

State of the World Economy

Warwick J. McKibbin

Director, ANU Research School of Economics

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Overview

- The last decade – global structural change combined with poor macroeconomic policy
- Looking Forward
 - Growth
 - The Euro
 - Fiscal Risks
 - Inflationary Risks
 - Commodity Prices
- Conclusion

The drivers

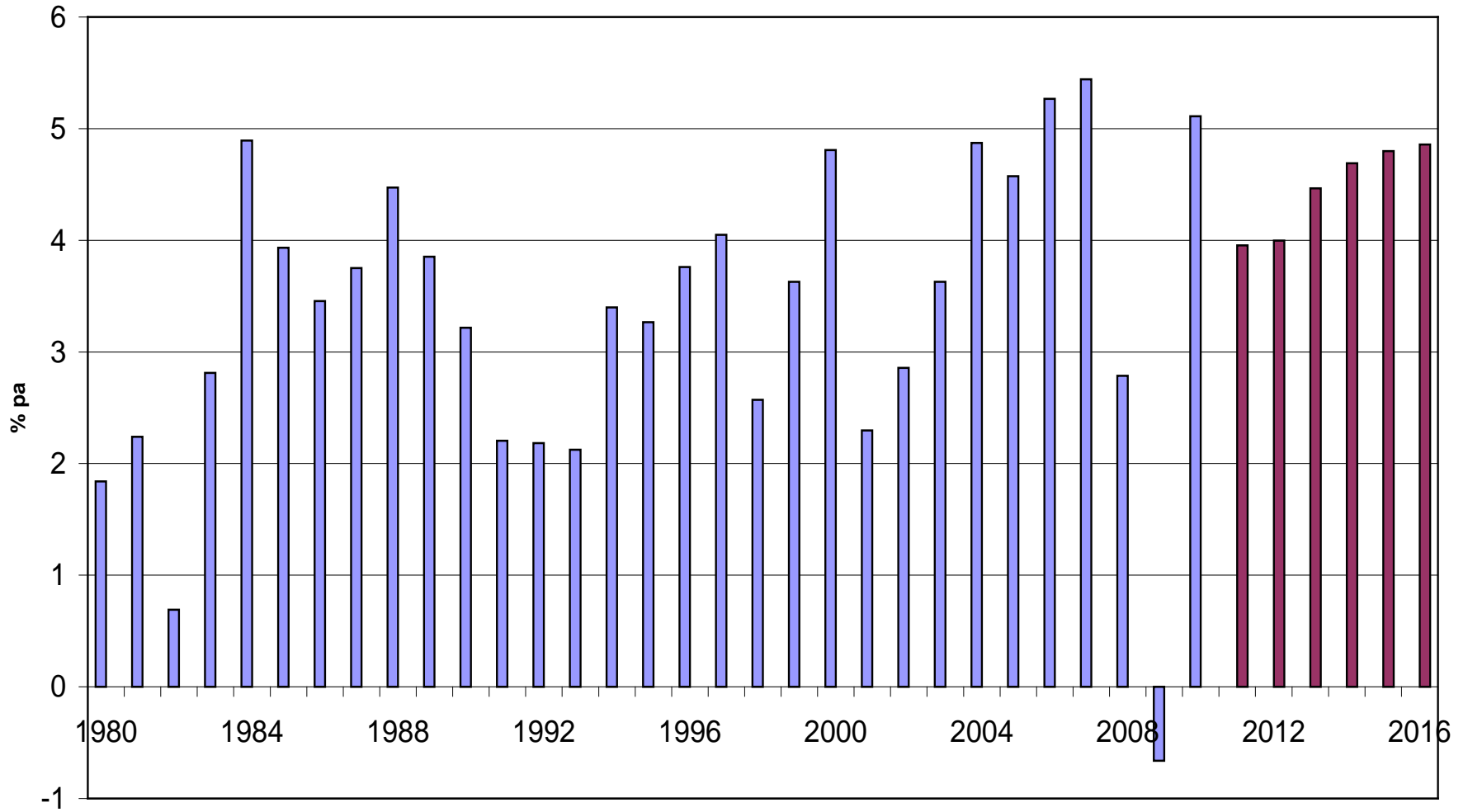
- The world will be dominated by long term trends from
 - The emergence of the BRICS into the global economy
 - Large demographic changes
 - Productivity and technical innovation
 - Impact and response to environmental problems

The 2000's

- Emergence of China and India has caused a large structural shock for western economies
- Countries have made the mistake of not allowing adjustment
- 2001 recession met with loose monetary policy which led to a misallocation of capital
- Crisis in 2008 met with demand management policy when the problem was structural change and capital misallocation

Growth

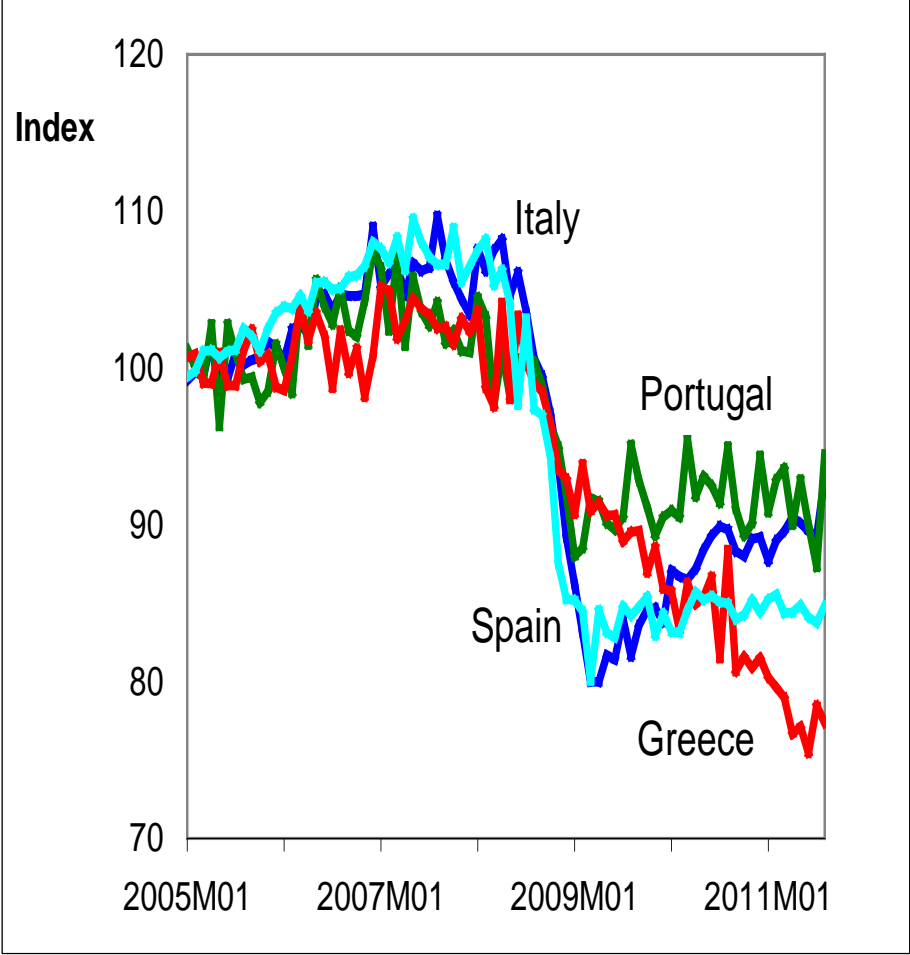
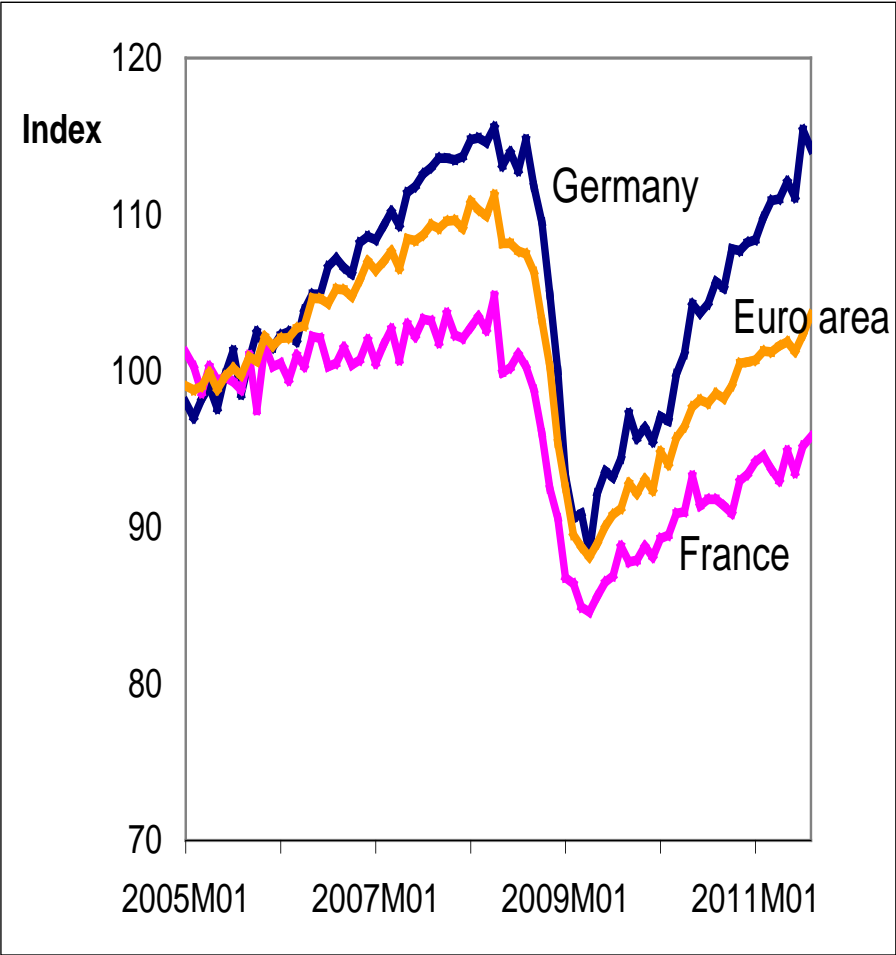
World GDP Growth



Source: IMF World Economic Outlook Sept 2011

Euro Area – Industrial Production

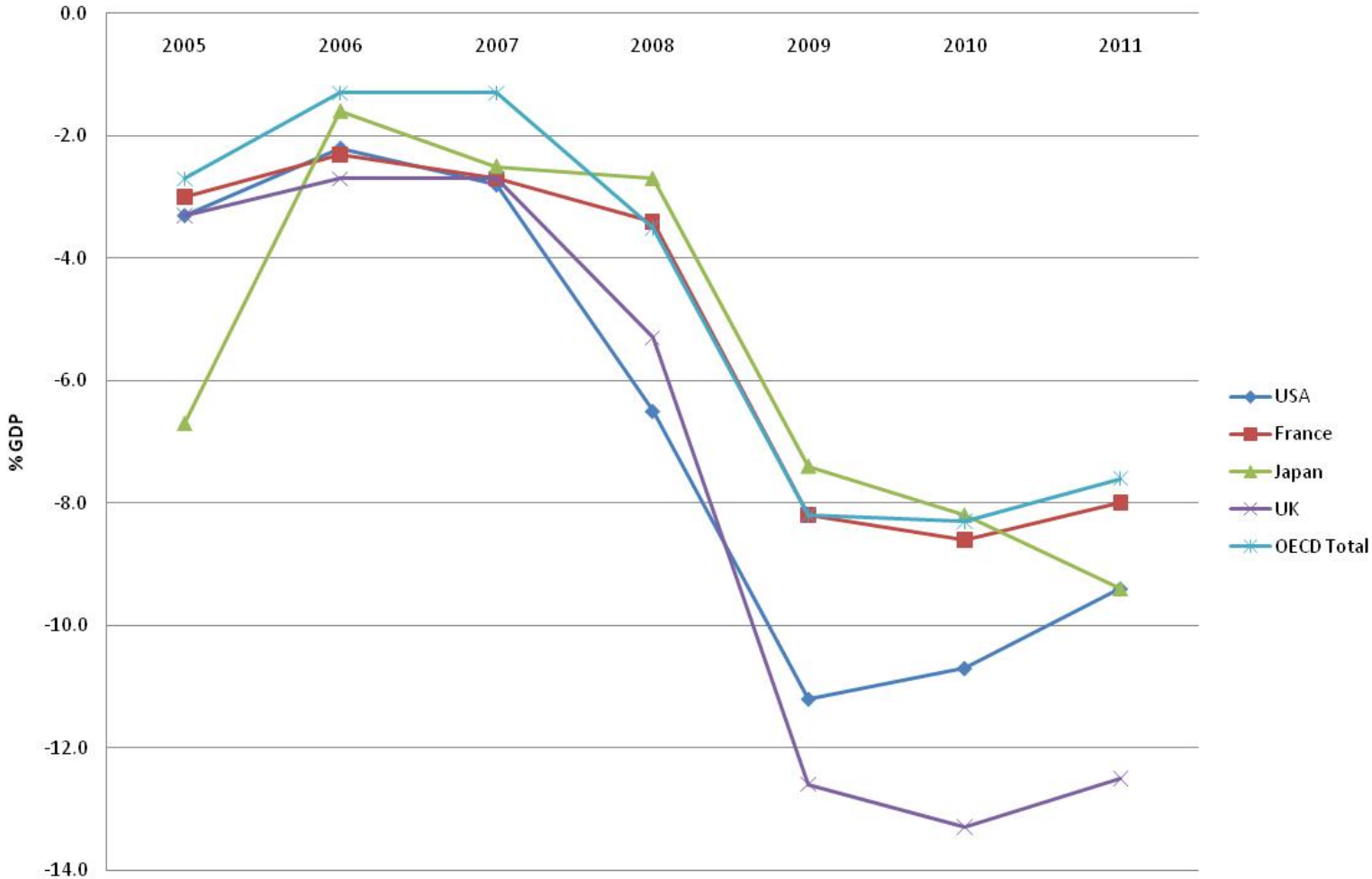
2005 Average = 100



Source: Eurostat

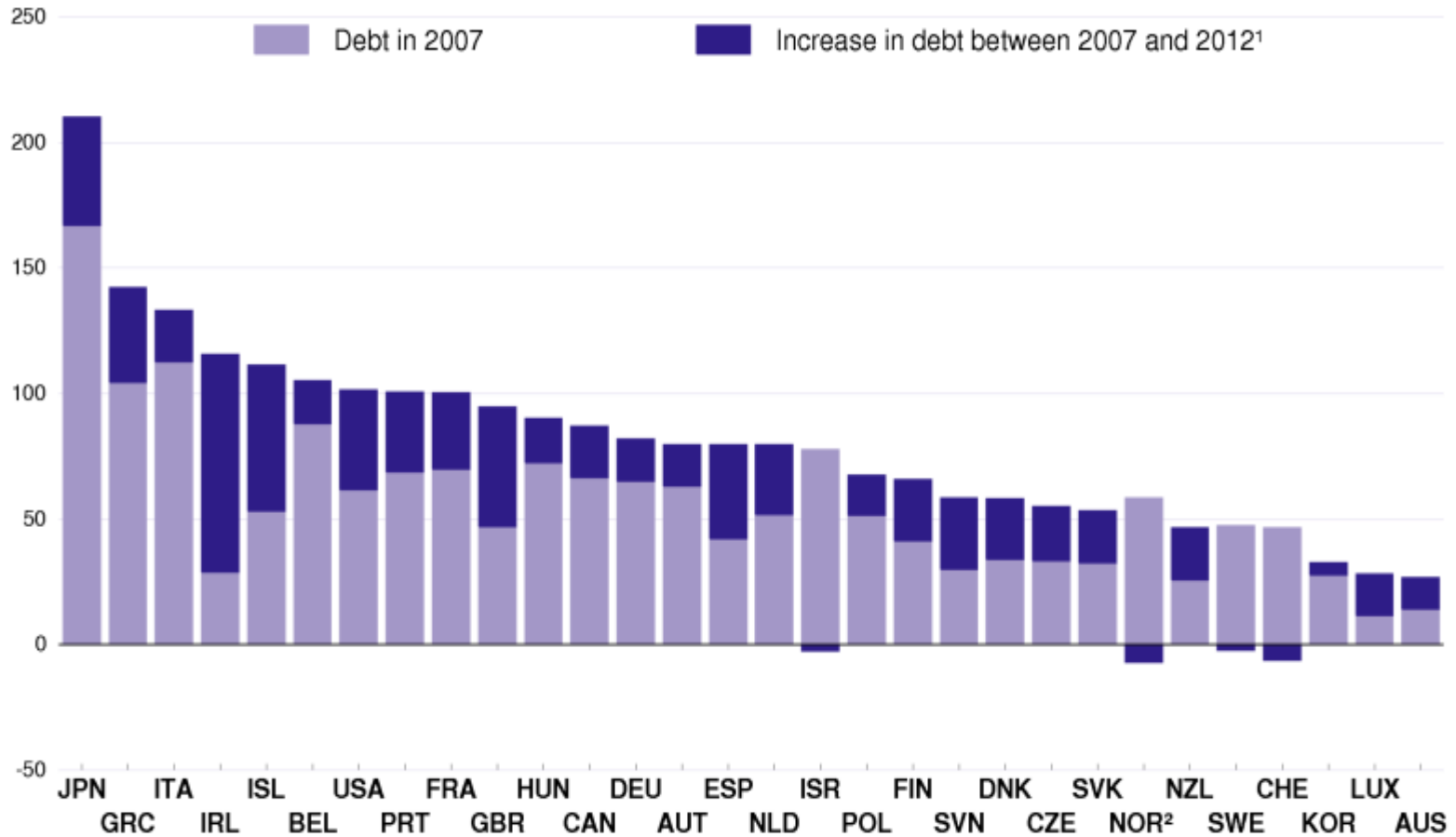
Fiscal Risks

Fiscal Deficits in OECD Economies (%GDP)



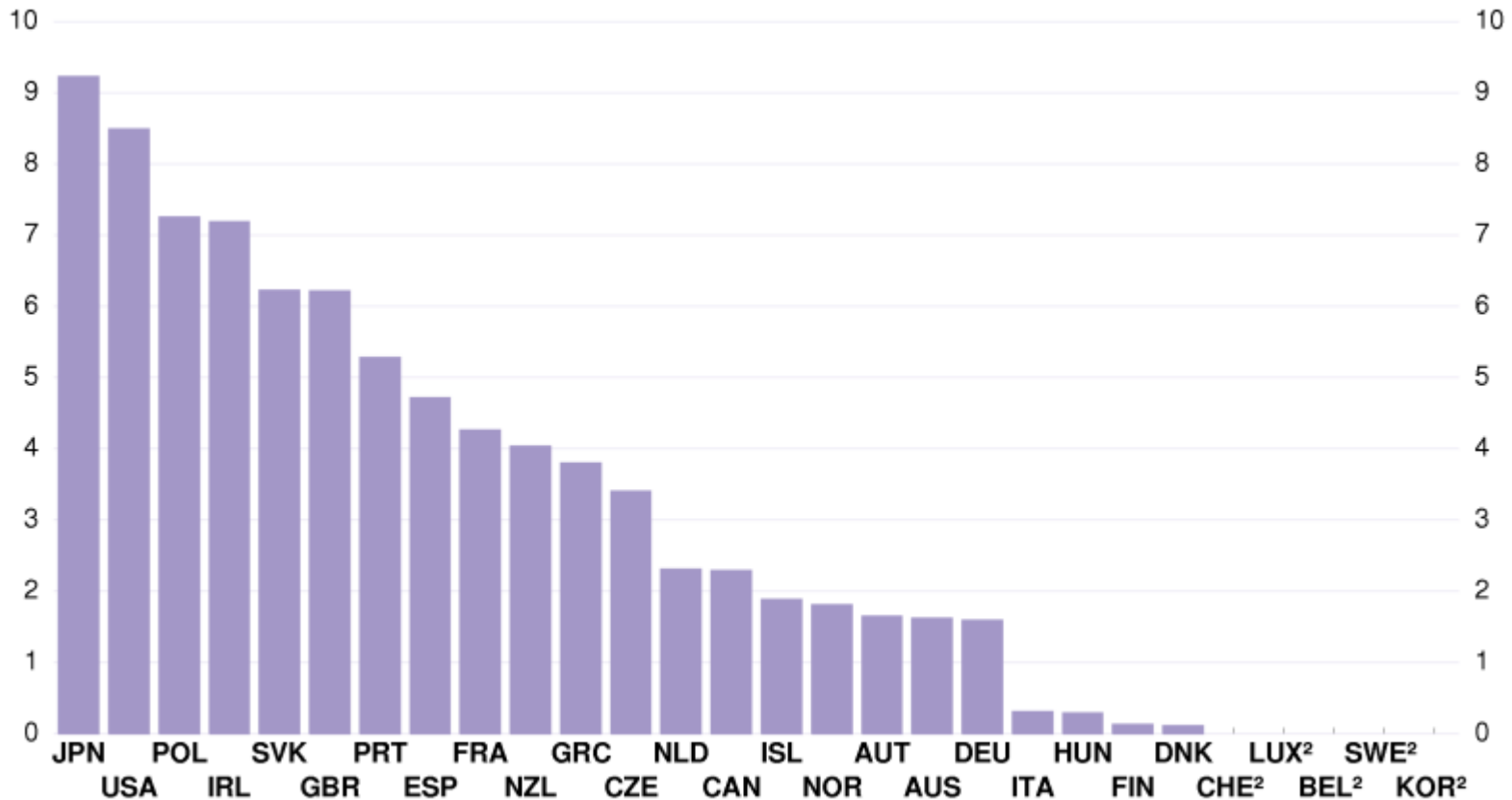
Source OECD Economic Outlook 86 Database (November 2009)

Government Debt to GDP



Source OECD Economic Outlook 88 Database (November 2010)

Required change in underlying primary balance to stabilise debt by 2025 in per cent of potential GDP



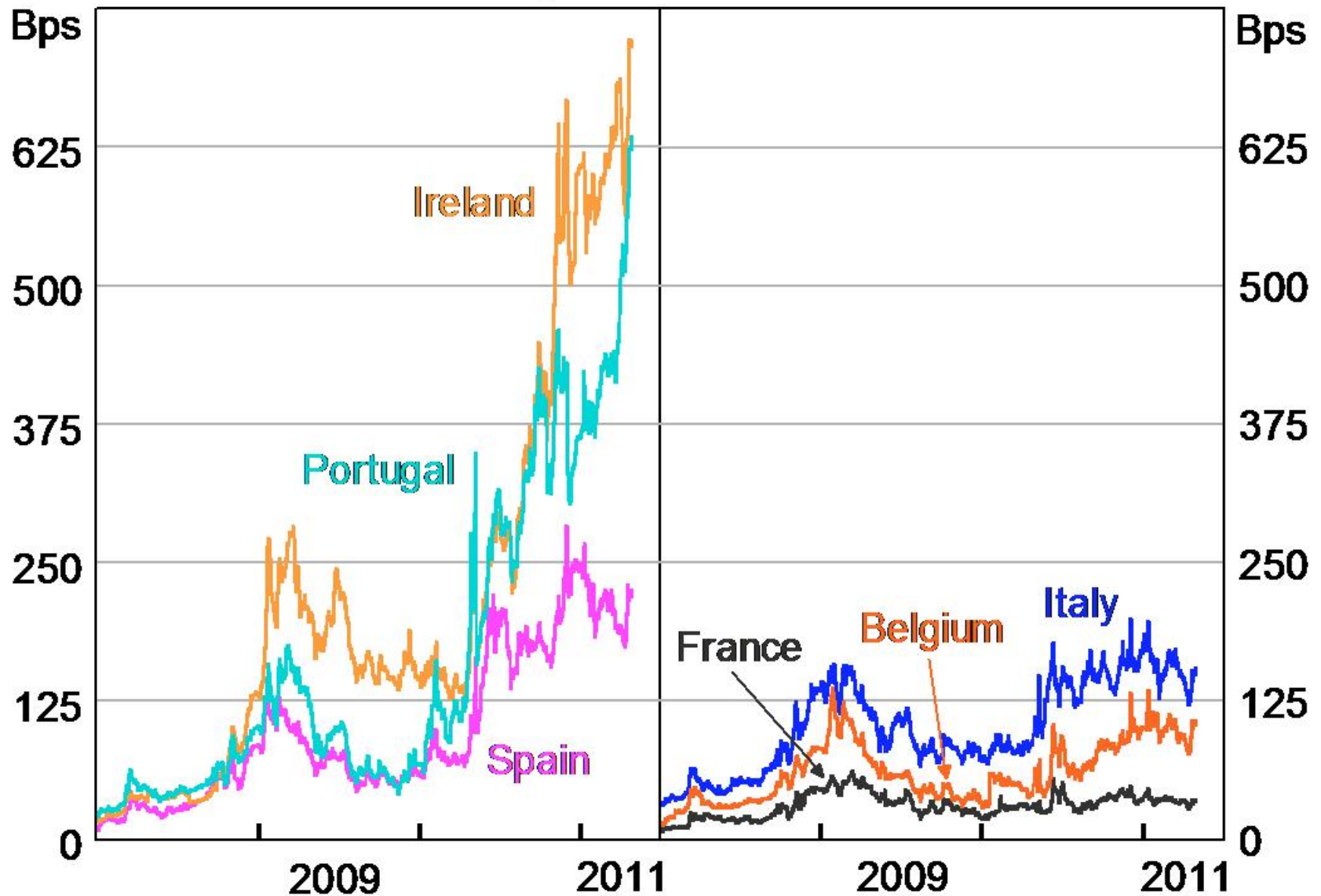
Source OECD Economic Outlook 88 Database (November 2010)

Two problems in Europe

- Exchange rate in southern Europe need to depreciate because of productivity differences
- Fiscal positions unsustainable

The Euro

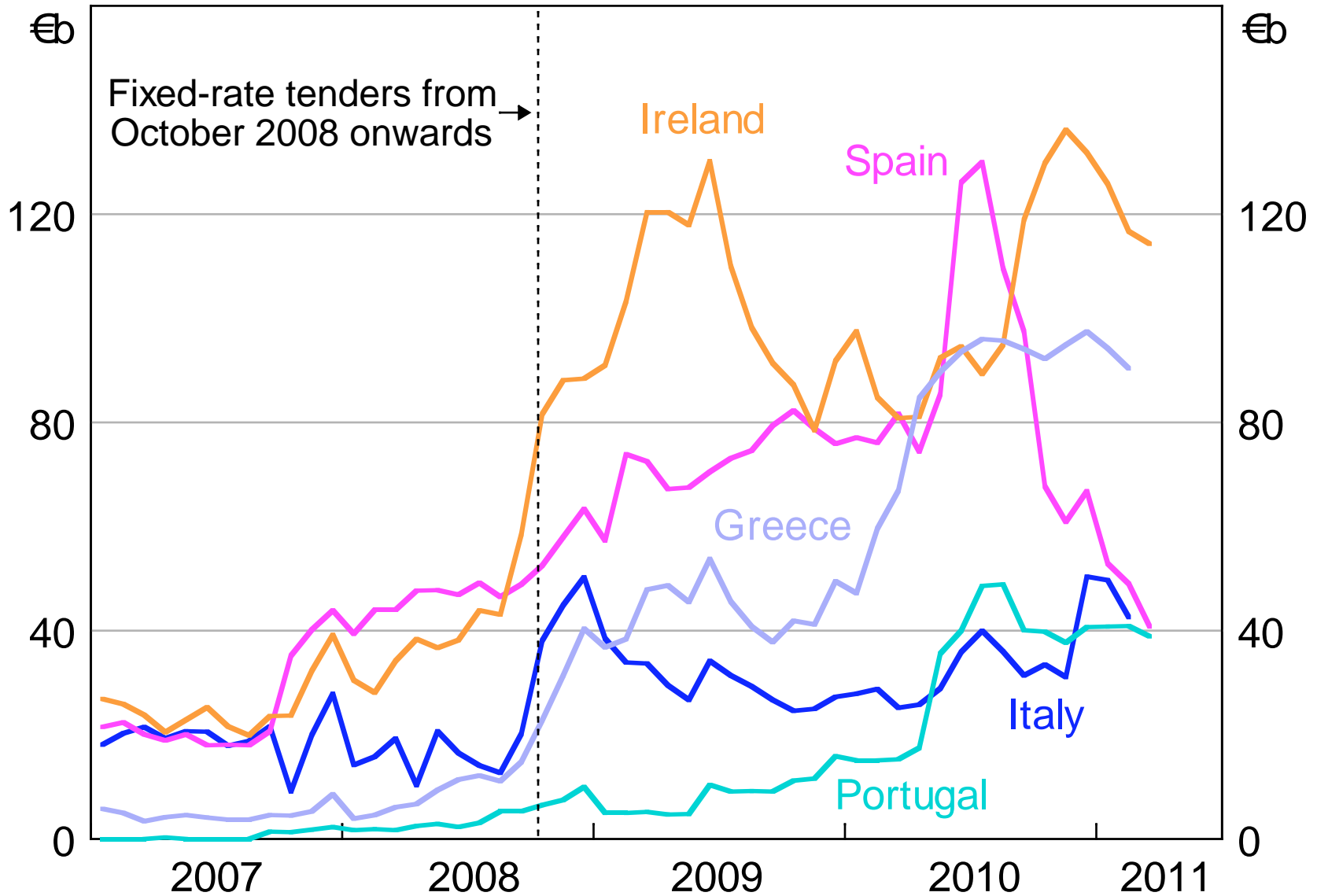
European Government Bond Spreads To 10-year German Bunds



Source: Bloomberg

ECB Lending to Banks*

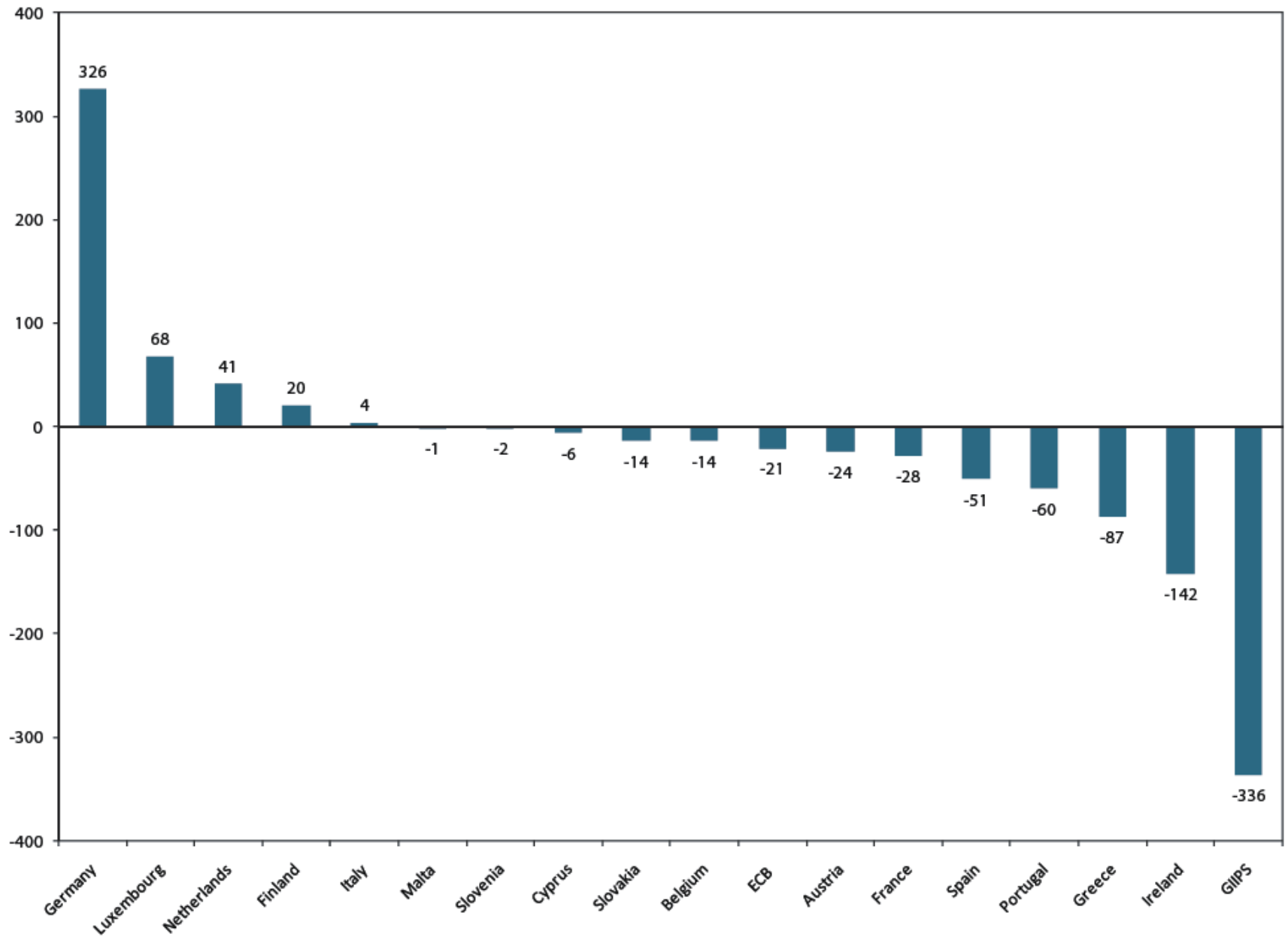
By national central bank



* Lending provided through monetary policy operations only

Source: central banks

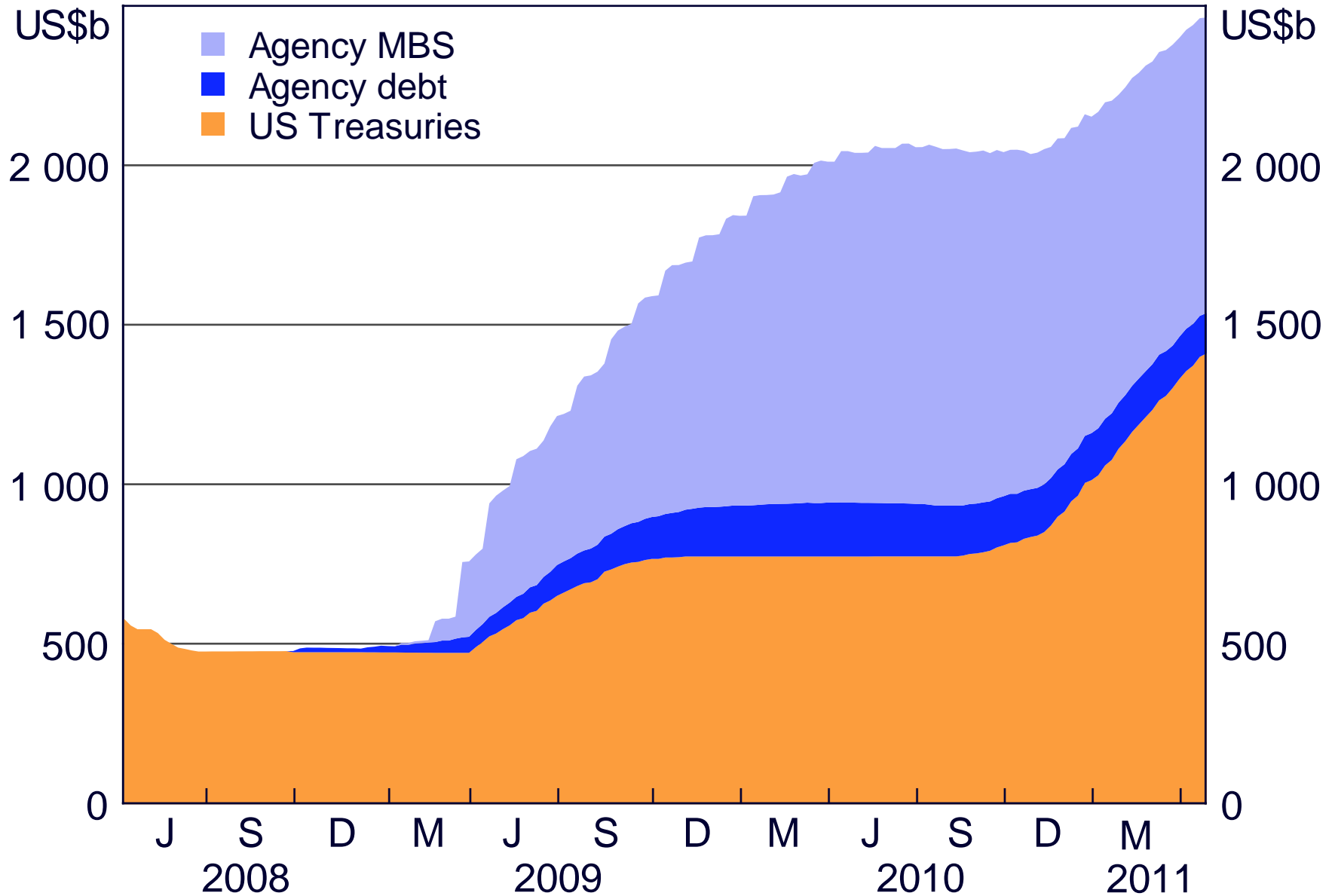
Figure 3 Claims of euro area members from netting of Euro System cross-border payments (in billions of euros)



Inflation Risks

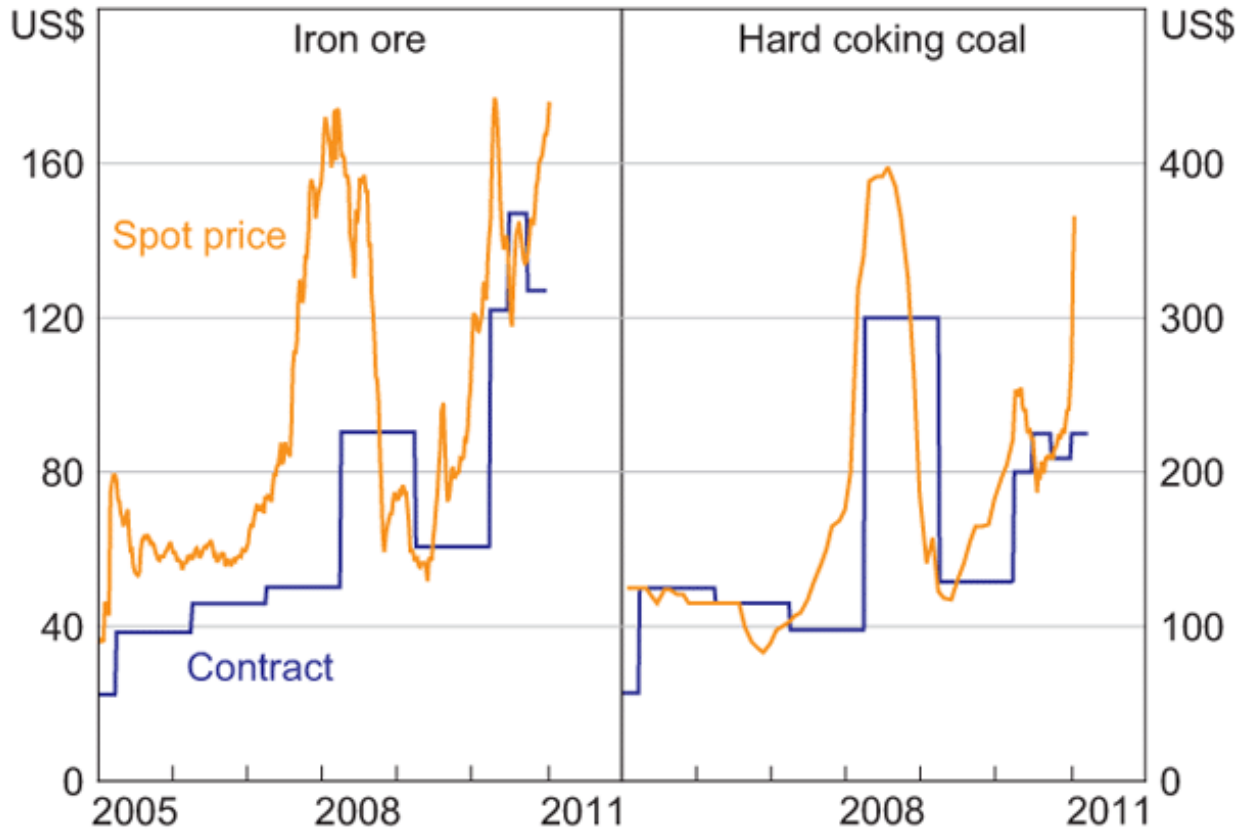
Fed Holdings of Securities

Weekly



Bulk Commodity Prices

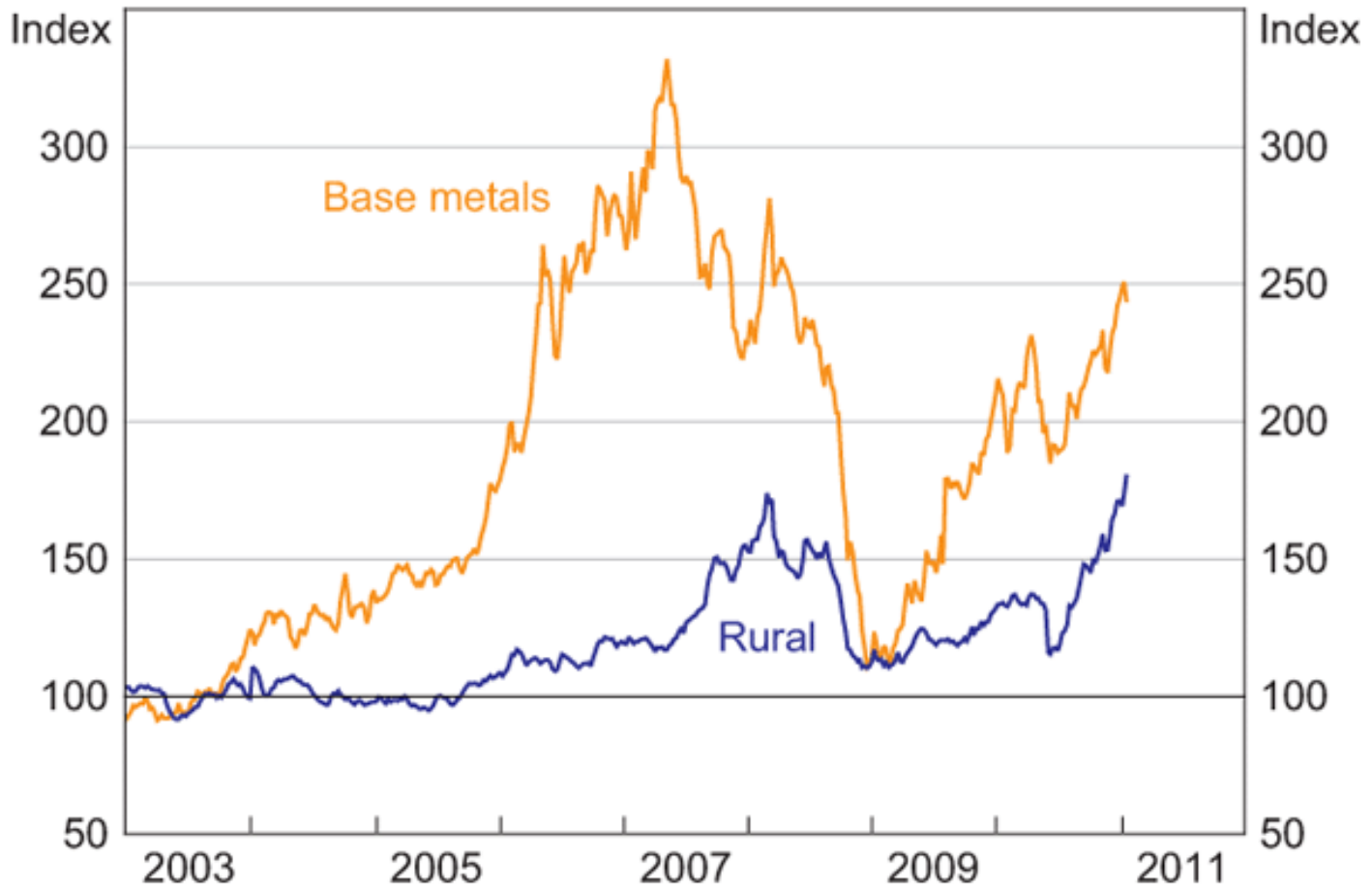
US\$ per tonne, free on board basis



Sources: ABARES; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

Commodity Prices

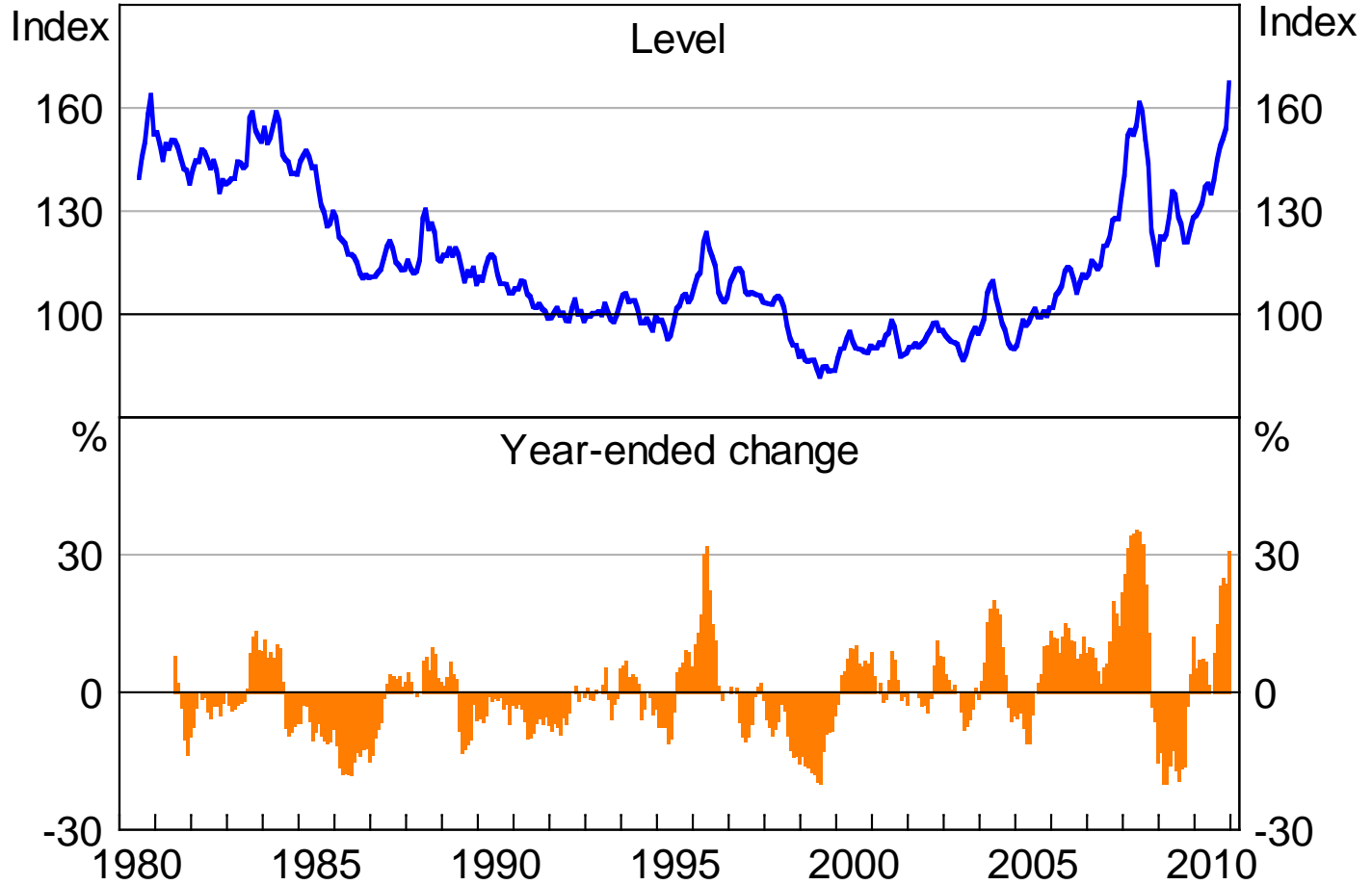
SDR, 2003 average = 100, weekly



Sources: Bloomberg; RBA

IMF Food Price Index

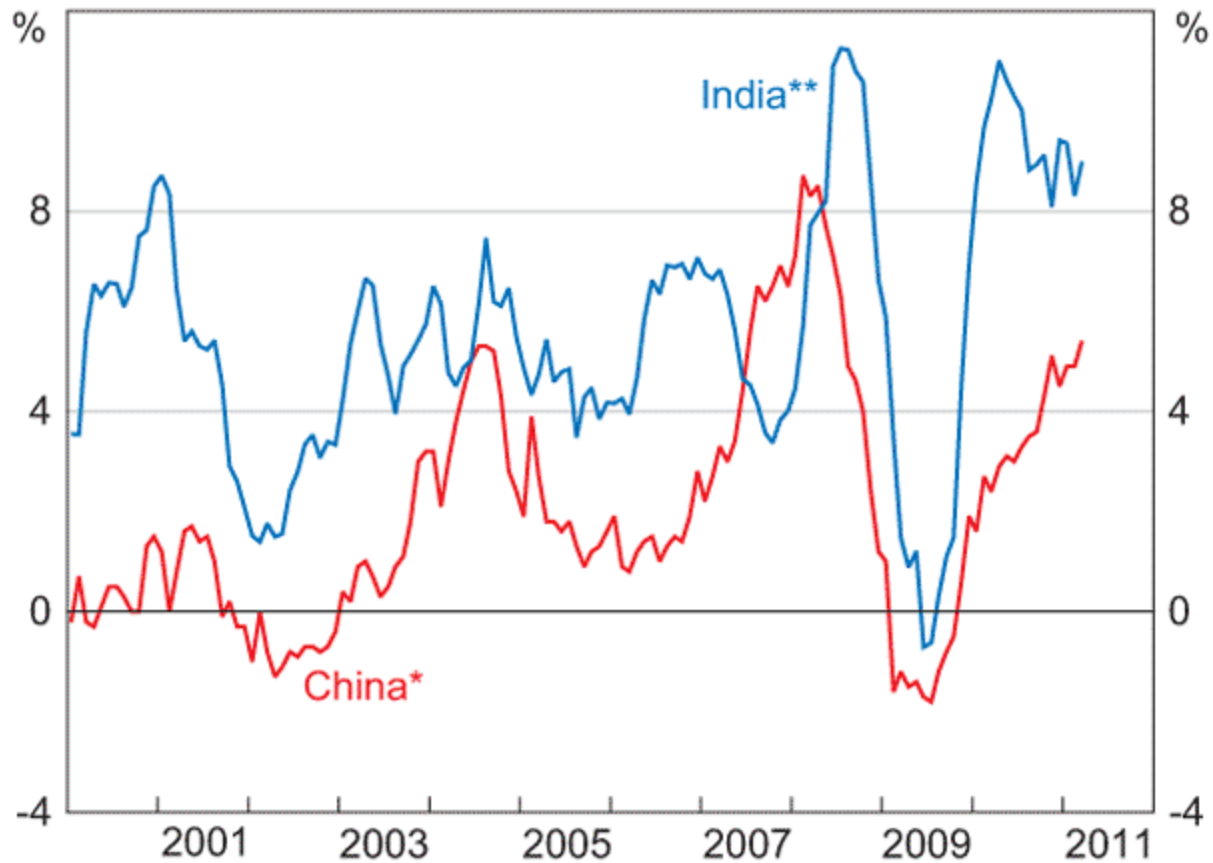
SDR, 1995 = 100



Sources: IMF; RBA

Inflation

Year-ended



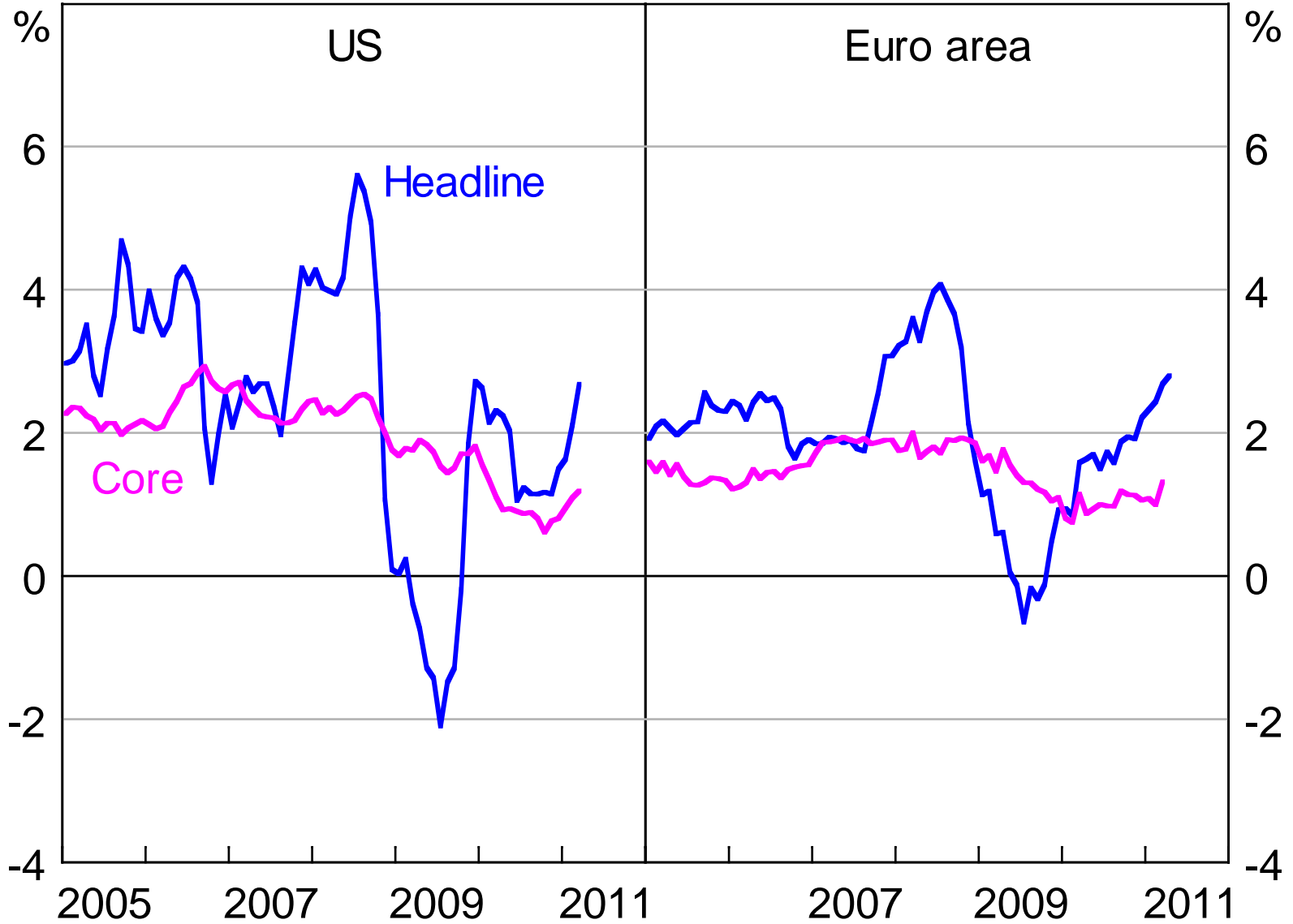
* Consumer price index

** Wholesale price index

Sources: CEIC; RBA

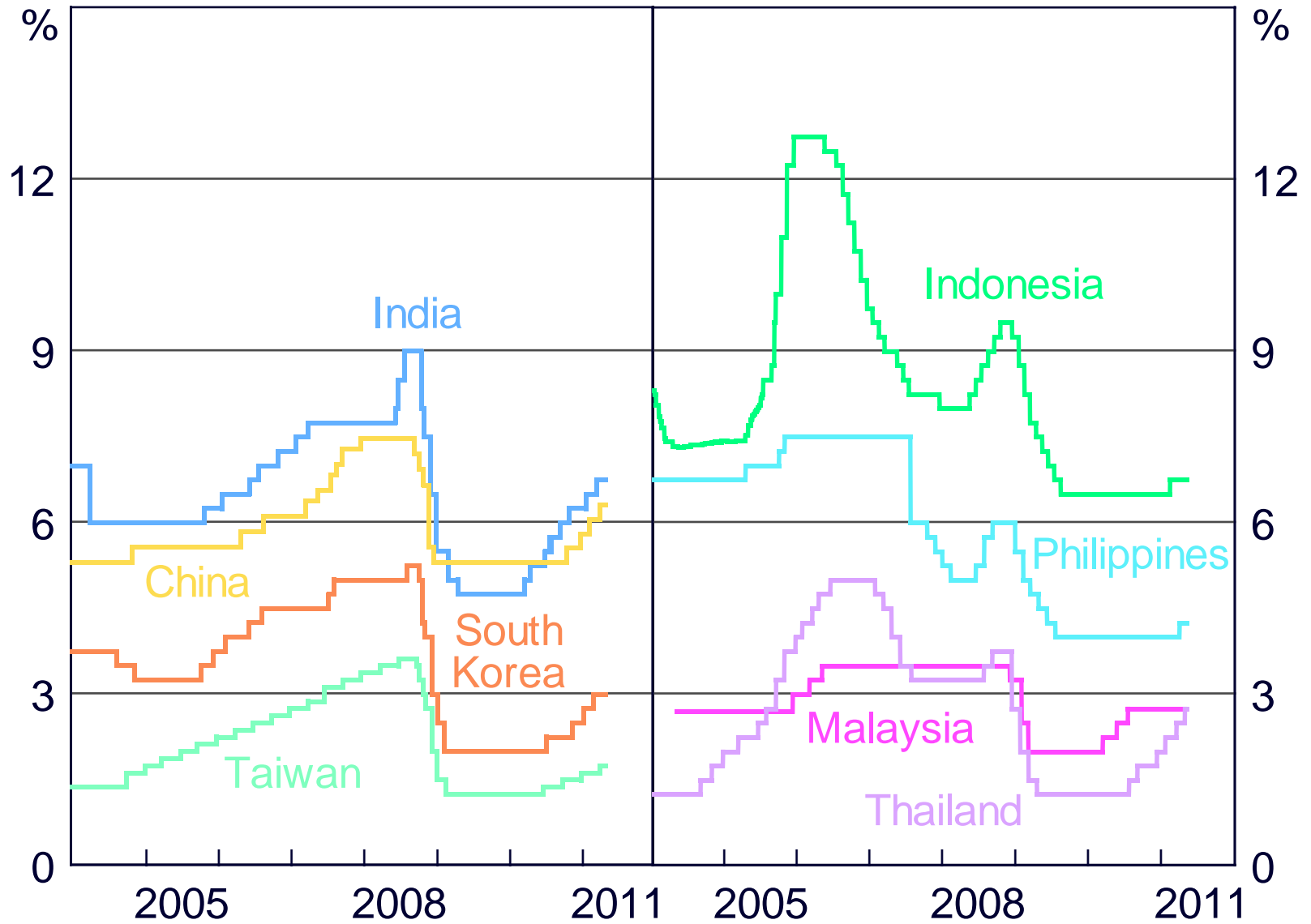
Consumer Price Inflation

Year-ended



Source: Thomson Reuters

Asia – Policy Interest Rates



Commodity Prices

Commodity prices

- Rising because of
 - Real growth in emerging economies (Chindia)
 - Loose monetary policies raising nominal demand
- The relative price of commodities likely to fall if
 - global supply responds
 - Growth in China falls
 - Non-commodity prices rise due to inflation

Conclusion

- The Emergence of China and India into the global economy is a major structural transformation
- US and Europe have not adjusted well but have tried to use demand policy to handle the shock

Conclusion

- Difficult but important to distinguish between relative price changes and overall inflation – the 1970s is an important lesson
- For commodity exporters the terms of trade increase is likely to reverse but the overall income gains will be positive as China becomes wealthier

Final thought

- Probability of a Euro crash is very very high