# The State of the Global Economy

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# Outline

- Introduction
- 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.
- Recovery slowed down in the U.S. 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 to safe haven and the successive waves of "Quantitative Easing—I, II and III". The Euro Zone economies went into a recession and global trade flows declined.

# Introduction

- Throughout this crisis, however, the economies of the BRICS countries (Brazil, Russia, India, China and South Africa) continued to do reasonably well. China, in particular, was able to maintain its real rate of growth above 7.5%, lending credence to the "Partial De-Coupling Hypothesis", that is, the Chinese economy can continue to grow, albeit at a slower rate, even as the U.S. and European economies go into economic recession. The same applies, to a greater or lesser degree, to the other BRICS and East Asian economies.
- This partial de-coupling can occur because of the gradual shift in the centre of gravity of the World economy from the United States and Western Europe to Asia (including both East Asia and South Asia) over the past three decades.

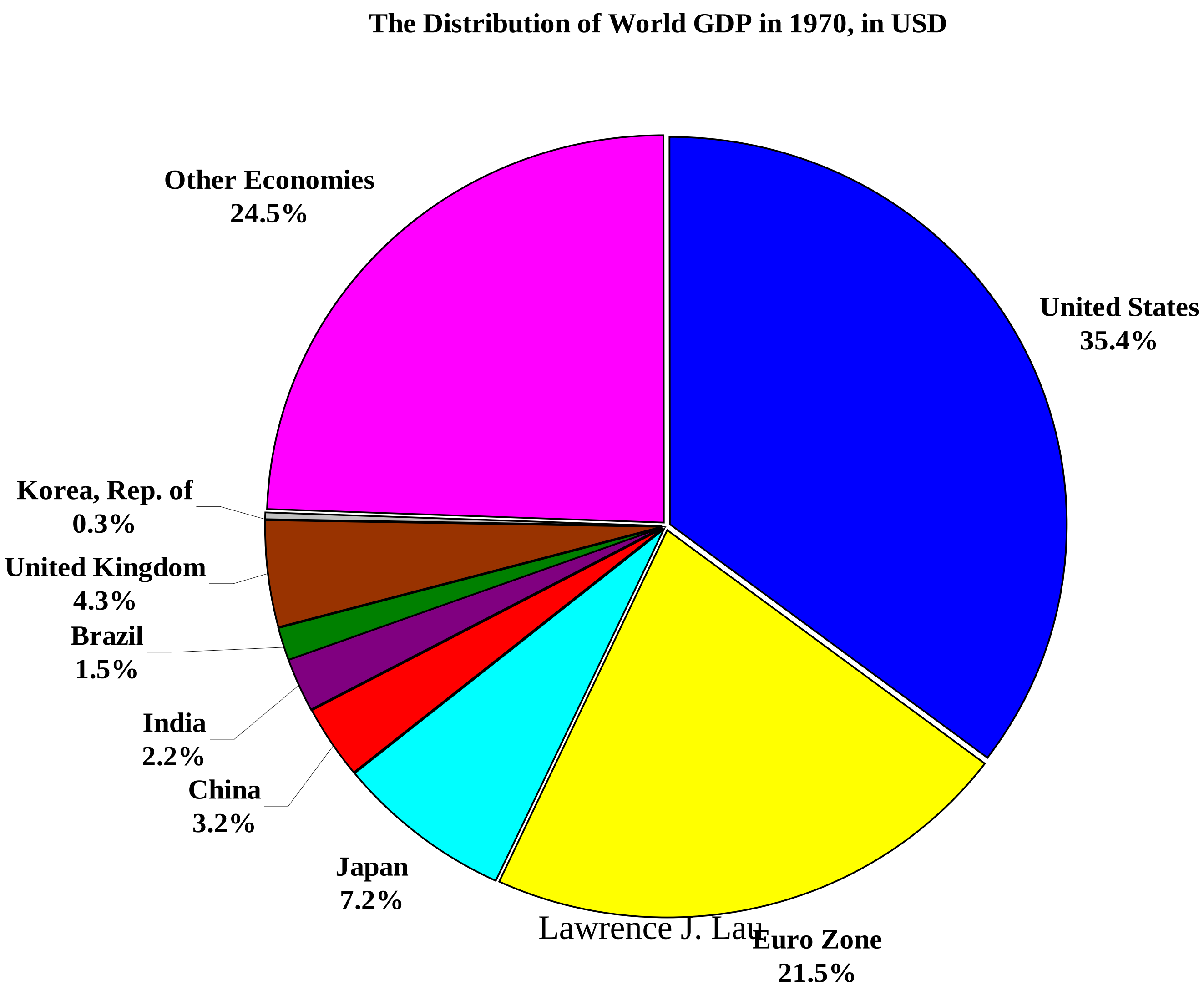
# Changing Patterns in the Global Economy: The Shifting Centre of Gravity

- 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 provided convincing 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.

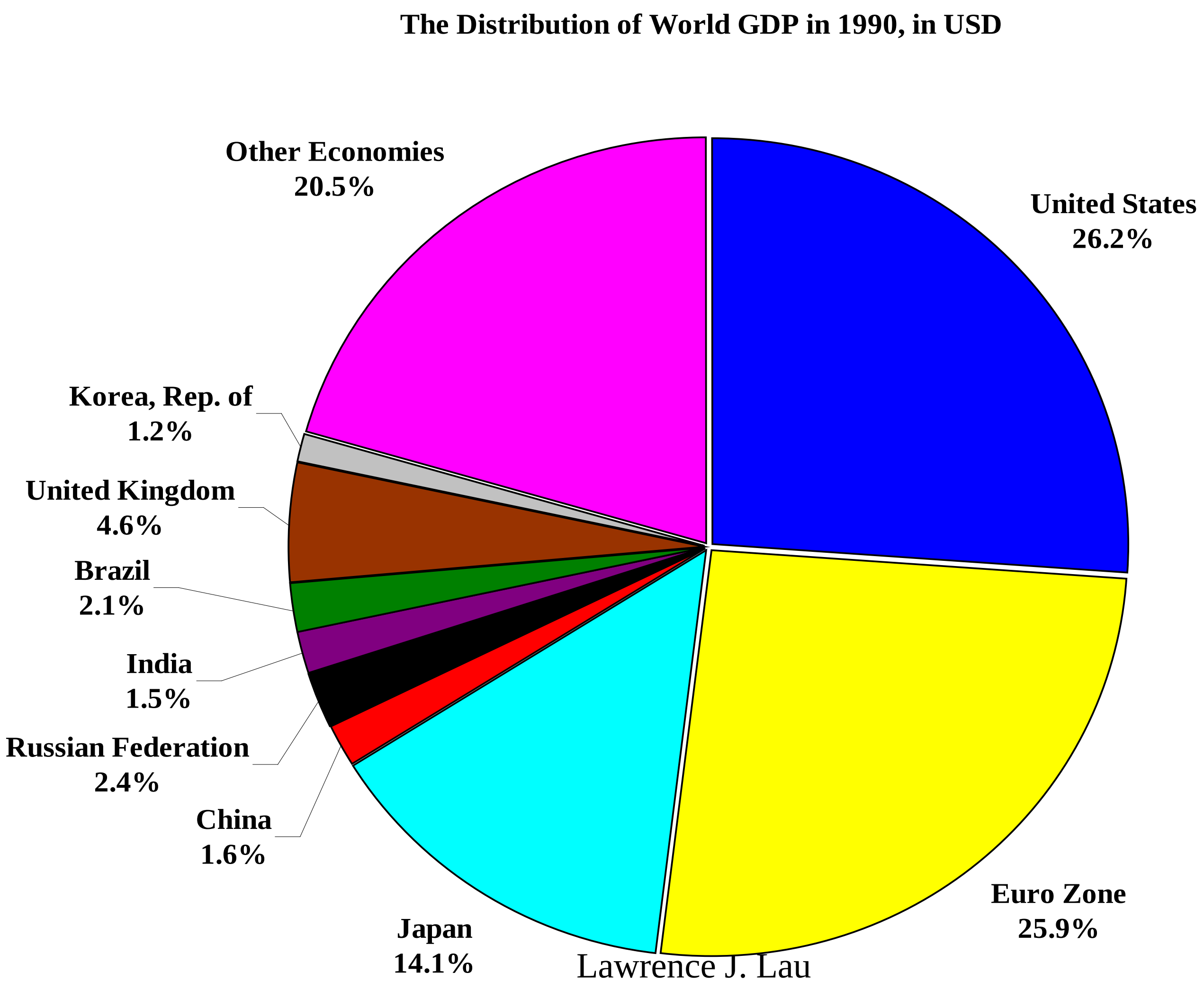
# Changing Patterns in the Global Economy: GDP

- 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, Khmer Republic, 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%.

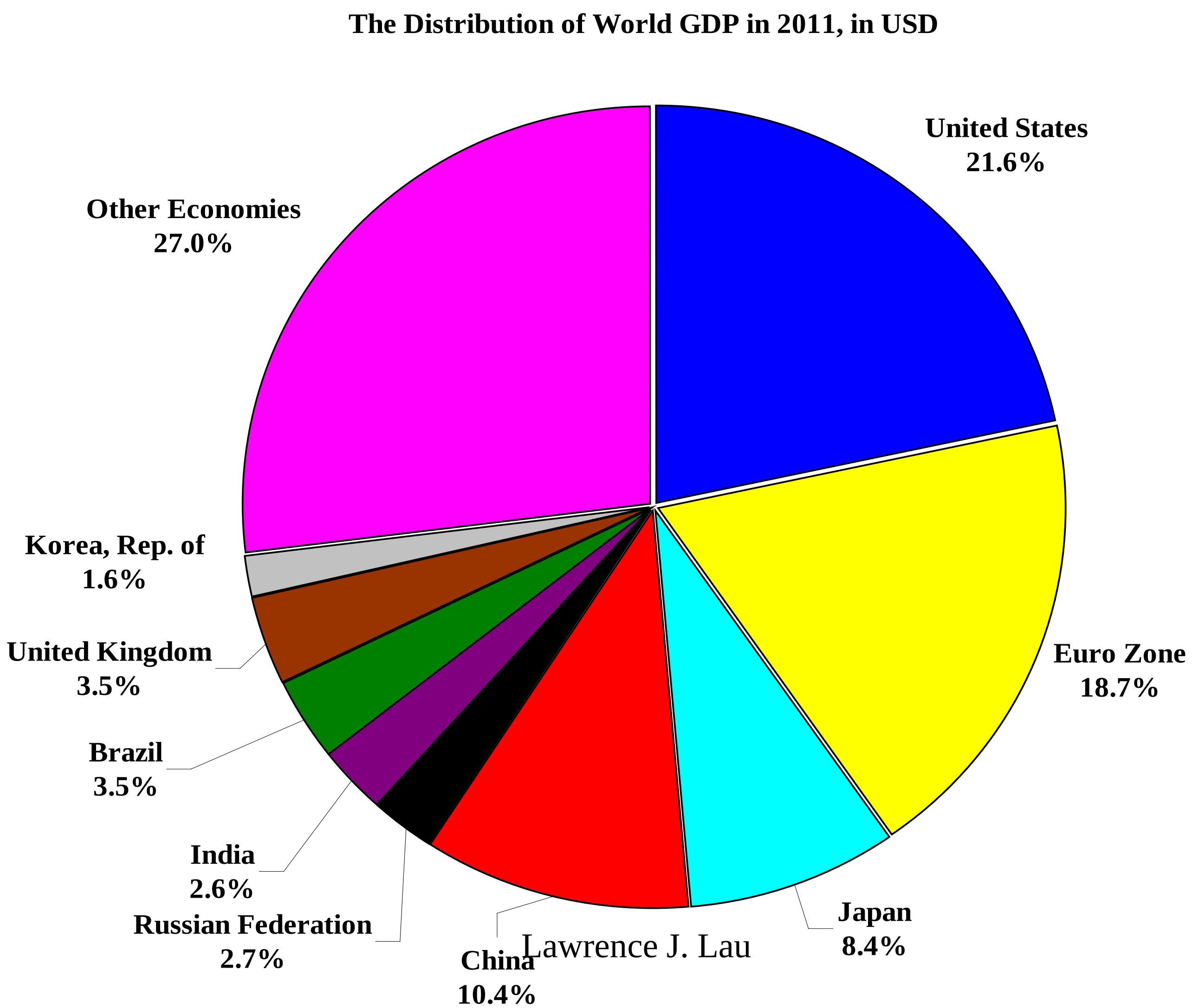
# The Distribution of World GDP, 1970, US$



# The Distribution of World GDP, 1990, US$



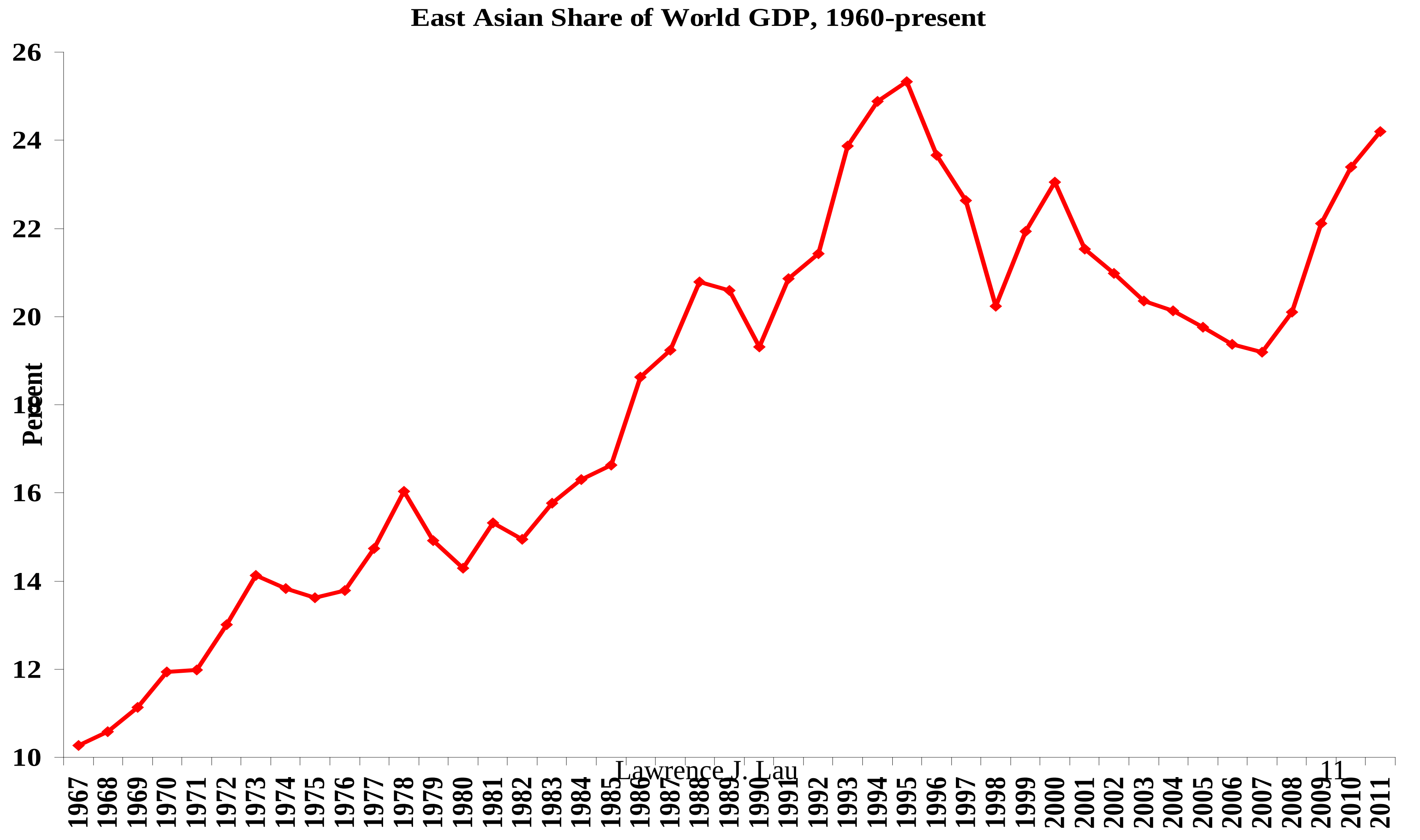
# The Distribution of World GDP, 2012, US$



# Changing Patterns in the Global Economy: GDP

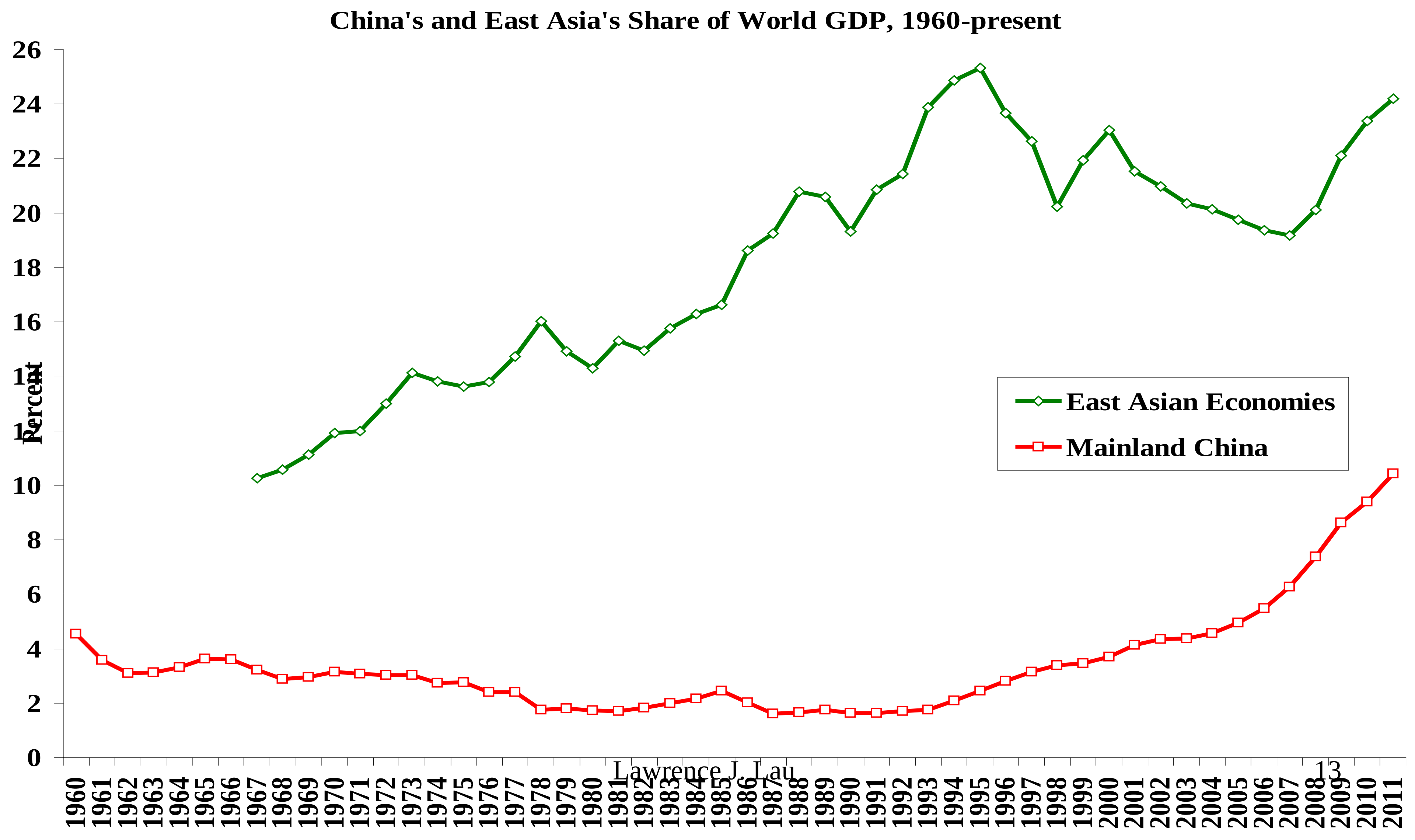
- The East Asian (defined as the 10 Association of Southeast Asian Nations (ASEAN) + 3 (China, Japan and the Republic of Korea) share of World GDP rose from just above 10% in 1970 to approximately 25% in 2012.
- The Chinese share of World GDP alone rose from less than 2% in 1970 to over 10% in 2012.

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



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

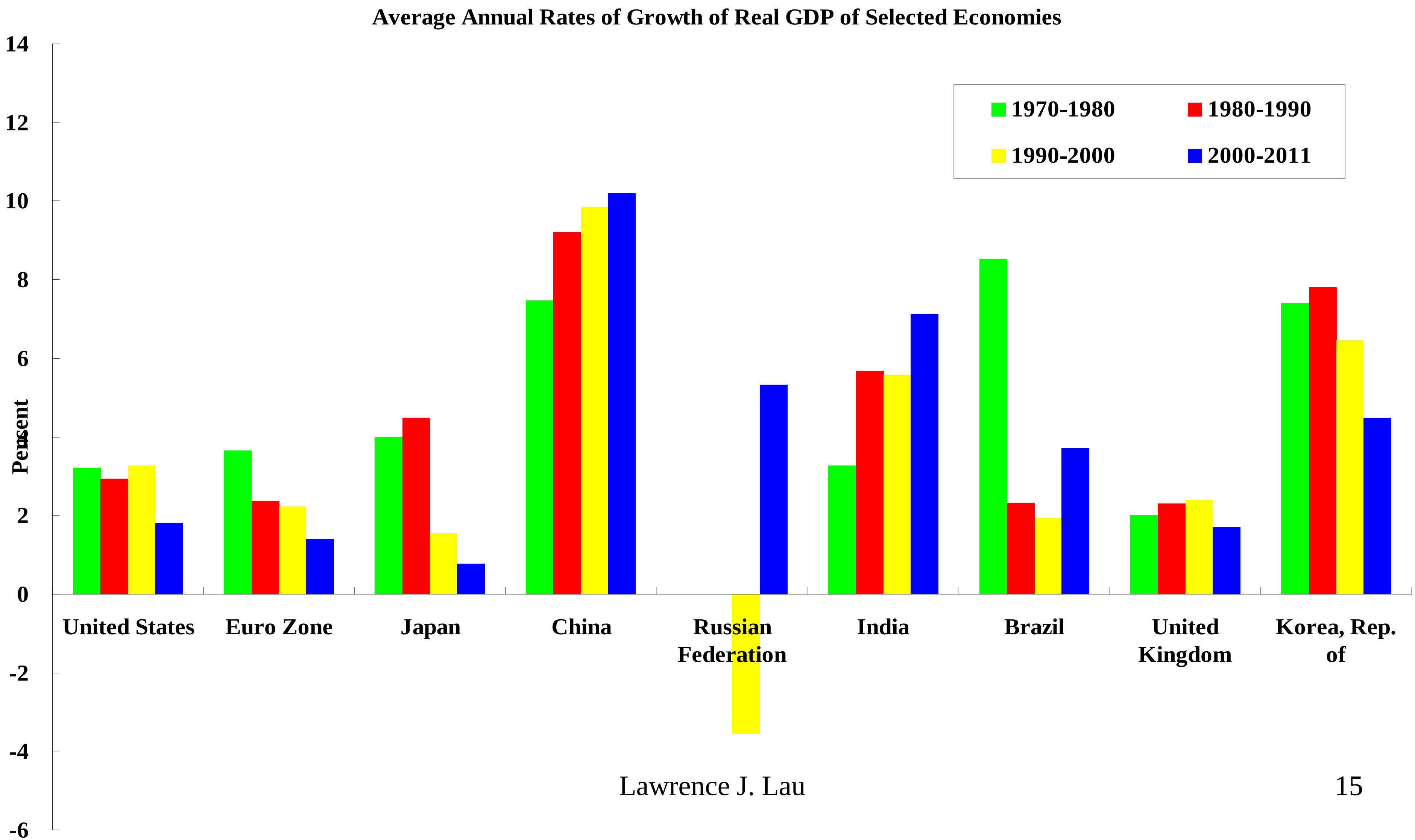
# China and East Asia's Share of World GDP, 1960-present (Current Prices)



# 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.
- 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.

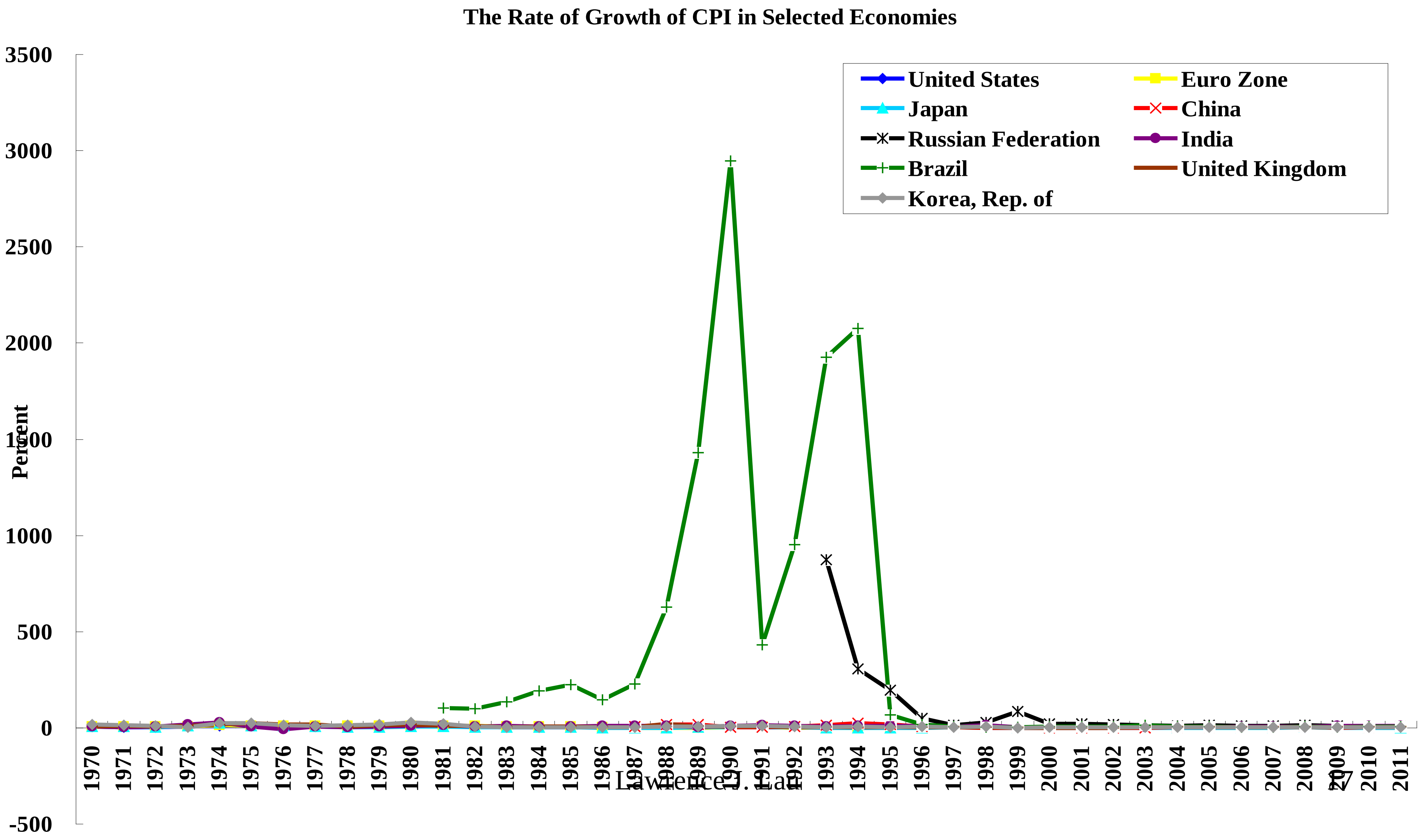
# Average Annual Rates of Growth of Real GDP of Selected Economies



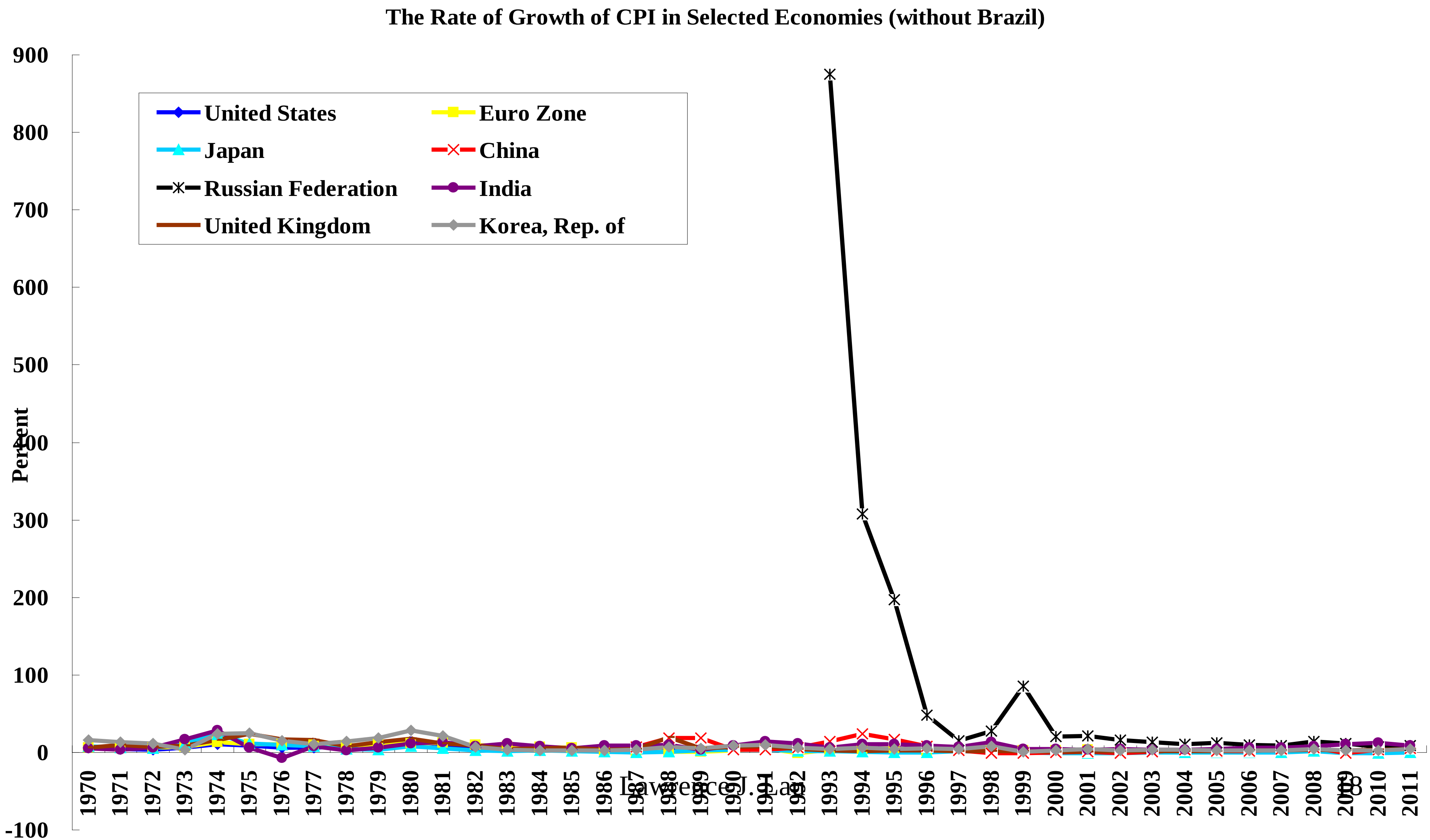
# Changing Patterns in the Global Economy: Inflation

- 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.

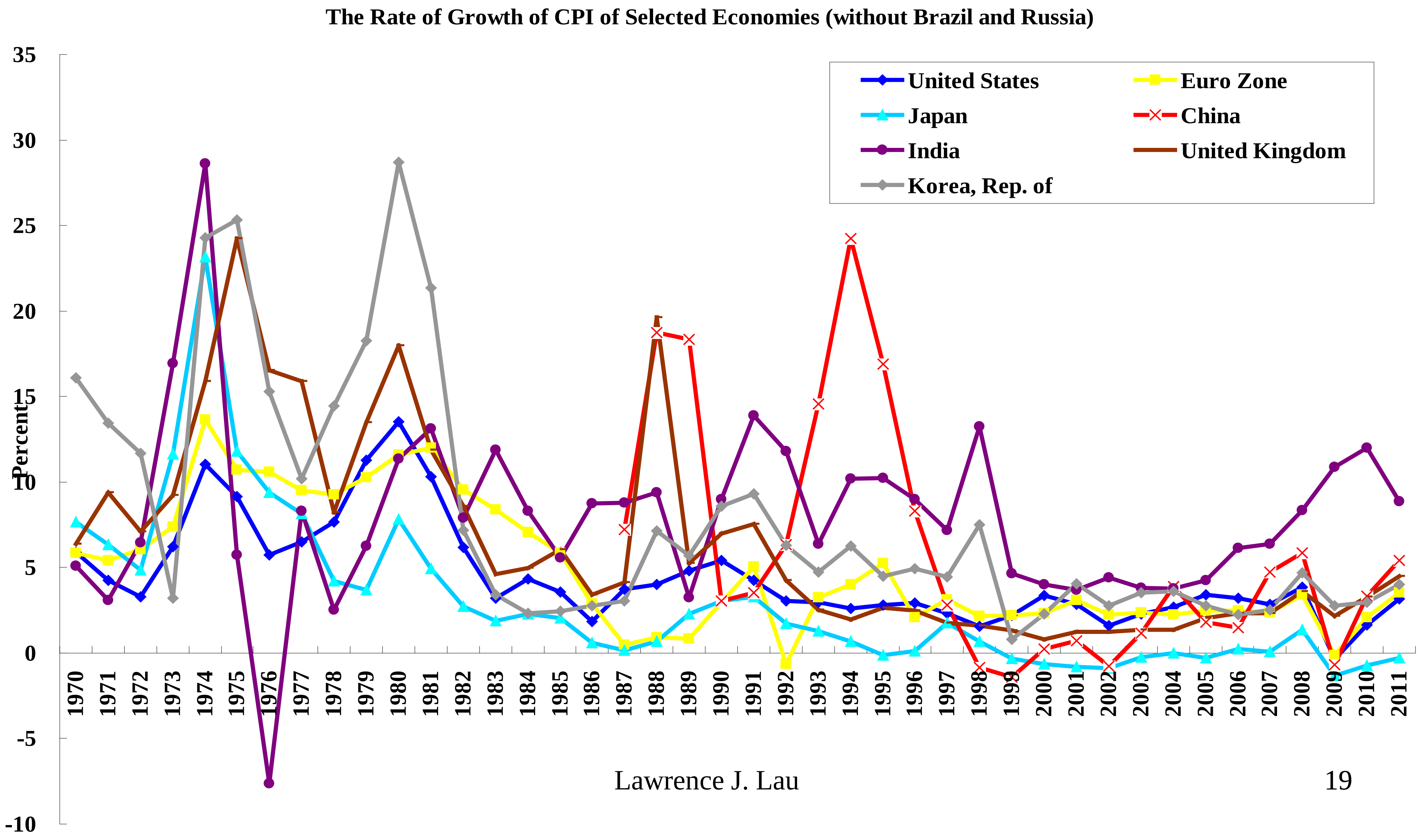
# The Rate of Inflation in Selected Economies



# The Rate of Inflation in Selected Economies (without Brazil)



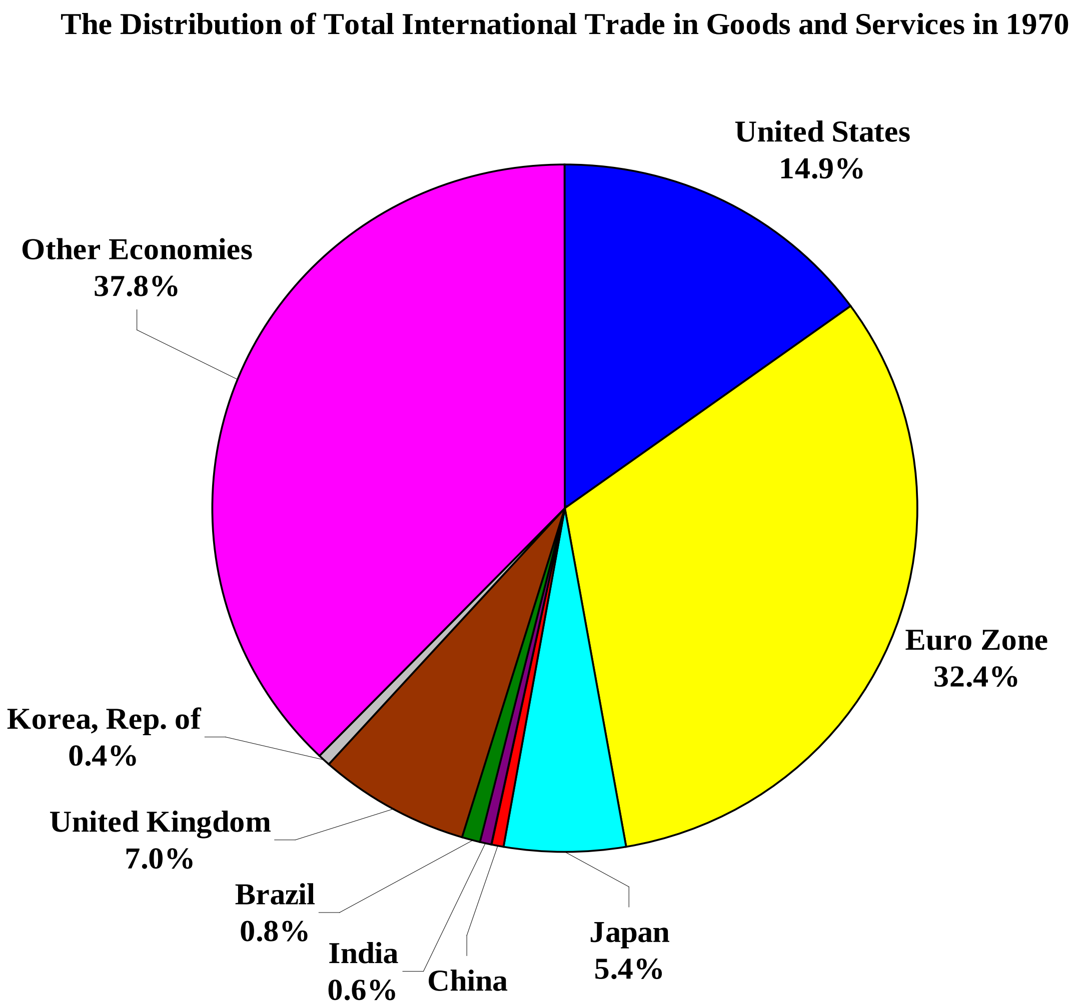
# The Rate of Inflation in Selected Economies (without Brazil and Russia)



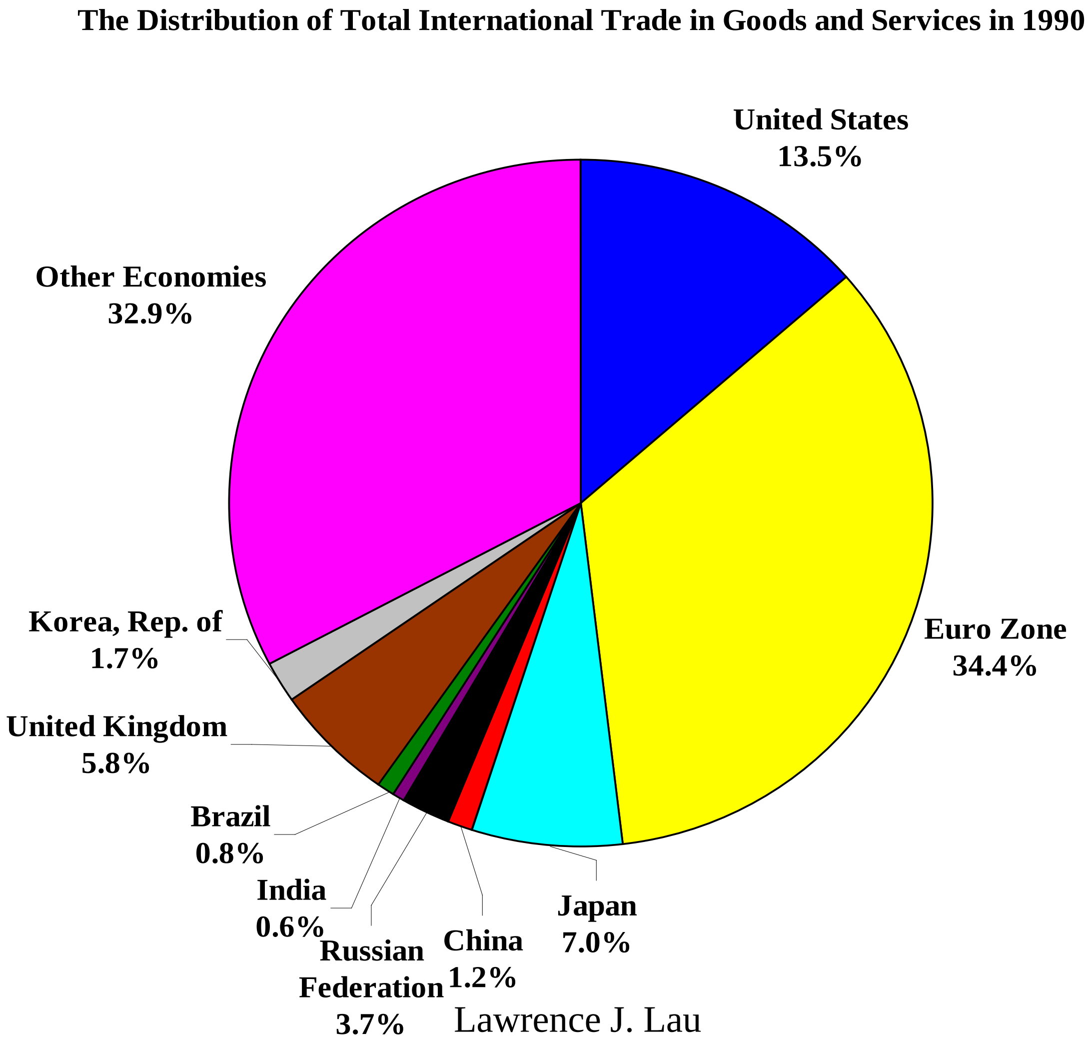
# Changing Patterns in the Global Economy: International Trade

- 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%.

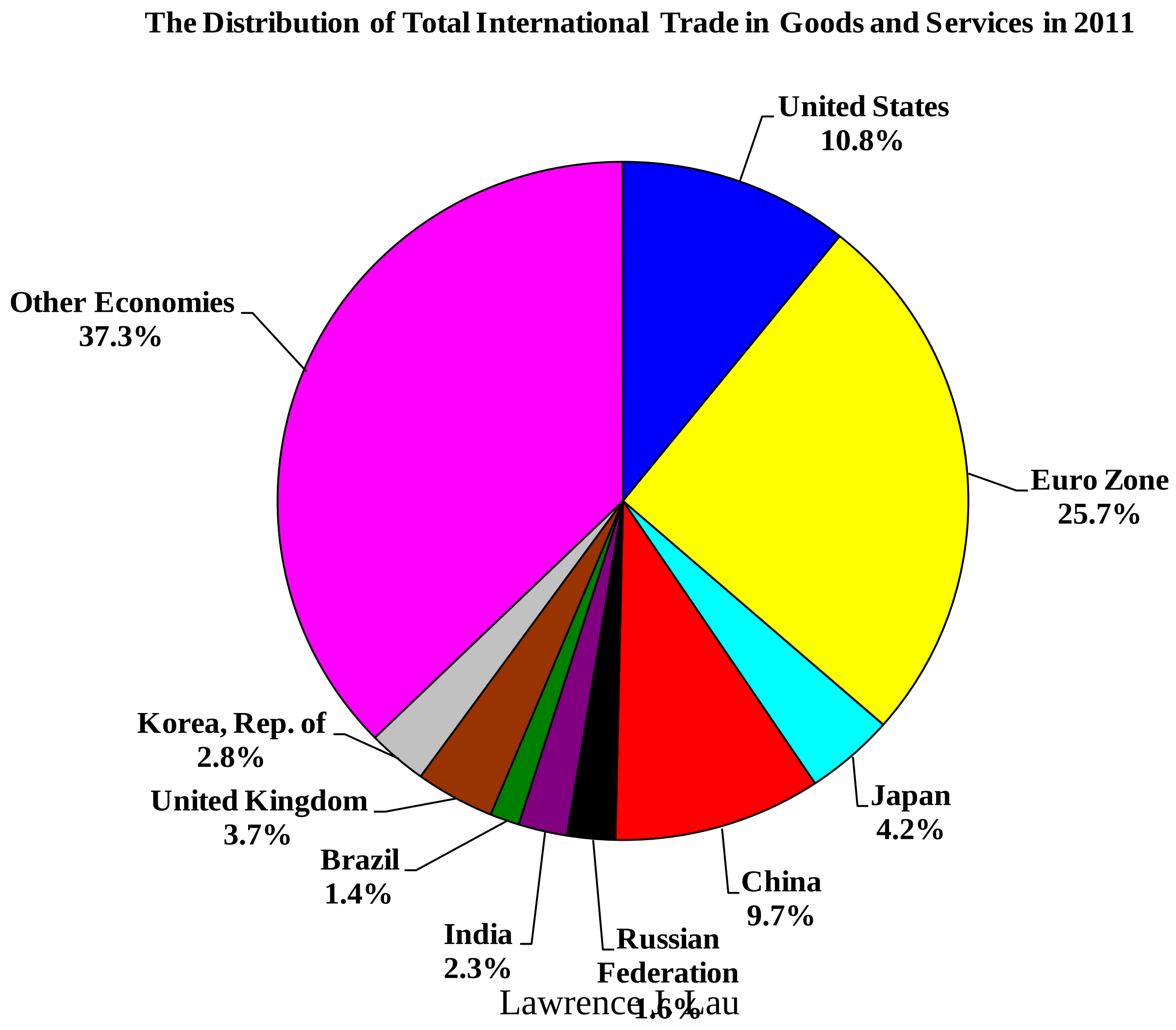
# The Distribution of Total International Trade in Goods and Services, 1970



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



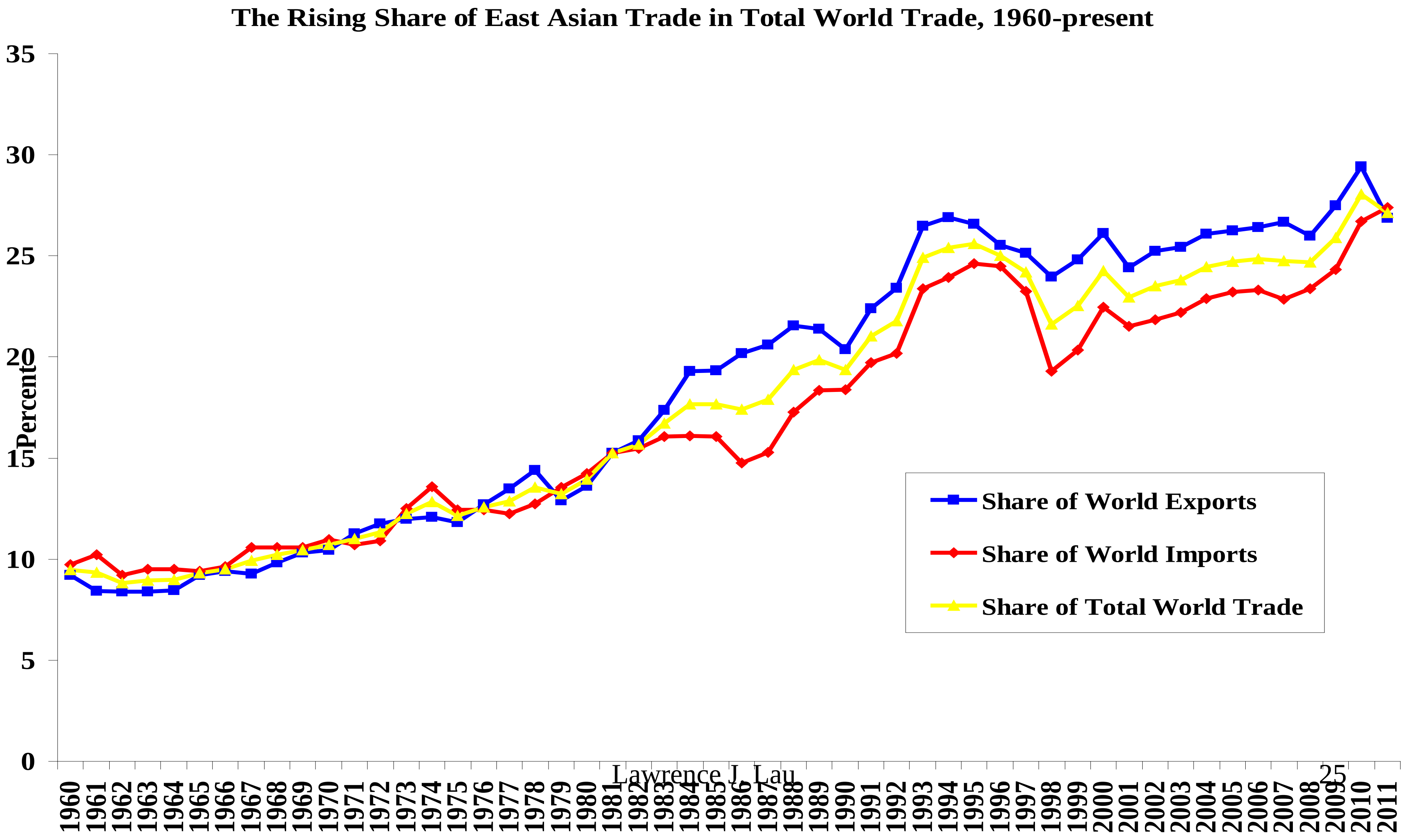
# The Distribution of Total International Trade in Goods and Services, 2011



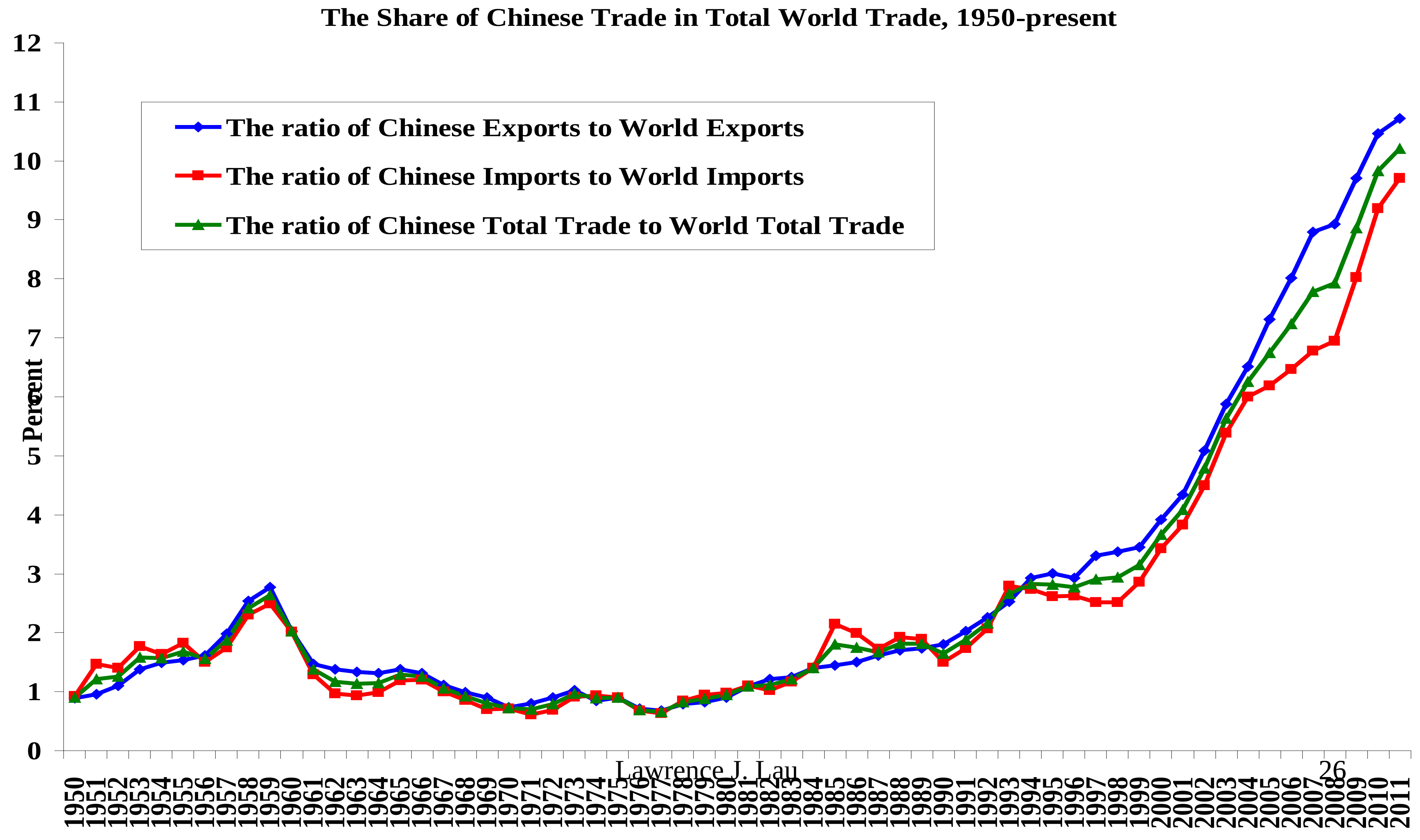
# Changing Patterns in the Global Economy: International Trade

- 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 10% in 1970 to just below 25% in 2011.
- The Chinese share of World trade rose from 1% in 1970 to 10% in 2011.
- Chinese international trade accounted for more than 40% of East Asian international trade in 2011.

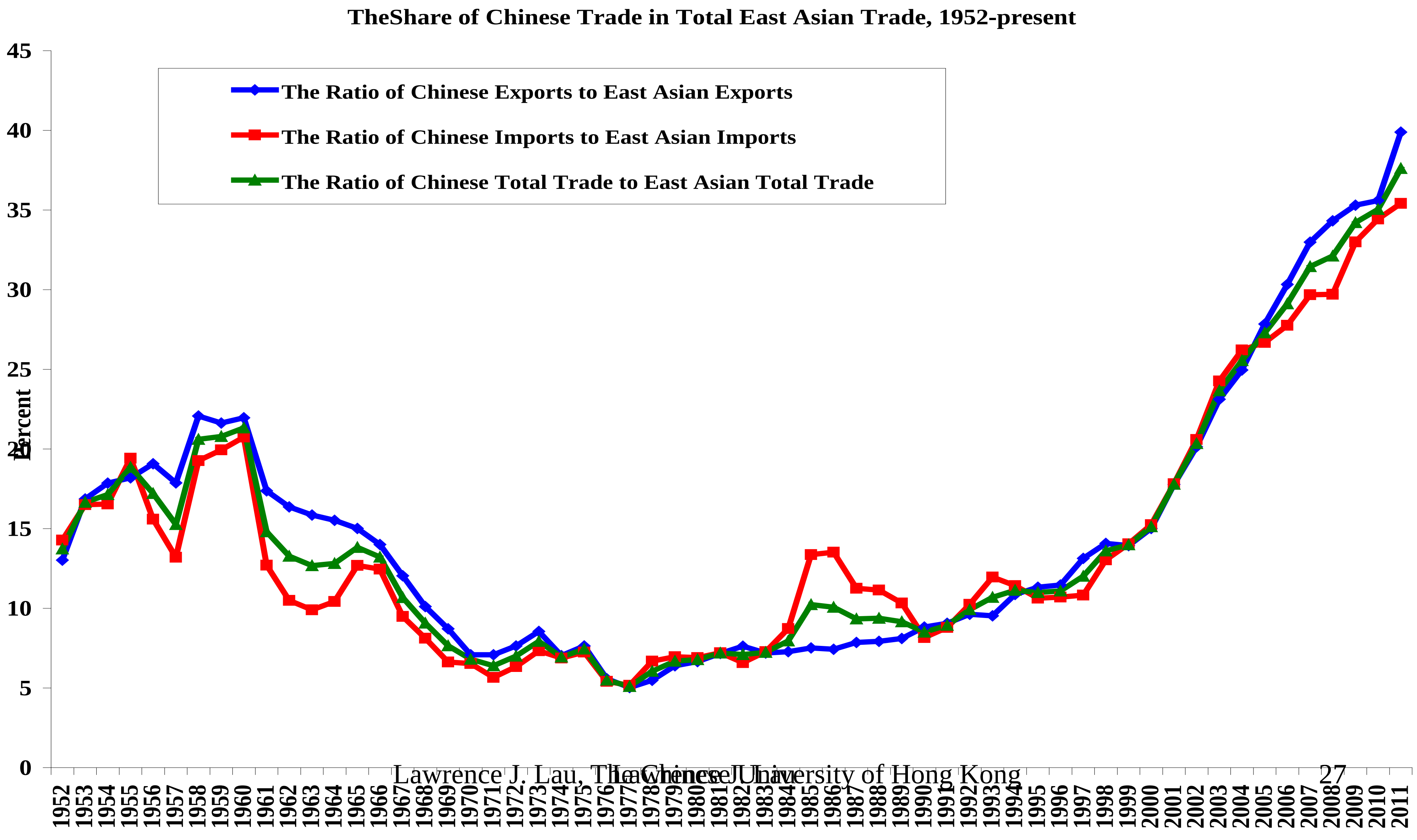
# The Rising Share of East Asian Trade in Total World Trade, 1960-present



# 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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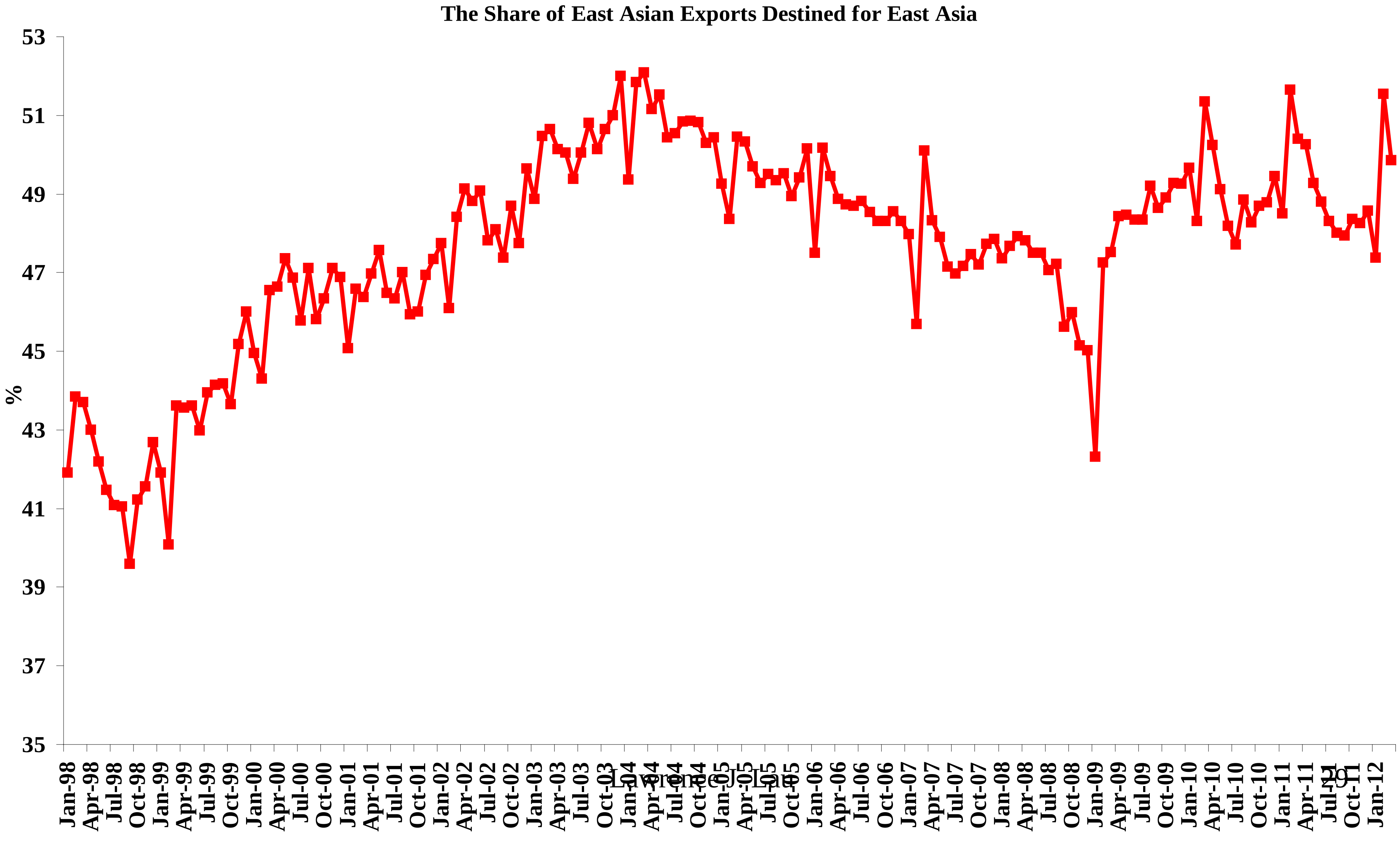
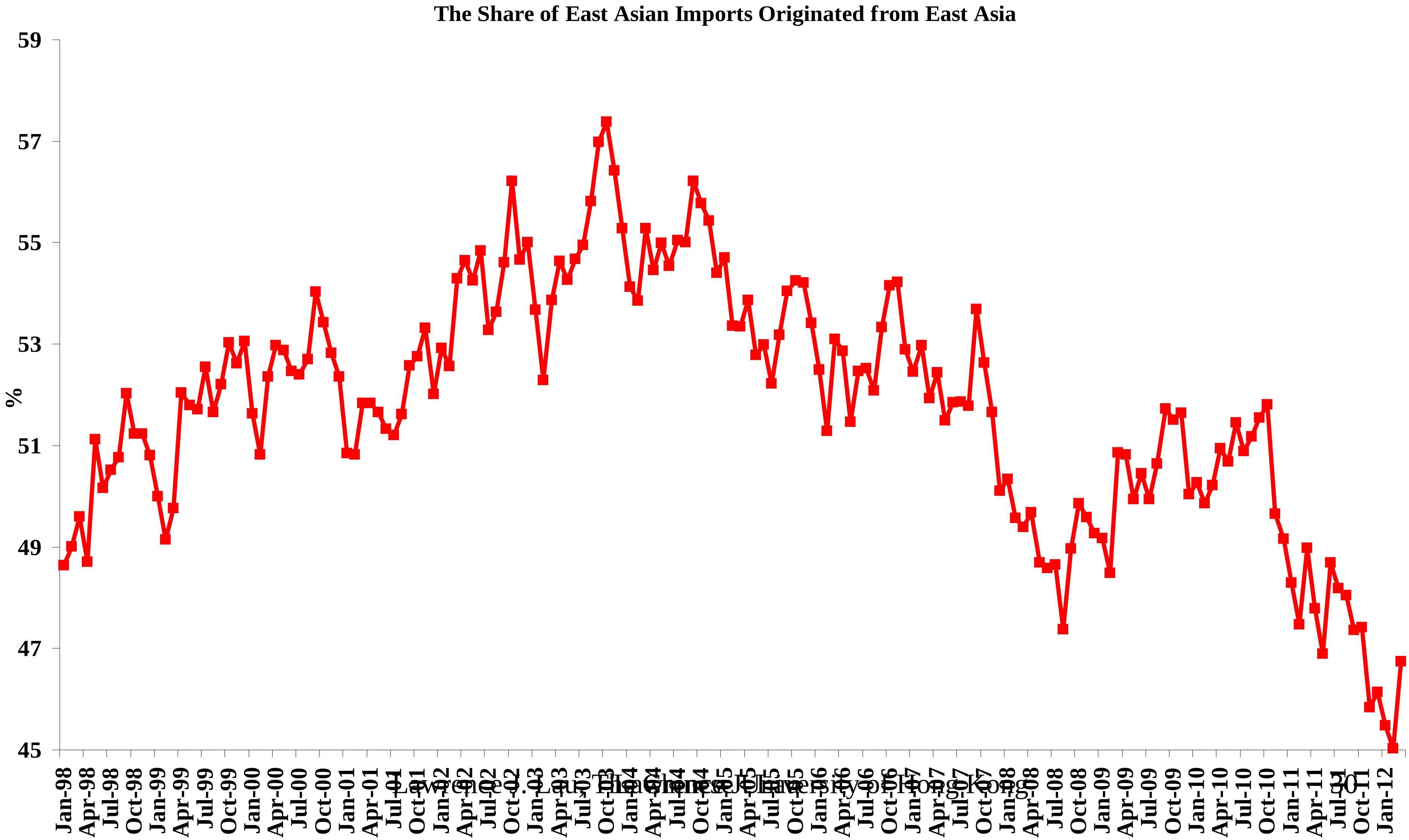
# Changing Patterns in the Global Economy: International Trade

- A particularly interesting development is the rise in intra-East Asian international trade. The share of East Asian trade destined for East Asia has risen to over 50% in the past decade. This is a sea-change compared to 30 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



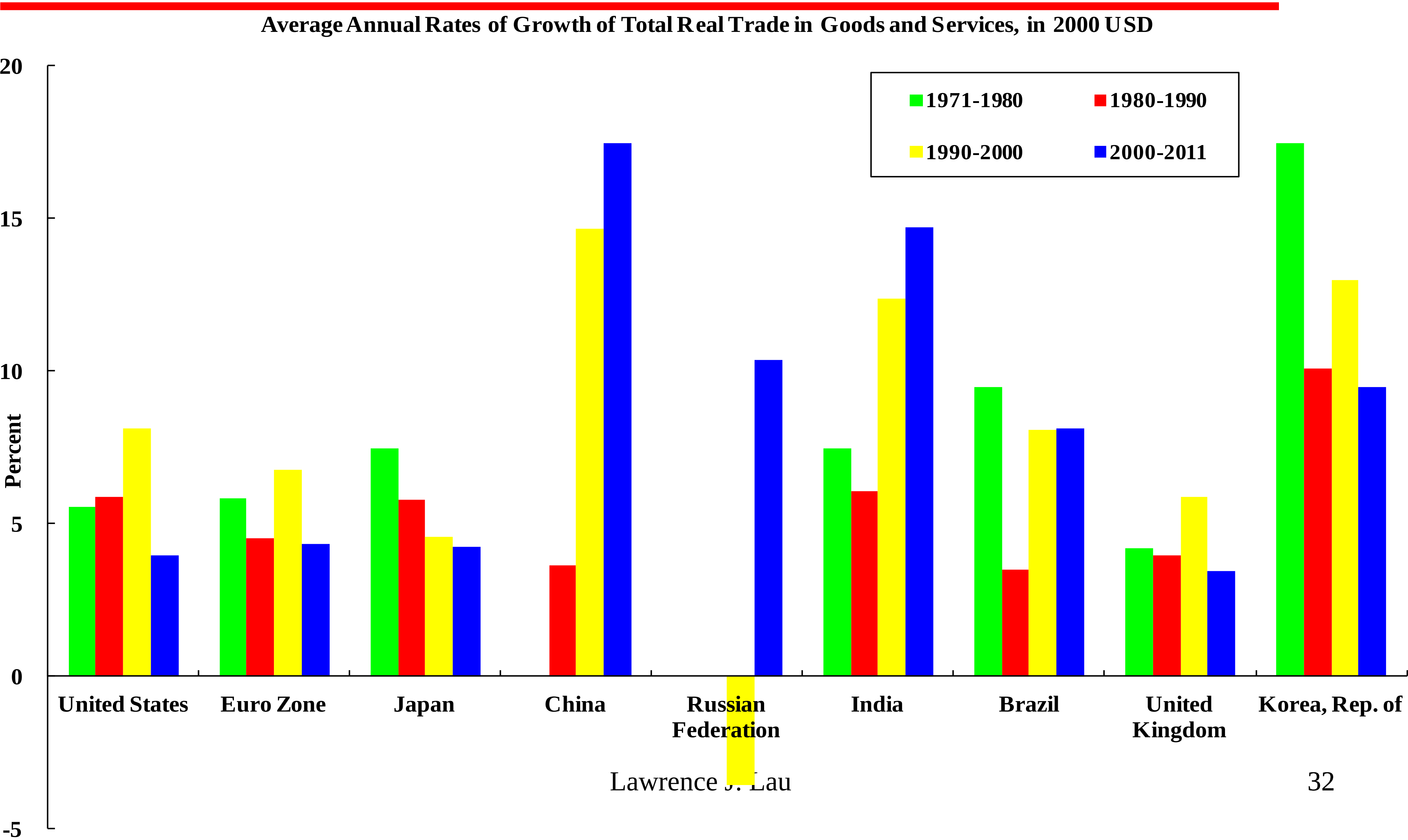
# The Share of East Asian Imports Originated from East Asia



# 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.

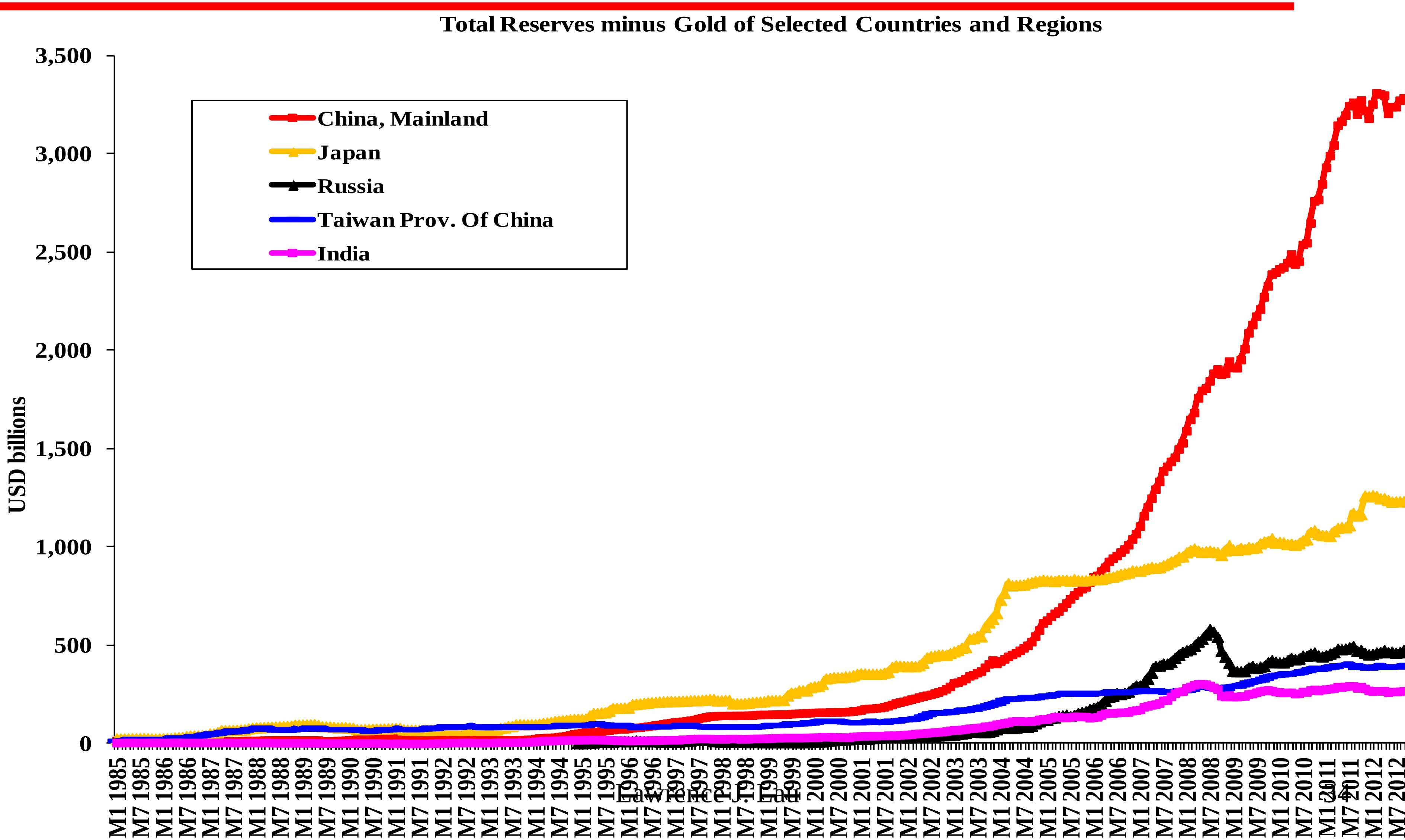
# Average Annual Rate of Growth of Total International Trade in Goods and Services



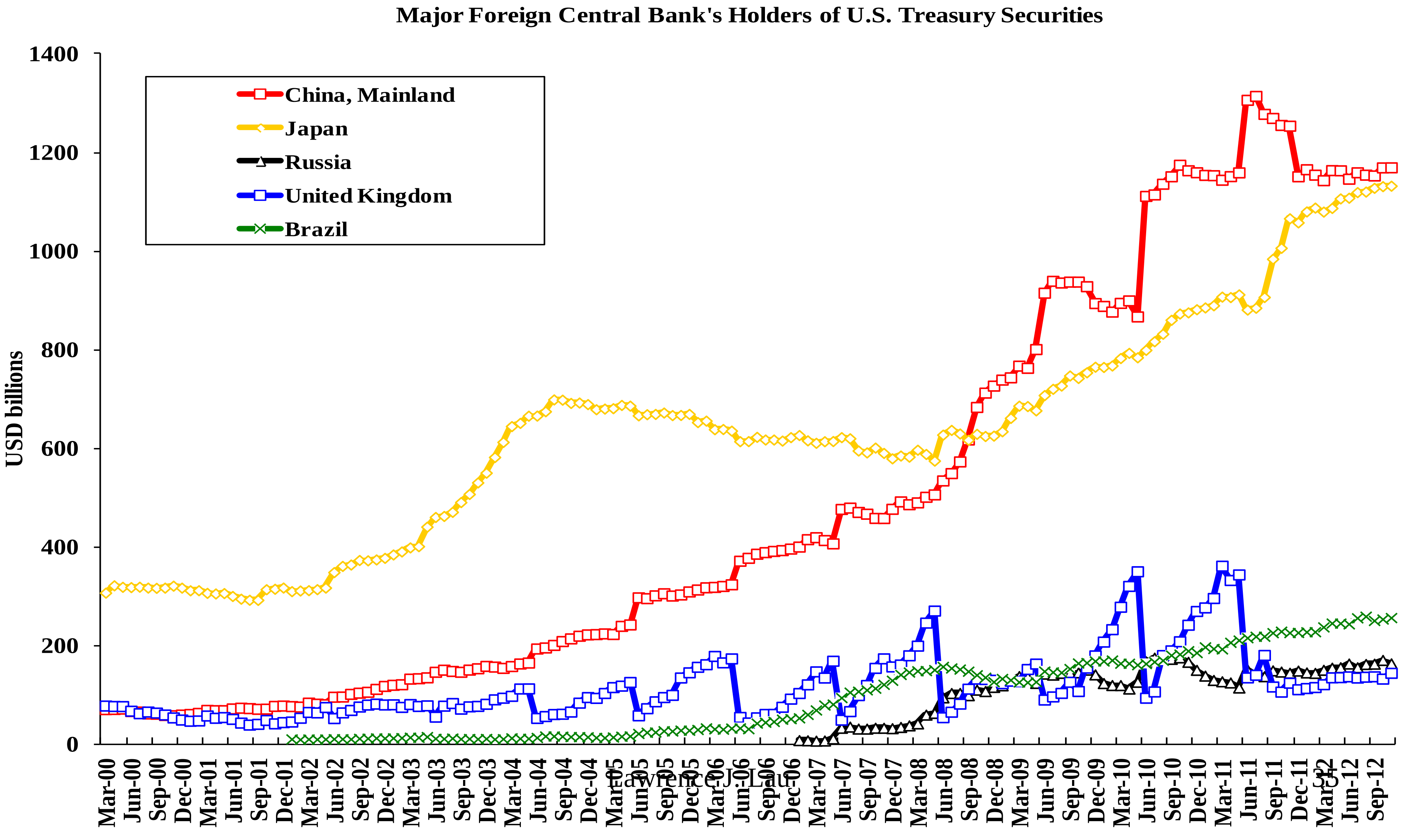
# Changing Patterns in the Global Economy: Official Foreign Exchange Reserves

- 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 in excess of US$3.2 trillion, almost all of which has been acquired during the past decade, followed by Japan with US$1.2 trillion.
- 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$1.2 trillion, followed by Japan as a close second.

# Total Foreign Exchange Reserves minus Gold, Selected Countries and Regions



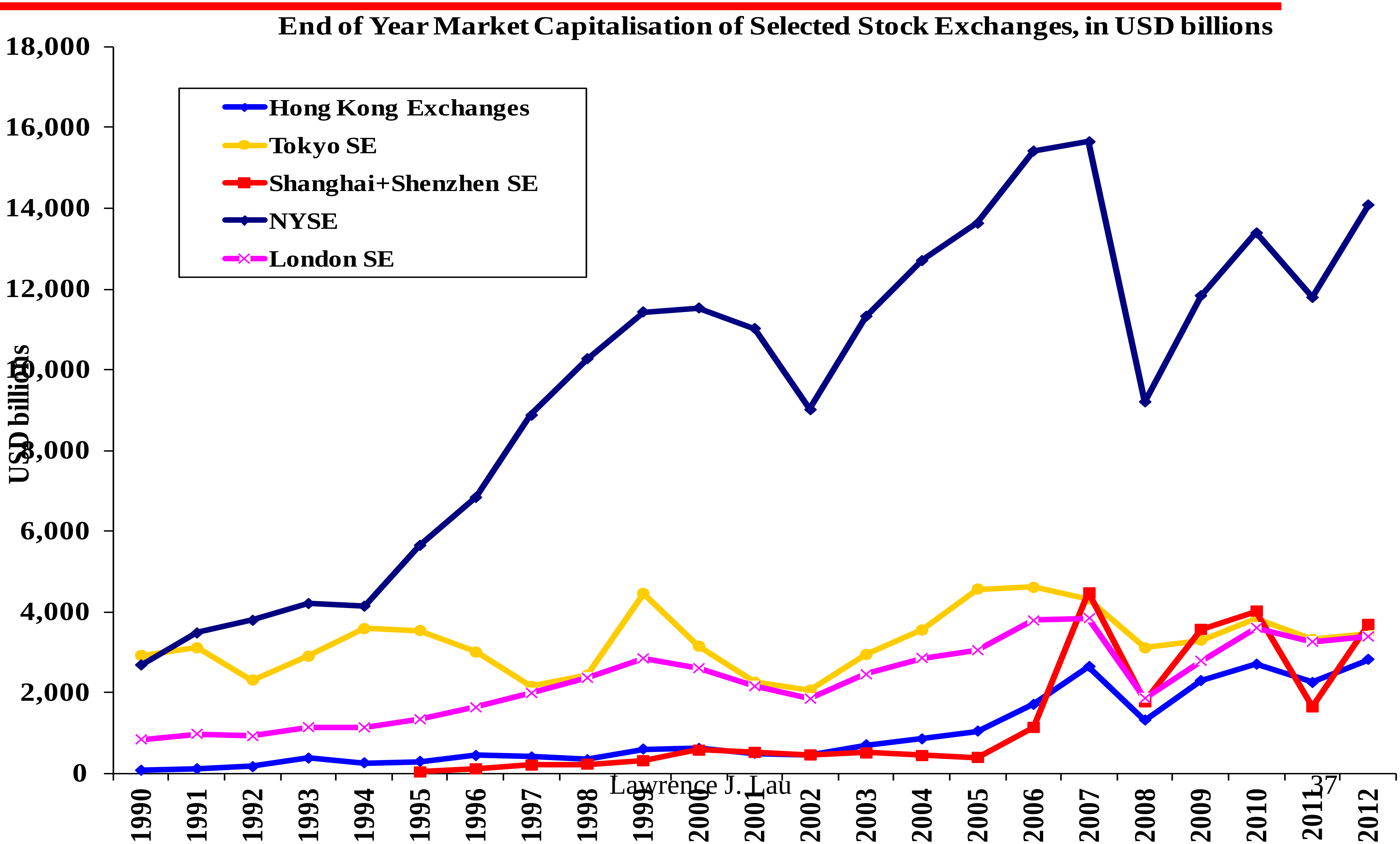
# Major Foreign Central Banks' Holdings of U.S. Treasury Securities



# 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 get started until the mid-1990s.

# End of Year Market Capitalisation of Selected Stock Exchanges



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

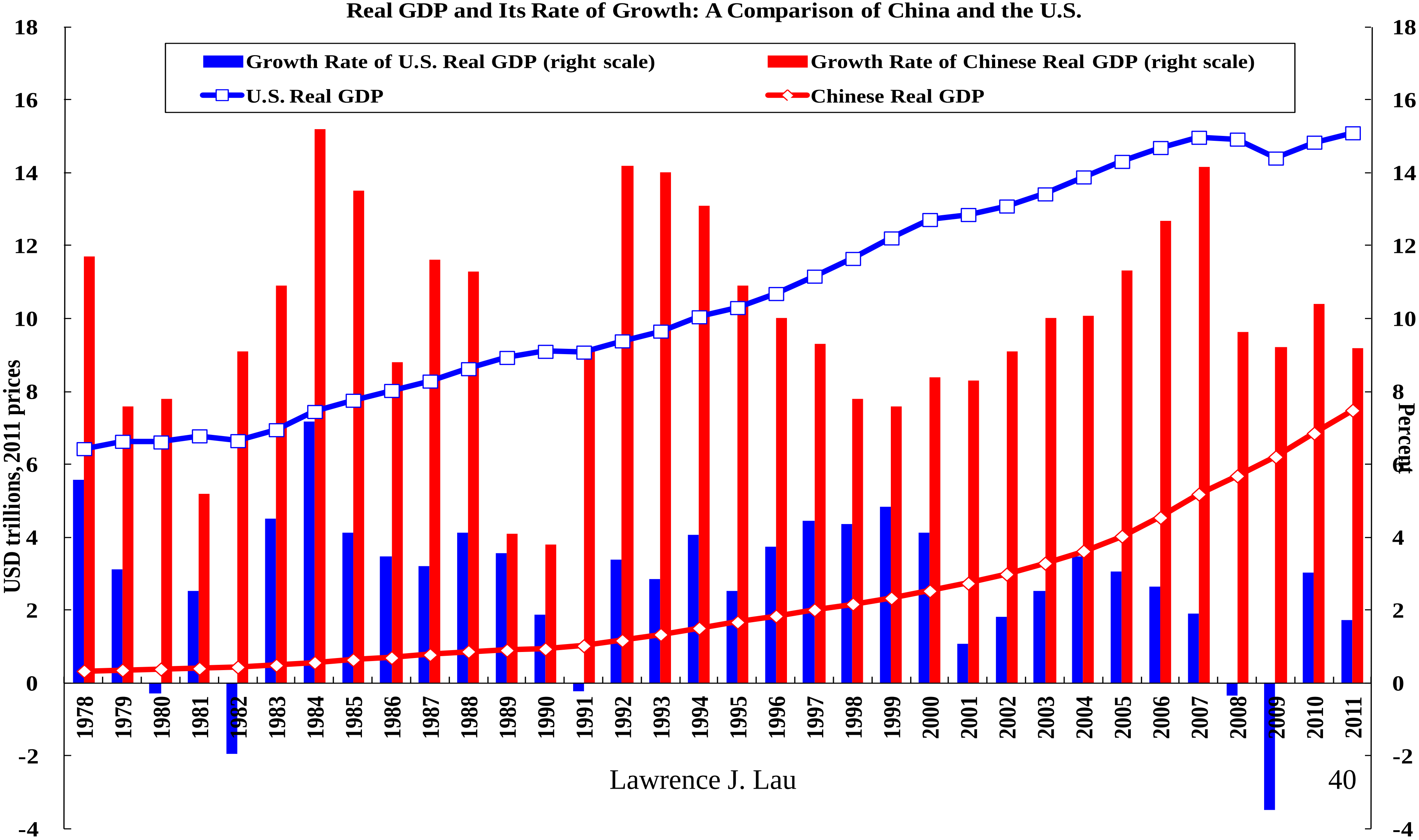
| | |
|---|---|
| ◆ U.S.A. | 18.7 trillion |
| ◆ Europe | 10.4 trillion |
| ◆ East Asia | 14.2 trillion |

- 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

# 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 9.8% per annum over the past 33 years. It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- Between 1978 and 2011, Chinese real GDP grew almost 22 times, from US$333 billion to nearly US$7.5 trillion (2011 prices) to become the second largest economy in the World, after the U.S. (In 2012 prices, probably US$8.4 trillion.)
- By comparison, the U.S. GDP (approx. US$15.1 trillion) was 2 times Chinese GDP in 2011.

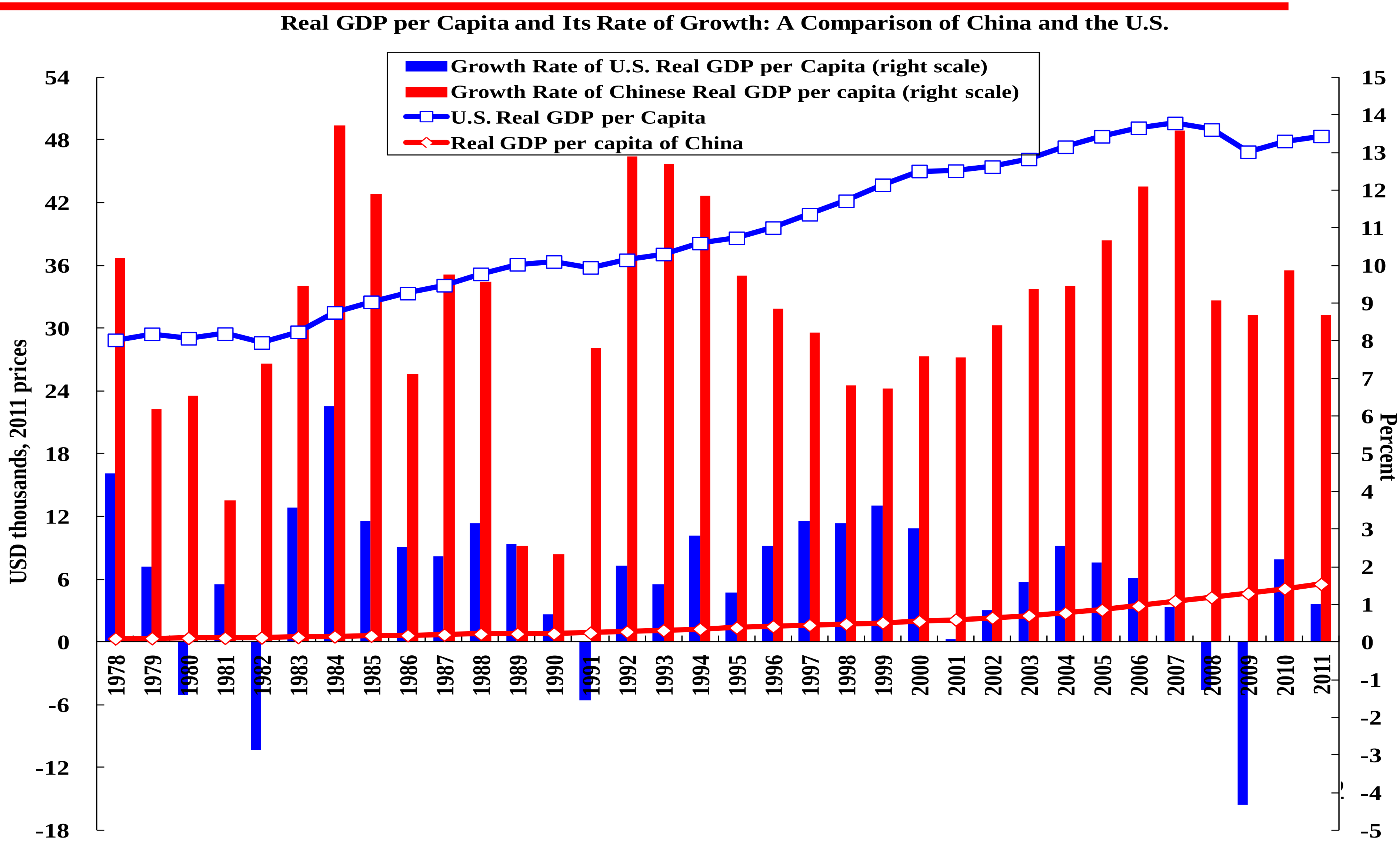
# Real GDP and Its Rate of Growth: A Comparison of China and the U.S. (2011$)



# 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 2011, Chinese real GDP per capita grew 15 times, from US$346 to US$5,555 (in 2011 prices). By comparison, the U.S. GDP per capita of approximately US$48,236, was 8.7 times Chinese GDP per capita in 2011.

# Real Chinese and U.S. GDP per Capita in US$ Since 1952 (2011 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 benefited from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.

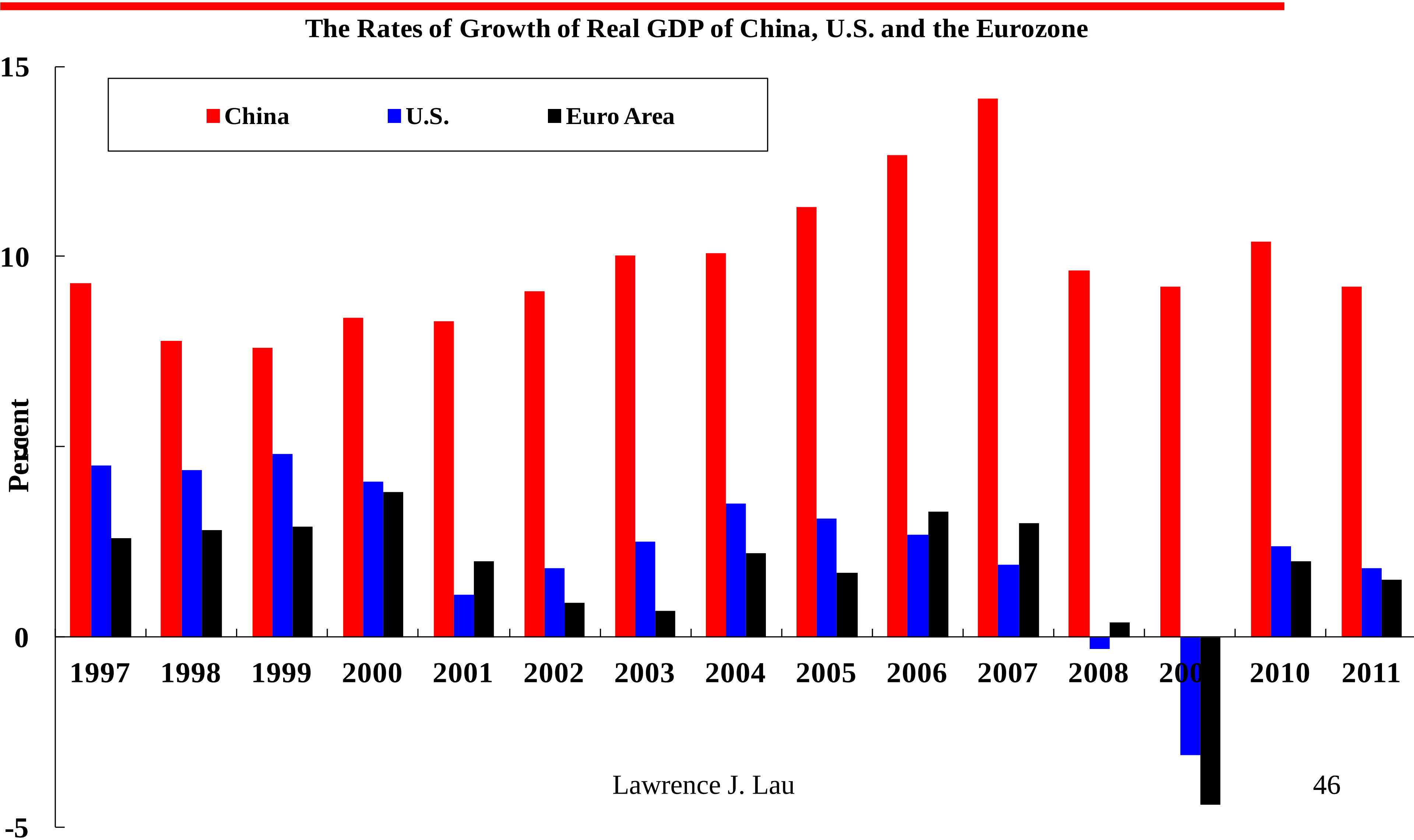
# The Chinese Economy in the Global Context

- 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 and the more recent European sovereign debt crisis.
- China is one of the very few socialist countries that have made a smooth transition from a centrally planned to a market economy. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

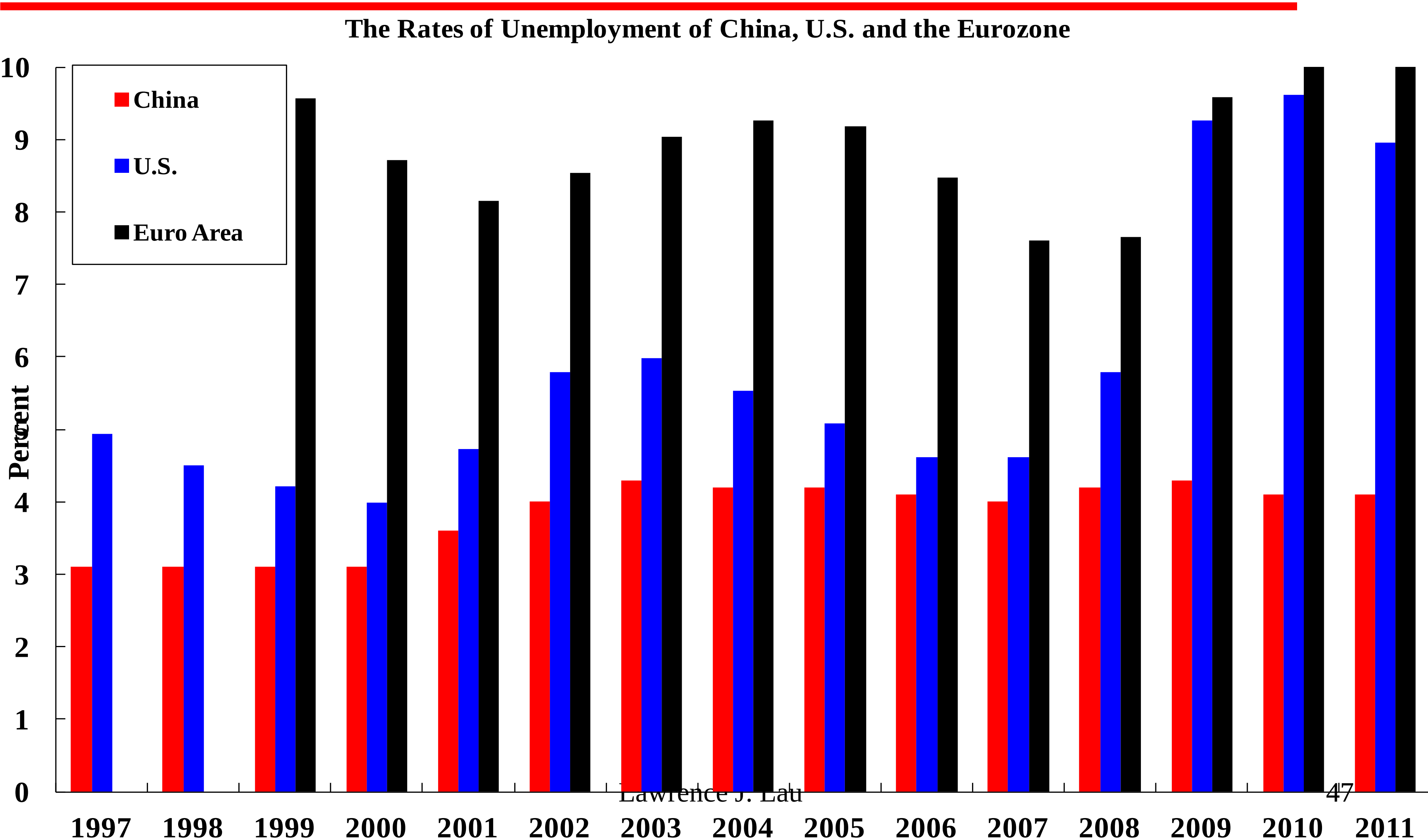
# The Near-Term Macroeconomic Outlook of the World Economy

- 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 very low rates. It has had positive rates of growth for 43 consecutive months.
- However, the Euro Zone economies continue to be affected by their sovereign debt crisis.
- The rates of unemployment have continued to be high for both the U.S. (7.8%) and for the Euro Zone (11.2%) and are unlikely to decline significantly in the near term.
- Fortunately, the rates of inflation have remained relatively subdued and in the case of China the rate of inflation has also begun to come down significantly.

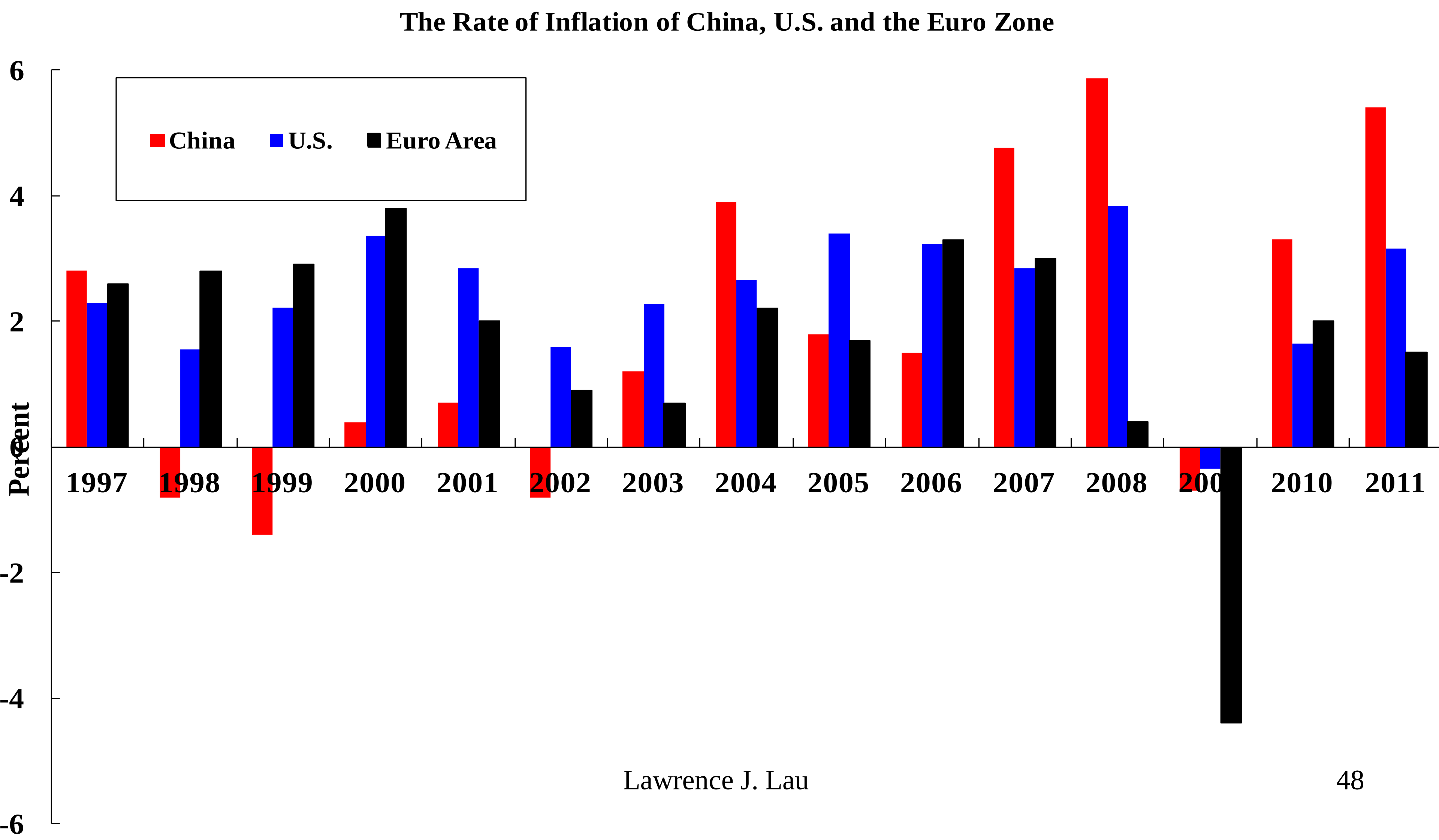
# The Rates of Growth of Real GDP of China, U.S. and the Euro Zone



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



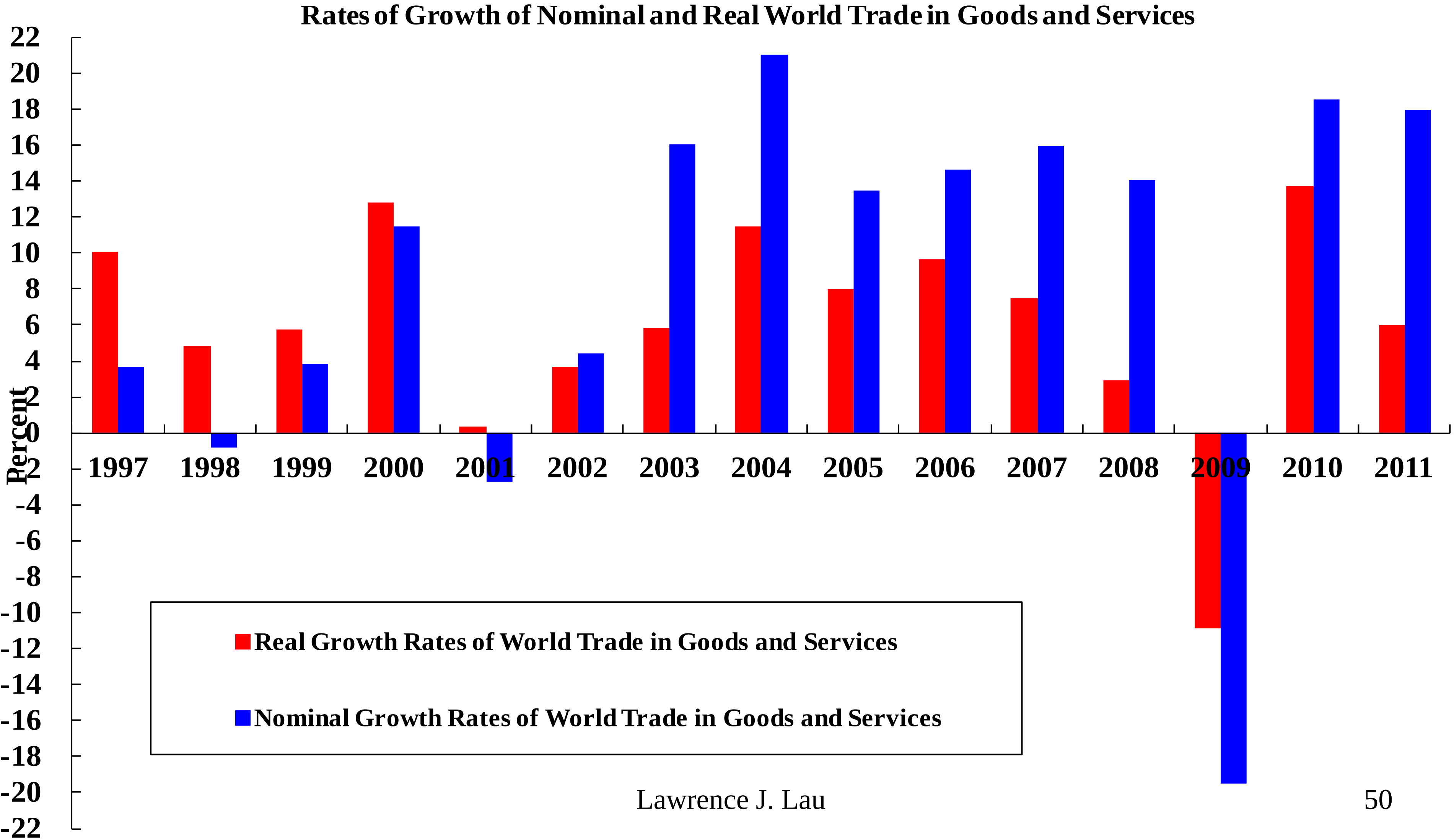
# The Rates of Inflation of China, U.S. and the Euro Zone



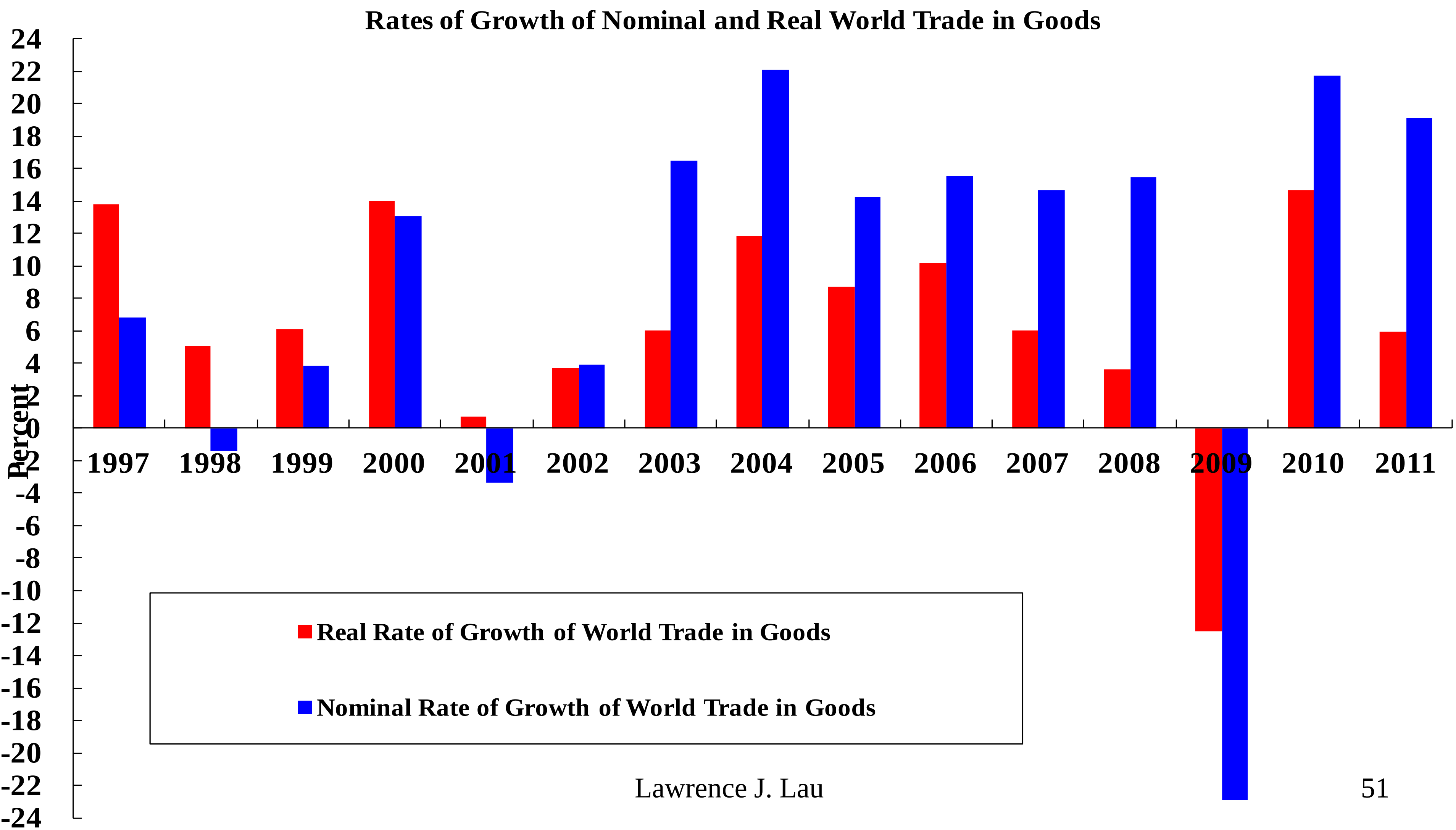
# The Near-Term Macroeconomic Outlook of the World Economy

- Under these circumstances, inevitably, the real rate of growth of world trade has also declined significantly.

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



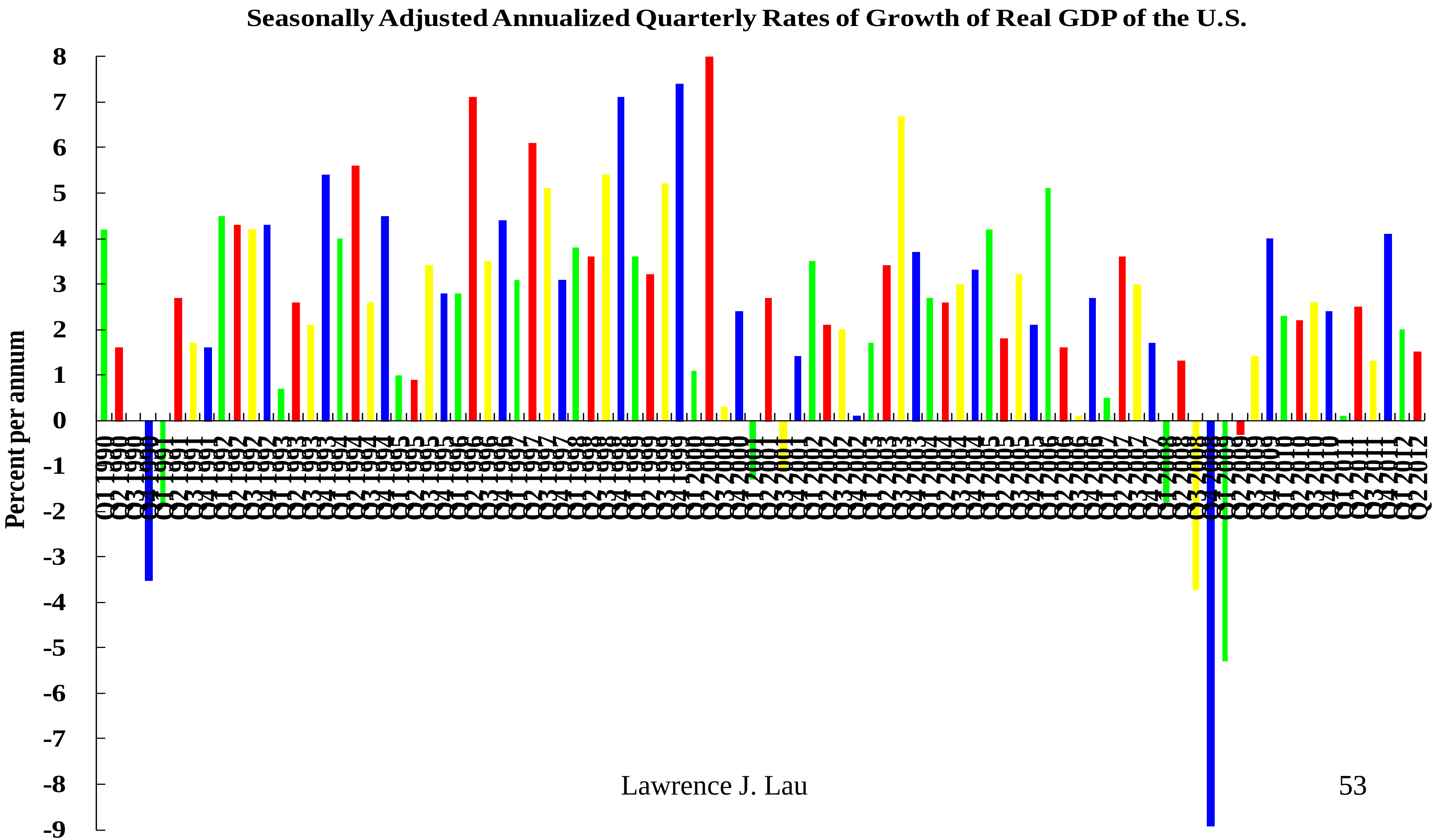
# Nominal and Real Rates of Growth of World Trade in Goods



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

- Economic recovery in the U.S. has been slow, despite all the monetary easing and has been affected internally by the uncertainties created by the Presidential election of last November and by the "fiscal cliff" and externally by the European sovereign debt crisis and the resulting recession in the Euro Zone economies.
- Decisions on large investment projects by private firms were and are likely to continue to be postponed until many of the uncertainties are resolved.
- However, it does appear that the recovery is solid and real, and that with a resolution of the European sovereign debt crisis, the U.S. economy should be able to embark on a renewed path of growth some time early in 2013.

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



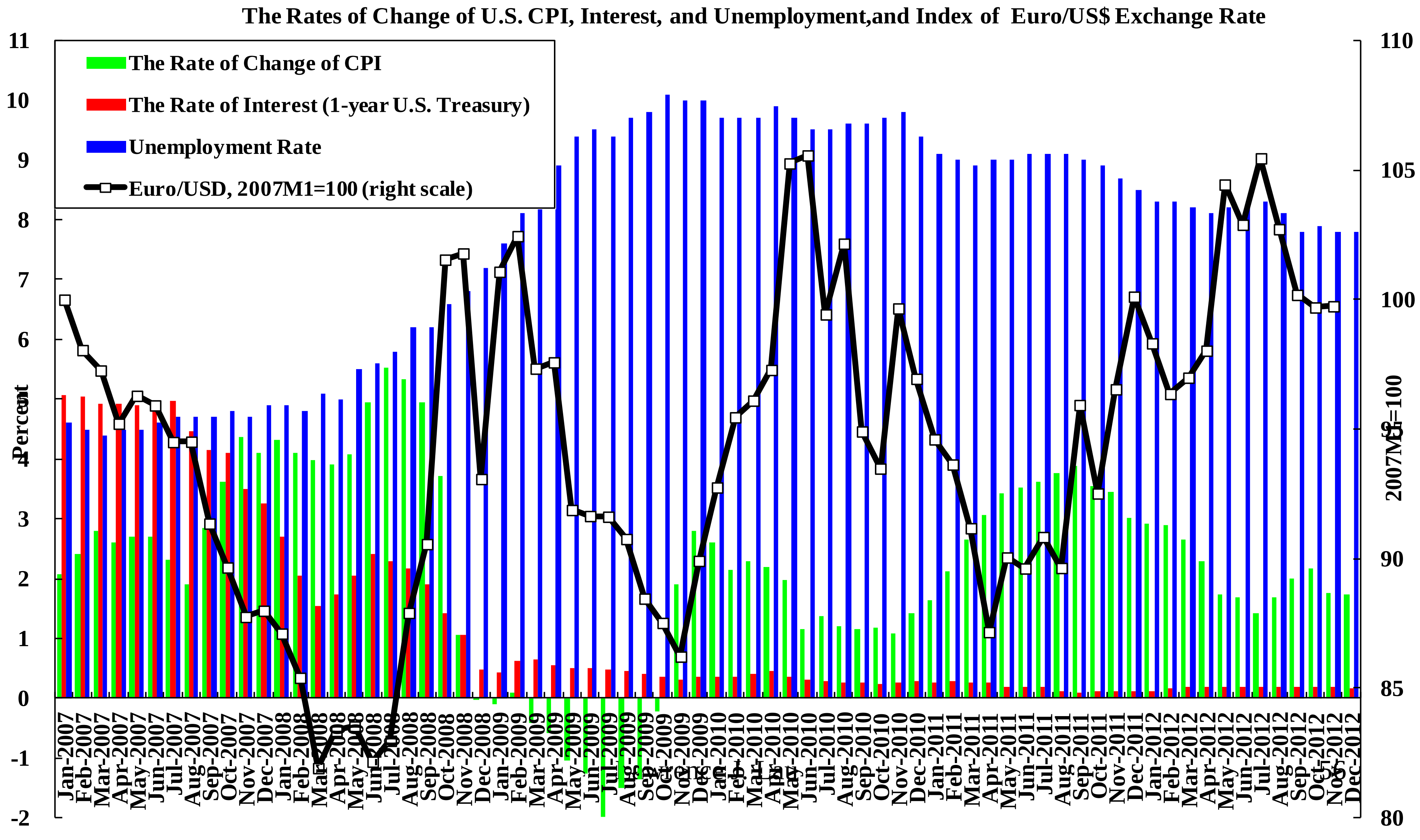
# The Near-Term Macroeconomic Outlook: The U.S. Economy

- While the U. S. economy is no longer contracting—the real rates of growth of the economy have been positive since the third quarter of 2009—the economic recovery has been exceptionally slow despite record low rates of interest (see the following Charts).
- The unemployment rate has stayed stubbornly high, above 7.8%, 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.

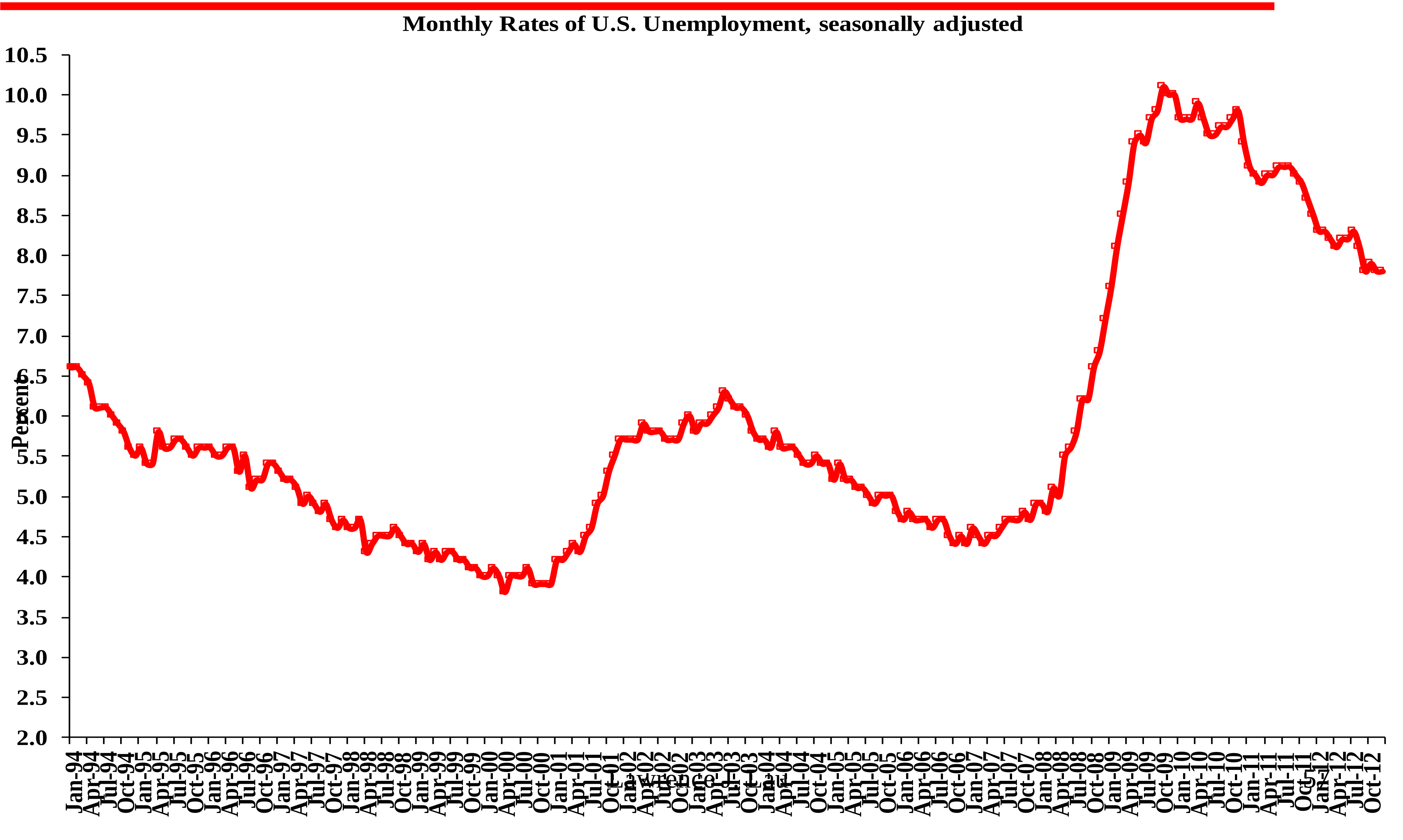
# The Near-Term Macroeconomic Outlook: The U.S. Economy

- 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. is unlikely to increase domestic investment, especially given all the uncertainties of this presidential election year.
- 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% and the inflation rate is below 2.5%, I personally believe that the rate of interest will begin to rise by the end of 2013.
- While the unemployment rate is unlikely to fall below 6.5% by the end of 2013, the rate of inflation, which is currently running at 2% per annum, can easily and quickly rise to 2.5%.

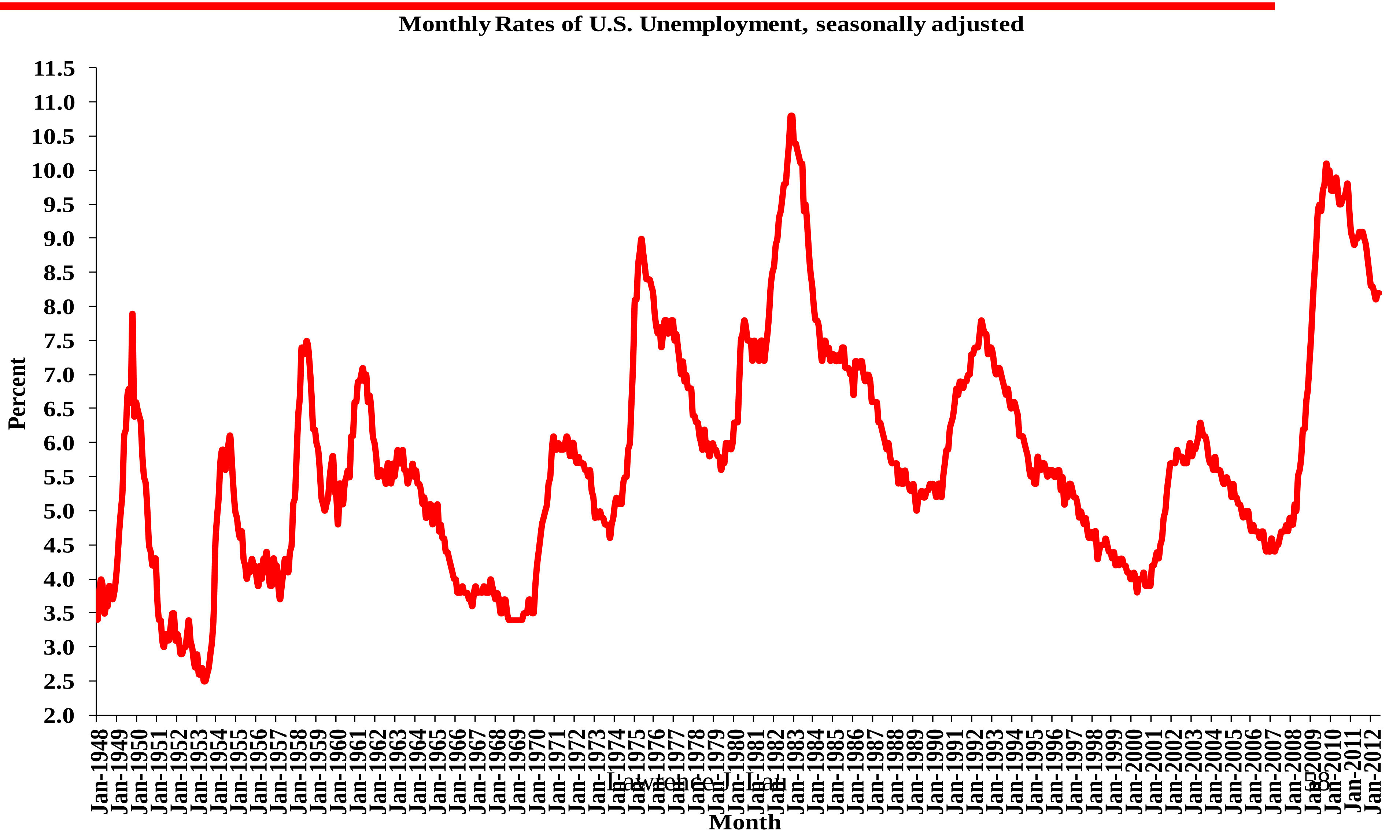
# The Rates of Change of CPI, Interest, & Unemployment, & Index of Euro/US$ Exchange Rate



# 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

- The problem 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 that can act as a signal to the firms and households that the economy will be improving soon.

# 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, these operations did not seem to have done the U.S. real economy much good. 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 on the other. It should be supporting growth and at the same time imposing austerity in terms of balancing recurrent revenue and recurrent expenditure.

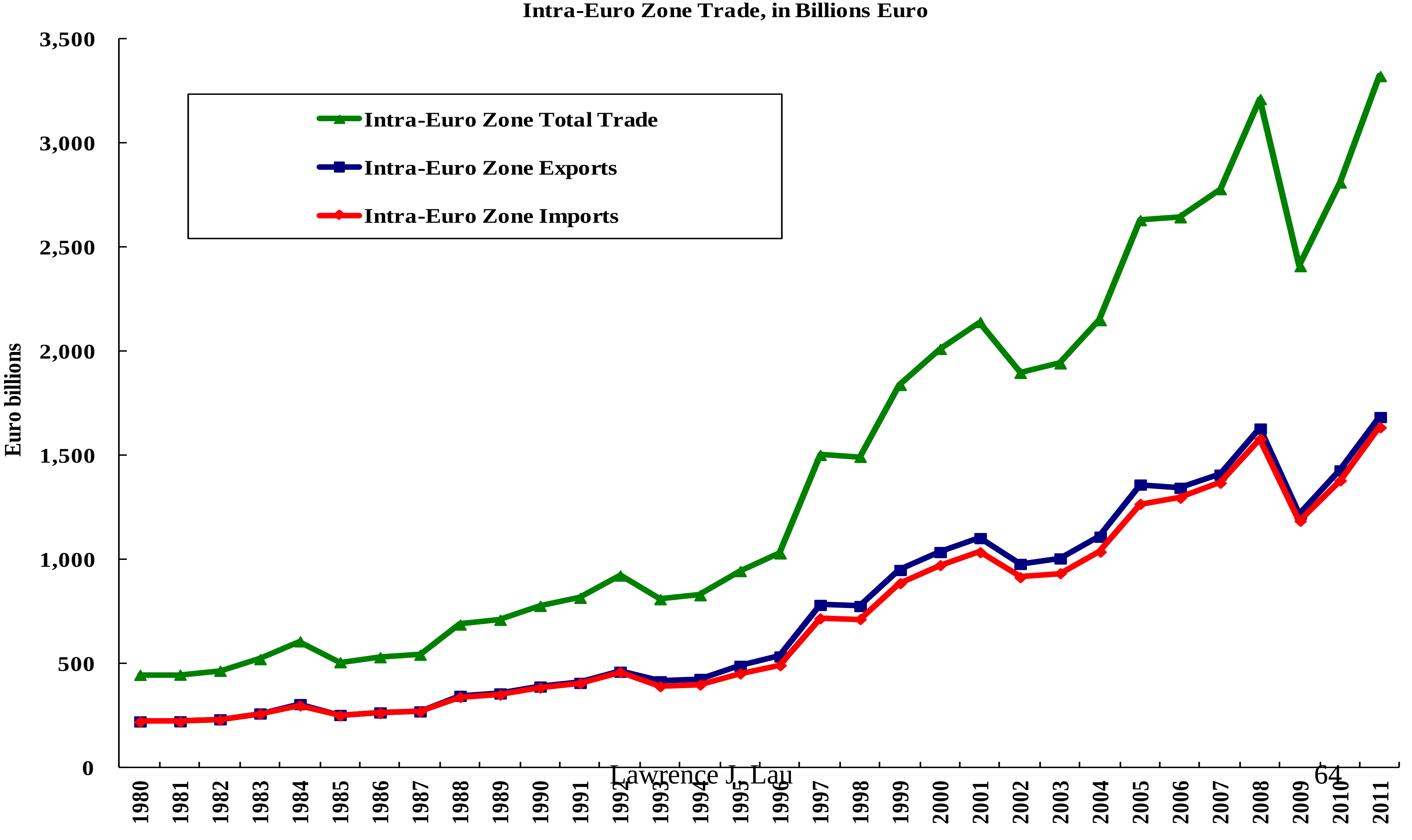
# The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- The Euro Zone economies, including Germany, are falling into recession as the European sovereign debt crisis has been 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 narrowed.

# 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, 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 in excess of 200%, 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.

# 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, which can increase the supply of U.S. Dollars 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?

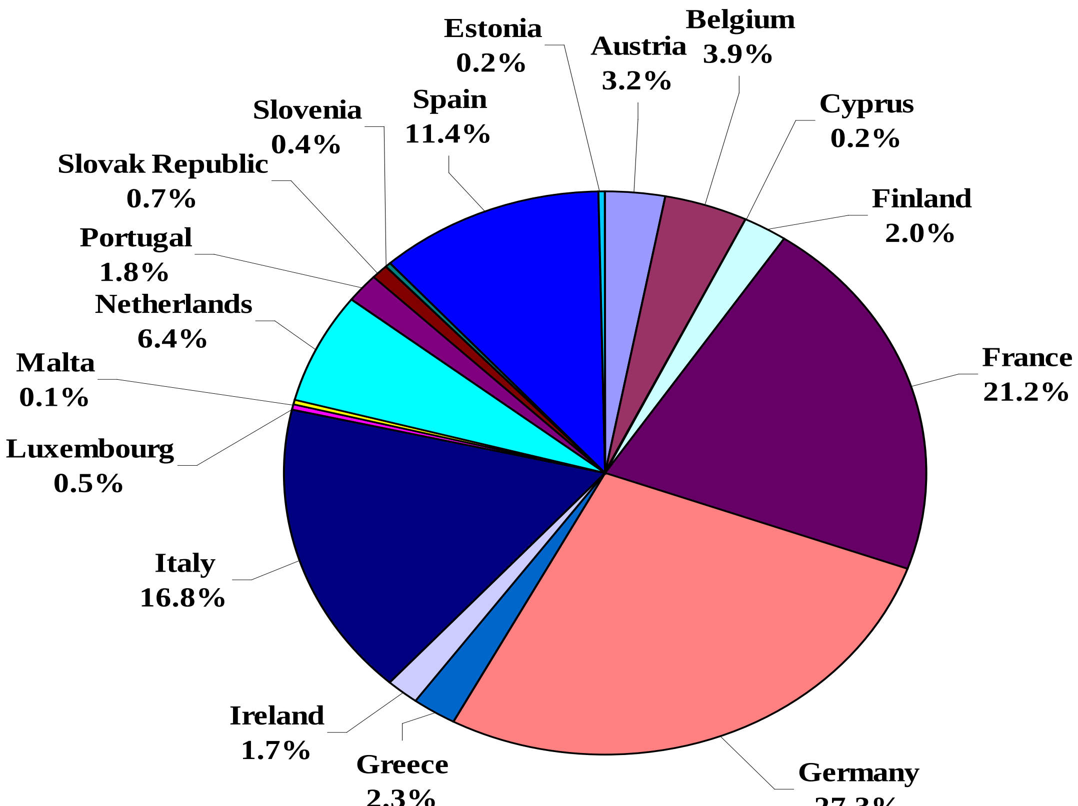
- The Euro Zone authorities should step in decisively and forcefully to maintain confidence in the Euro and Euro Zone debt. Confidence, once lost, is extremely difficult and costly to restore.
- Fiscal contraction at a time of recession feeds negative expectations about the future. It is better to have a short-term fiscal expansion in capital expenditures to promote the resumption of growth, coupled with a longer-term plan for achieving fiscal balance in recurrent expenditures in the long run.

# The Near-Term Macroeconomic Outlook: The Euro Zone Economies

- The Greek economy accounts for less than 2.5% 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 higher 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. 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 2011

The Distribution of the GDP of Euro Zone in 2011, 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: The Euro Zone Economies

- The World Bank has forecast, in its Global Economic Prospects report, that the Global GDP, which grew 2.3% in 2012, will grow at 2.4% in 2013, 3.1% in 2014 and 3.3% in 2015. So there should be steady improvement in the World economy over time.
- The World Bank has also forecast that developing economies which grew 5.1% in 2012, will accelerate their growth to 5.8% in 2015.

# 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.
- However, if current trends continue, it will probably take between 15 and 20 years before Chinese real GDP can 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 plateau in 2045).

# Concluding Remarks

- The long-term outlook for the U.S. economy is really 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 advanced hydraulic fracturing technology.
- At the present time, the World economy desperately needs a healthy U.S. economy.  The whole World wishes the U.S. Congress every success in resolving the budget expenditure and debt issues!