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GLOBAL ECONOMIC OUTLOOK – EUROPEAN CHALLENGES AND GROWTH OF EMERGING ECONOMIES

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I. BACKGROUND

Asian Crisis (1997-1999) and many countries wanted to accumulate OWNED reserves, necessitating surpluses on the current account.

But who would run deficits? The US took it on.

First, private houseowners. Then the banks. Then the state.

Financial crisis in the making, spreading to other countries.

EURO, and room for manoevering is limited.

Greece should devalue but has no currency to write down.

II. WHAT HAPPENS IN EMERGING ECONOMIES?

1990: Emerging markets, 14 % of world manufacturing

2010: Increased to 34 %. ENORMOUS CHANGE

2000-2007: Annual growth in Chinese exports of 25 %.
Could not continue.
And did not continue.
Exports in 2009 about the same as in 2007

Surplus on current account, 10 % of GDP in 2007, 1-2 % in 2012

2011: China's GDP 28 % larger than 3 years earlier
Whereas GDP of the US about the same

Financial crisis has weakened the US economically and politically

GDP: 15.500 billion dollars i USA, 8.000 in China

China's GDP a bit more than half of USA's (estimates 2012)

2003: Goldman Sachs, China ahead in 2041
2010: Goldman Sachs, China ahead in 2027
2011: The Economist, Kina ahead in 2018

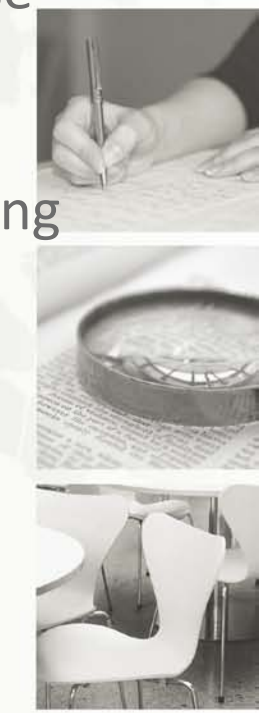
Remember there are four Chinese per American
Also, the demographic dividend is running out in China

Financial crisis and China becomes more confident in own model
The crisis is ”Made in America”

Wen Jiabao had to straighten up the Americans when fear arose that Freddie Mac og Fannie Mae would not service their debt

BUT: Chinese state owned banks are loaded with non-performing loans, after surge in lending in 2009.

An estimated 2.000 bn USD (Fitch), or 30 percent of GDP.



China has about 250 bn dollar in accumulated OUTWARD direct investments, against 1.000 bn in INWARD

Geely buys Volvo

State Owned Enterprise buys Elkem

2005: CNOOC was denied Unocal

"Soon a company near you will be Chinese"

Make sense for China to diversify over

- Countries, Instruments (increasingly real assets), and Currencies

BUT: Is the development in China sustainable?

- The political regime is short on legitimacy
- Insecure leaders
- Increasingly an uneven distribution of income
- Corruption is endemic
- China gets old before she gets rich
- Middle Income Trap and China grinds to a halt?

Leader transition in the fall/next spring.

Sort av election campaing unfolding, e.g. Bo Xilai in Chongquin

Party chief and prime minister ready (Xi Jinping og Li Keqiang)

But not the remaining seven in PBSC

III. WHY DO COUNTRIES LEND AND BORROW?

Borrowing, to have real investments exceeding domestic savings, requiring imports to exceed exports

Lending, and saving more than you need, to acquire claims on ROW, requiring exports to exceed imports

Problem when accumulation of debt makes for **increased consumption**, rather than **increased real investments**, i.e. capital accumulation

From a global point of view, emerging markets ought to borrow and mature economies ought to lend. It is the other way around

IV. MORE ON EUROLAND

What does it take for a country to benefit from a currency union?

Cultural similarities in terms of attitude towards

- Low inflation
- Balanced budgets
- Wage formation contributing to economic stability

What about Greece and Italy versus Germany and the Netherlands?
Large differences. A trial and error period of at least five years needed?

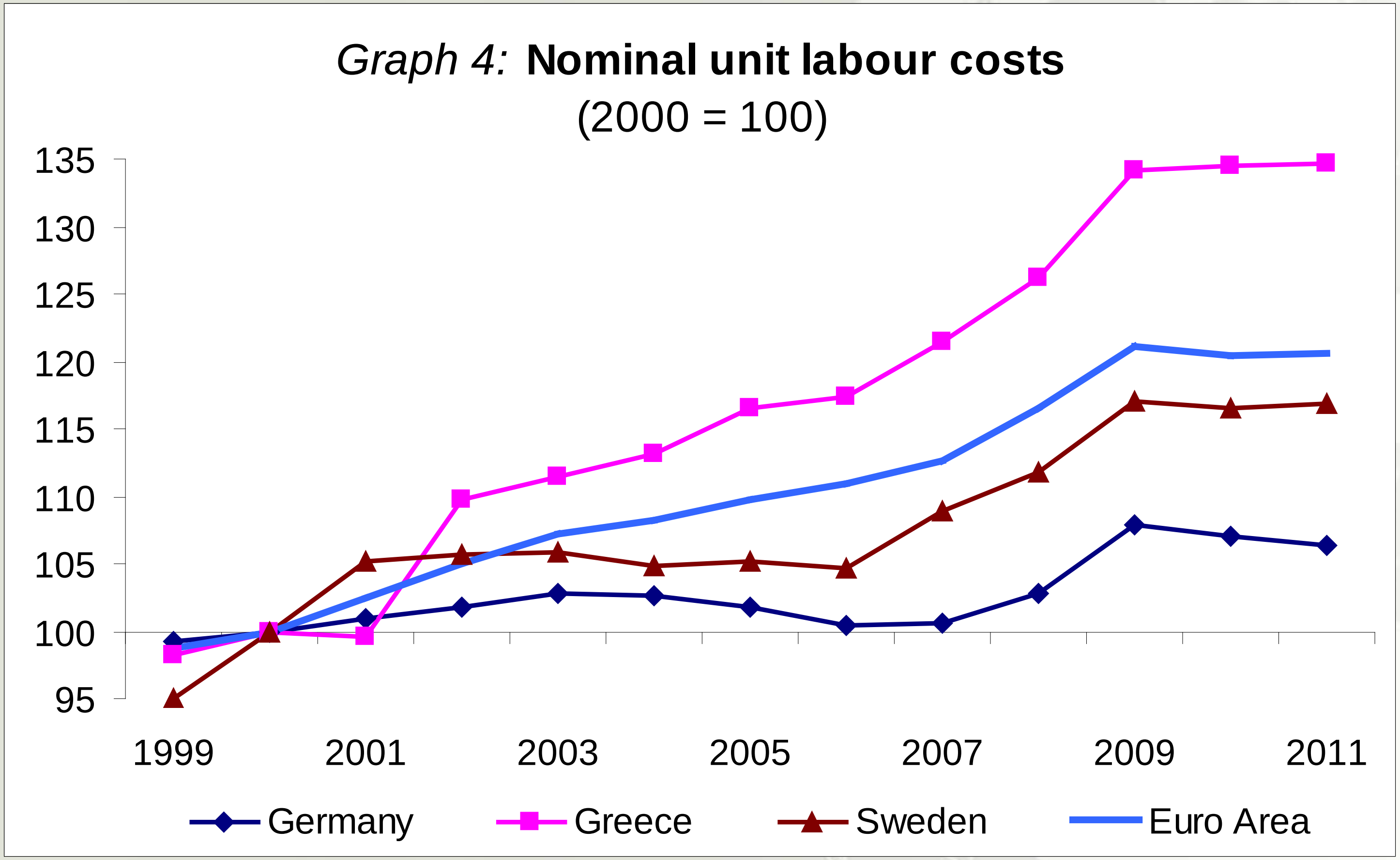
Economists focused on theory of optimum currency areas.
Business cycles fairly similar, and a currency union is fine.

The real issue became one of extending credit way beyond reasonable limits.

- Come 1999 and euro replaces domestic monies
- Common rate of interest set in Frankfurt
  - Too low for Greece – too high for Germany

- Finance freely available to Club-Med countries, generating unsustainable economic growth

  - Inflation and labor costs do vary across euroland
  - Spain and Ireland, sound public finances to start with.
  - The PRIVATE sector borrows too much
  - Ireland makes a big mistake – guaranteeing all debt to banks
    - Should have taken a clou from Iceland (2010)
    - As well as from Norway (1992)



Graph 4: Nominal unit labour costs
(2000 = 100)
135
130
125
120
115
110
105
100
95
1999
2001
2003
2005
2007
2009
2011
Germany
Greece
Sweden
Euro Area

- Many ”eurolands” have behaved as if they had their own currency. That could be written down.
- Rules of the game, i.e. Stability and Growth Pact, not observed
- Banks having problems, and public money is supplied
    - The concern that banks are too big to fail is misplaced

- Main issue I: How to distribute the losses? (Balance sheet)
- Main issue II: How to have production pick up? (Flow issue)

    Which issue is the most difficult one?

Need for contractionary fiscal policy (issue I)

But also in need of increased demand (issue II)

Devaluation the perfect tool – unfortunately not available

COMMON FISCAL POLICY?

Eurobonds that all of the eurozone countries are collectively responsible for repaying, based on solidarity. Fiscal policy for each country becomes a matter to be decided in Brussel.

Expanding the monetary union into a fiscal union.

This means transfers between countries.

In the same way that there are tranfers within the USA, between states;

in China, between provinces; and in Norway, between "fylker"

BUT : Lack of democratic basis for this.

Would require a time consuming and complicated process

Is there enough solidarity among the 17 countries?

- Will necessary structural changes in Greece take place?

- Two things are required of Greece, in or out of euro:
  - Sufficient political resolve within Greece to reform radically the state and the economy
  - Willingness among other Europeans to foot a sizeable bill for the failures and fraud of past Greek governments

Last year, public deficit was not 3,7 % of GDP, but 13,6 %.

V. GLOBAL ECONOMIC OUTLOOK

Optimism has moved east.
Where is The American Dream? Who is harboring it?

87 % of Chinese – our country is moving in the right direction
45 % in India, 30 % in USA and 26 % in France

New book: *Is France Finished?*

In Shanghai last year, talking to a man in his fifties
What are you most proud of in China”, I asked
”A brighter future”, he replied



USA on a sustained, downward trajectory?
Without realizing it?

Will the US measure up?
McCain three years ago: We need seven more years. Why?
Because it takes three elections to wake up the American people

Advantage USA: Demograhy and Melting Pot
Disadvantage: Polarized society and incapable of acting

USA is down, but not out?
Will remain ”the indispensible nation” for a long time

Europe in the doldrums. What kind of Europe will emerge?

VI. FINANCIAL INNOVATIONS AND FINANCIAL MARKETS

I hear about these wonderful innovations in the financial markets, and they sure as hell need a lot of innovation. I can tell you of two -- credit-default swaps and collateralized debt obligations -- which took us right to the brink of disaster. Were they wonderful innovations that we want to create more of?

You want boards of directors to be informed about all of these innovative new products and to understand them, but I do not know what boards of directors you are talking about. I have been on boards of directors, and the chance that they are going to understand these products that you are dishing out, or that you are going to want to explain it to them, quite frankly, is nil.

I mean: Wake up, gentlemen. I can only say that your response is inadequate. I wish that somebody would give me some shred of neutral evidence about the relationship between financial innovation recently and the growth of the economy, just one shred of information. I am getting a bit wound up here.

Is it really a true reflection of the financial sector that it rose from 2 1/2% of value added according to GNP numbers to 6 1/2% in the last decade all of a sudden? Is that a reflection of all your financial innovation, or is it just a reflection of how much you pay? What about the effect of incentives on all our best young talent, particularly of a numerical kind, in the United States?

I made a wiseacre remark that the most important financial innovation that I have seen the past 20 years is the automatic teller machine. That really helps people and prevents visits to the bank and is a real convenience.

“However, that does not make it right to say that innovation in itself is a bad thing.”

I am not sure that I said innovation in itself is a bad thing. I said that I have found very little evidence that vast amounts of innovation in financial markets in recent years have had a visible effect on the productivity of the economy. Maybe you can show me that I am wrong. All I know is that the economy was rising very nicely in the 1950s and 1960s without all of these innovations. Indeed, it was quite good in the 1980s without credit-default swaps and without securitization and without CDOs.

I do not know if something happened that suddenly made these innovations essential for growth. In fact, we had greater speed of growth and particularly did not put the whole economy at risk of collapse. That is the main concern that I think we all need to have.

I do not want to stop you all from innovating, but do it within a structure that will not put the entire world economy at risk.

From interview with Paul Volcker,
WSJ, 14 December 2009

Trade-off between ROBUSTNESS and OPTIMALITY?

COMPLEXITY generating more costs and less benefits?

COMPLEX system needs SIMPLE RULES?