The State of the Global Economy

Part III

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- The Shifting Centre of Gravity of the Global Economy
- The Rise of the Internet-Based Economy
- The Global Financial Crises Since 2007 and the Aftermath
- The World Price of Oil
- The Short-Term and Long-Term Global Economic Outlook
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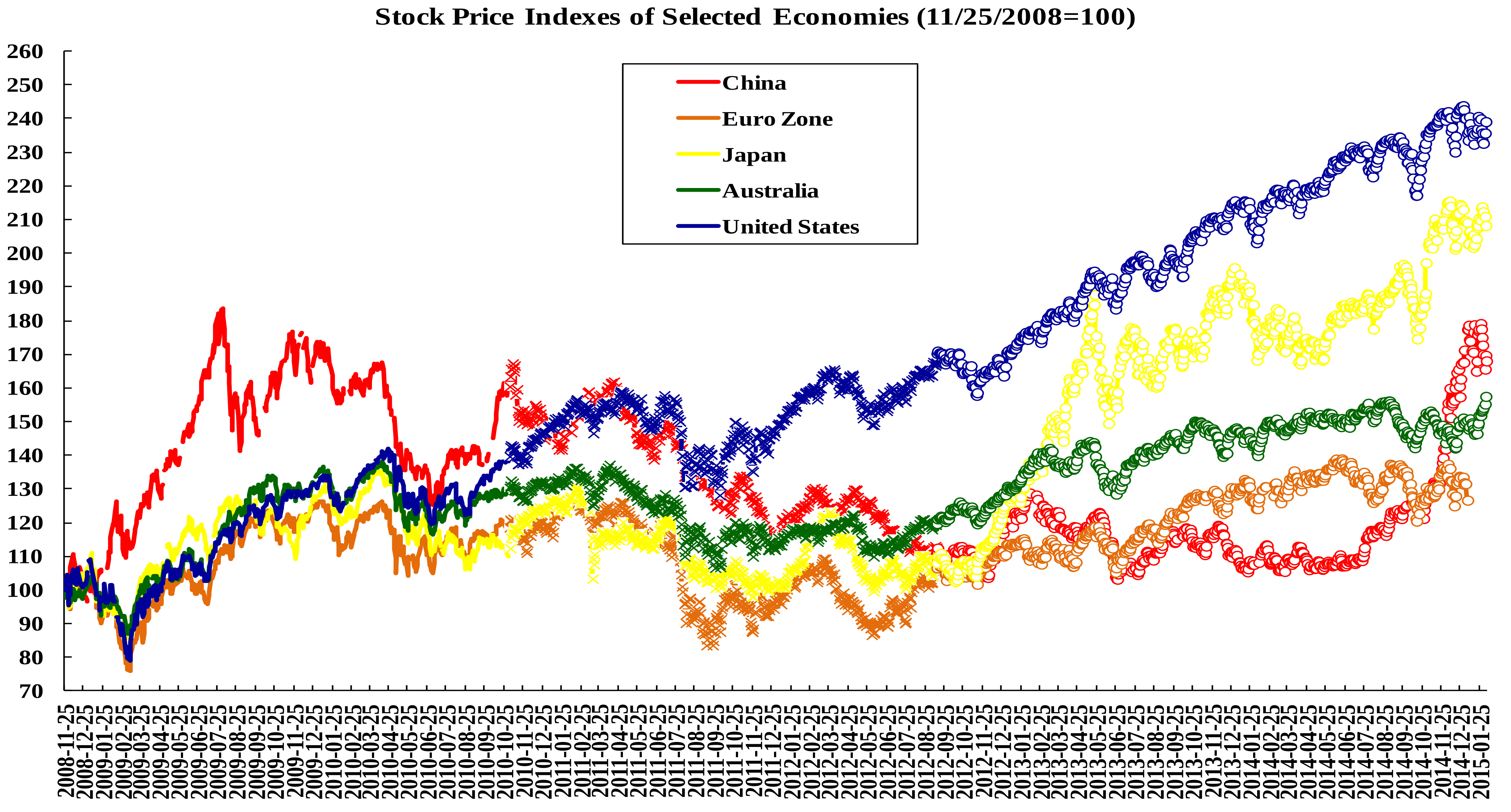
Stock Price Indexes of Selected Economies (11/25/2008=100)



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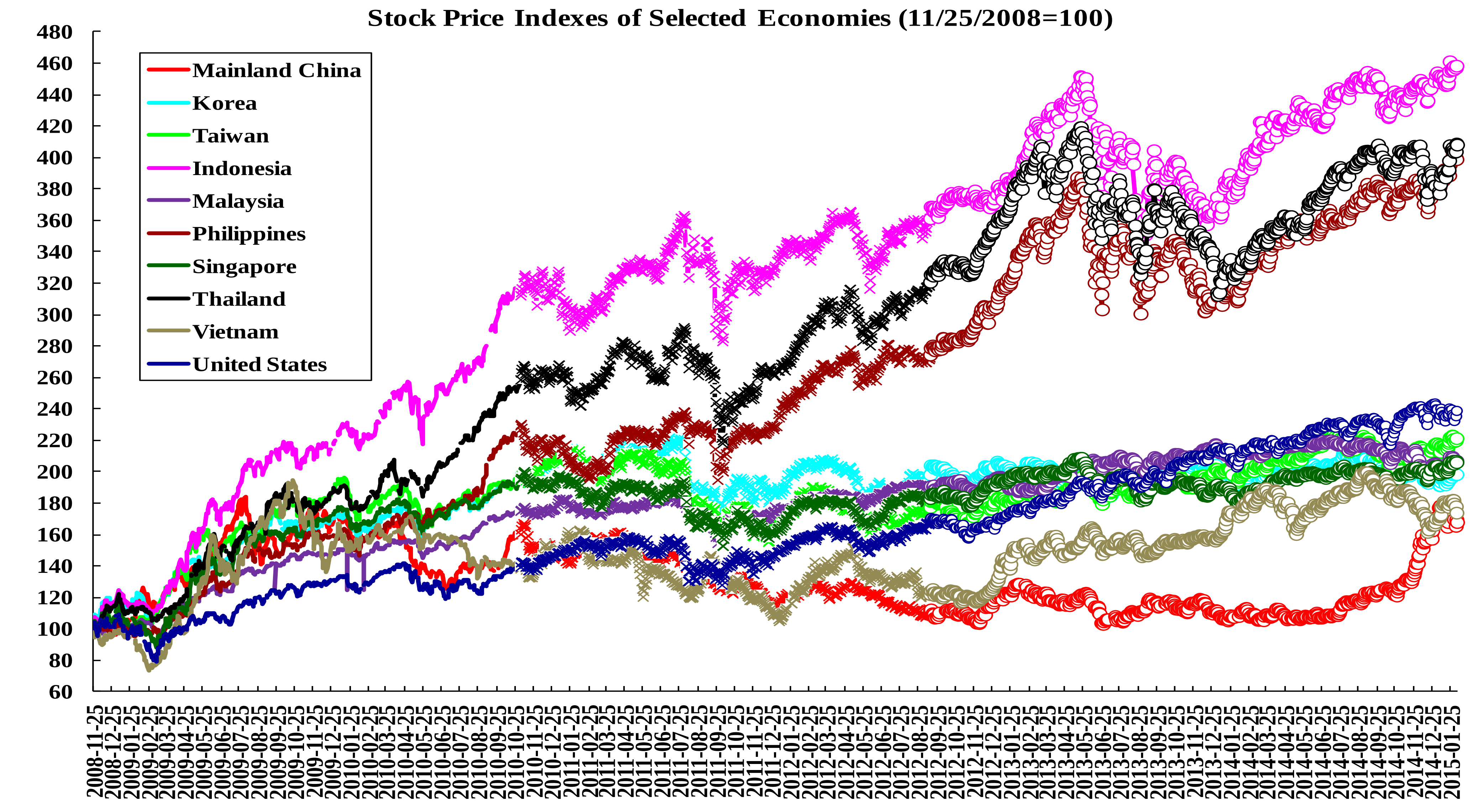
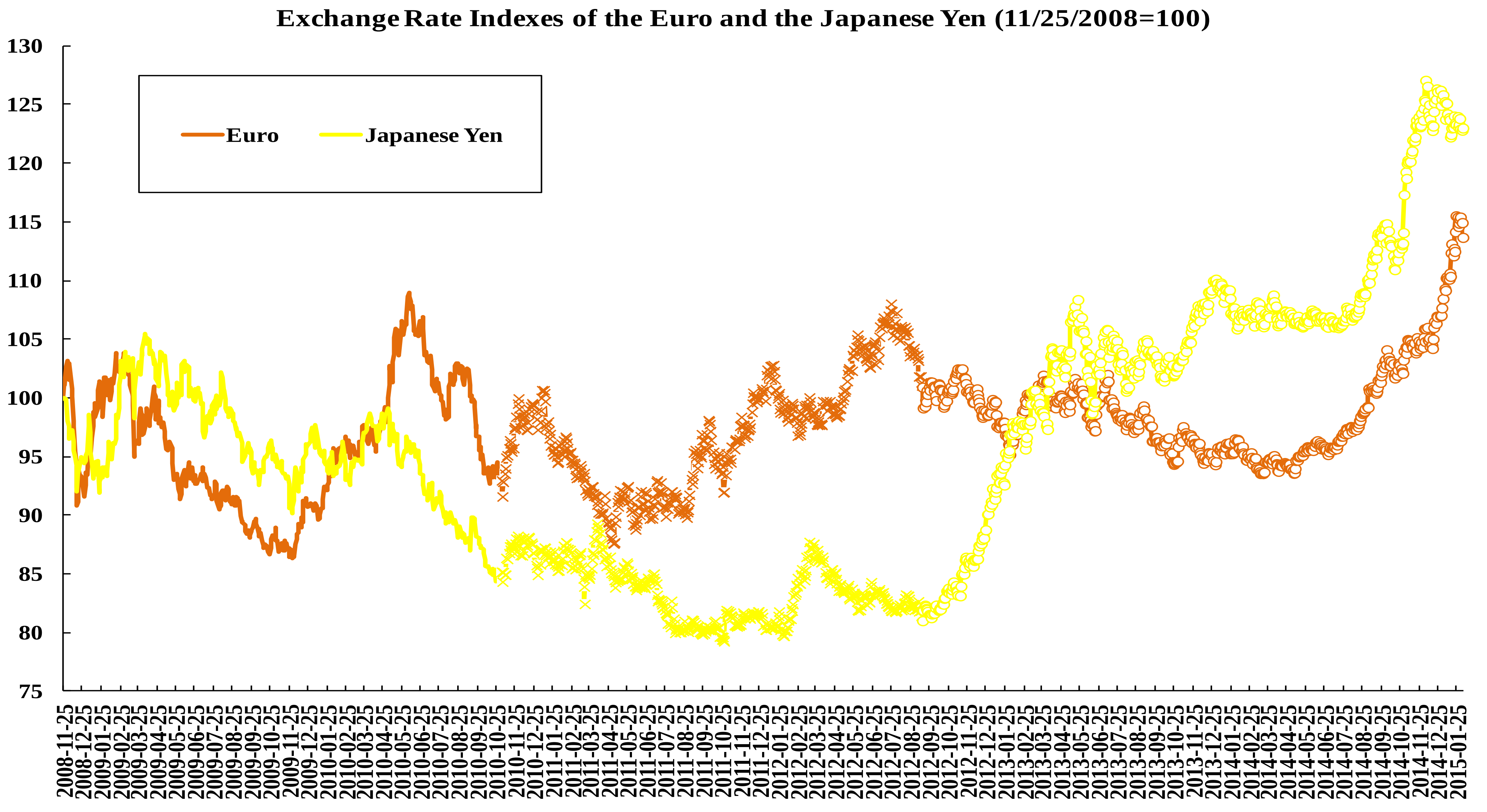


“Counter-Quantitative Easing” by the Euro Zone and Japan

- Japan, which saw its exchange rate rose to 75 Yen/US$ from 100 Yen/US$ as a result of the QEs, greatly hurting its exports, launched its own “Counter-QE” in late 2012. The Japanese “Counter-QE” was quite effective in driving the exchange rate of the Japanese Yen down to the 125 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. At the beginning of 2015, the European Central Bank (ECB) is poised to launch its own QE.

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



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.

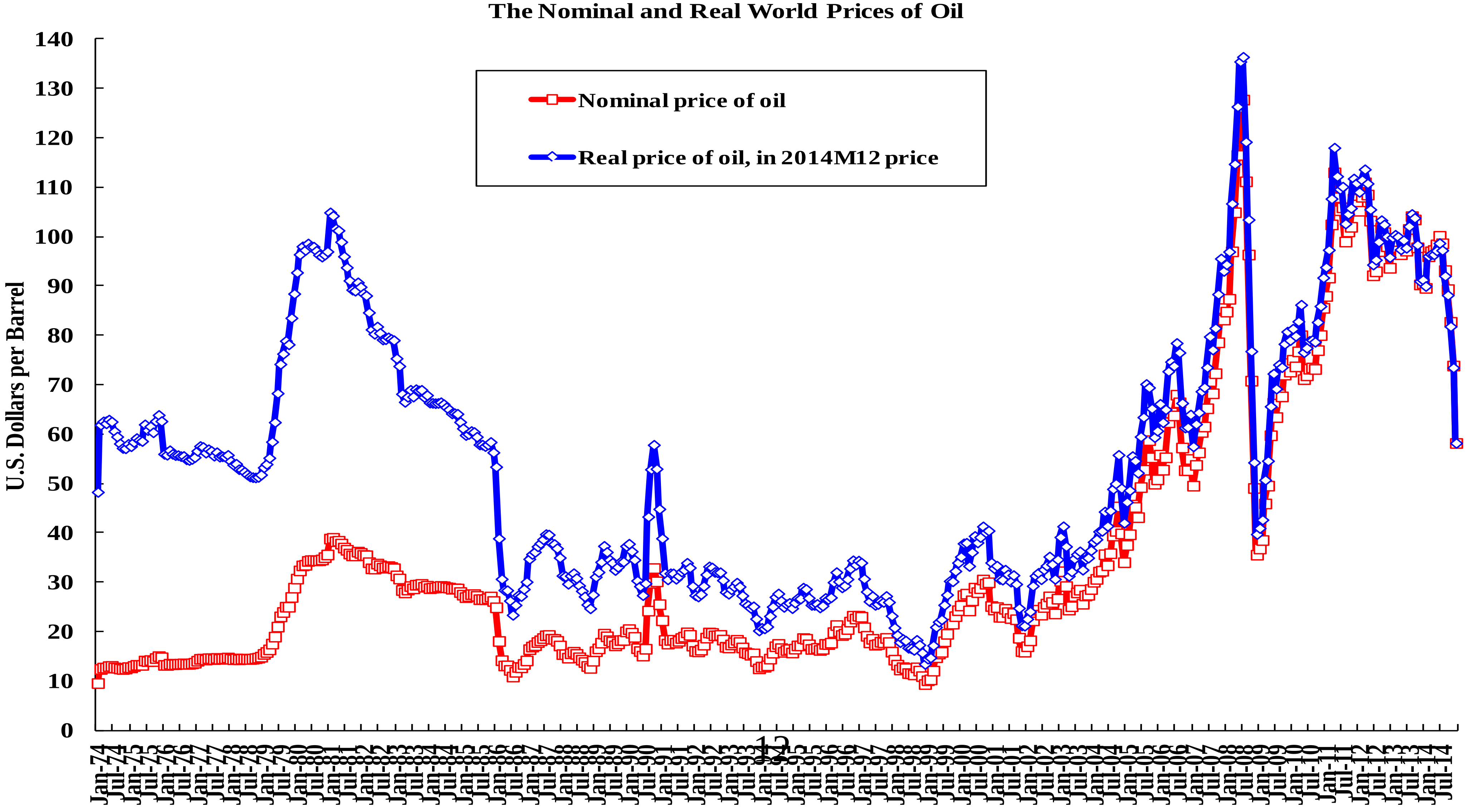
The Global Financial Crises Since 2007 & the Aftermath: Ending Quantitative Easing

- Similar QE policies in Europe and Japan have also not had their desired effects.
- One must accept the conclusion that monetary policy alone is not sufficient to turn an economy around. What is needed is an increase in aggregate demand that can change expectations about the future of the economy.
- Austerity cannot turn an economy around. One must make a distinction between recurrent expenditures and capital expenditures. While recurrent expenditures should be tightly controlled, capital expenditures, for example, investment in public infrastructure, are necessary to facilitate and stimulate economic growth.

The World Price of Oil

- As discussed before, the recent change in the World oil supply situation should bring a positive net benefit to the World economy. However, the economies of the major oil exporting countries such as Russia, Saudi Arabia and Venezuela, will suffer.
- The World price of oil is unlikely to fall below US$40 a barrel (in real terms this is approximately equivalent to the average World price of oil before the run-up in oil prices in 2003).
- The World price of oil is also unlikely to rise above US$70 a barrel on a sustained basis because of the competitive supply from shale oil and gas.

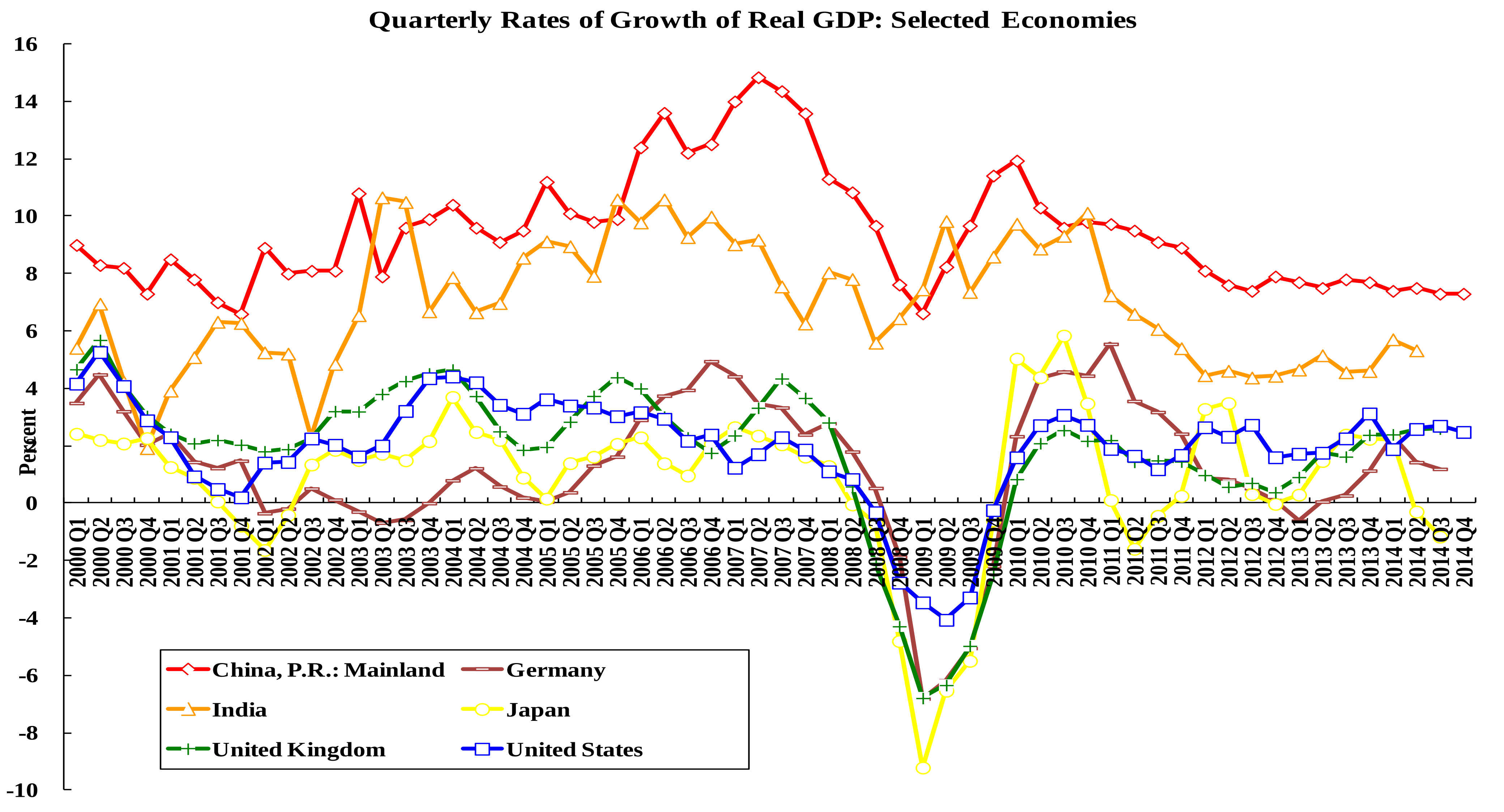
The Nominal and Real World Prices of Oil (2014 prices)



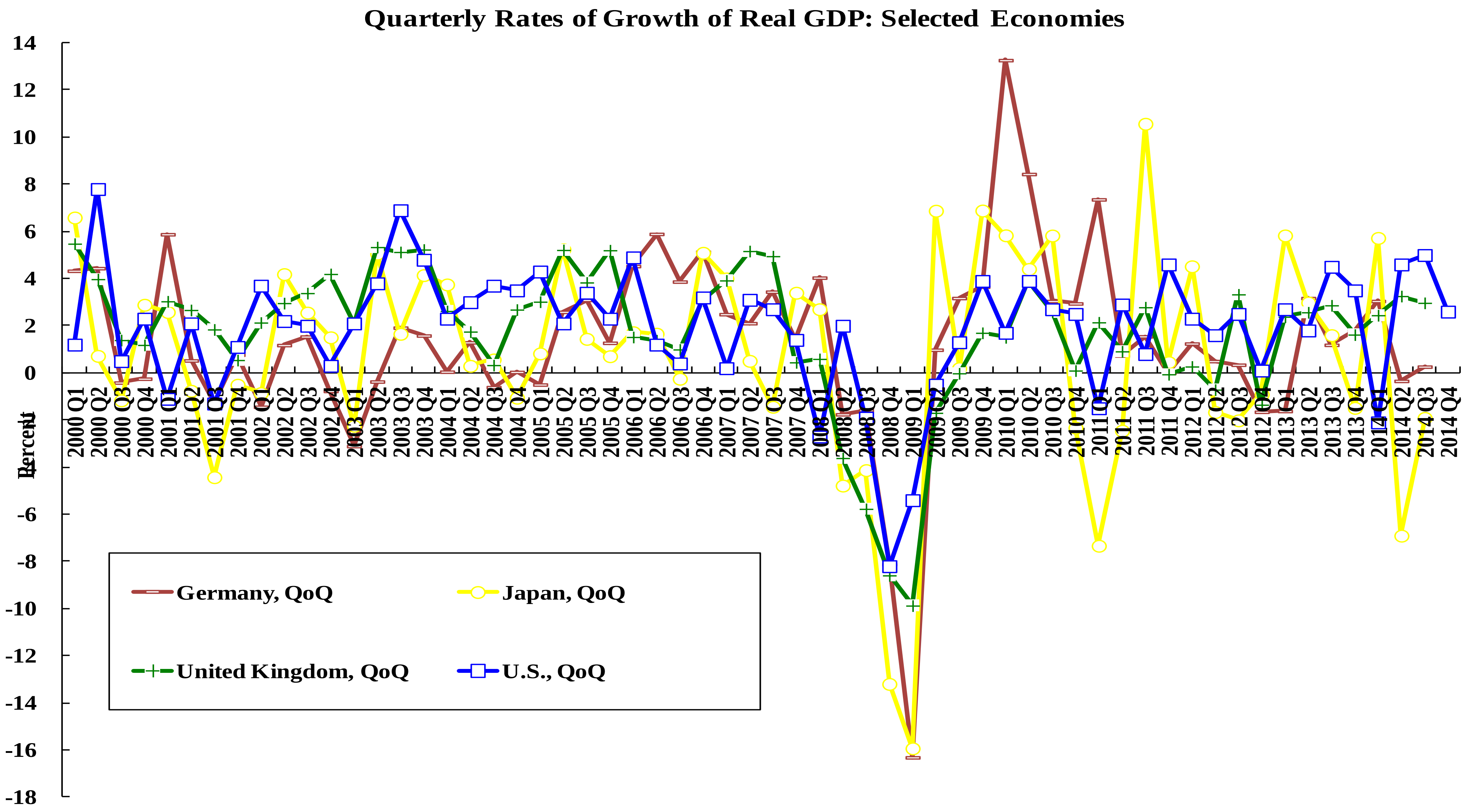
The Short-Term and Long-Term Global Economic Outlook

- 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



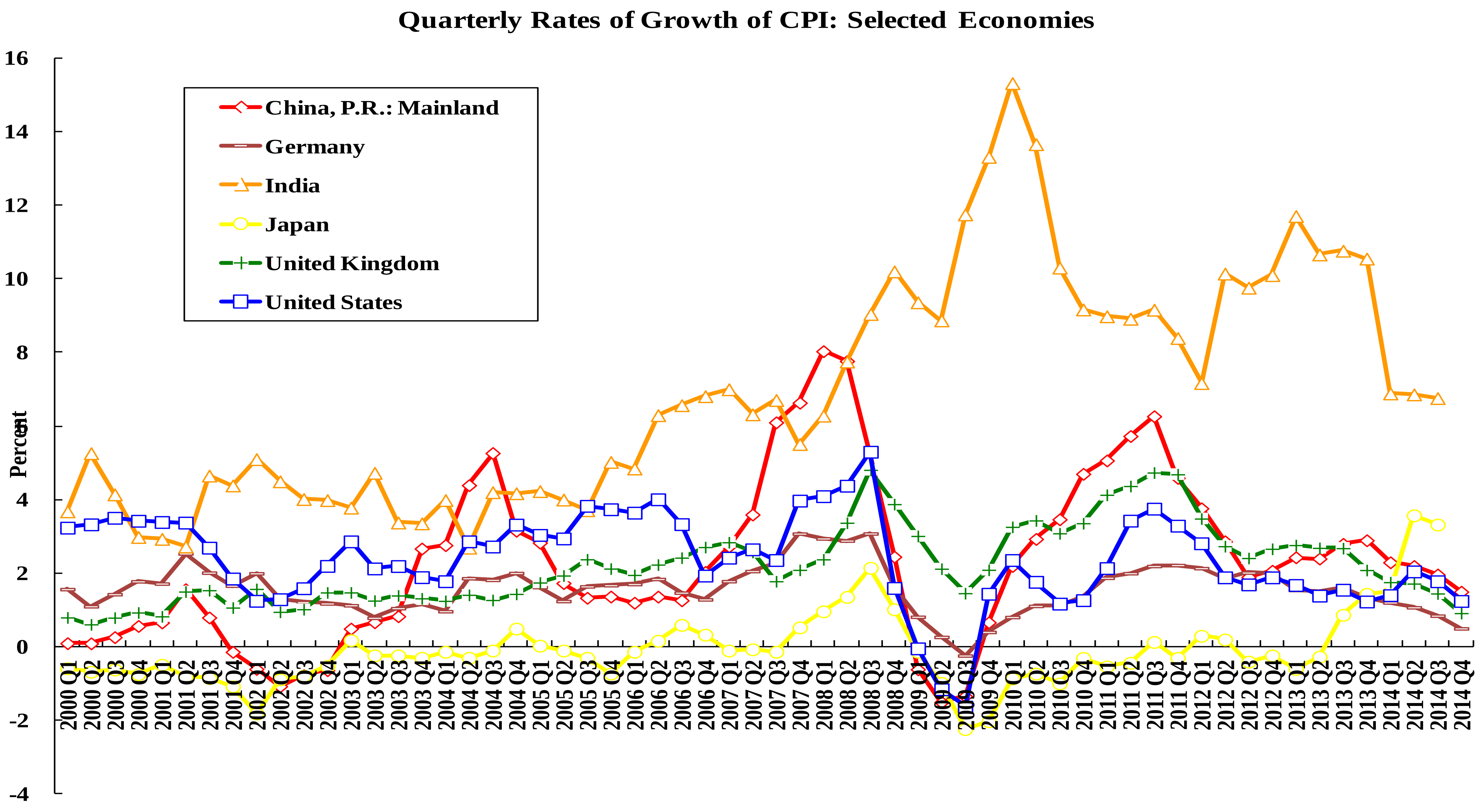
Seasonally Adjusted Quarterly Rates of Growth of Real GDP: Selected Economies



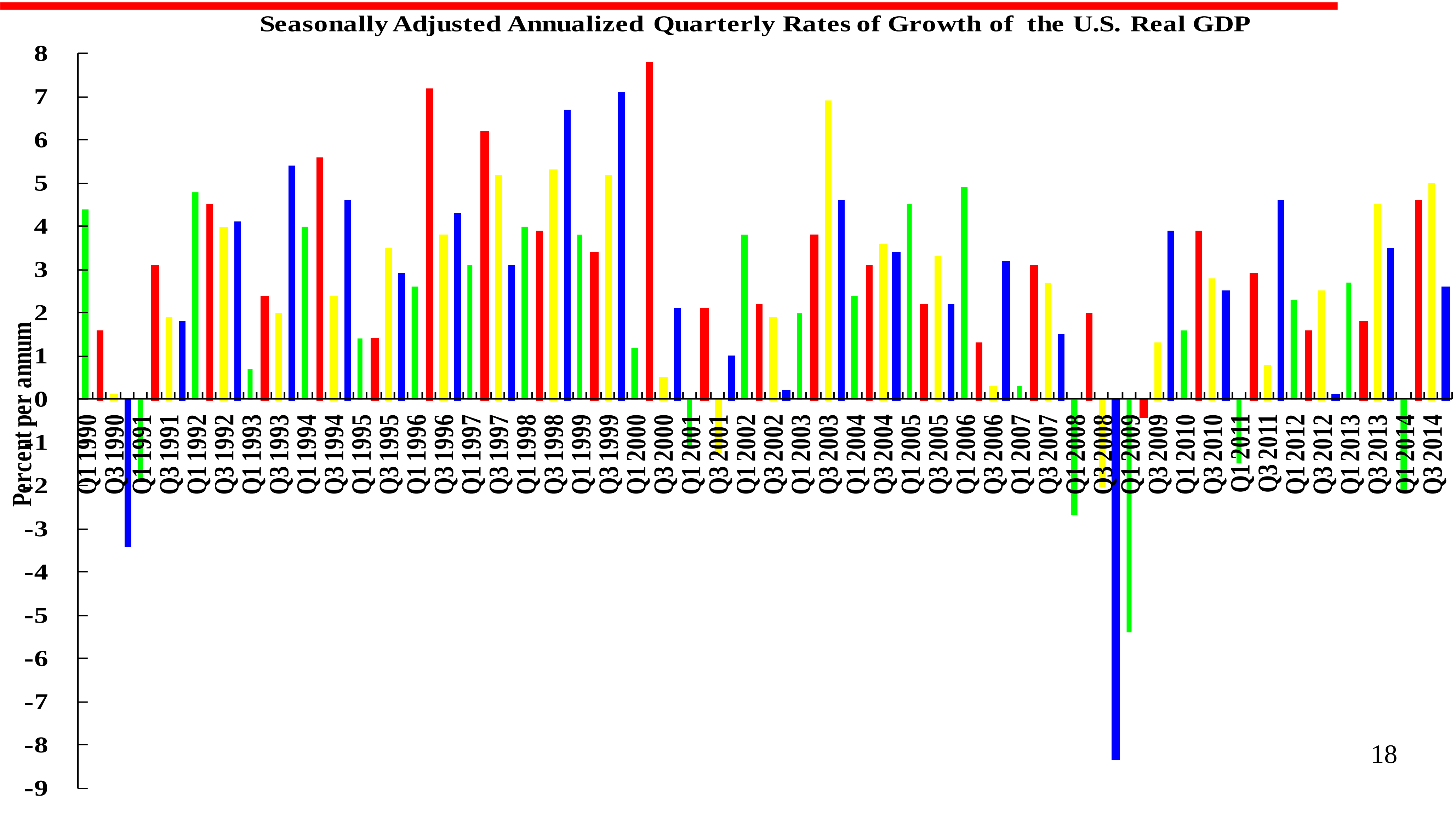
The Short-Term Economic Outlook: Inflation

- 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.

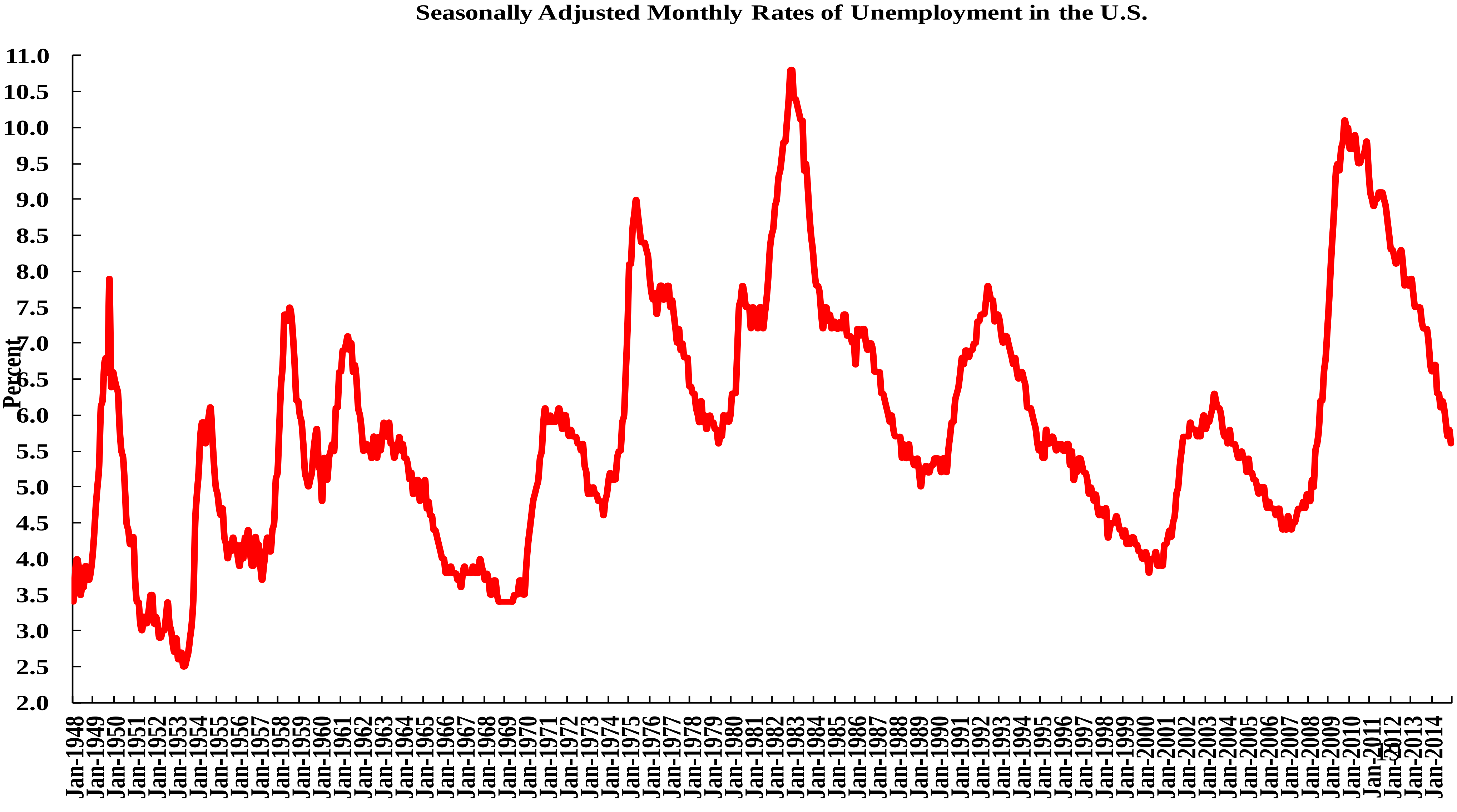
Quarterly Rates of Inflation: Selected Economies



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



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



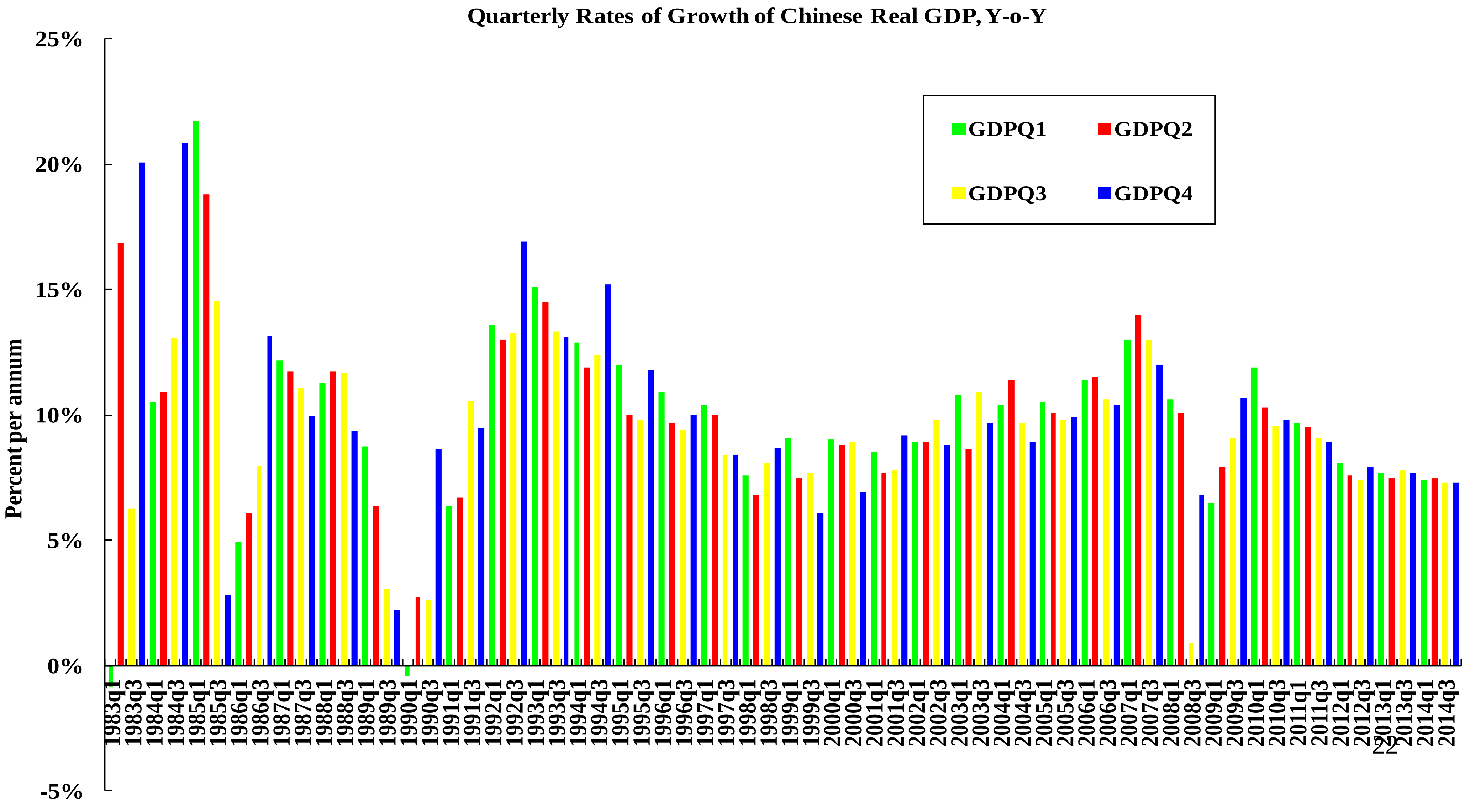
The Short-Term Economic Outlook: The Euro Zone Economy

- 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.

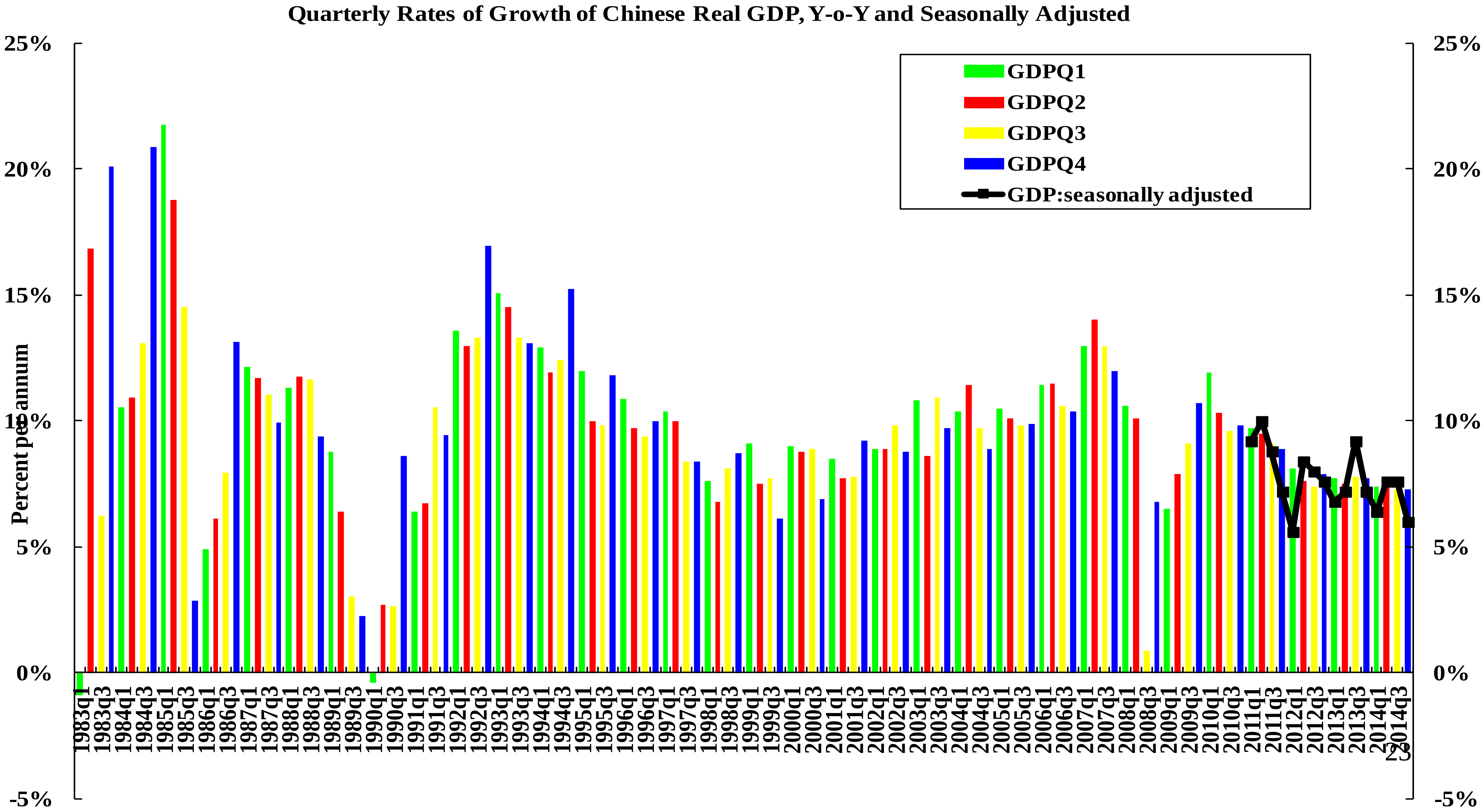
The Short-Term Economic Outlook: The Chinese Economy

- The Chinese economy grew 9.2% in 2009, 10.4% in 2010, 9.3 % in 2011, 7.7% in 2012 and 2013 and 7.4% in 2014 even as the European economies remained in recession and the U.S. economy just began to have a more robust recovery. 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. 2014Q2, 2014 Q3 and 2014Q4, the rates of growth were 7.4%, 7.5%, 7.3% and 7.3%, Y-o-Y, respectively. All the shot-term economic indicators suggest that the Chinese rate of growth has begun to stabilise around 7%.
- The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%. Given the realised rates of growth for 2011-2014, an average real rate of growth of 7% per annum is definitely achievable for Twelfth Five-Year Plan (2011-2015) period.

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



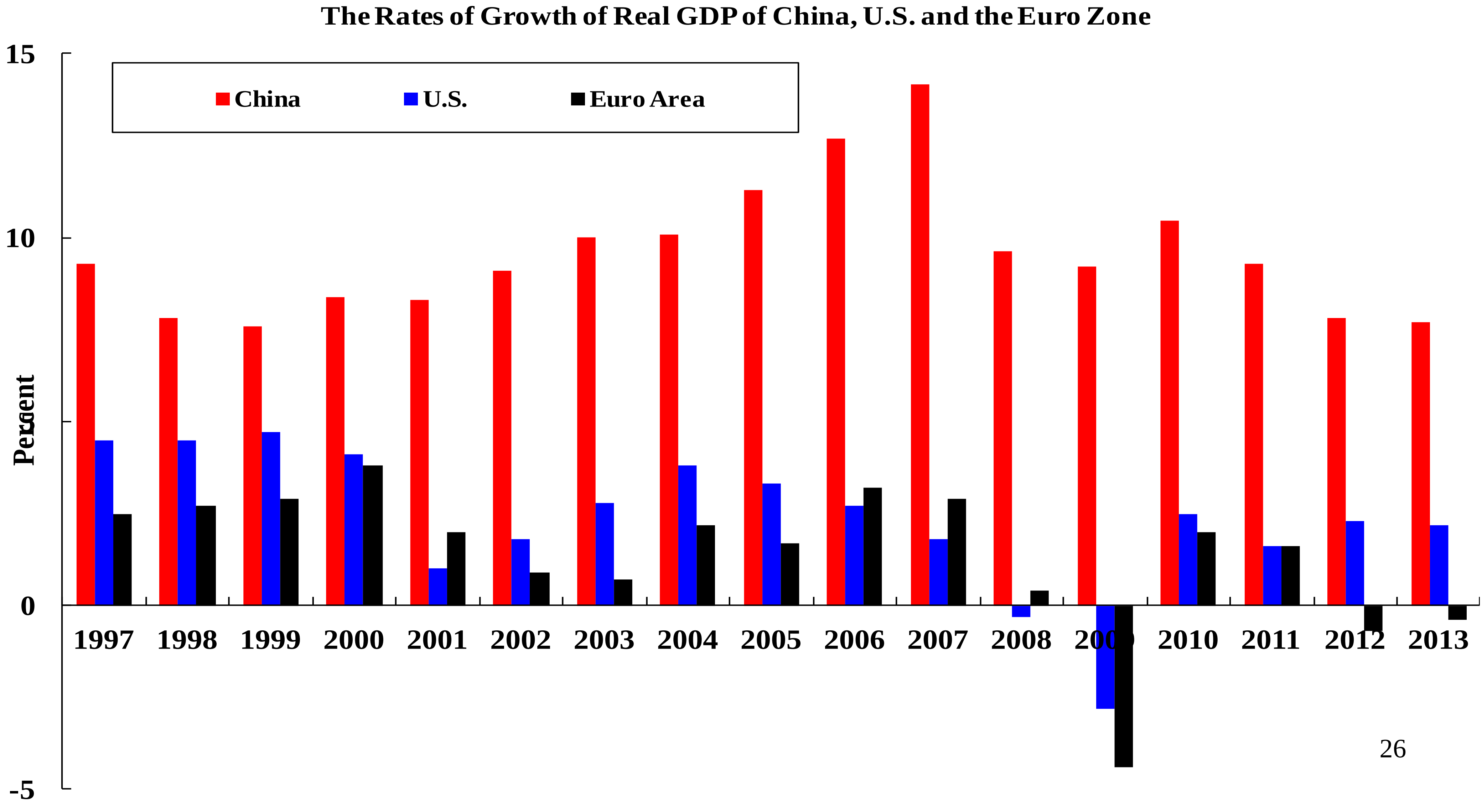
Near-Term Forecasts of Annual Rates of Growth of Chinese Real GDP

Forecasts of Annual Rates of Growth of Chinese Real GDP			
Forecasting Organisation	2015	2016	2017
Asian Development Bank	7.20%	NA	
The International Monetary Fund	6.80%	6.30%	
The Organisation for Economic Cooperation and Development	7.10%	6.90%	
The World Bank	7.10%	7.00%	6.90%
The Conference Board (U.S.)	5.90%	5.90%	
Fitch Ratings	6.80%	6.50%	

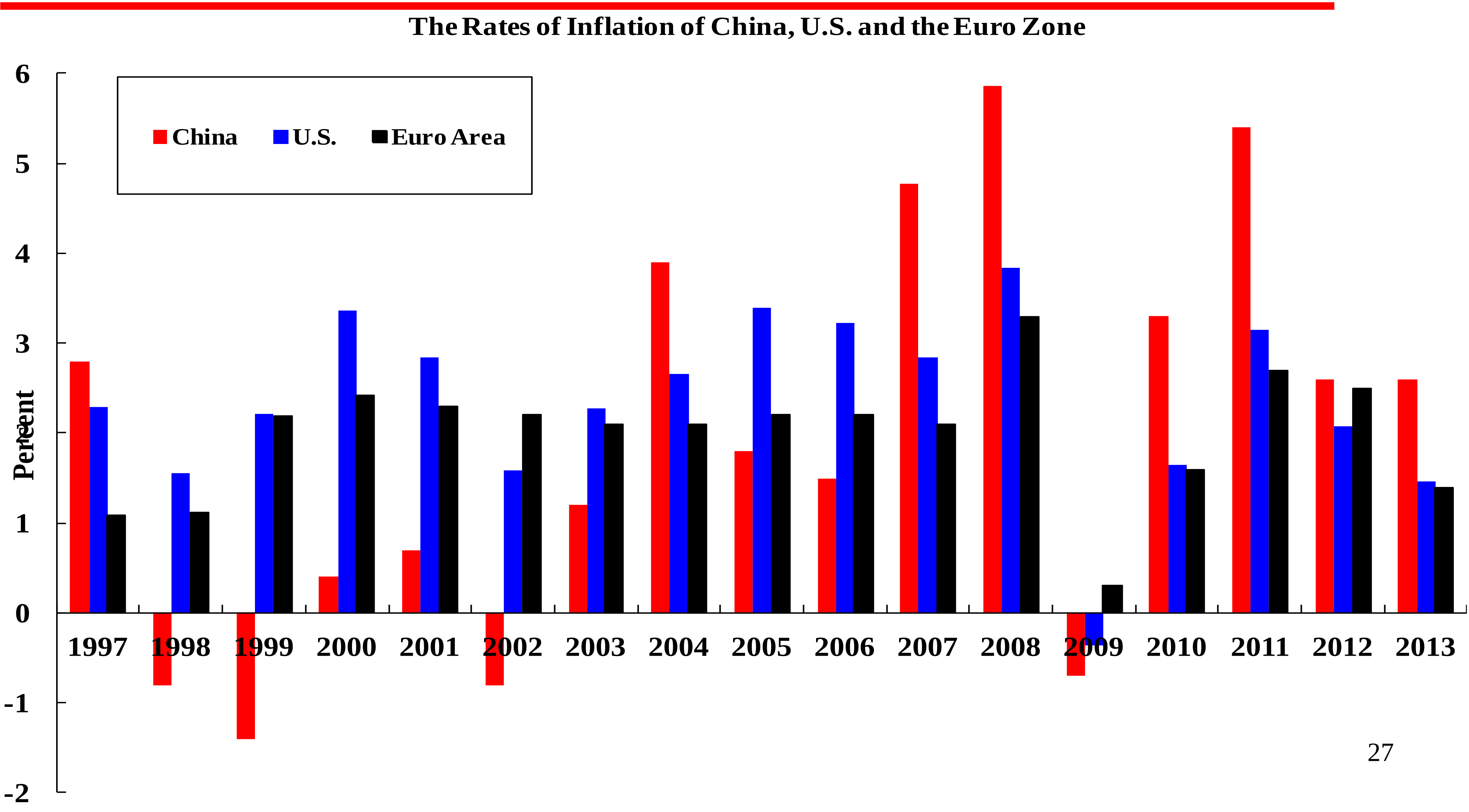
The Long-Term Economic Outlook

- 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.

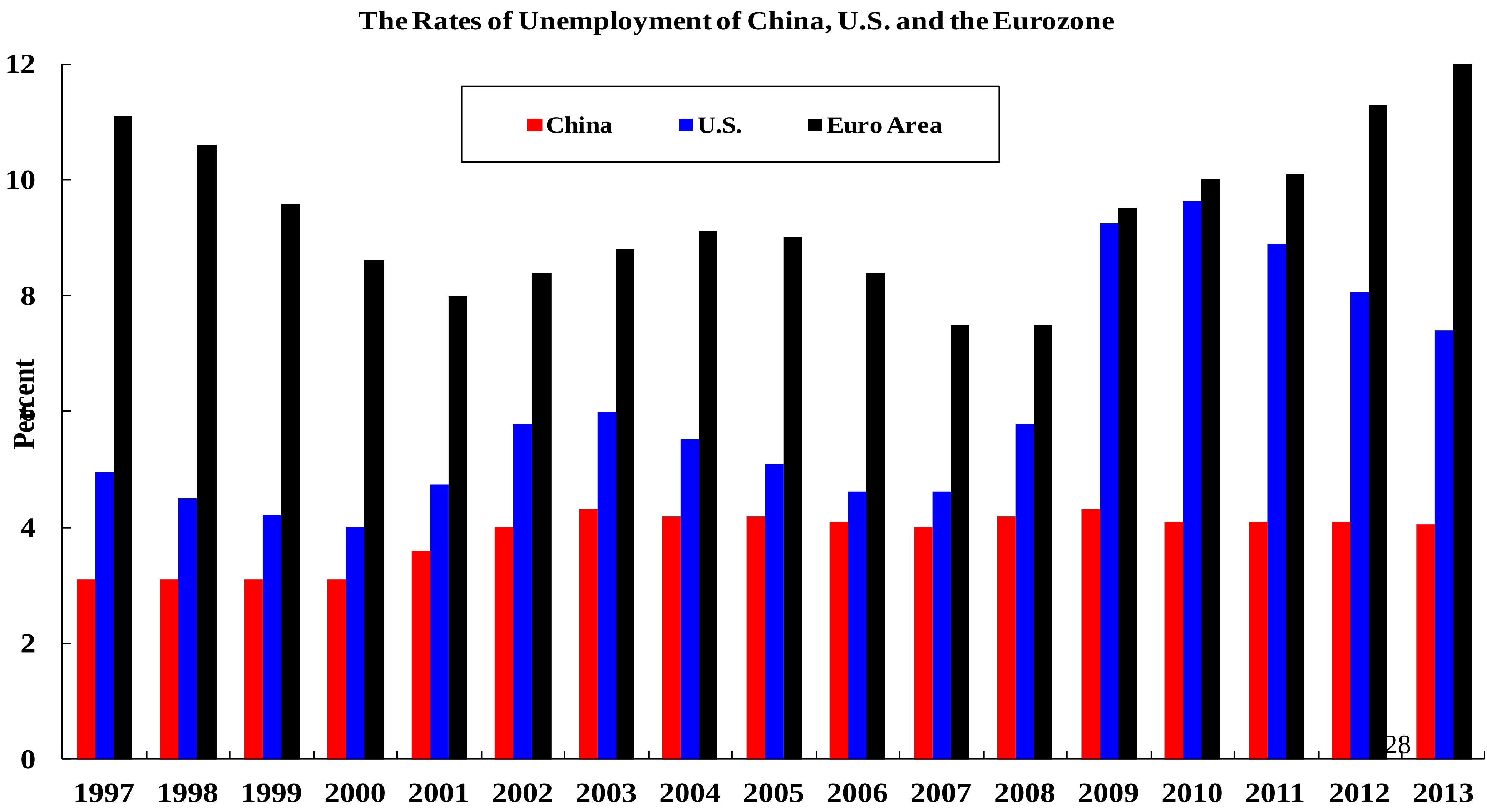
The Rates of Growth of Real GDP of China, the U.S. and the Euro Zone



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



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



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.
- The decline in the World oil price since mid-2014 is a net positive factor for the World economy.
- 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 may 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 or investment in manufacturing and residential real estate.
- 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 de-coupled 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 of around 7% in 2015.
- In the long term, the U.S. economy is likely to return to a growth path of 3.5% 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.
- By 2030, the Chinese real GDP per capita is projected to exceed US$21,000 (in 2013 prices), which would still be just a quarter of the projected then U.S. real GDP per capita of US$83,600.
- 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 Chinese economy has been growing and continues to grow at much higher rates than North American and Western European economies and Japan.
- Even though China has grown into the second largest economy in the World and also the second largest trading nation in the World, it is still very much a developing economy in terms of its real GDP per capita and in terms of the indigenous technology contents of its exports.
- However, with a saving rate in excess of 40%, China is potentially a large foreign direct and portfolio investor to the rest of the World.
- But the Chinese economy by itself is not large enough to turn the World around. The idea of a G-2 group of countries consisting of only China and the United States leading the World economy is premature.