



WHAT HAPPENS NEXT?

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What happens next?

“The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the second world war.” Alan Greenspan, Financial Times, March 16th 2008

What happens next?

“Simply stated, the bright new financial system – for all talented participants, for all its rich rewards – failed the test of the market place.” Paul Volcker, April 8th 2008

What happens next?

- What is driving the world economy?
- What is upsetting the world economy?
- What are the prospects for the world economy?
- What might derail the world economy?
- Conclusion

1. What is driving the world economy?

- First answer: “the great moderation”
- Second answer: “the great convergence” or the “China shock

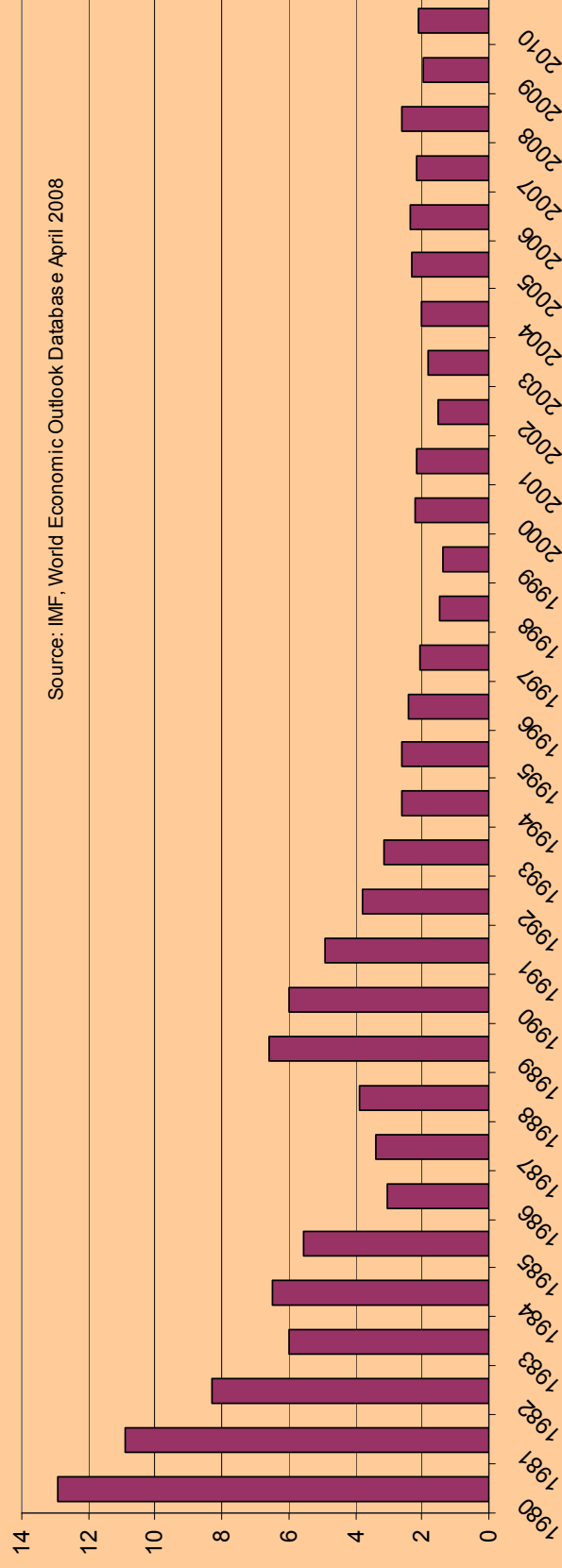
1. What is driving the world economy?

- What is “the great moderation”?
- Crucial to success has been low and stable inflation.
- *For a long time disinflation was “made in China”*

1. What is driving the world economy?

RESTORATION OF MONETARY STABILITY

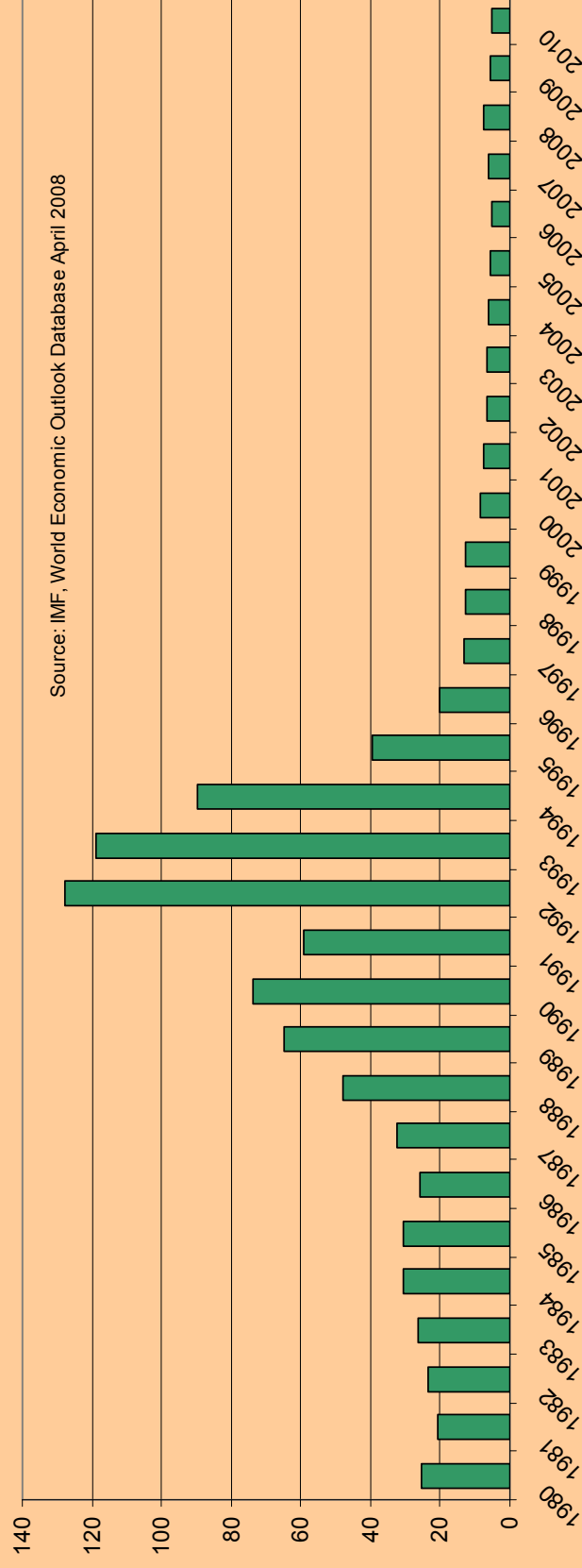
THE UP AND DOWN OF INFLATION IN ADVANCED COUNTRIES (consumer price indices)



1. What is driving the world economy?

RESTORATION OF MONETARY STABILITY

THE UPS AND DOWNS OF INFLATION IN DEVELOPING ECONOMIES
(consumer price indices)



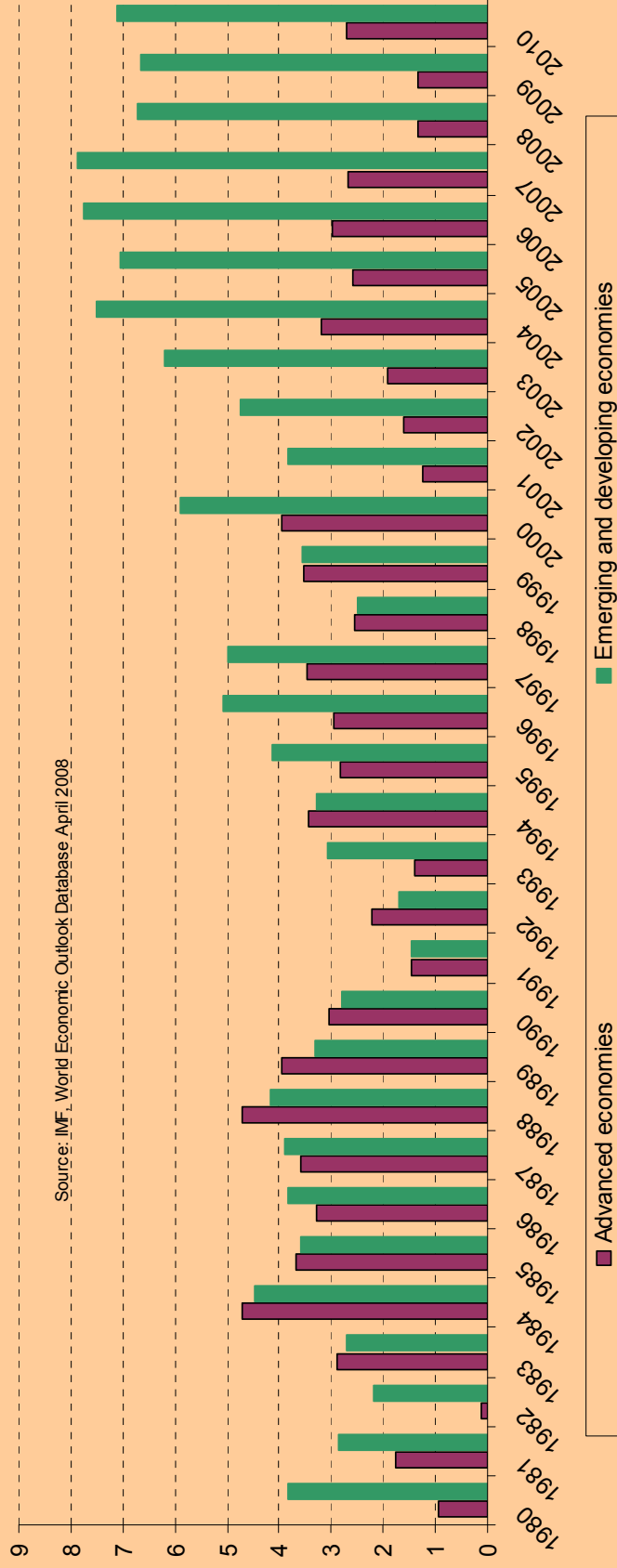
1. What is driving the world economy?

- What is “the great convergence”?
- The world economy has been driven by the biggest globalisation and convergence story of all time:
 - The ongoing global move to the market;
 - Liberalisation of barriers to trade and capital flows;
 - Declining costs of transport and communications;
 - Entry of countries containing billions of people into the world economy; and
 - The dynamic growth of those economies.

1. What is driving the world economy?

THE GREAT CONVERGENCE BECOMES EVIDENT

GROWTH OF THE WORLD ECONOMY
(at purchasing power parity)



2. What is upsetting the world economy?

- First answer: “global imbalances”
- Second answer: “revulsion” – the deflationary result of imbalances
- Third answer: “inflationary pressure” – inflationary results of imbalances, plus convergence
- *Every one of these things is “made in China”*

2. What is upsetting the world economy?

- “Imbalances” have been the result of huge gaps between savings and investment across the globe
- The US has been the target for these excess savings
- But if a country spends more than its income, so must its citizens.
- Who did most of that spending? US households

2. What is upsetting the world economy?

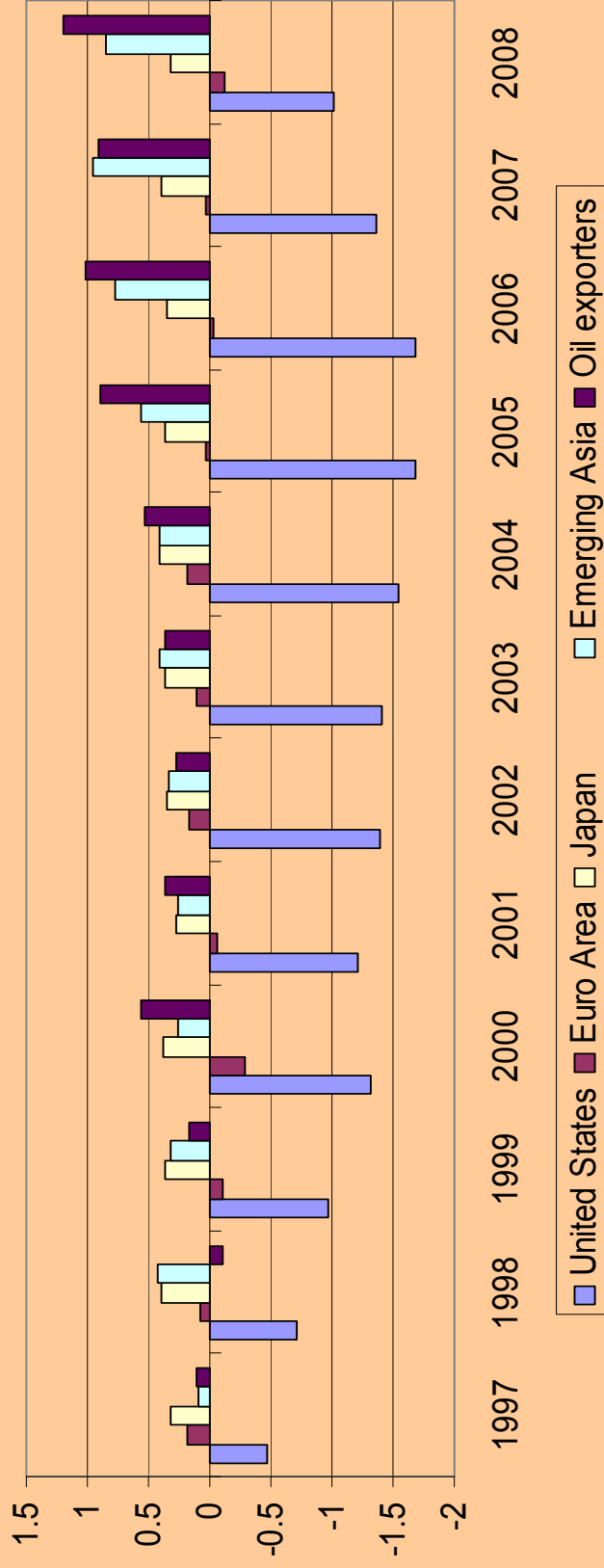
- In the exporting countries, monetary policy is looser than it would otherwise be, if the government is intervening in the currency markets to accumulate reserves
- In the recipient countries, monetary policy is looser than it would otherwise be, to stimulate the demand that offsets the trade deficit's drag on real output
- Foreign currency reserves are also invested in recipient countries, lowering interest rates and stimulating growth of demand

2. What is upsetting the world economy?

EMERGENCE OF THE IMBALANCES

CURRENT ACCOUNT IMBALANCES (per cent of world GDP)

Source: IMF, World Economic Outlook, April 2008

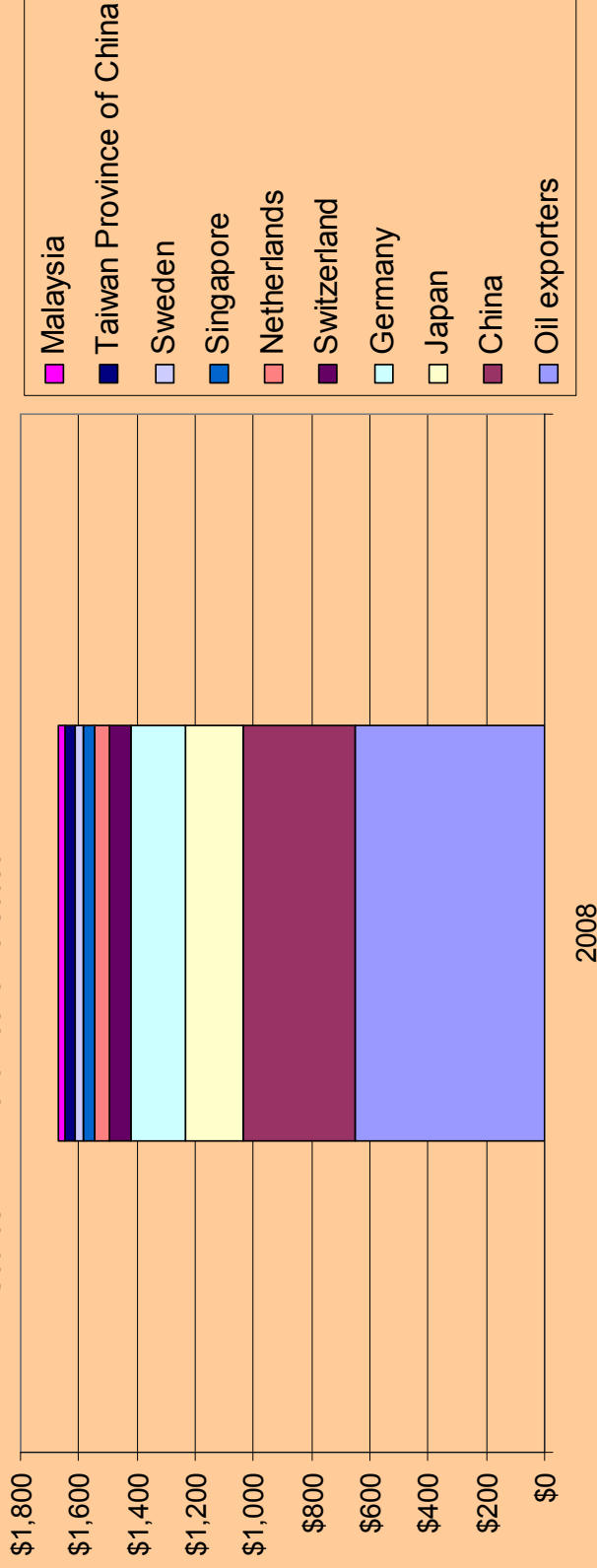


2. What is upsetting the world economy?

WHERE THE BIG SURPLUSES HAVE EMERGED

WORLD'S 10 LARGEST CURRENT ACCOUNT SURPLUSES

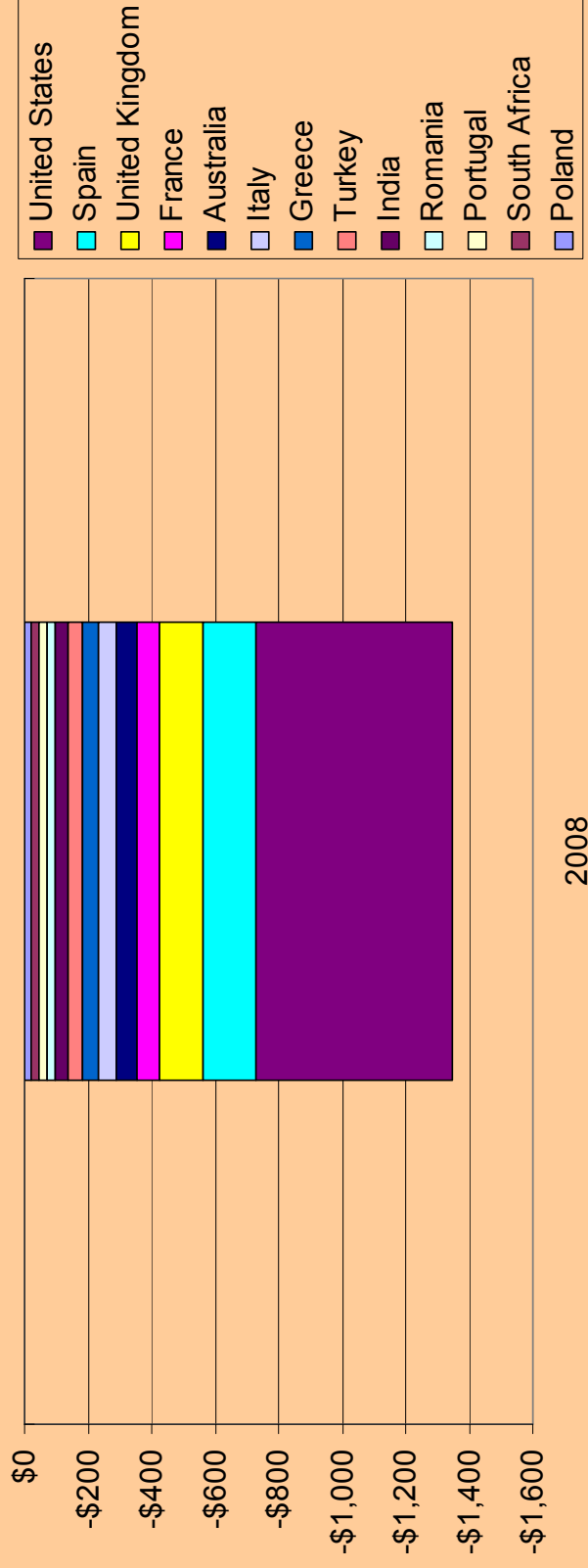
Source: IMF World Economic Outlook



2. What is upsetting the world economy?

WHERE THE BIG DEFICITS HAVE EMERGED

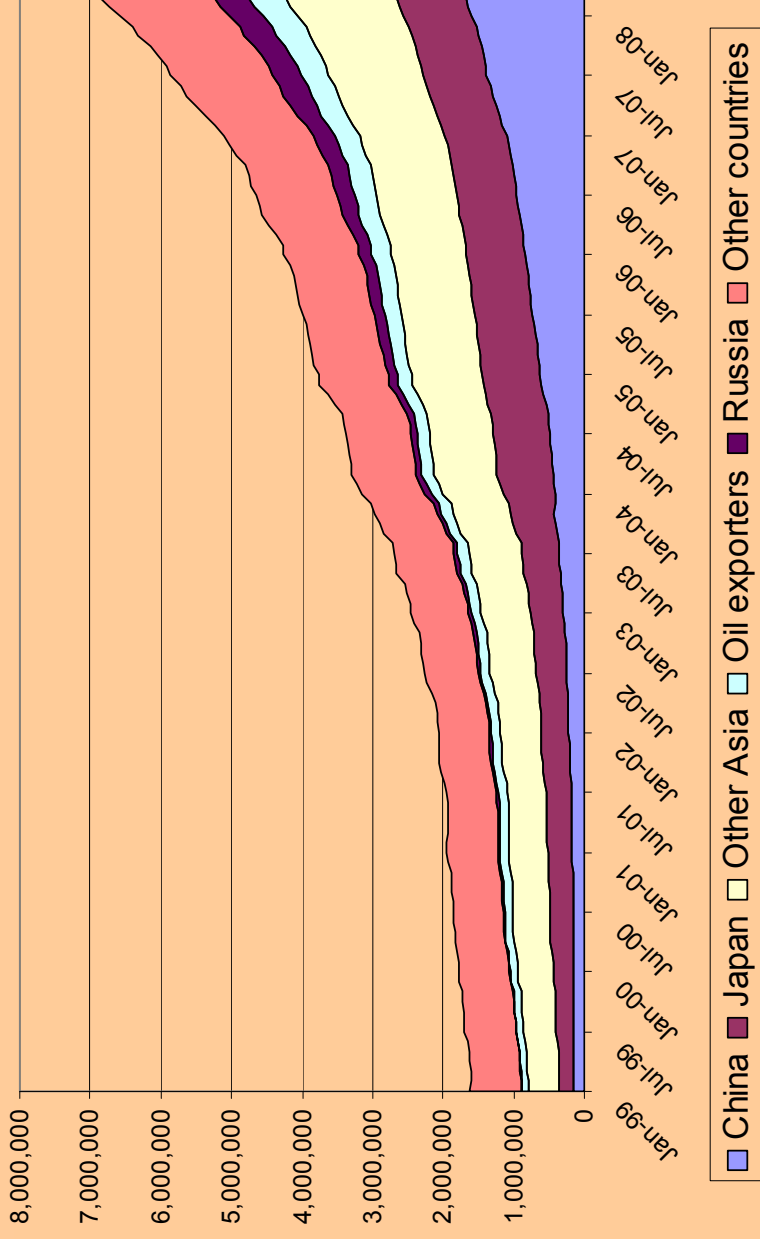
WORLD'S 12 LARGEST CURRENT ACCOUNT DEFICITS, 2008



2. What is upsetting the world economy?

THE GREAT RESERVE EXPLOSION

FOREIGN CURRENCY RESERVES (\$m)



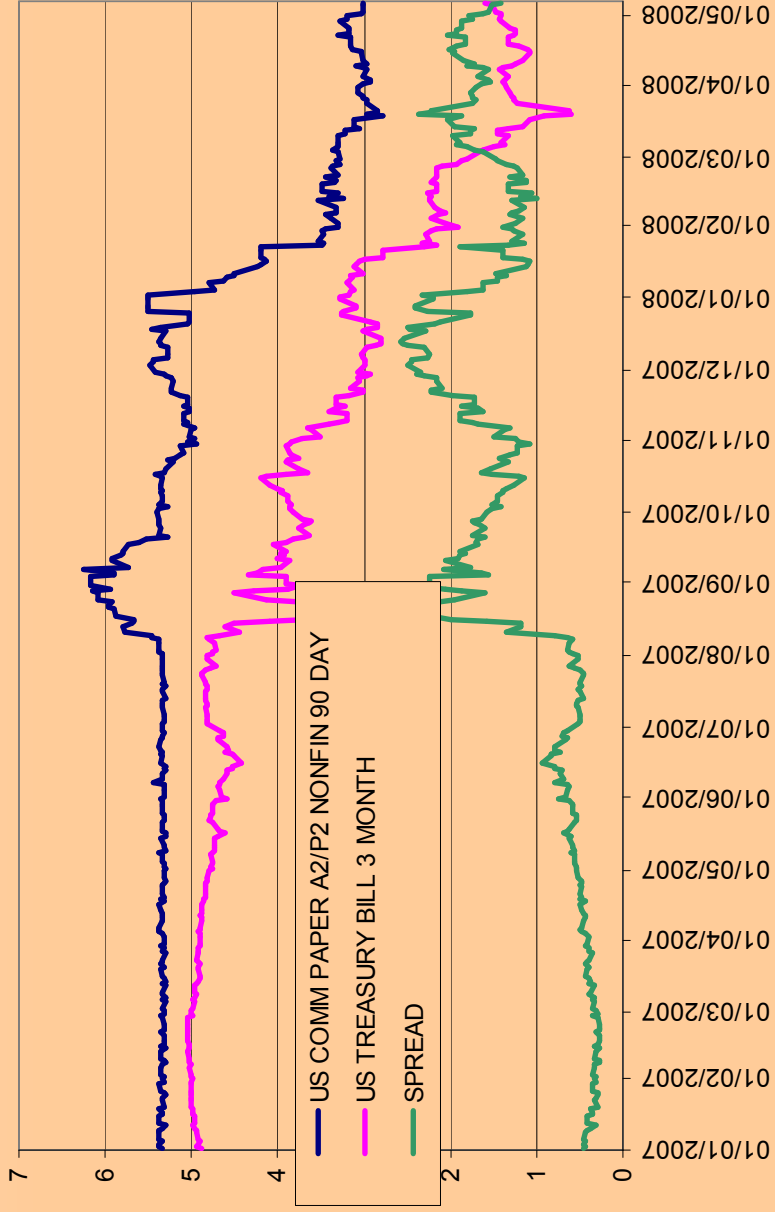
2. What is upsetting the world economy?

- “Revulsion”?
- The late Hyman Minsky produced a canonical model of financial instability, based on a simple idea:
 - When times are good, investors take on risk
 - The longer the times stay good, the more risk they take on.
 - Ultimately, they take on too much risk, asset prices overshoot and then fall, debt is called in and asset values (and, at worst, financial institutions) collapse
- *Success breeds excess*

2. What is upsetting the world economy?

AND FLIGHT TO SAFETY

SPREADS OF COMMERCIAL PAPER RATES OVER US TREASURY BILLS



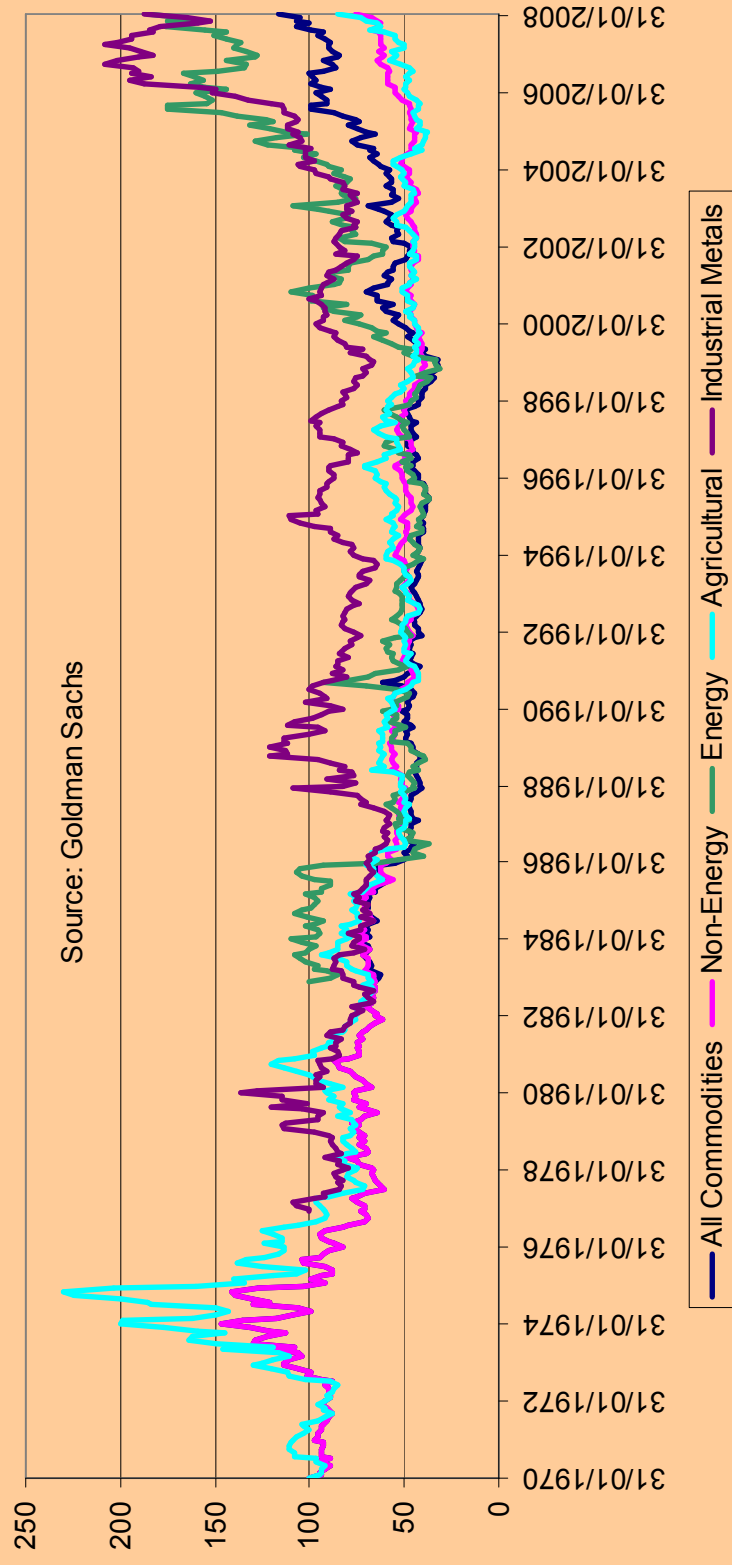
2. What is upsetting the world economy?

- Inflation is the consequence of two big processes: imbalances that generate huge monetary growth and convergence
- Convergence is a *real* process. It is generating huge demand for resources
- So the huge Asian labour supply shock and rising incomes are creating a “land-supply” shortage and shifting relative prices
- The world is becoming Malthusian

2. What is upsetting the world economy?

GLOBAL COMMODITY BOOM

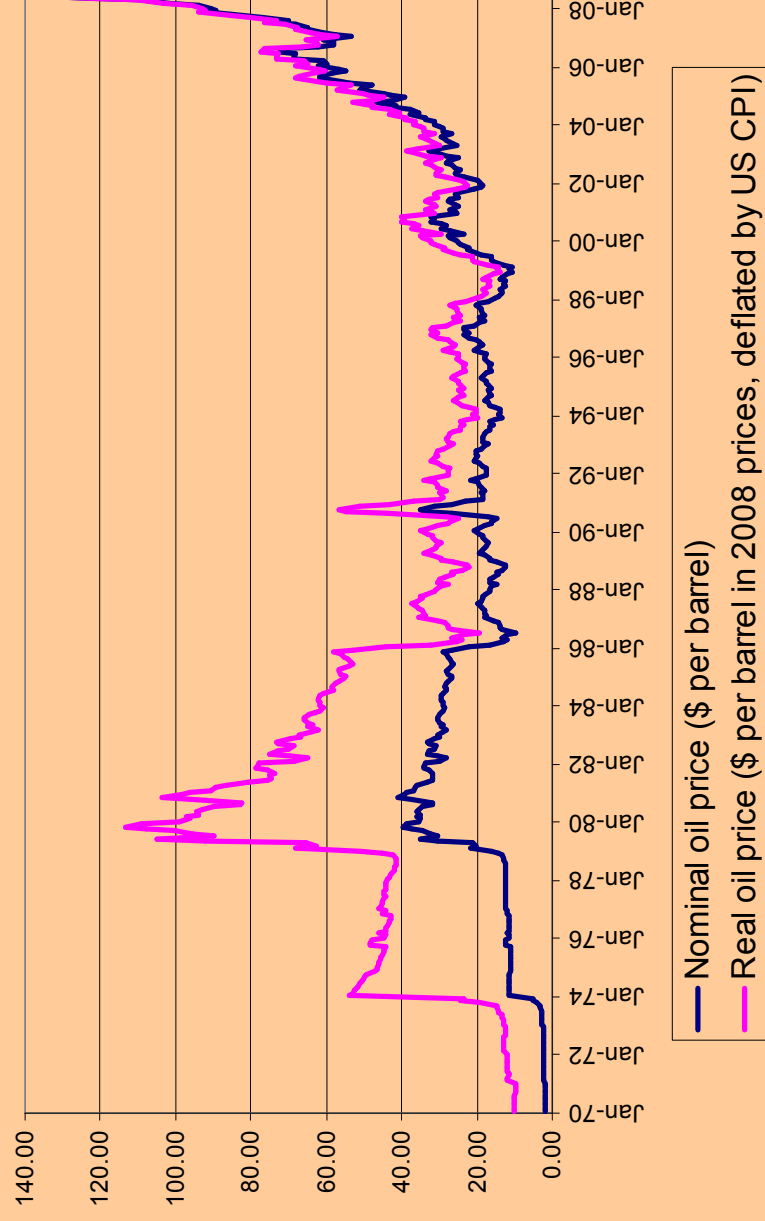
REAL COMMODITY PRICES
(deflated by unit value of exports from high-income countries)



2. What is upsetting the world economy?

GLOBAL OIL BOOM

NOMINAL AND REAL PRICE OF OIL



2. What is upsetting the world economy?

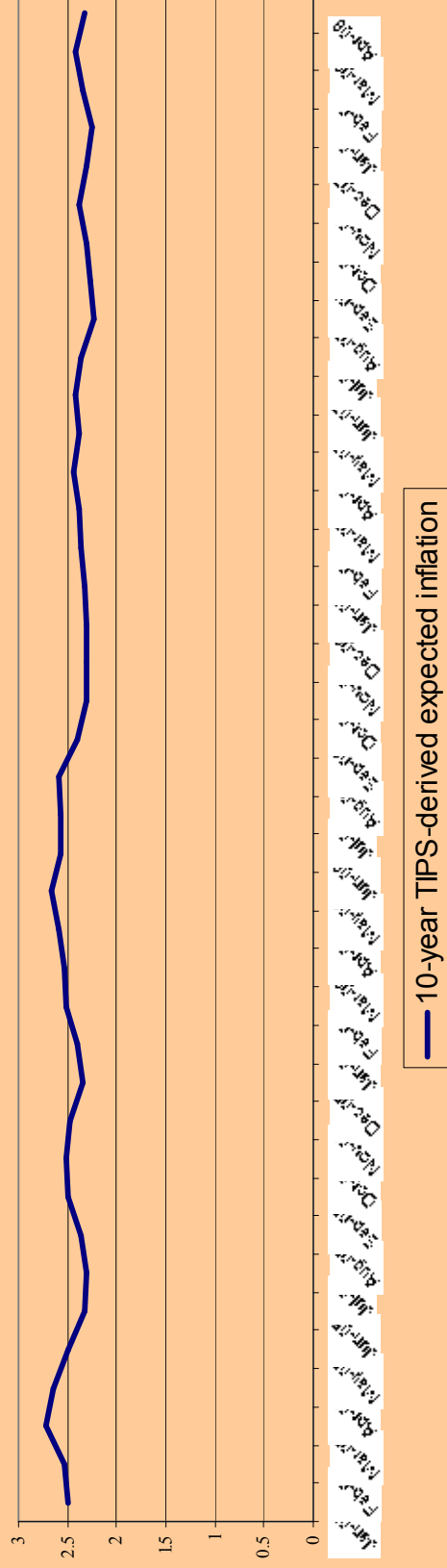
- More broadly, forces of dollar disinflation are weakening:
 - China's wages are now rising, as are its export prices
 - This trend is reinforced by the appreciation of the Yuan-Renminbi;
 - US productivity growth has slowed; and
 - The one-off impact of globalisation has weakened

2. What is upsetting the world economy?

YET LITTLE SHIFT IN INFLATION EXPECTATIONS

EXPECTED INFLATION IN THE US

Source: Cleveland Federal Reserve



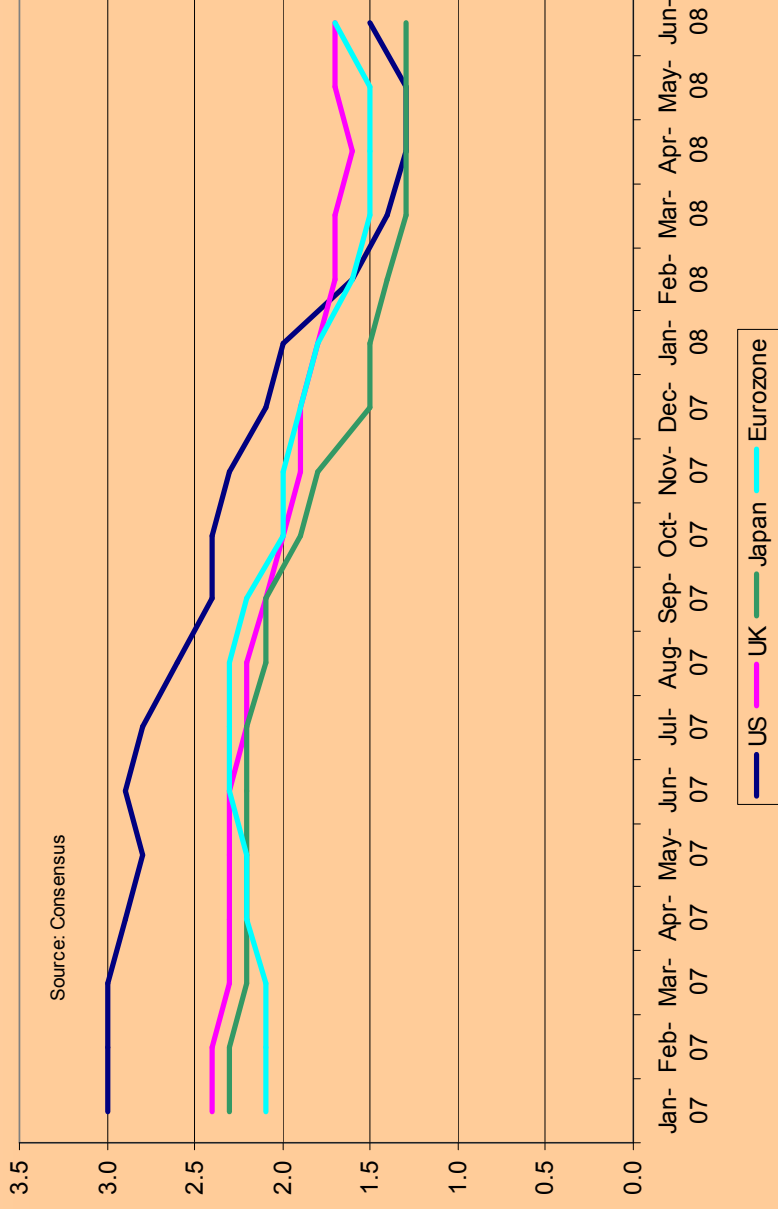
3. What are the prospects?

- The world now has a “great unwinding” to go through:
 - Unwinding of credit excesses;
 - Unwinding of global imbalances; and
 - Unwinding of inflationary pressures
- This will surely take an extended period of time

3. What are the prospects?

HIGH-INCOME COUNTRIES SUFFER FROM DROOP

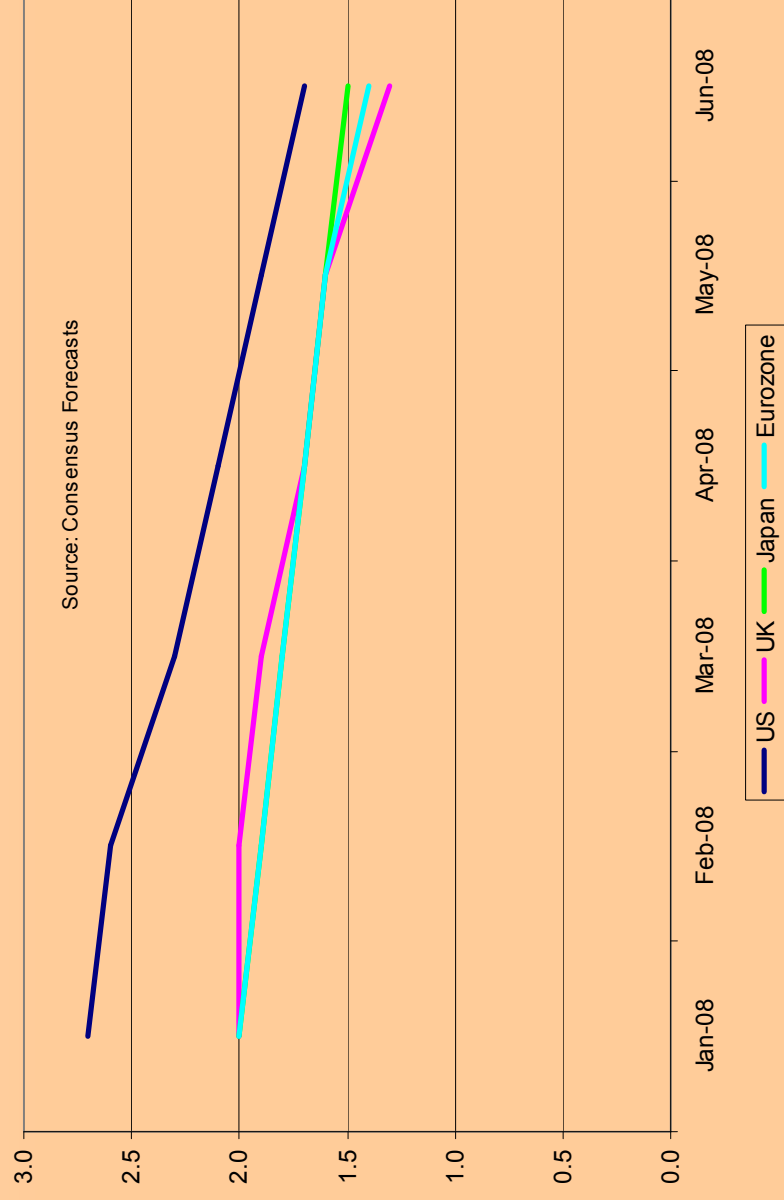
SUCCESSIVE FORECASTS FOR 2008



3. What are the prospects?

HIGH-INCOME COUNTRIES SUFFER FROM DROOP

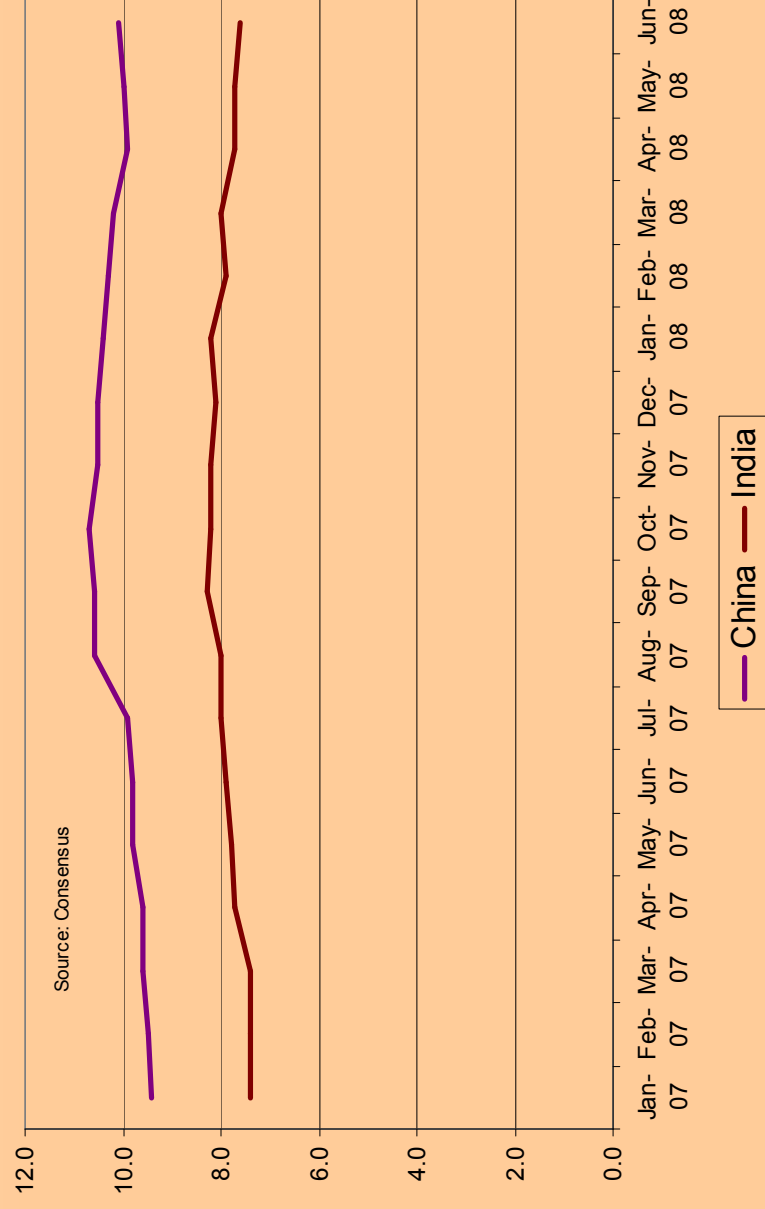
SUCCESSIVE FORECASTS FOR 2009



3. What are the prospects?

WHILE CHINA AND INDIA REMAIN ROBUST

SUCCESSIVE FORECASTS FOR 2008



3. What are the prospects?

WHILE CHINA AND INDIA REMAIN ROBUST

SUCCESSIVE FORECASTS FOR 2009



4. What might derail the world economy?

- Answers:
 - Dollar Crisis
 - Resource Crisis
 - Protectionism
 - Conflict

4. What might derail the world economy?

- First answer: a dollar crisis
- An uncontrolled decline in the dollar would be inflationary for the US and contractionary for the rest of the world
- The net effect would be contractionary
- But the risk is not that great, since the countries that have invested \$6 trillion in currency reserves, about two-thirds in dollars, do not want to lose their money
- They also want to preserve export competitiveness

4. What might derail the world economy?

- Second answer: resource shortages
- Oil production in non-Opec countries is disappointing
- OPEC production is not rising to compensate
- Demand is growing by at least 1m barrels ever year, to fuel transport fleets in emerging economies

4. What might derail the world economy?

- Third answer: protectionism
- The coming US slowdown/recession and soaring euro are going to increase protectionist sentiment substantially in both economies
- As is the rise in inequality in the high-income countries
- But I am reasonably optimistic, because of the economic interests behind openness;
- And there are also powerful institutional checks on protection

4. What might derail the world economy?

- Fourth answer: geo-political disorder
- The dangers here include mega-terrorism and conflict among great powers, particularly over resources
- The US is in slow *relative* decline.
- China is not challenging the US head on, as Germany and Japan did in the 20th century; but it is not a country with which the US can readily co-operate, as the US could with the UK.
- Conflict is possible, but unlikely

5. Conclusion

- Is globalisation going to continue?
 - Almost certainly, yes, but it will go along with protectionism, resistance to free movement of people and global friction.
- Is there going to be a significant slow-down?
 - Yes, in the US and maybe some other countries with similar problems
- Will emerging economies decouple?
 - Definitely not, but emerging economies have the capacity to grow briskly
 - Yet there will be huge challenges, as turbulence returns and
 - The US external balance adjusts