

# The global economy in 2011

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# Three big issues

- Cutting the deficit: how fast?
- Currency wars
- QE or not QE?

# The debt problem

- Once upon a time...the west paid its debts and emerging markets defaulted
- But history is a lot more complex than that
- Reinhart/Rogoff: “This Time is Different”
- Spain defaulted eight times in 19<sup>th</sup> century, Portugal six and Greece four
- In 20<sup>th</sup> century, Germany defaulted twice, Austria twice and Greece once more

# The economic power shift

- Advanced economy public debt/GDP figures set to rise to more than 100% by 2015 (IMF)
- Emerging market debt will be only 30% of GDP by 2015
- And yet emerging market countries still pay a yield premium – “original sin”

# The power shift 2

- In the past, default by one emerging market caused runs on the rest
- Now investors can distinguish between Brazil and Argentina
- Contagion now a western phenomenon: Greece/Ireland/Spain/Portugal

# Relegation zone

- Barclays Capital measured the fiscally vulnerable countries
- Worst 10 were: Lebanon, Greece, Pakistan, Vietnam, Ukraine. Egypt, Ireland, Lithuania, Italy and Romania
- Best 10: Hong Kong, Singapore, South Korea, Chile, Taiwan, Germany, South Africa, Czech, Malaysia and Uruguay

# Not just government debt

- Total debt as % of GDP
- Britain 466%
- Spain 366%
- France 322%
- Italy 315%
- Switzerland 314%
- US 296%
- Source: McKinsey Global Institute

# To cut, or not to cut

- The Greek example
- The debt trap, when bond yield is higher than rate of GDP growth
- Water flowing out of bath faster than it can be filled by the tap
- Excessive burden on future generations
- Crowding out

# But....

- Britain, US, Germany not in Greek position
- Bond yields are well below debt trap levels
- Balancing budget in recession did not work in 1930s, has not worked for Ireland
- No crowding out since the private sector doesn't want to borrow

# Not 1981

- British budget opposed by 364 economists
- Followed by 1980s boom
- But it was accompanied by sharp fall in interest rates, inflation and pound
- This time, rates and inflation already at rock-bottom levels
- Classic Keynesian problem: who will spend?

# St Augustine

- Lord give me chastity, but not yet
- Give me a balanced budget, but not yet
- Medium term plan for cutting the deficit
- Domestic demand will be weak
- So the best thing is to rely on foreign demand (ie exports)
- Which leads us to...

# Currency wars

- Most countries would like to see their currencies fall
- Pound dropped in 2008
- Dollar fell in 2009
- Swiss intervened to slow a currency rise
- Japanese intervened last month
- Greeks, Irish don't have the option

# Something has to go up

- The Chinese don't want their currency to rise too fast
- Will this lead to retaliatory action?
- Bill passed the House, but not the Senate
- World saw competitive devaluations in 1930s
- But there were also tariffs...

# How to drive currency down?

- Intervention is very expensive; only works with international co-operation
- Talking works only briefly
- Other option is to cut rates but they are already near zero
- That leaves expanding the money supply or...

# QE or not QE?

- Stands for quantitative easing, ie the creation of money
- Old as the hills, Nero debased the coins, Henry VIII was “old coppernose”
- No longer just printing
- Central bank buys assets
- Expands money, drives down yields

# But does it work?

- Failed in Japan, but was it too little, too late?
- Could it be too much? In Weimar republic and Zimbabwe, associated with hyperinflation
- No example of it working properly

# This time

- Money supply has expanded, but not lending to business
- Bond yields are already low.
- How do we get out of it? Bank of England already owns £200 billion, must sell some time

# The outlook

- History suggests that the recovery from financial crises is slow, at best
- We have borrowed growth from the future
- Demographics, starting to weigh, particularly in Europe
- Taking on debt is a sign of confidence in rising GDP/asset prices/population

# Deadweight debt

- Must be rolled over, creating crises of confidence
- Secured against assets, dangers of negative equity
- People haven't saved enough for retirement
- Debt is owed to foreigners, why go through austerity for them?

# Plenty of risks

- Trade wars
- Cutting too much, too fast
- Stagnate/inflate/default

But....

Emerging markets provide some hope

One day, they will consume as well as  
produce