The International Economy in 2011

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The middle of 2011 marked two years since the start of the current recovery. The dominant fact about this recovery is that it has been led by the emerging markets rather than by the "advanced countries", most of which have remained at best with excess supply, a positive output gap and a slow rate of growth and at worst are dominated by continuing crisis. Indeed, most developing countries and not just those usually now referred to as "emerging markets" (those developing countries that have achieved regular access to the international capital market) have been growing faster than the advanced (or developed) countries during the present upswing. There are those of us who believe that this is the start of a historical trend that is likely to persist unless and until the world is consumed by the threat of climate change.

Growth in 2011

The advanced countries may be classified into North America, Western Europe, Japan, and the remainder. The remainder consist of Australia and New Zealand and several East Asian countries—the former New Industrial Economies—that have recently been promoted to the rank of advanced countries by the IMF (Korea, Hong Kong, and Singapore, and presumably they would have promoted Taiwan too if it were a member of the IMF). These, apart from Sweden and maybe Canada and Germany, are the only advanced countries that have been prospering and achieved reasonably full employment in the wake of the crisis. They in fact have been behaving more similarly to the emerging markets than to other advanced countries.

North America, specifically the United States, has been accustomed to leading the business cycle, and therefore it was a shock to discover that in this instance they were no longer the leading country and the world was capable of growing without their leading the recovery. andAt the start of the year the omens were for continued, if gentle, growth. The outlook worsened, and growth slowed, in the third quarter, a development that has usually been attributed to a political dogfight about raising the debt limit and the subsequent downgrading of the United States' credit rating by S&P. Growth picked up again towards the end of the year, and current prognostications are similar to those a year ago. The main threats are seen as continued increases in the price of gas (petrol) in the short run and continued fiscal deficits in the long run. The realized growth rate for the full year was 1.7% (almost all figures are taken from the current WEO database, though for historical data there were also figures from IFS). The fact of a gentle continuing recovery has been insufficient to reduce greatly the unemployment rate, which remains 8.1% as of April 2012. Similarly, the housing market remains depressed.

Canada has been growing somewhat faster than the United States for most of the period, a development usually attributed to the fact that they had not got around to abandoning regulation of the banking system in the same measure as the United States and therefore did not have to purge as many bad loans. This is surely reinforced by the fact that they entered the recession in a stronger macroeconomic position (lower budget deficit, low inflation, and less debt) as a result of relatively austere macroeconomic policies during the boom years.

The major fact about Europe is the continuing crisis in the euro area, and the resulting slow growth and threat of recession. This Yearbook contains a separate chapter about the European Sovereign Debt Crisis, and consequently it would be double-counting to repeat that analysis here. Suffice it to say that the European "core," dominated by Germany (with 3% growth), has grown at a relatively healthy rate, but that the "periphery" (of mainly southern European countries) has suffered a recession. Overall the euro area avoided a statistical recession in 2011 (realized growth was 1.4%).

However, European countries classified as advanced contain other countries besides the euro area, of which the three largest are Britain, Sweden, and Switzerland. Despite the strong depreciation of sterling, British growth has been held back by the effort to curb the deficit, and growth has been even slower than that of the euro area (a mere 0.7%). In contrast, Sweden followed prudent policies and built a very strong banking system after emerging from its crisis of 20 years ago, and it reaped the fruit in its strong growth since the recent crisis (4% last year). The Swiss franc appreciated strongly during the year, but even so Switzerland had reasonably healthy growth (1.9%).

Japan has suffered from low growth during most of the past 20 years, and just as growth began to look stronger in the mid-2000s it was hit by the world financial crisis and the induced recession. Because of its past weak growth and the belated attempts to use fiscal policy to escape from recession, it has the world's highest ratio of gross debt/GDP, now over 200%. Last year it had in addition a 9.0 earthquake, the induced tsunami, and the resulting nuclear disaster. This distorted the timing of recovery, with a strong negative impact on growth in the short run but the possibility of recovery subsequently. The recovery so far has disappointed, with overall negative growth last year (-0.7%). The balance of payments anyway was weakening as a result of the appreciation of the yen, but in addition Japan's imports of fossil fuels have increased greatly as a consequence of the elimination of the nuclear power which formerly supplied a third of the demand for electricity.

While most OECD countries remain with a significant output gap and have barely caught up with the output level of 2007 (average growth since 2007 is 0.9%), most developing countries and emerging markets suffered only a short-run shock from the crisis. On average, their income level was 23% higher than in 2007 by the end of last year. There are of course a few developing countries (mostly small) that had performed worse over the period 2007-11 than most developed countries, but they are outweighed by the likes of China.

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East Asia, dominated by China, remains the world's most dynamic and fastest-growing region. In China most of the increased investment ordered by the government to counter the recession was being phased out, but the natural growth of the economy outweighed both this and continued contraction of the external surplus to yield a growth of GDP of 9.2%. Policy was centered on combating inflation rather than trying to boost demand. The other large country of the region, Indonesia, grew by 6.5%. Most of the smaller countries, except Thailand which was ravaged by the worst floods in the postwar period, grew strongly.

South Asia, more dominated quantitatively by India than East Asia is by China, continued to belie its past reputation as a stagnant backwater. India itself grew at 7.2%; while this disappointed many Indians, it looks fairly impressive from a global standpoint. Bangladesh was not far behind with growth of 6.1%. Sri Lanka expanded its GDP strongly (8.2%) after the end of the civil war, and Nepal may also have benefited from the ending of a war, though growth was only 3.5%. Pakistani growth remained disappointing.

What were formerly called the "economies in transition"—Russia and the developing economies of East and Central Europe, plus Central Asia—enjoyed a fairly normal year. After their strong adjustment efforts in the previous year, East and Central Europe avoided entering into crisis despite their big debts, and were passive onlookers at the travails of Southern Europe. Growth in East and Central Europe and the CIS averaged just over 5%.

The Middle East was more preoccupied with liberating itself from dictators, and/or with wars, than with maximizing GDP growth. On the basis of continued high oil prices, however, the GDP of the area expanded by 3.5%. Unemployment remained problematic.

Africa grew by 5.2% in 2011. This is in line with the recent trend, which has seen Africa staging an impressive recovery from the long period of near-stagnant GDP per head. While some African countries are certainly the beneficiaries of oil developments, the revival is far more general than can be explained in this way.

Latin America grew at some 4.5% on average, which is close to most estimates of the trend. Press reports continue to speak of "miraculous" growth in Brazil, though in fact it came in during 2011 as 2.7%, which is actually rather unimpressive (and below even non-official estimates of potential). Last year there were no systematic differences in growth rates between Latin American countries depending on whether or not they benefit from strong commodity exports to China, or on the ideological orientation of their government. The fastest-growing countries were Panama and, if one believes the statistics they report to the IMF, Argentina.

Crisis-induced Losses

There is no doubt that crises are expensive. Many financial assets are worth less and output falls. Is it possible to make a sensible evaluation of the costs?

Many of the most obvious costs are recouped as recovery from the crisis proceeds. At one stage one read in the press comparisons between the estimated value of a class of assets (such as housing or equities) immediately before the crisis and at a certain subsequent date. These figures were enormous, many trillions of dollars. But such comparisons implicitly assume that there was no bubble-inflation of values prior to the crisis, and that the subsequent fall in values will prove permanent. Both assumptions are patently absurd, and the latter implies that the costs attributed to the same crisis vary from one day to the next; in particular, that the costs fall as the recovery in asset prices proceeds. Similarly, much attention was focused on the amount of money that the government put into fighting the crisis (say, the cost of the TARP program in the United States). This too was a wrong measure; as recovery has proceeded and the government has sold off many of the distressed assets that it bought, so the cost of the program has fallen.

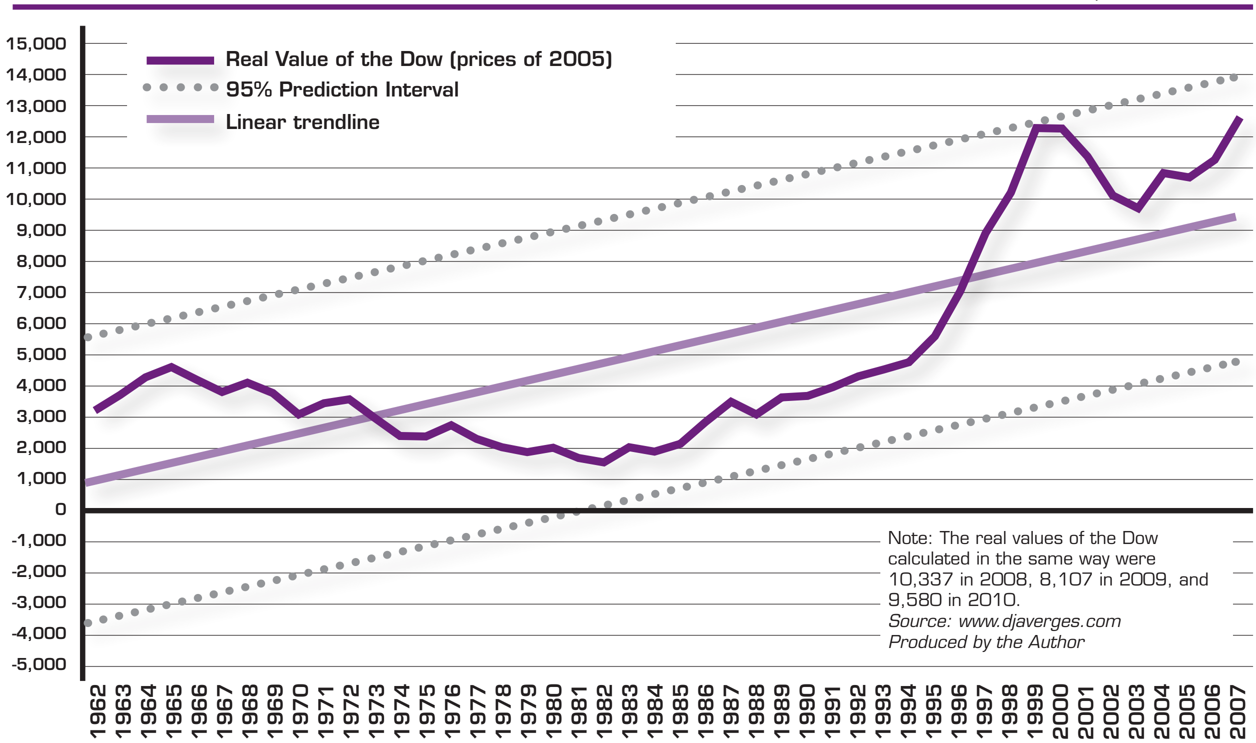
The correct measure of the costs of a fall in asset prices would be the difference between the trend measure of asset prices before and after the crisis, allowing for the trend increase that occurred during the crisis years. This is a figure that no one has attempted to calculate. It is easy to understand why. For example, I tried a calculation of the loss of stock market wealth in the United States. I assumed that the Dow-Jones industrial average was a correct measure of the price of stocks in general. I calculated the value of the Dow in a given year as the average of the closing prices on the first trading day of each month. I deflated the resulting figure by the US GDP deflator to get the real value of the Dow in a given year (based on the year 2005 = 100). Statistics were readily available from 1962 onwards, so I assumed that the period 1962-2007 gave me the desired trend measure of the value of the Dow before the crisis. Figure 1 illustrates the result of this exercise, including the 95% prediction limits. All the subsequent values lie well within the prediction intervals, i.e. there is no scientific basis for estimating how much wealth was reduced by the crisis. Even at the peak prior to the crisis, and in the depth following it, and assuming that a daily rate can be compared to the annual rates shown in the diagram, one does not move outside the prediction intervals. Swings in the Dow, and in this it is representative of stock prices, have historically been large.

Fortunately there is a far better basis for estimating the cost of a crisis in terms of lost production. For most economies one knows, or can estimate, the rate of growth of productive potential (the supply-side rate of growth). One decides some period at or close to the start of the crisis when the economy appeared in reasonable balance, suffering neither excess demand nor supply. From then on one cumulates the shortfall of actual recorded growth in GDP from the benchmark provided by the growth of potential output. For example, in the case of the United States one might take the growth of productive potential to have been 3% per year up to the crisis.[1] It is usually reckoned to have fallen somewhat since, so one might assume that from 2008 on it grew at 2.5 percent per annum. (This is in line with most commentators.) Taking the US as at full capacity in 2007 (which implies an element of excess demand in 2006), the cost of the crisis up to the end of 2011 was 29.1% of a year's GDP.[2] Similar exercises for the other industrial countries yield similar high estimates of the cost of the recession.

Inflation

It has become common to dismiss concerns with inflation as a case of worrying about yesterday's problem. In fact, the current World Economic Outlook database shows that last year six of the seven major advanced economies (the exception was Japan) had consumer price inflation above what appears to be developing as the international norm of 2% per annum. This year only the two EU economies (France and Germany) are forecast to decline below the 2% threshold. Britain, which a decade ago appeared to have licked the inflation problem, is now in its fourth year of having inflation above its target zone. In

FIGURE I. REAL VALUE OF THE DOW,
1962-2007 (prices of 2005)



the emerging and developing economies, there were no countries reporting triple-digit inflation and very few reporting double-digit, but an awful lot in the range of 5% to 8%. Maybe it is worth keeping an eye on inflation, and continuing to think about ways (such as more competitive labor and product markets?) in which inflation could be reduced.

Trade

Trade (measured by the IMF as the growth in the value of exports) expanded briskly in 2011, by 18.1%.[3] It reached a new peak, greater than in 2008 (the previous peak). The 18.1% was composed of a faster rate of growth by developing countries (24.6%) than by the advanced countries (15.7%). This was only slightly less rapid than in 2010, when world exports grew by 21.8%, and the exports of the emerging and developing countries grew a full 10 percentage points higher than those of the advanced countries. The rapid growth of the past two years is presumably largely explained as trade catching up with the value it would have reached but for the recession. Indeed, rough extrapolation of the pre-recession rate of growth of trade suggests that it has not yet caught up with the value that could have been expected in the absence of the Great Recession.

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This is relevant information for assessing the hope of avoiding increased protectionism in the wake of the financial crisis. Immediately after the crisis there was a call for countries to avoid resorting to protectionism (reminiscent of the calls in the wake of the first oil crisis). Since there was no overt and blatant resort to protectionism, there was a fair degree of satisfaction in financial circles at the success of the calls and the difference in outcome to the 1930s, when most countries resorted to protectionist policies in the hope of passing on part of the decline in output to their trading partners. It had long been recognized that this policy was collectively self-defeating, and a part of the mission of the international organizations created at the end of the war was that of preventing a similar orgy of destructive policies. Hence the initial reaction to the resumption of vigorous trade growth was a tendency to congratulate policy-makers for having learnt from the mistakes of their predecessors. But the finding that over two years into the recovery trade has still not caught up with where it would have been in the absence of the Great Recession compels one to reconsider whether the self-congratulation was premature.

The Global Trade Alert has recorded hundreds of cases of overt and covert protection since the onset of the Great Recession, most of them by countries that belong to the G-20. Particularly disturbing is the fact that new cases were erupting as frequently in the 4th quarter of 2011 as in earlier quarters. New local content requirements are particularly widespread, often in association with green energy and fiscal stimulus programs. Most episodes of the new protection are designed to escape the letter of WTO rules, aiming to "beggar my neighbour" quietly. Also discouraging is the breakdown of negotiations to conclude the Doha Development Round in December 2011, and populist calls in the recent European elections to stiffen borders both against foreign goods and foreign immigrants.

Current Account Imbalances

Most of the countries with large current-account payment imbalances as a proportion of GDP last year were either fuel producers and exporters (all except Qatar of oil) or were small. China registered a surplus of2.8% of GDP and the United States a deficit of 3.1% of GDP. Because the size of the Chinese surplus came in well below the IMF predictions in past years, the IMF decided to convene a working group charged to consider whether it was over-forecasting future Chinese surpluses (see Ahuja et al 2012). The new World Economic Outlook reflects the deliberations of this Group and forecasts a considerably smaller Chinese surplus in the out-years. As a direct result of this revision, the forecasts of "fundamental equilibrium exchange rates" with which I am associated show exchange rates far closer to equilibrium than they have done in previous exercises (Cline and Williamson 2012). China is estimated as only 3.6% undervalued and the United States as only 3.2% overvalued. Large imbalances persist in a number of smaller economies, including Australia, New Zealand, South Africa, and Turkey on the deficit side and Hong Kong, Malaysia, Singapore, Sweden, Switzerland, and Taiwan on the surplus side.

There is of course a second serious imbalance in the world economy today, involving Germany and the Netherlands on the surplus side and the countries of Southern Europe on the deficit side, while the euro area as a whole remains in reasonable balance. This imbalance is discussed in the separate article on the European crisis.

Development

The once-popular notion that development has been a colossal failure and development aid simply pouring money down a rat-hole now looks dated. In an era when emerging markets led the recovery and almost all exhibit symptoms of financial success (like ratios of sovereign debt to GDP and ratings by the credit agencies) that can only make the old industrial countries envious, it is not plausible to contend that only Western countries plus a handful of special cases are capable of developing. Countries that have come close to catching up with the technological frontier in the postwar period include Southern Europe, Israel, Finland, Japan, the new industrial economies of East Asia (Hong Kong, Korea, Singapore, and Taiwan), and the sheikhdoms of the Persian Gulf. China, India, Indonesia, most of the rest of S.E. Asia, much of Latin America, and parts of South Asia are heading in the same direction. There are still some countries that are dependent on aid and have not yet taken off, but even Africa (for long the favorite example of the pessimists) is now regarded as the next frontier rather than a hopeless case.

What accounts for this change in outlook? Primarily, the performance of what used to be known as developing countries. Nowadays it is customary to refer to those that have achieved regular access to the international capital market as emerging markets, and the group as a whole is referred to as "emerging and developing economies". This group now accounts for over 36% of world output when GDPs are added weighting by PPPs. The same is true for manufacturing: whereas in the early postwar years this was dominated by the industrial countries, today almost a half of all manufacturing takes part in developing countries (even though several of the recently successful countries have been reclassified). While there is still a clear tendency for the advanced countries to manufacture more complex and advanced products, it is increasingly the case that more complex products are being exported by developing countries. It is no longer taken for granted that the research and development of a multinational company will be concentrated exclusively in advanced countries.

This performance has been aided by technological developments and a generalization of good education. Two technological developments stand out. First, the great advances in transportation and communications have enabled many products to be produced anywhere in the world, with much more emphasis therefore devoted in determining the locale of production to the quality and cost of local labor. Second, the widespread availability of air conditioning has essentially eliminated one advantage of temperate over tropical countries. The generalization of good education is the most convincing reason for expecting the future to be different to the past.

The era of the "Great Divergence" in living standards is over. The future will be marked increasingly by the rest catching up with the West. The troubling aspect of current developments is the great increase in inequality within most countries, and no longer what historically has been the major cause of increasing world income inequality, which was growing inequality between countries. It is generally agreed that this growth in intra-national inequality has two causes, technology and international trade, with most economists placing most of the weight (maybe 80-20) on technology. I differ from this judgment only in suspecting that there is a large overlap, in which both technology and international trade are implicated, which amounts to maybe 20% as well. That is, I suspect that many of the jobs that are shifted overseas from the advanced countries would not have been movable in the absence of technological innovations.

International Governance

The G20 summit, held in Cannes in 2011, has remained the principal meeting place of the major world leaders. It first met at summit level, as opposed to the finance ministers and central bank governors who had been meeting since 1999, in Washington during the most acute phase of the financial crisis, in Nov 2008. It is this group that has taken over from the G7/G8 as directorate of the world economy.

It was announced in Cannes that in future the G20 summits will continue the 2011 practice of meeting just once per year (previously they had met twice-yearly). The G8 has also continued to meet at summit level, and in 2011 met in Chicago, but the G20 is now recognized to be the dominant meeting. The 19 national members of the G20 are the G8 (US, Canada, Japan, Germany, France, Italy, the UK, and Russia), China, Korea, Indonesia, Australia, India, Saudi Arabia, Turkey, South Africa, Brazil, Argentina, and Mexico, plus the EU. It thus represents the expansion of the G8 by the addition of Australia and the EU plus 10 developing economies.

After preliminaries in which France spoke of using the Cannes summit as a forum for convening a new Bretton Woods conference, the outcome was a disappointment. The conference ended with the customary bromides about how the members were all committing themselves to an Action Plan for Growth and Jobs, but there was no indication that any substantial modification of existing international policies had been proposed, far less agreed on.

The existing international organizations continued to function without major changes. The Managing Director of the International Monetary Fund resigned, and was replaced by the French Minister of Finance, Christine Lagarde. The Food and Agriculture Organization elected José Graziano, a Brazilian, as its new Director-General last year.

Notes

1. Actual GDP grew marginally under 3 percent on average over the previous decade, but the predominant view of economists appeared to be that productive potential was if anything growing slightly faster.

2. This is the sum of 2.5% output below potential in 2008, plus a shortfall of 8.8% in 2009 (when output fell by 3.8% while the potential would have grown by 5%), plus a shortfall of 8.4% in 2010 (growth of 2.9% that year reduced the waste by 0.4%), plus a shortfall of 9.4% in 2011.

3. The WTO publishes trade statistics which enable one to deduce the behavior of non-oil trade, a more relevant metric than the statistics for total trade published by the IMF. But unfortunately the WTO had still not published figures for 2011 when this publication went to press. Since oil trade fell by 37% (largely, though not entirely, because of the price decline) in 2009, and recovered by almost 30% in 2010, this explains a part of the volatility in IMF statistics for total trade. WTO statistics also showed a 20% fall in exports of manufactures in 2009, followed by a similar rebound in 2010, as against a 6% trend increase earlier in the decade.

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