

The State of the Global Economy Part III

Lawrence J. Lau 刘遵义

Ralph and Claire Landau Professor of Economics, The Chinese Univ. of Hong Kong
and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

Executive Leadership Programme
Institute of Global Economics and Finance
The Chinese University of Hong Kong
Hong Kong, 28th August 2014

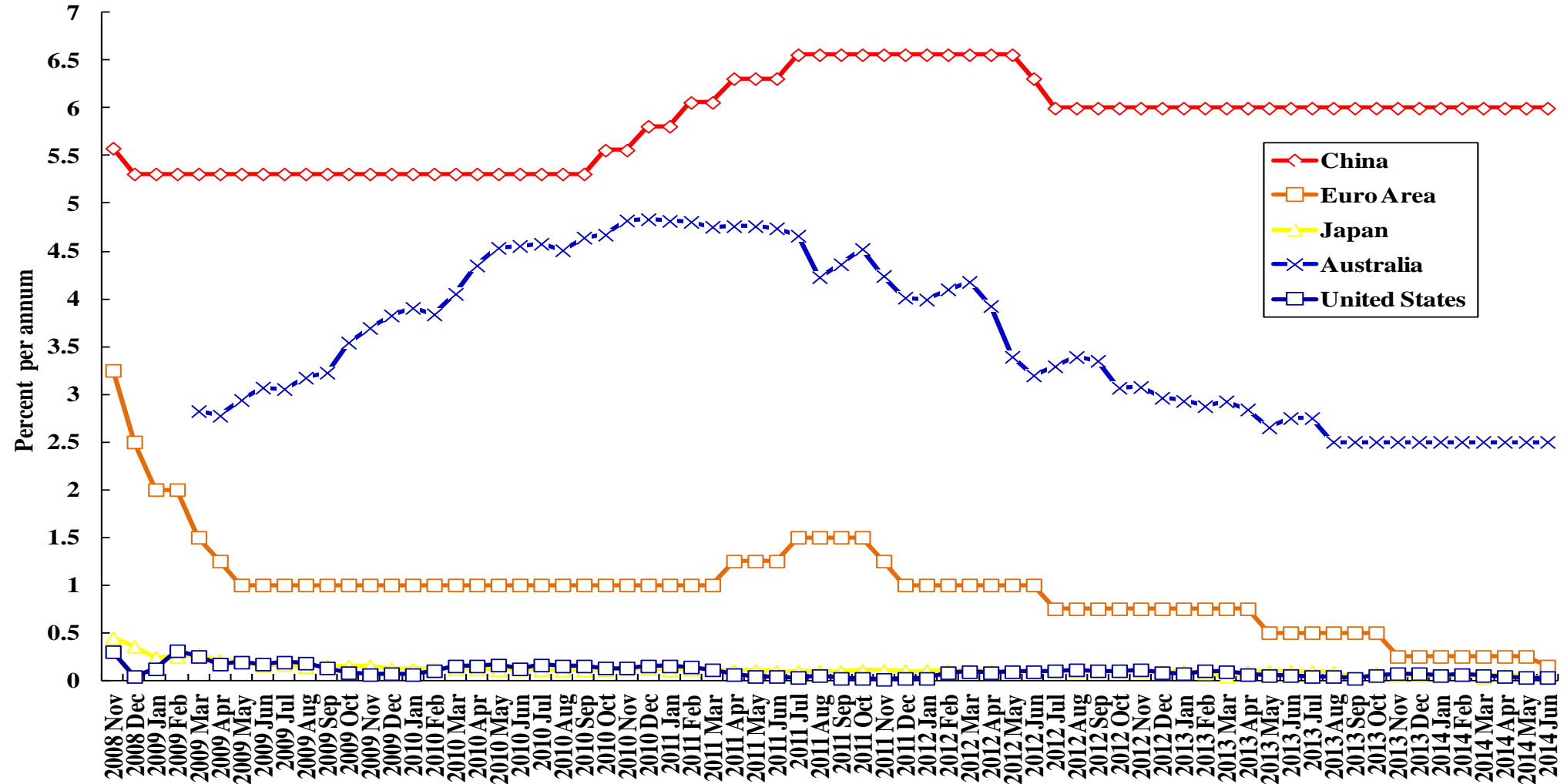
Tel: (852)3550-7070; Fax: (852)2104-6938

Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl

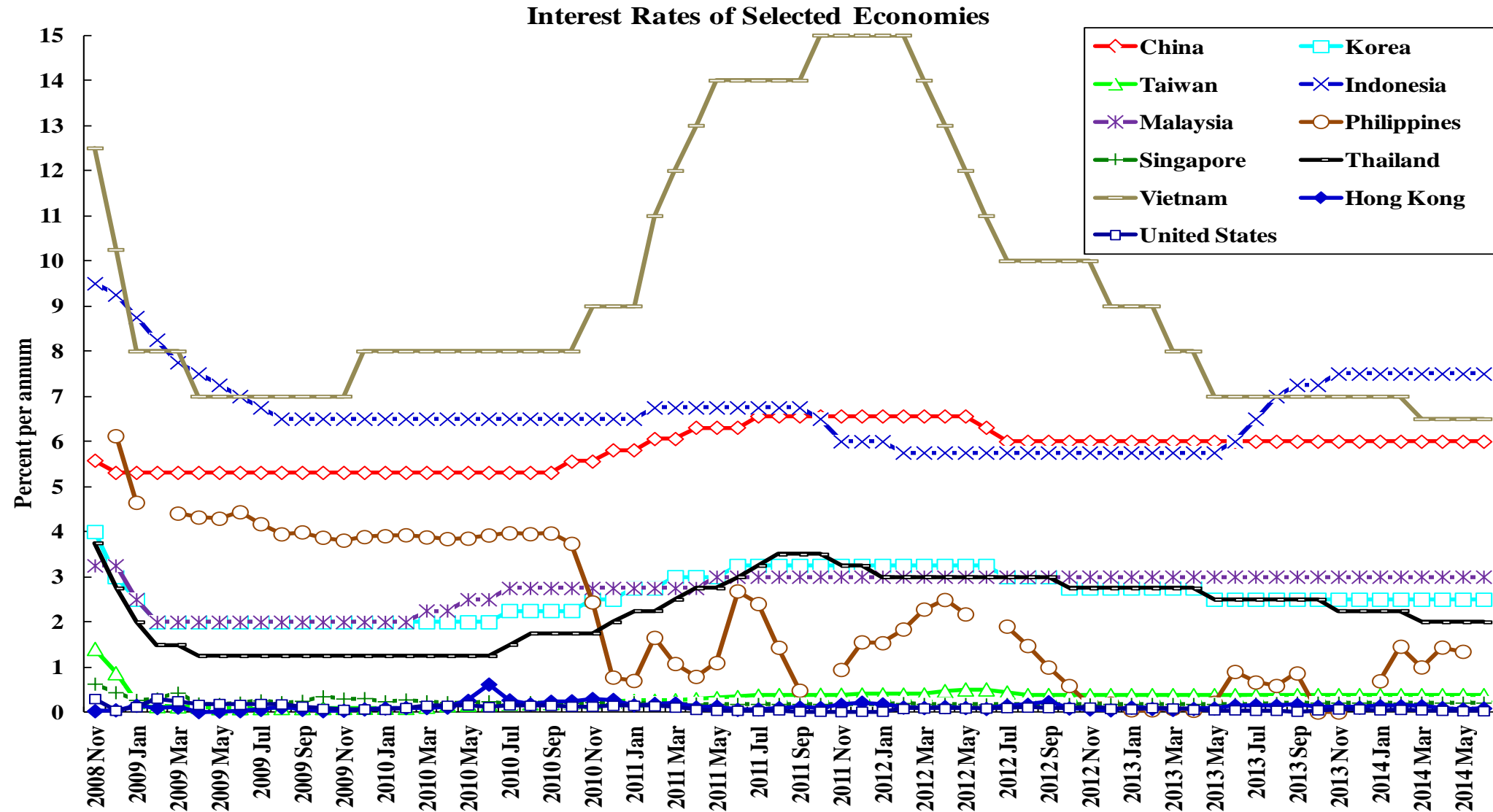
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The Effects of Quantitative Easing: Interest Rates of Selected Economies

Interest Rates of Selected Economies

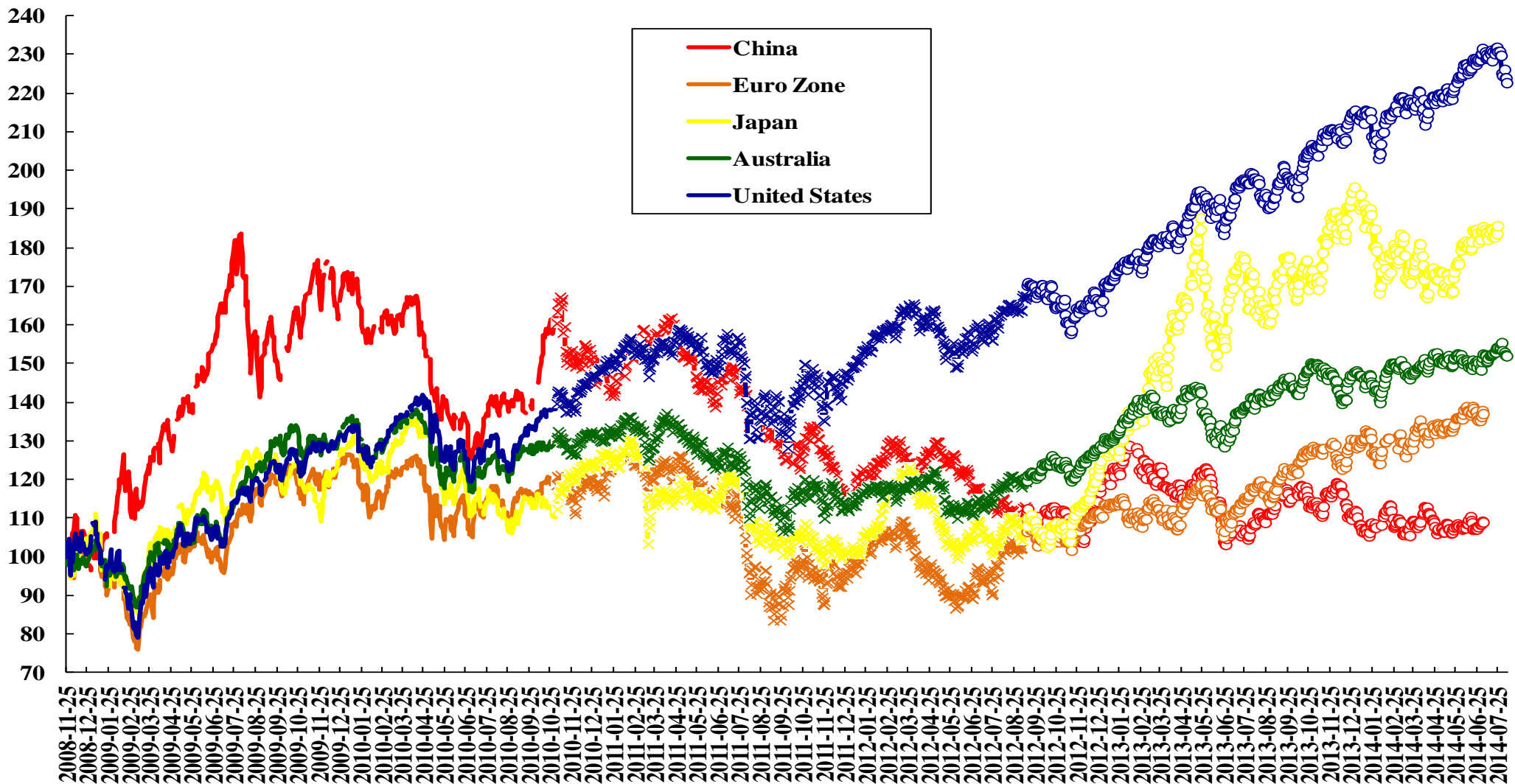


The Effects of Quantitative Easing: Interest Rates of Selected Economies



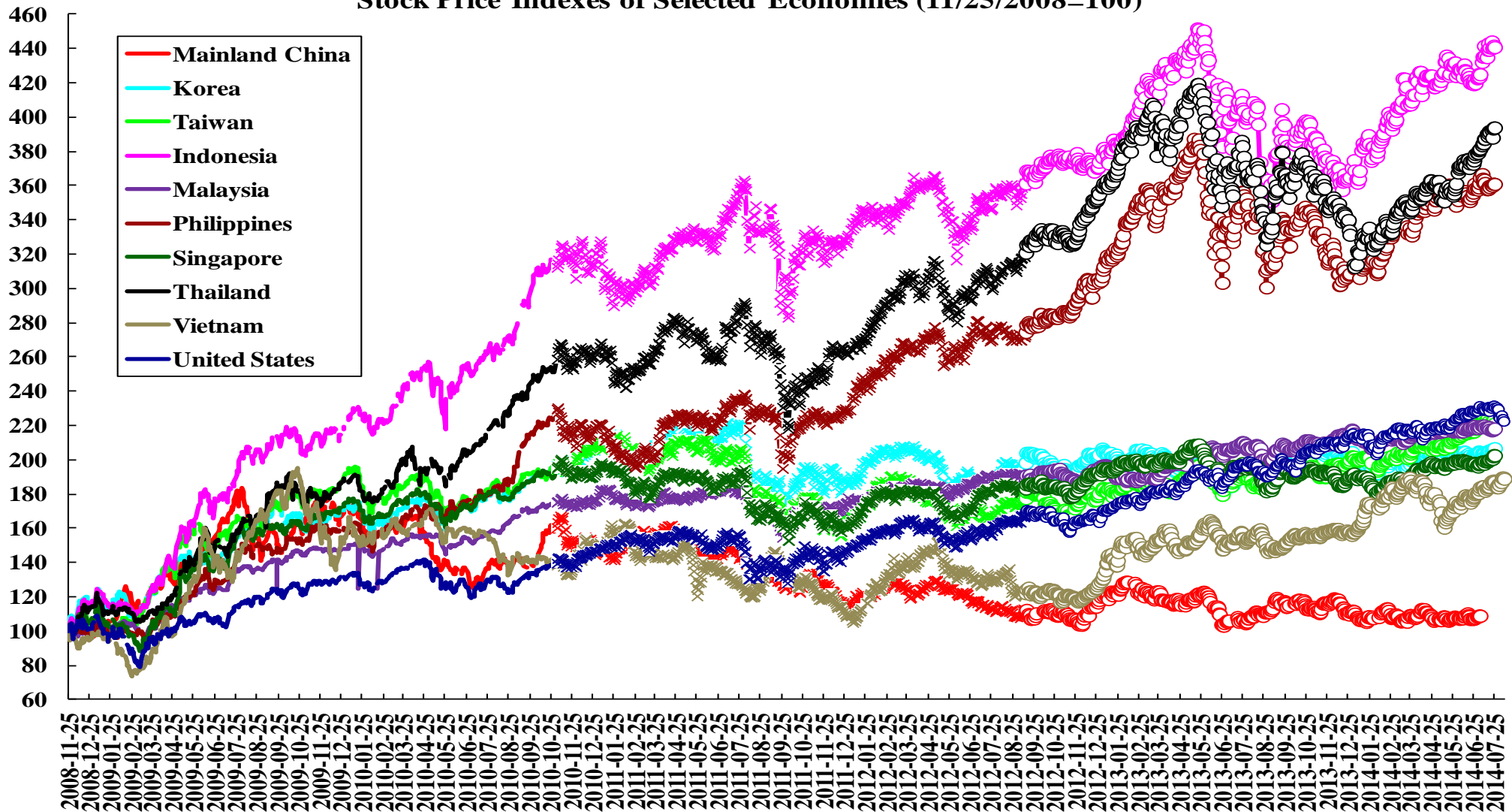
Stock Price Indexes of Selected Economies (11/25/2008=100)

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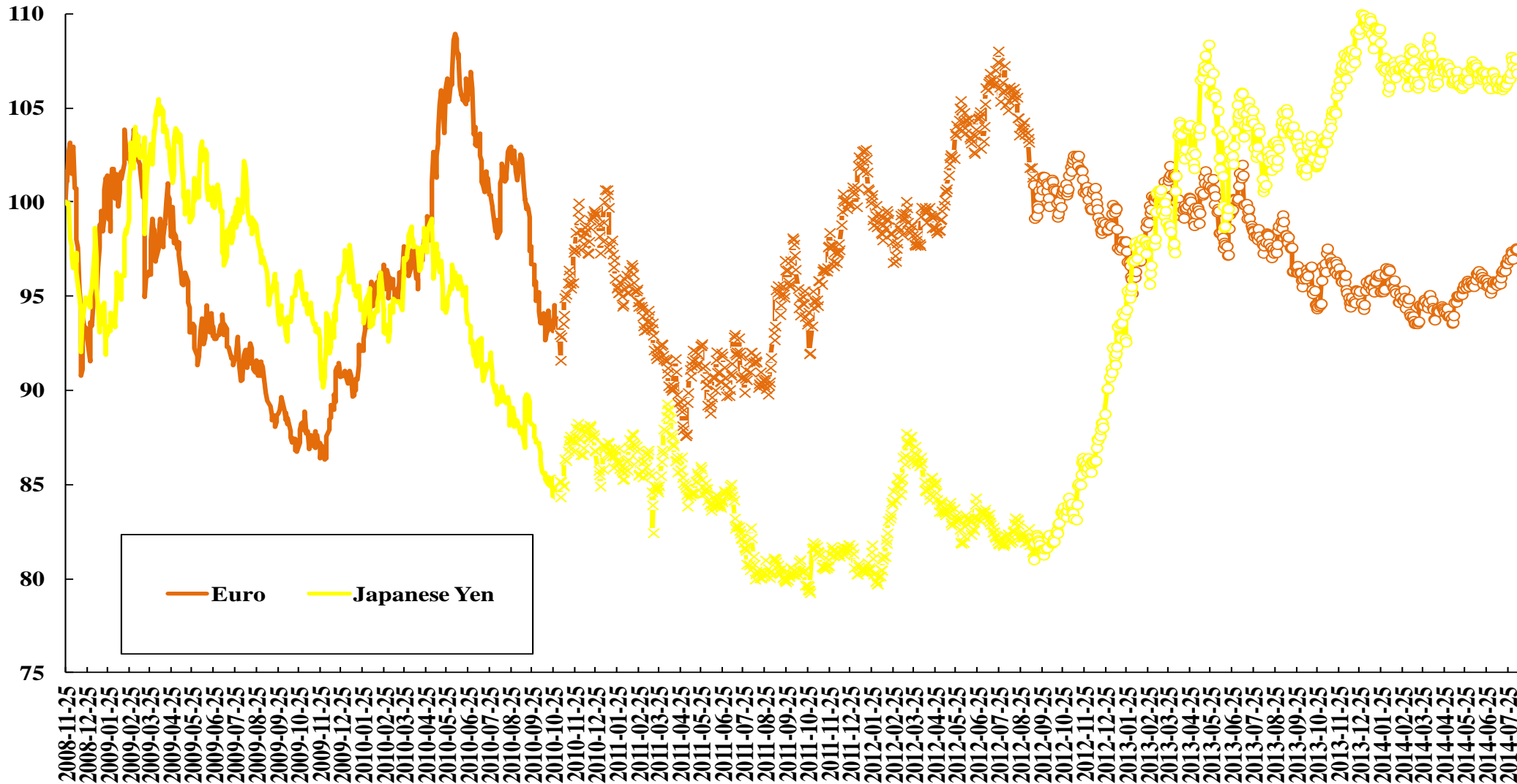


“Counter-Quantitative Easing” by the Euro Zone and Japan

- ◆ Japan, which saw its exchange rate rise to 75 Yen/US\$ from 100 Yen/US\$ as a result of the QEs, greatly hurting its exports, decided to launch its own “Counter-QE” in late 2012. The Japanese “Counter-QE” was quite effective in driving the exchange rate of the Japanese Yen back to the 100 Yen/US\$ level.
- ◆ The Bank of Japan could have achieved the same result by intervening directly in the foreign exchange market to stabilise the Japanese Yen/U.S. Dollar exchange rate, but there was probably opposition to its direct intervention from the U.S. Government on ideological grounds.
- ◆ The Euro did not appreciate too much relative to the US\$ except during QE1 because of the sovereign debt and other economic problems within the Euro Zone itself.

Exchange Rate Indexes of the Euro and the Japanese Yen (11/25/2008=100)

Exchange Rate Indexes of the Euro and the Japanese Yen (11/25/2008=100)



The Tapering of Quantitative Easing

- ◆ “Quantitative Easing” has not been particularly effective in stimulating new gross domestic investment, increasing real GDP or lowering unemployment in the U.S.
- ◆ That is why I argued previously that there would not be a QE3 because it would not have been effective in improving the real economy in the U.S.
- ◆ However, there was QE3 and it was, as expected, not effective in stimulating the U.S. real economy. Thus, tapering and ending QE3 would only be a matter of time.
- ◆ That is why tapering began after the December 2013 meeting of the U.S. Federal Open Market Committee and the end would come in October 2014.
- ◆ The QEs succeeded in stabilising the U.S. financial sector in the aftermath of the global financial crises, but failed so far to return the U.S. real economy to a path of sustainable growth.

The Global Financial Crises Since 2007 & the Aftermath: What Else Could Have Been Done?

- ◆ What the U.S. economy needed the most was a real economic stimulus—an increase in aggregate demand with a strong enough impact that it can change the expectations of consumers and investors about the economic future.
- ◆ Instead of purchasing U.S. Treasury and agency securities during the QEs, the U.S. Federal Reserve Board could have offered to purchase say US\$600 billion worth of new medium and long-term bonds issued by the fifty individual states, approximately in proportion to their populations, the proceeds of which would be used solely for the construction of new basic infrastructure or the major maintenance of existing basic infrastructure within the respective states.

The Global Financial Crises Since 2007 & the Aftermath: What Else Could Have Been Done?

- ◆ This could have created the aggregate demand necessary to make good use of the existing excess capacity in the construction and the construction material sectors as well as their idle workers in the U.S. It would have boosted both real GDP and employment across the board, and thereby changed expectations in a positive direction.
- ◆ Such an offer should be welcome by the governors of almost all the states that suffer from sluggish economic recovery, high unemployment rates and budget deficits.
- ◆ Moreover, the purchase of such bonds would not in principle require the approval of the U.S. Congress.

The Global Financial Crises Since 2007 & the Aftermath: Ending Quantitative Easing

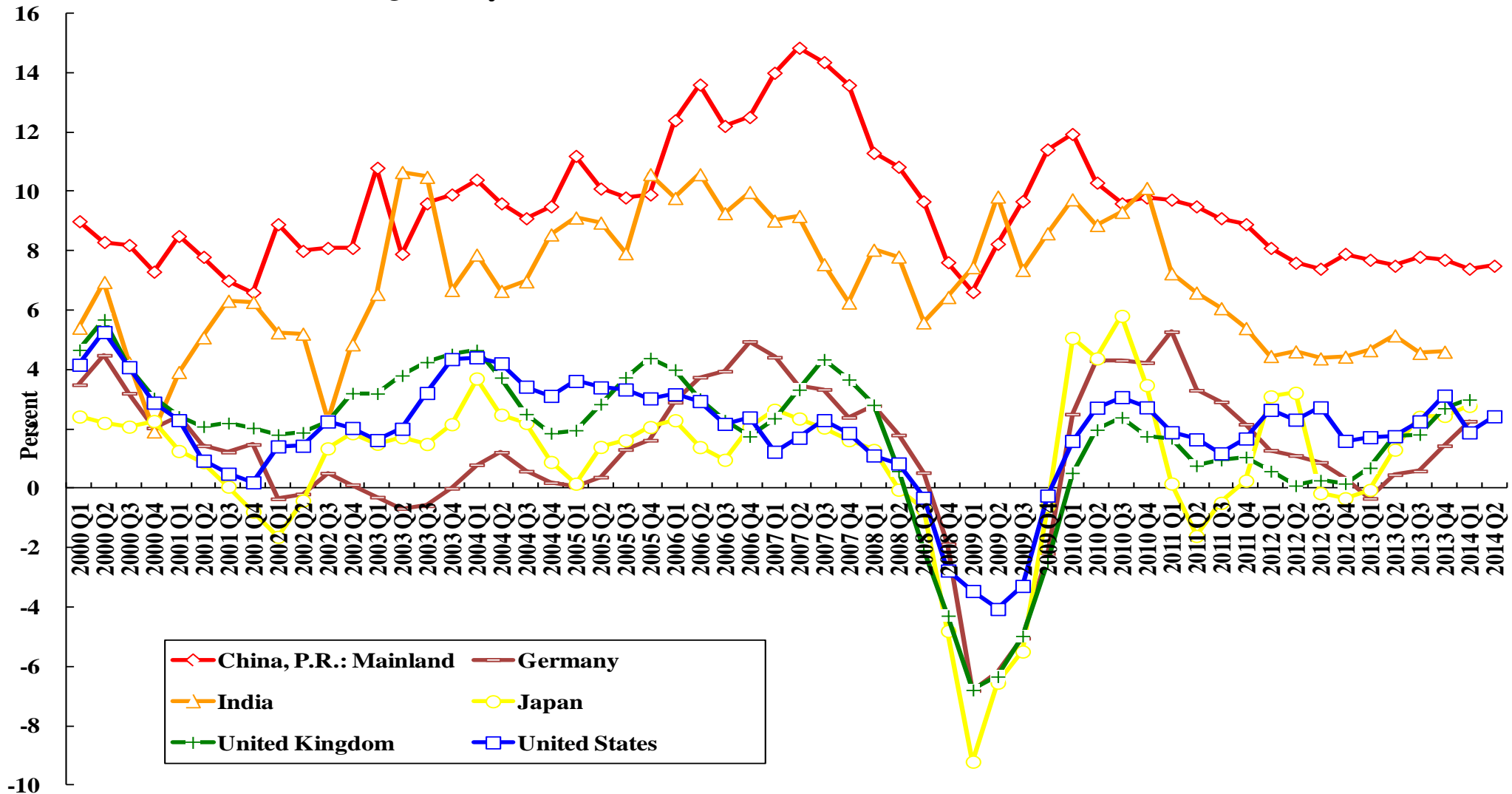
- ◆ As QE3 has had only a very modest effect on the real U.S. economy, it will hence also not have much impact on the real U.S. economy when it is finally ended. However, it did lead to a rise in the prices of assets, especially financial assets, and a decline in the long-term interest rates, including mortgage rates, and hence a slight recovery of the housing market.
- ◆ Thus, if the medium- and long-term interest rates were to rise again after the ending of QE3, the asset prices may fall significantly, and the recovery in consumption and investment may stall once again because of the negative “wealth effect.”
- ◆ The QEs collectively, through the excess liquidity released to the rest of the World, have also enabled the U.S. Dollar to devalue relative to most other currencies in the World, helping U.S. exports. They have also led to temporarily lower interest rates and higher asset prices elsewhere. With the tapering and ending of QE3, these developments are likely to be reversed.

The Short-Term and Long-Term Global Economic Outlook

- ◆ We now turn to examine the short-term and the long-term economic outlook of the global economy. First, we focus on the short-term economic outlook of the United States, the Euro Zone and China. In the following charts, we present the quarterly rates of growth of selected major economies, first in terms of year-over-year quarterly rates and then in terms of seasonally adjusted quarterly rates (both China and India do not have long time-series of seasonally adjusted quarterly rates).
- ◆ 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. Rates of growth worldwide have been declining since the beginning of the series of global financial crises in 2007. China has slowed down but has been able to maintain its rate of growth around 7.5%. India has also slowed down but has still been able to grow at around 4%. These rates of growth are all significantly higher than those of the developed economies, which have been struggling to maintain a positive rate of growth.

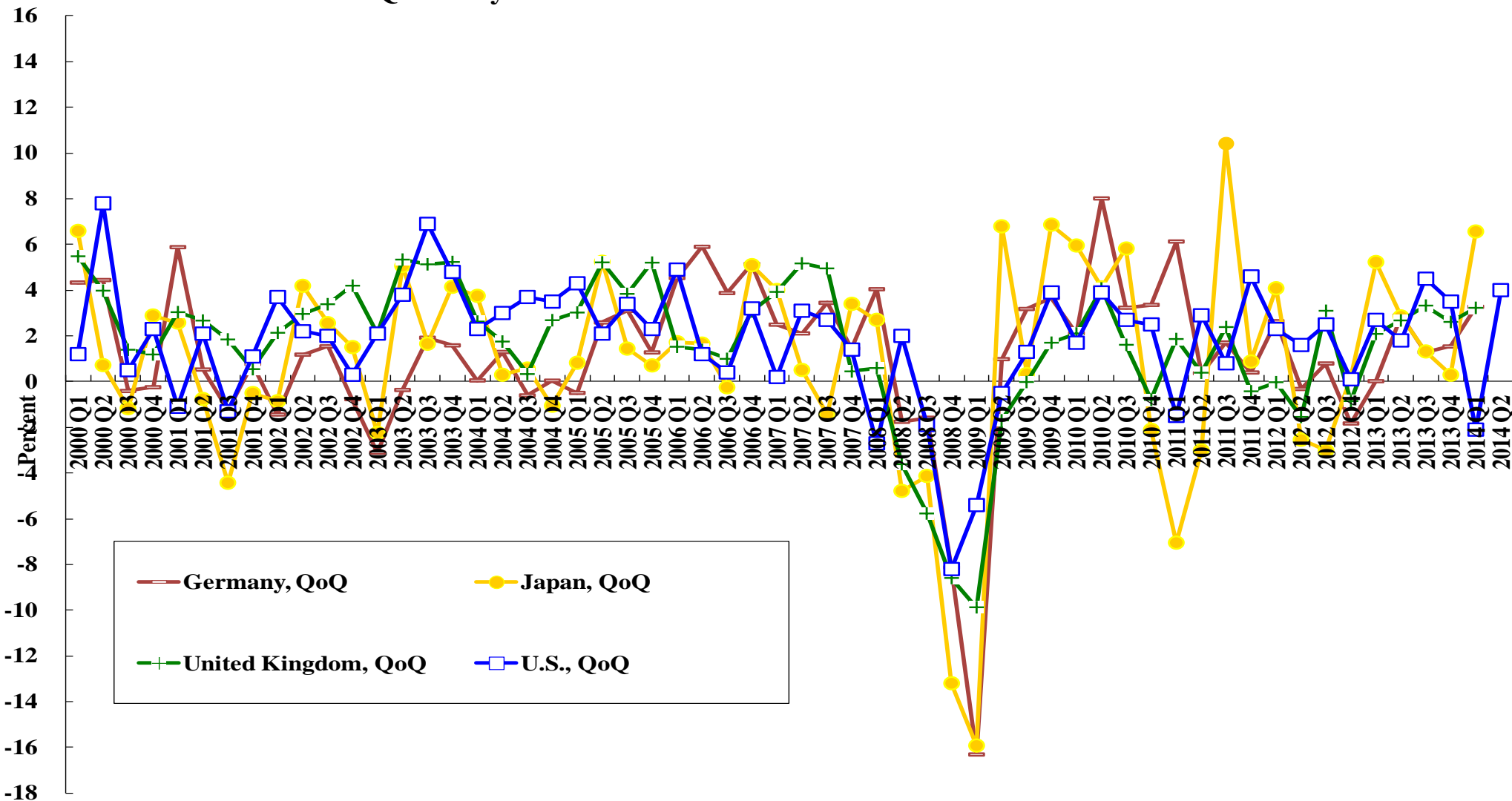
Year-over-Year Quarterly Rates of Growth of Real GDP: Selected Economies

Quarterly Rates of Growth of Real GDP: Selected Economies



Seasonally Adjusted Quarterly Rates of Growth of Real GDP: Selected Economies

Quarterly Rates of Growth of Real GDP: Selected Economies



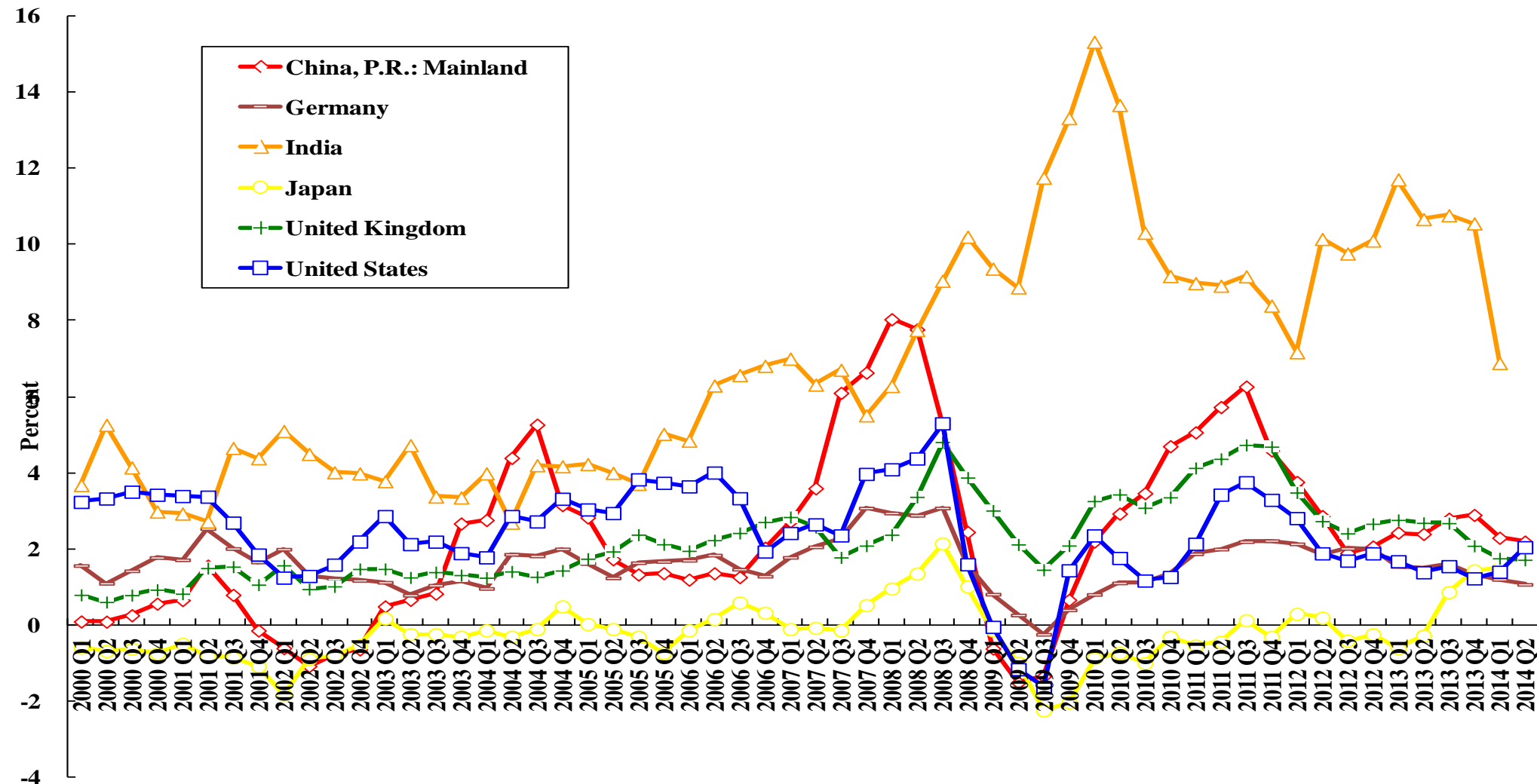
The Short-Term Economic Outlook:

Inflation

- ◆ In the following chart, we present the quarterly rates of inflation of selected economies.
- ◆ Fortunately, the rates of inflation have remained relatively subdued in the developed economies. In China, the rate of inflation has begun to come down significantly. India is the only major economy with a relatively high rate of inflation. The real fear in countries like Japan and the U.S. and in the Euro Zone is deflation, not inflation.

Quarterly Rates of Inflation: Selected Economies

Quarterly Rates of Growth of CPI: Selected Economies



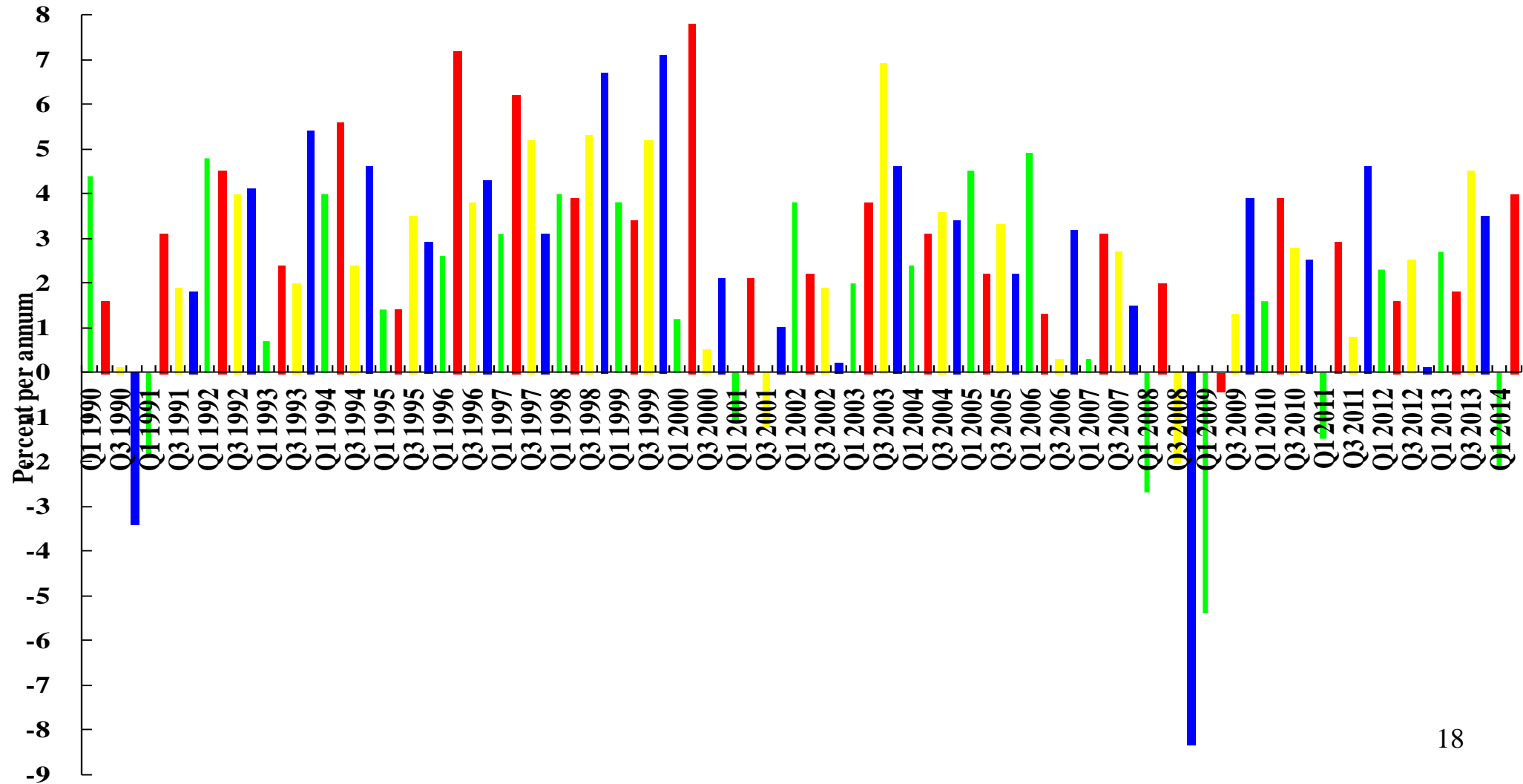
The Short-Term Economic Outlook:

The U.S. Economy

- ◆ The U.S. economy has had positive rates of growth, year-over-year, for all except two quarters since the 3rd quarter of 2009. 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. It is likely that the U.S. economy will continue to grow at a rate between 2.5% and 3% per annum in the short term.
- ◆ While the U.S. unemployment rate has come down recently to reach 6.1%, much of the decline may be attributed to discouraged workers withdrawing from the labour force. The unemployment rate is equal to $[(\text{the number of job-seekers} - \text{employment}) / \text{the number of job-seekers}]$ which is in turn equal to $(1 - \text{employment} / \text{number of job-seekers})$. A decline in the number of job-seekers increases the employment/number of job-seekers ratio and hence decreases the unemployment rate. Actual employment has not increased that much.

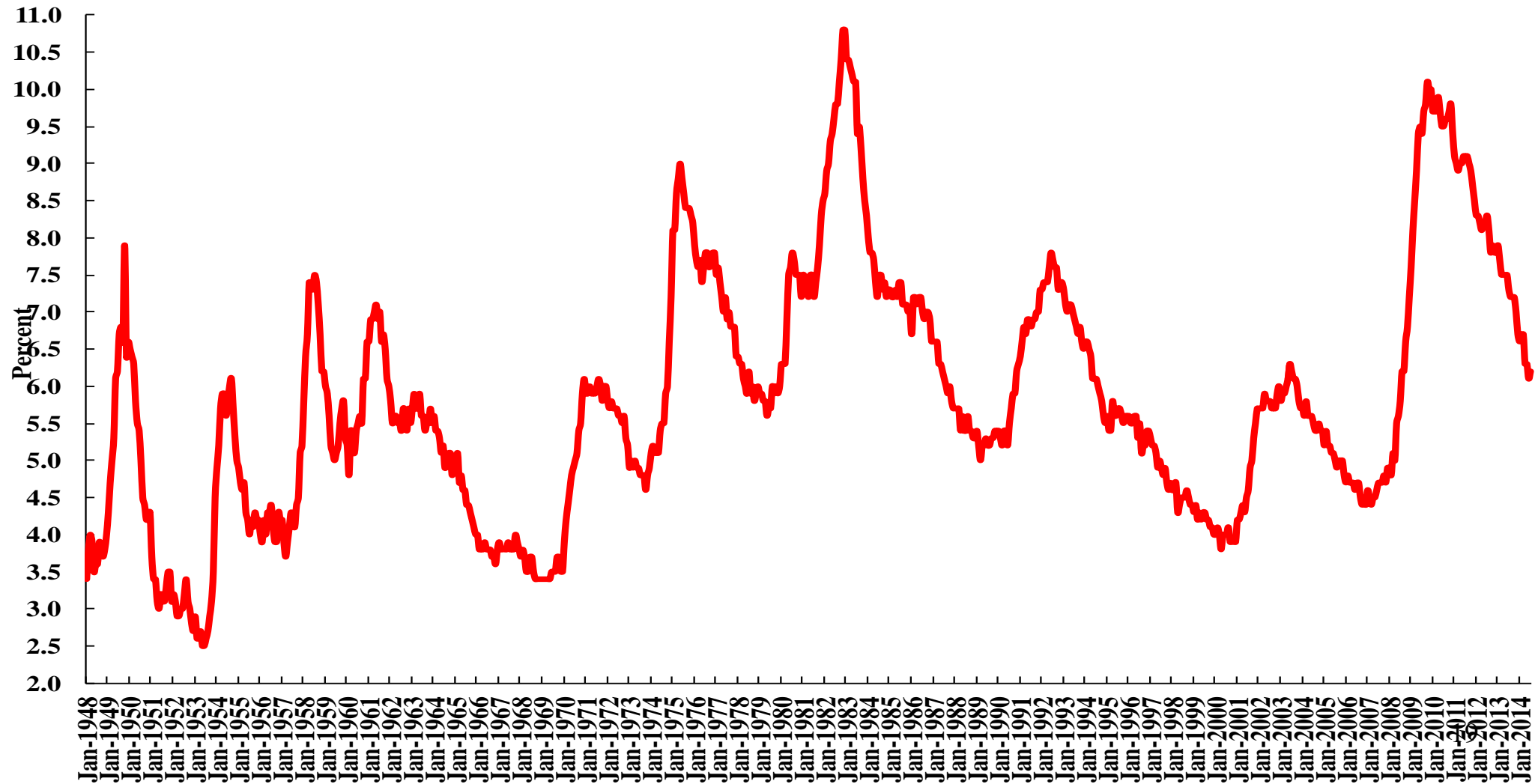
Seasonally Adjusted Annualised Quarterly Rates of Growth of the U.S. Real GDP

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



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

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



The Short-Term Economic 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 Short-Term Economic Outlook: The Euro Zone Economy

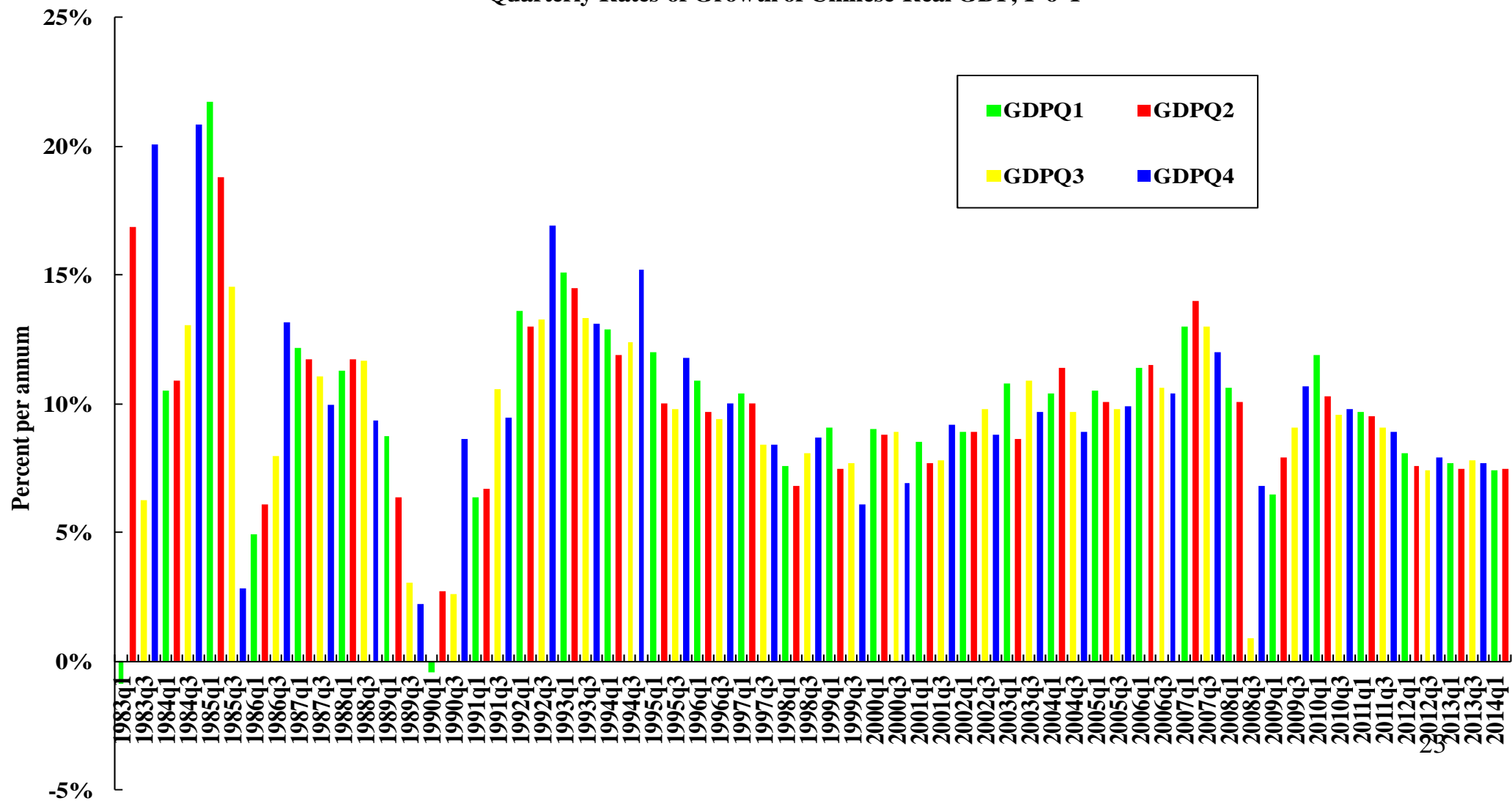
- ◆ The Euro Zone economies have turned around to show a small positive growth recently, as the Euro managed to survive as a major international reserve currency and the sovereign debt crisis began to be resolved gradually. In the short term, a good performance for the Euro Zone economy as a whole is a rate of growth of 1% per annum. It is unlikely to grow at more than 2% per annum.
- ◆ The rates of unemployment in the Euro Zone economies have continued to be high and are unlikely to decline significantly in the near term.

The Short-Term Economic Outlook: The Chinese Economy

- ◆ The Chinese economy grew 9.2% in 2009, 10.4% in 2010, 9.3 % in 2011, 7.7% in 2012 and 2013 even as the European and U.S. economies remained in recession. However, the slowdown is unmistakable but should be considered to be a positive development.
- ◆ In 2013Q3 and 2013Q4, the rates of growth of real GDP were 7.8% and 7.7%, Y-o-Y, respectively. In 2014 Q1 and 2014Q2, the rates of growth were 7.4% and 7.5%, Y-o-Y, respectively. All the economic indicators suggest that the Chinese rate of growth has begun to stabilise between 7% and 8%. The target growth rate of the Chinese economy for 2014 is around 7.5%.
- ◆ The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%. A real rate of growth of over 7% per annum is definitely achievable for 2014.

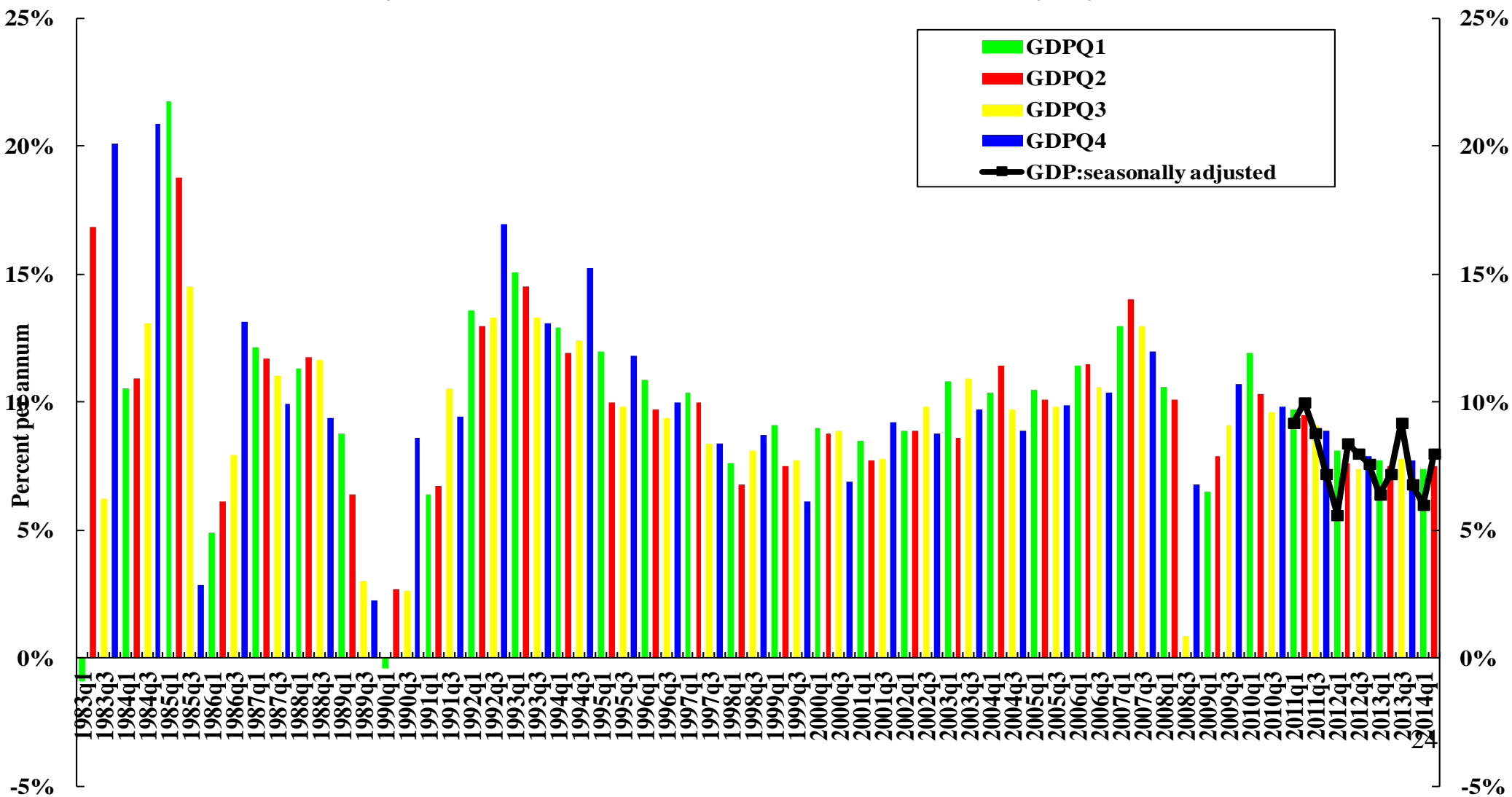
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y

Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted

Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted

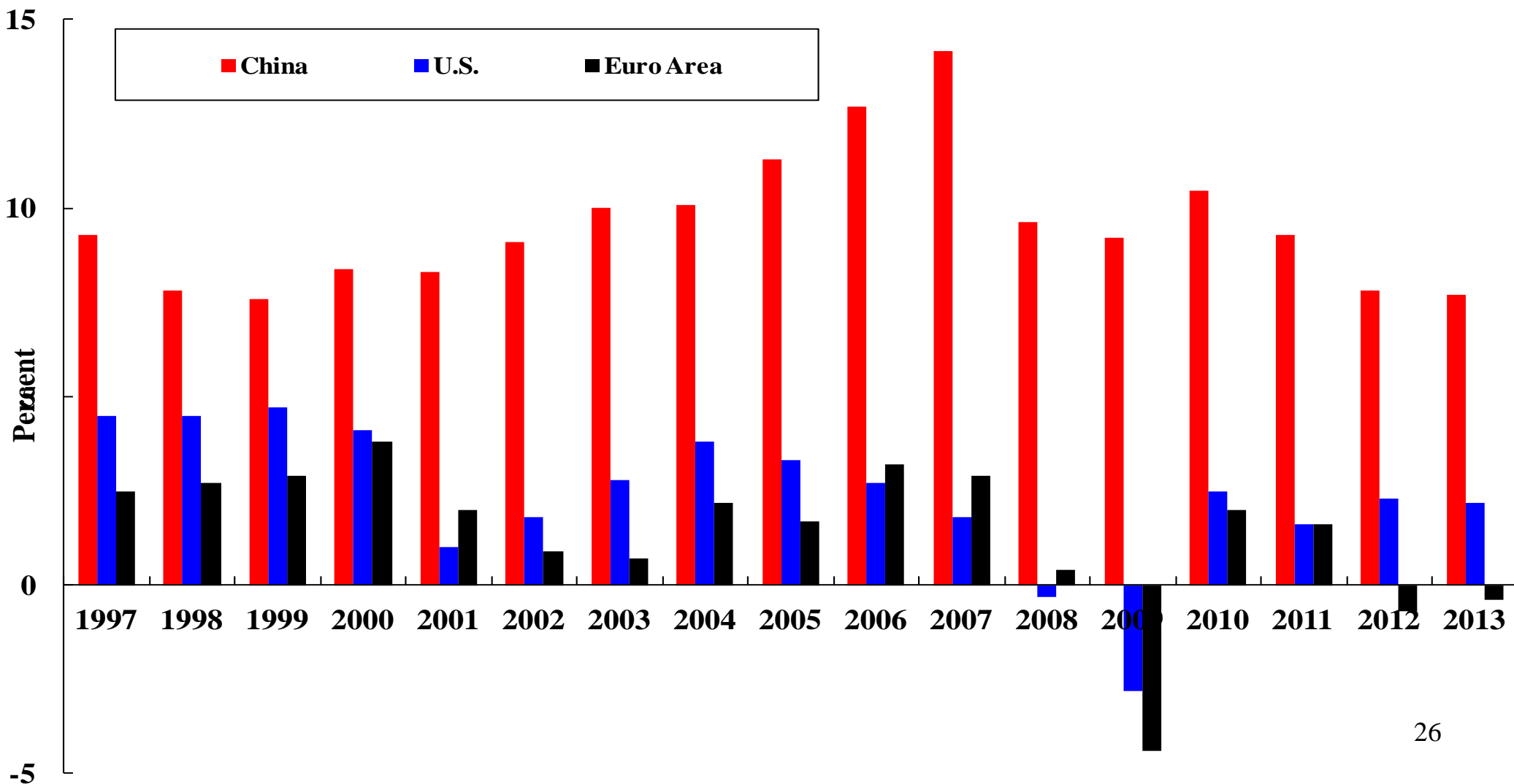


The Long-Term Economic Outlook

- ◆ In the following charts, we compare the annual rates of growth of real GDP, inflation and unemployment of China, the Euro Zone, and the U.S.
- ◆ It is evident that while the rates of growth of GDP have all been declining, the average rate of growth of the Chinese economy is more than double that of the U.S. economy, which is in turn higher than that of the Euro Zone economy. This situation is expected to continue in the near future.
- ◆ China has been having a higher rate of inflation than both the U.S. and the Euro Zone over the past decade. However, the rates of inflation seem to show a tendency for convergence.
- ◆ China has the lowest unemployment rate among the three economies, with the U.S. unemployment rate falling and the Euro Zone unemployment rate rising.

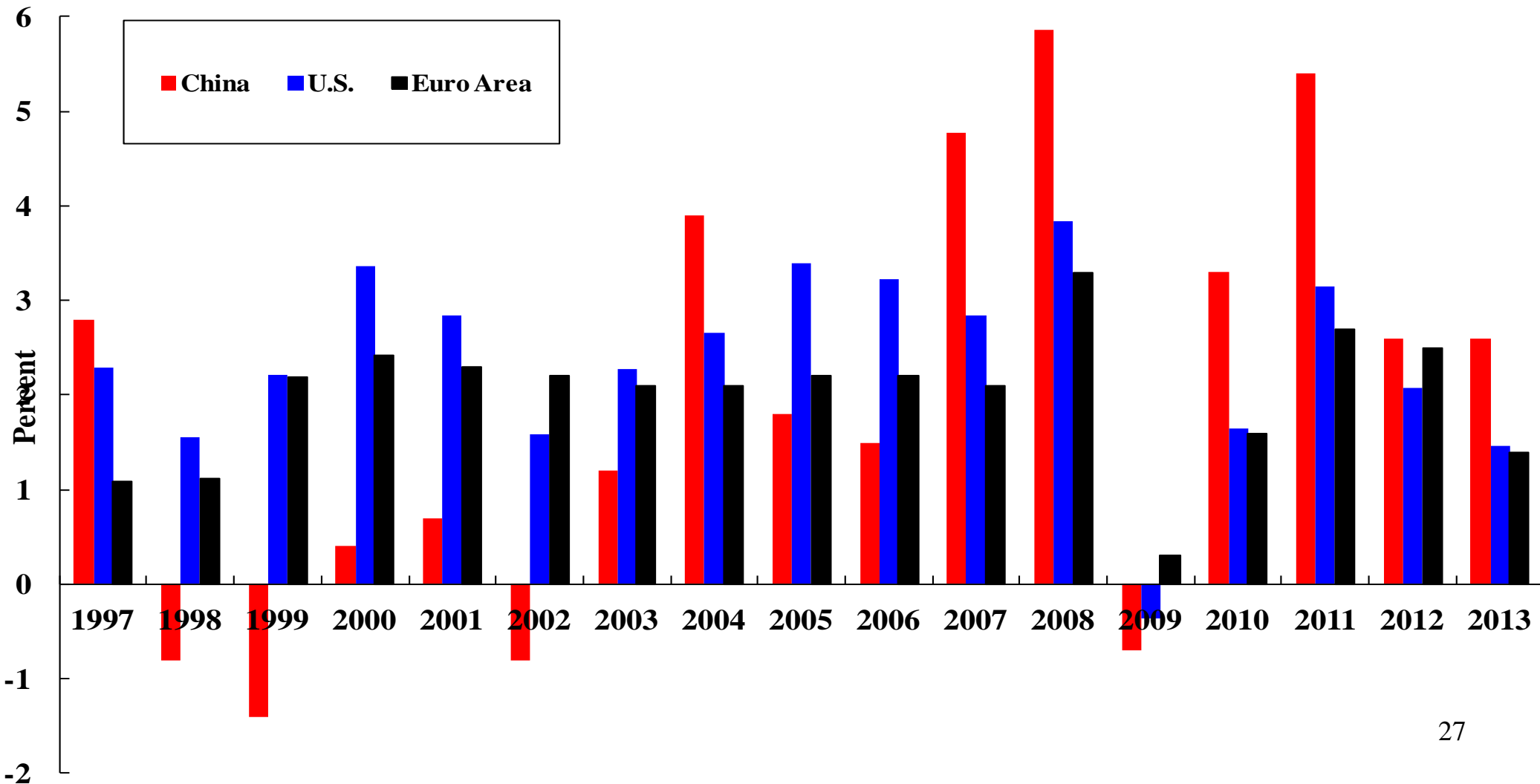
The Rates of Growth of Real GDP of China, the U.S. and the Euro Zone

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



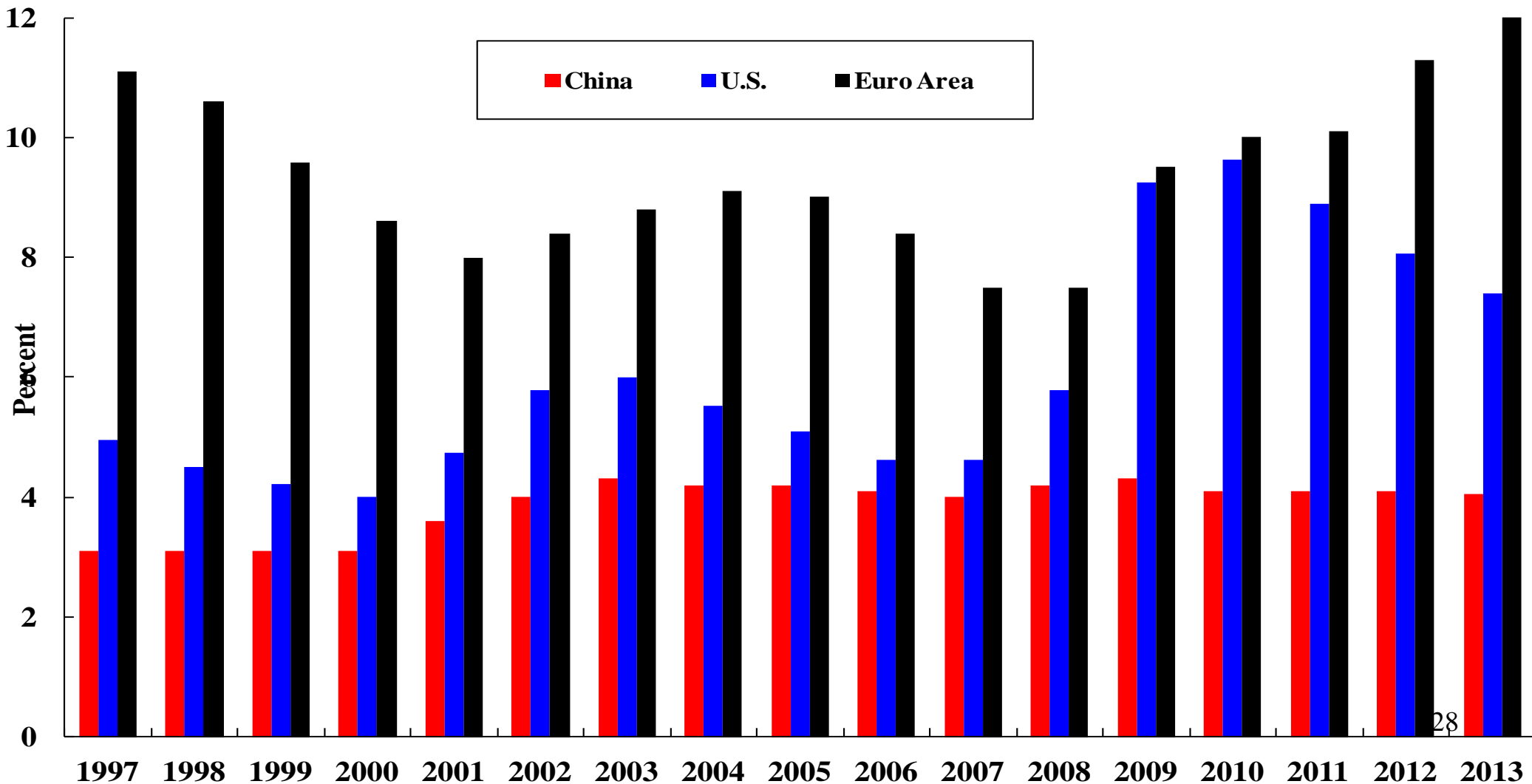
The Rates of Inflation of China, the U.S. and the Euro Zone

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



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

The Rates of Unemployment of China, U.S. and the Eurozone



The Long-Term Economic Outlook

- ◆ 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 and is likely to stay down for a while.
- ◆ Hence, the growth of World trade is unlikely to be an important driver of World economic growth.

The Long-Term Economic Outlook

- ◆ However, there is also a favourable factor with the energy markets of the World shifting 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.
- ◆ Yet, 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.

The Long-Term Economic Outlook: The U. S. Economy

- ◆ The long-term outlook for the U.S. economy is actually 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.
- ◆ Thus, the U.S. is likely to return to its long-term growth path of between 3% and 3.5% per annum within a couple of years.

The Long-Term Economic Outlook: The Euro Zone Economy

- ◆ In the long term, the Euro Zone economy is more problematic. Structural reforms in many areas are necessary. For example, labour laws and regulations should be amended so as to make it easier for young people to find jobs; pension plans should be changed from defined-benefits to defined-contributions, so that retired workers can be more adequately supported; marginal tax rates should be lowered so as to provide more incentives to invest and to work. None of these reforms are likely to be easy. The expectation is that the Euro Zone economy as a whole is unlikely to grow more than 2% per annum in the longer term.

The Long-Term Economic Outlook: The Chinese Economy

- ◆ Going forward, on the supply side, the Chinese economy has strong economic fundamentals: a high domestic saving rate, abundant labour, and a huge internal market. In time, Chinese economic growth will also be driven by innovation and technical progress in addition to the growth in tangible inputs.
- ◆ On the demand side, Chinese economic growth will be driven by the growth of its own internal demand, consisting of infrastructural investment, public consumption (education, health care and environmental control, preservation and restoration) and household consumption, rather than the growth of exports.
- ◆ 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.

The Long-Term Economic Outlook: The Chinese Economy

- ◆ There are at present huge excess manufacturing capacities in China in industries such as steel, cement, glass, aluminum, ship-building, solar panels, residential housing, etc.
- ◆ One important implication of the excess capacities in the manufacturing industries is that its output or GDP is not supply-constrained but demand-constrained—as long as there is aggregate demand, the supply will be there to meet the demand. The Chinese GDP is primarily determined by aggregate demand and the Government exercises a decisive influence on the level of aggregate demand.
- ◆ Thus, China should be able to continue to grow at an average annual rate of 7% for the next five to ten years, more or less independently of what happens in the rest of the World.

Concluding Remarks

- ◆ The centre of gravity of the global economy has been gradually shifting to East and South Asia from North America and Europe. The centre of gravity of the East Asian economy has been gradually shifting to China from Japan.
- ◆ The Chinese and East Asian economies have been partially decoupled from the United States and Europe.
- ◆ The partial de-coupling of East Asia from the U.S. and Europe 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), the Chiang-Mai Initiative, as well as other regional initiatives.

Concluding Remarks

- ◆ RCEP principles were adopted by ASEAN leaders in 2011 and then by ASEAN+6 leaders. RCEP is supposed to cover eight areas: trade in goods, services, investment, economic and technical cooperation, intellectual property, dispute settlement, and others.
- ◆ While the growth of tangible capital, supported by a high domestic saving rate, has been the principal source of past Chinese and East Asian economic growth, the growth of intangible capital (human capital and R&D capital) will have to become a much more important source of Chinese economic growth, as it has already become in the more developed East Asian economies such as Japan, South Korea, Singapore and Taiwan.

Concluding Remarks

- ◆ In the short term, the U.S. rate of growth will gradually increase to 3% or above, but it will take several quarters. The Euro Zone as a whole will be able to achieve a low, but positive rate of growth. China will be able to achieve a growth rate between 7% and 7.5% in 2014.
- ◆ In the long term, the U.S. economy is likely to return to a growth path of 3% or more per annum. The Euro Zone as a whole is likely to grow at perhaps 2% per annum on average. The Chinese economy is likely to grow at around 7% per annum for the next five to ten years. The Indian economy will have a similar potential growth rate.

Concluding Remarks

- ◆ 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).