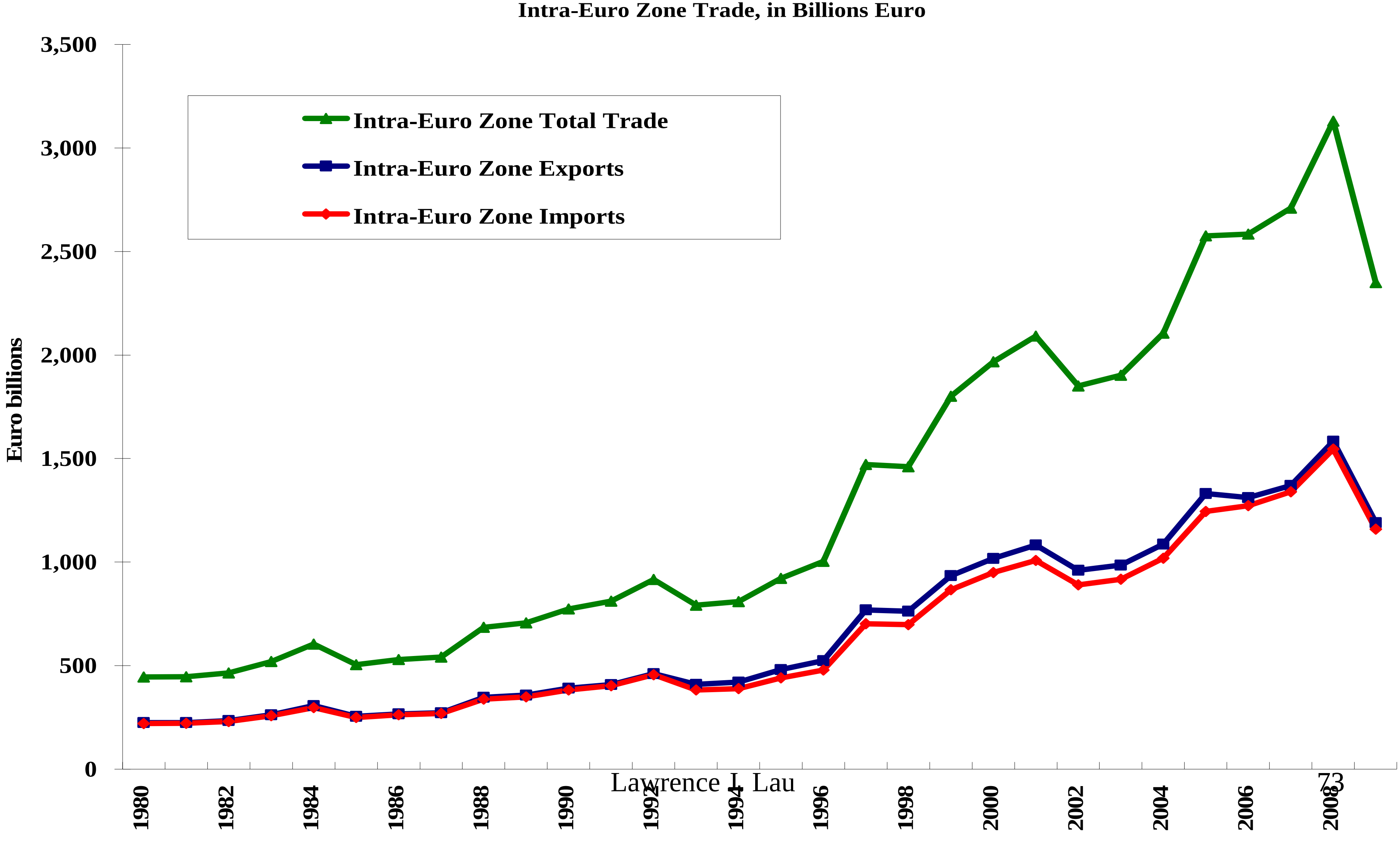
The Distribution of the GDP of Euro Zone in 2010, in Euro billions



The European Debt Crisis

- After the introduction of the Euro as a single currency for countries in the Euro Zone in the late 1990s, intra-Euro Zone trade tripled to approximately 3 trillion Euro (or US$4 trillion) even though there had been no tariffs among the major countries in the Euro Zone since the 1960s.
- The single currency has greatly facilitated trade and direct investment within the Euro Zone and enhanced economic efficiency.

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



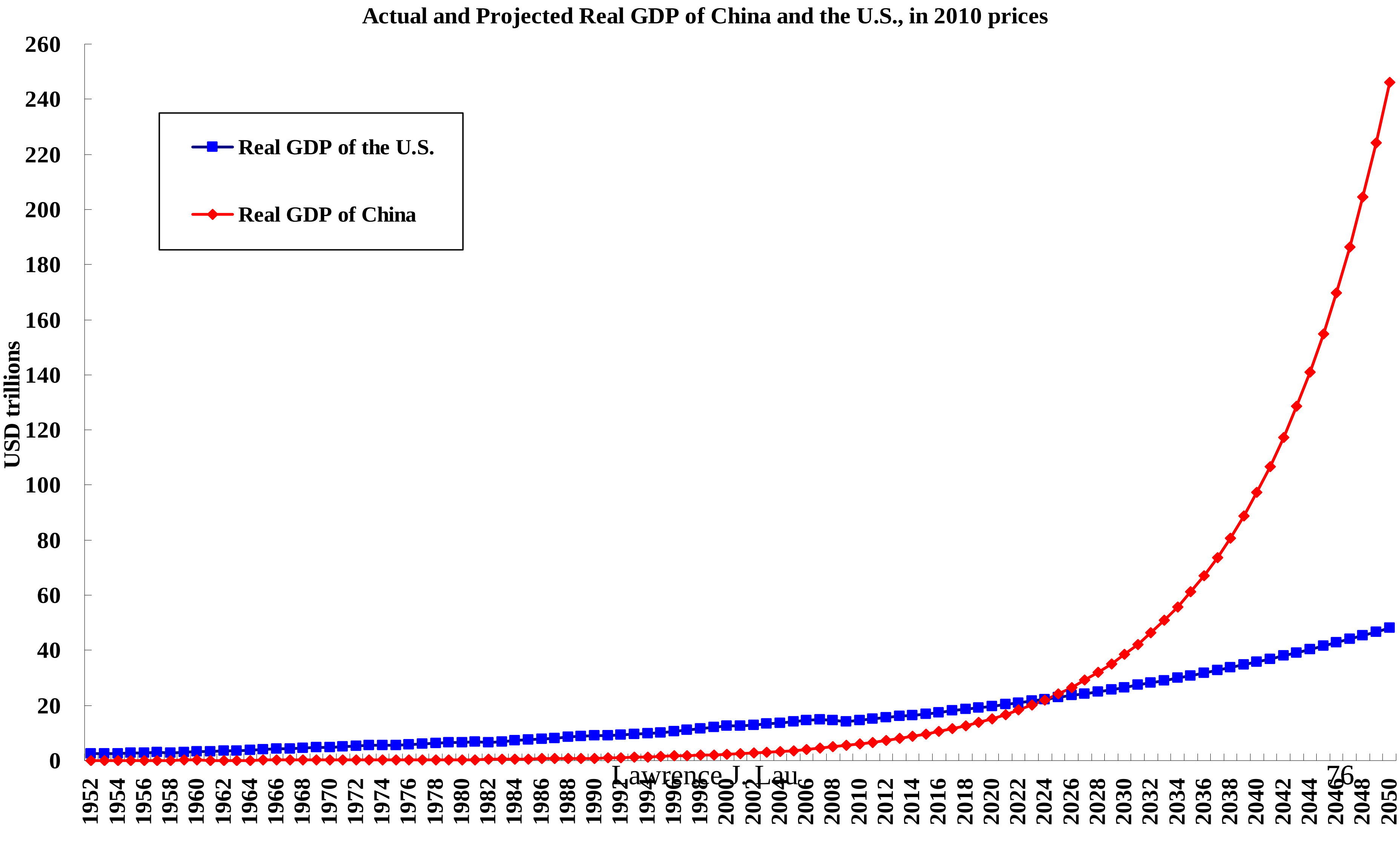
The European Debt Crisis

- In helping to save Greece from default, the major European countries are in fact also saving their own banks, which are major holders of Greek sovereign debt.
- Germany has been running large trade surpluses vis-à-vis other countries within the Euro Zone and hence has a self-interest in seeing that the other countries remain economically stable.
- The consequences of a collapse of the Euro are unthinkable and that is why it will not be allowed to happen as long as Germany and France have the ability to maintain the status quo.

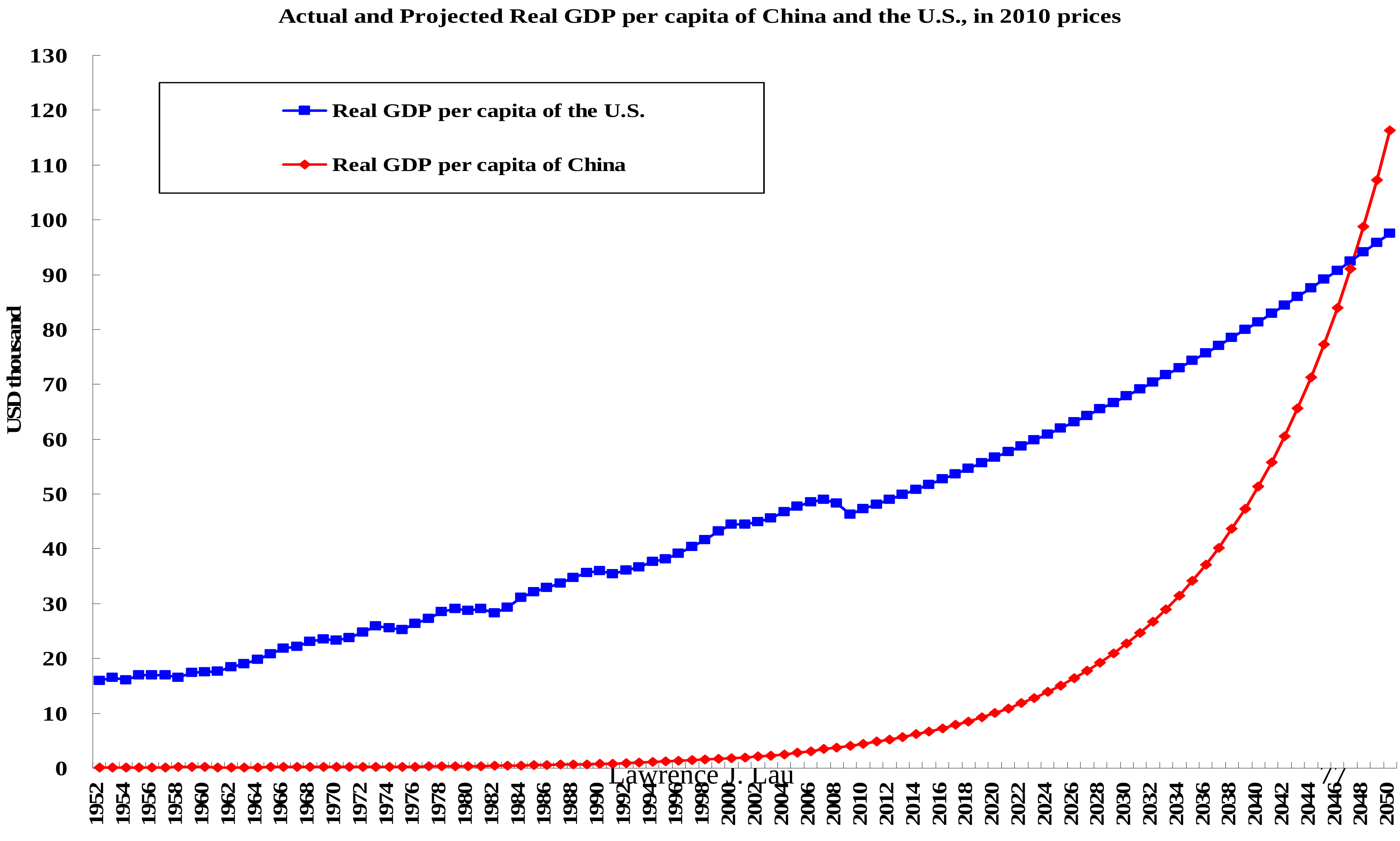
The Projected Distribution of World GDP

- Given the current trends in rates of economic growth, East Asia as a whole will surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2015.
- Chinese GDP will catch up with U.S. GDP by 2025, when each will account for approximately 15% of World GDP.
- It is projected that Chinese GDP per capita will catch up with U.S. GDP per capita by 2050, at which time Chinese GDP will be approximately five times that of the U.S. and will account for between a third and a half of World GDP (depending on the growth rates of other economies, especially the developing economies of today).

Actual and Projected Real GDP of China and the U.S., in 2010 prices



Actual and Projected Real GDP per Capita of China and the U.S., in 2010 prices



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.
- Chinese GDP will probably catch up with U.S. GDP in approximately 15 years, some time around 2025, with U.S. and China each accounting for approximately 15% of World GDP. In the meantime, the U.S. economy will still be the largest in the World.
- It will probably take another 20 to 25 years, perhaps longer, before the middle of this Century, for Chinese per capita GDP to reach a level comparable to that of the then U.S. per capita GDP. If and when that happens, Chinese GDP will be approximately five times that of U.S. GDP.

Concluding Remarks

- The partial de-coupling of global economic growth is a new phenomenon. But with the continued economic growth of not only China but also India, supported by their respective internal demands, East Asia should be able to manage even as the U.S. and European economies remain in recession.
- Continuing economic integration of the East Asian economies is inevitable—East Asian economies now trade more with one another than with either United States or Europe and are likely to continue to do so, especially given the economic problems being faced by the United States and Europe.

Concluding Remarks

- The U.S. economy, because of its innovative capacity, high-quality human capital and abundance of natural resources, will resume its growth in a couple of years.
- The Euro Zone will be able to sort out its problems and the Euro will remain a major international reserve currency.
- The global economy will survive the global financial crisis with East Asian economies relatively unscathed.