The Global Economic Outlook

Dark clouds on the horizon

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CLOUDS ON THE HORIZON

Rising food and oil prices?  
Unpredictable

A Chinese hard landing?  
Rather unlikely

A US fiscal policy disaster?  
Improbable

A Euro breakdown?  
Unfortunately possible
CHINA - HOUSE PRICES*
(2010 = 100)

* In real terms.
GROWTH IN LENDING TO THE BUSINESS SECTOR
(per cent changes; 3 mnths. mov.avrgs.)

United States

Eurozone

2005 2006 2007 2008 2009 2010 2011 12
US - HOUSE PRICES*
(2000 = 100)

EUROZONE - HOUSE PRICES*
(1980 = 100)


1968-2000 trend line (0.35% p.a.)

1980-2000 trend line (1.5% p.a.)

*In real terms. * 1st half 2012.
EUROPE - A NEW RECESSION?

(GDP; per cent changes; 3 qtrs. mv. avrgs.)

Source: Oxford Economics.
RECESSION AND RECOVERY

(GDP; levels; 2007 Q1 = 100)
THE EUROZONE'S PROBLEMS

The immediate problem is one of deficits and debt in a number of Southern countries. These are seen as excessive by financial markets.

The medium-run problem is one of insufficient competitiveness in a number of, again, Southern countries.

And there could be an even longer-run problem that has to do with different and diverging governance standards between Northern and Southern Europe.
HOW TO DEAL WITH EXCESSIVE DEFICITS AND DEBT?

The easiest way to eliminate both is to have growth and inflation. Unfortunately, neither are forthcoming.

The standard answer is, therefore, to enforce austerity: cut public expenditure and raise taxation.

The problem with this medicine is that it depresses economic activity: as a ratio to GDP deficits and debt either do not decline or they may even increase.
# REDUCTIONS IN PUBLIC DEBT

(in percentage points of GDP)

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<tbody>
<tr>
<td>Total reduction</td>
<td>89</td>
<td>212</td>
</tr>
<tr>
<td>due to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal policy</td>
<td>-21</td>
<td>-124</td>
</tr>
<tr>
<td>Growth</td>
<td>56</td>
<td>98</td>
</tr>
<tr>
<td>Inflation</td>
<td>53</td>
<td>228</td>
</tr>
</tbody>
</table>

Source: W.Buiter.
GREEK AND EUROZONE GDP GROWTH
(per cent changes; 3 years mov. avrgs.)

GREECE'S PUBLIC DEFICIT AND DEBT
(in per cent of GDP)

Includes significant "hair cut* in 2012

Deficit (l.h.sc.)

Debt (r.h.sc.)
WHAT ELSE CAN GREECE DO?

Leaving the euro seems, by now, to be a distinct possibility.

The hope would be to replicate Argentina's experience.

... but Argentina's conditions at the time were very different from Greece's conditions today - hence huge risks.

In either case, if Greece leaves there is a high danger of contagion.
GREECE AND ARGENTINA
(GDP; levels; 2011 Q1 or 2000 Q1 = 100)

CAN THE EUROPEAN CENTRAL BANK PREVENT CONTAGION?

Yes in theory, since the ECB can print money and buy public sector debt (it has unlimited firing power)

The recently announced OMT (Outright Monetary Transactions) programme goes in this direction

But many in Germany (and elsewhere) are opposed to this. Why?

Two major reasons:

i) Fear of future inflation

ii) Fear of future indiscipline and profligacy in the weaker countries
ITALY AND SPAIN - BOND YIELD DIFFERENTIALS*

26.7.12: Draghi's "Whatever it takes"
6.9.12: OMT Announcem.

* Difference between yields on 10 year Spanish or Italian Euro bonds and equivalent German 10 year Eurobonds.
WHAT HAPPENS IF CONTAGION SPREADS?

Severe consequences in the short-run (and not just in the Eurozone)

One possible scenario would be for Southern Europe to return to separate currencies, while Northern Europe retains the Euro.

Introducing new currencies is difficult. Banks and financial markets may have to be closed; deposits might have to be frozen; capital control would seem inevitable; currencies would swing wildly (with the Northern Euro rising sharply); contracts would have to be renegotiated, etc., etc.

The economic costs of this could be huge and the turmoil could well last for at least two-three years.
### US - MAJOR EXPORT MARKETS
#### 2011

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<tr>
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<th>$ bn.</th>
<th>in % of total</th>
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<tbody>
<tr>
<td>World</td>
<td>1481</td>
<td>100.0</td>
</tr>
<tr>
<td>Canada</td>
<td>281</td>
<td>19.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>198</td>
<td>13.3</td>
</tr>
<tr>
<td>Euro Z.</td>
<td>197*</td>
<td>13.3</td>
</tr>
<tr>
<td>China</td>
<td>104</td>
<td>7.0</td>
</tr>
<tr>
<td>Japan</td>
<td>66</td>
<td>4.5</td>
</tr>
</tbody>
</table>

* Or 1.5 per cent of US GDP.
GROWTH OF EARNINGS
(1999 Q.1 = 100)

PRODUCTIVITY GROWTH
(GDP per employee; 1999 Q.1 = 100)
TOTAL REAL EXCHANGE RATES
(1999 Q.1 = 100)

Source: IMF.
EUROZONE CURRENT ACCOUNT BALANCES
(in per cent of GDP)

"North"**

* Germany, Netherlands, Belgium, Austria and Finland.
** Italy, Spain, Greece and Portugal.

"South"***
WHO WILL FINANCE ALL THESE DEFICITS?

Any deficit must be financed

In existing monetary unions the deficits of uncompetitive areas either do not persist, because wages decline (e.g. in the US) or, if they persist, they are financed by the country's richer regions (e.g. in Italy, or in Spain, or in Belgium, etc.).

No such mechanism exists in the Eurozone and public opinion in the richer countries is hardly likely to favour one!

In its absence, either the "weak" regions/countries improve their competitiveness, or they are condemned to low growth/high unemployment.
EMU - NORTH-SOUTH CONVERGENCE

ESTIMATES OF SIZE OF SHADOW ECONOMY (in per cent of GDP)

Source: F. Schneider.
EMU - NORTH-SOUTH CONVERGENCE
ESTIMATES OF SIZE OF SHADOW ECONOMY
(in per cent of GDP)

USA EZ Nth.EZ Sth. USA EZ Nth.EZ Sth.

Source: F.Schneider.
EMU - NORTH-SOUTH CONVERGENCE

PERCEPTIONS OF CORRUPTION

Source: Transparency International.

1999-2000

USA  EZ Nth. EZ Sth.

2010-11

USA  EZ Nth. EZ Sth.
GOVERNANCE STANDARDS

PRESENCE OF THE RULE OF LAW
(deviations from international average)