A world divided

In one of the most highly-rated sessions at the recent ASFA National Conference, MARK THIRLWELL reported on the divided global economy.

When looking global, there are five features of the post-GFC international economy and their implications, to consider.

1. A CRISIS-PRONE WORLD ECONOMY

Between 2002 and 2007 (although some would push that start date back a bit further), the world economy was characterised by something called The Great Moderation – a period of strong economic growth with subdued inflation and low volatility.

During this time, many policymakers, investors, financiers and households either forgot about risk altogether, or priced it at very low levels. Yet it would have taken only a quick look at in the rearview mirror to see that the world was actually quite prone to financial accidents. Consider, for example, the ERM crisis, the Mexican crisis, the Asian crisis, LTCM, the Russian default, the dotcom crash and Argentina's default, to list but a few.

Such financial mishaps were happening at a rate of roughly one every three years or so. With hindsight, the period following Argentina's default represented nothing more than a temporary lull.

Reality reasserted itself with a vengeance in the form the global financial crisis (GFC), when the world of the Great Moderation was replaced by a world of black swans and fat tails.

Indeed, 2008 actually offered a surplus of crises – a veritable flock, bevy, wedge, or (perhaps most appropriately) a bank of black swans. 'GFC' could have applied to any one of three crises that struck that year – the Global Food Crisis (the price of rice hit US$1000/ton in May/June of 2008), the Global Fuel Crisis (where the price of oil hit US$138/barrel in July), or the Global Financial Crisis triggered by the collapse of Lehman Brothers where the world suffered from a series of bank runs and financial collapses, and at times, whole economies seemed to be heading into bankruptcy.

Such was their ubiquity that nasty surprises became, well, almost unsurprising. As a result, policymakers, investors and households in many parts of the developed world are now much more aware of the variety of potential economic risks they face.

This in turn has had several implications, including:

- A rise in household savings and a bias towards balance sheet deleveraging that is currently contributing to weak domestic demand and a lackluster economic recovery.
- An increased risk of self-fulfilling crises. For example, take sovereign credit risk. Debt burdens on the European periphery which appeared to be sustainable at a time of low risk premia, become all too clearly unsustainable when those risk premia were adjusted suddenly and sharply upwards.
- A change in the reaction functions of policymakers as they become much more aware of downside risks, and more inclined towards policy experimentation.

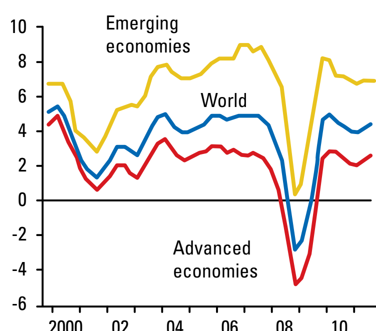
2. A WORLD ECONOMY FACING THE TWO Us: THE UGLY AND THE UNCERTAIN

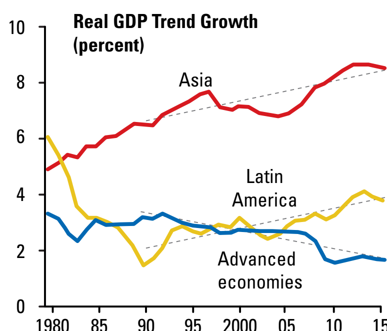
The recent crisis had two troubling features for the near-term outlook for the crisis-hit developed world. It was a financial crisis, and it was synchronised across a large number of economies.

On past experience, this implies a recovery that is slow and gradual at best. Among other things, that makes for an ugly economic and political outlook, with high unemployment, angry voters and nervous politicians.

Moreover, the outlook is not just ugly. It's also unusually uncertain. Many of the world's developed economies have embarked on a series of policy experiments, with no consensus as to the outcome.

Experiment one is the US Federal Reserve's decision to embark on another





Source: IMF International Monetary Fund (IMF), *World Economic Outlook: Recovery, risk and rebalancing.* (2010)

bout of quantitative easing(QE2). Opinions on the efficacy of this vary widely, ranging from those who think it will involve little more than fruitlessly pushing on a piece of string, to those who worry about huge inflationary expectations and the greenback's loss of status as global reserve currency.

Experiment two is the decision by some European economies, including the UK, to opt for preemptive fiscal tightening, a move seen by some as perhaps delivering a confidence driven boost to economic growth and by others as policy madness along the lines of the 1930s.

This uncertainty has the potential to interact with the first feature of the world economy in potentially unpleasant ways.

3. A DIVIDED WORLD ECONOMY

Over its history, the world economy has been marked by many dividing lines: between rich and poor; colonising and colonised; communist and capitalist. Now, we have a new geography of economic growth.

In 2009, only three OECD member economies managed to generate positive economic growth (one of them was Australia). Advanced economies, as a group, shrank by a bit more than three percent in real terms.

In contrast, emerging and developing economies managed to grow by about 2.5 percent. This year, the IMF thinks that while the first group will expand by less than 2.5 percent, the second will grow by more than 6.5 percent.

The aftermath of the GFC has confirmed the resilience of a phenomenon present pre-crisis. That is, the opening up of a substantial gap in the underlying growth performances of the developed and developing parts of the world economy.

It's not that the cyclical performance of the two categories has de-coupled. The events of the final quarter of 2008 and the first quarter of 2009 confirmed that. But trend, or potential growth performance has not only decoupled, but is showing signs of diverging as it slows in the advanced economies and accelerates in Latin America and especially developing Asia

Differences between the two groups of economies are not confined to growth rates. There are diverging performances in terms of public sector debt and deficits as well. According to the IMF, while advanced economies will have an overall fiscal deficit of about seven percent of GDP this year, in developing and emerging economics the gap is expected to be just over three percent of GDP.

Similarly, while the stock of advanced economy public debt is expected to exceed 100 percent of GDP this year, in developing and emerging economies, the corresponding estimate is just 37 percent.

So one part of the world economy is facing a depressing 'new normal' of slower growth, more debt, and higher unemployment. But for many emerging markets (and Australia), the post-GFC world in many ways looks very much like the pre-GFC one – a world of strong growth, risks of overheating, inflation and asset bubbles, and the policy challenges provided by large-scale capital inflows.

Indeed, for these economies, arguably the 'GFC' hasn't really been a global crisis at all.

4. A WORLD ECONOMY OF DANGEROUS FAULT LINES

Part of the world is too hot, part is too cold, and in this sense our world economy is now a divided, almost schizophrenic, place. At the same time, however, it is also more interconnected than ever before.

This combination is producing frictions or fault lines between the two parts of the world economy, where competing policy objectives and perspectives are rubbing up against each other.

There are two obvious examples:

- Exchange rate policy/global imbalances. This is the policy focus of a developed world, led by Washington, worried about insufficient demand and searching for new sources of growth, including exports to emerging markets; and
- International spillovers from loose monetary policy/QE2. This is the focus of a developing world worried about the destabilising consequences of further waves of capital inflows, and concerned about too much growth.

Both are clearly connected, but the underlying policy concerns are quite different. Which makes reaching agreement difficult, and reaching an impasse relatively easy.

5. A WORLD ECONOMY SUFFERING FROM THE 'GHOSTBUSTERS PROBLEM'

This divided world both increases the need for international cooperation while simultaneously making it harder to deliver. So finding the answer to the Ghostbusters problem – who do you call when the world economy is in trouble? – gets more pressing even as the answer gets more difficult.

In our divided world economy, the old answer to this question, the G7, no longer cuts it. Equally, the new boys' club, the BRICs summit, isn't really up to scratch. Which is why we have ended up with the G20, which effectively combines the previous two non-answers and adds in a little extra as well.

Making the G20 work is the pressing challenge when it comes to managing our divided world economy. The new grouping actually got off to a remarkably good start during the financial crisis, although in large part this was a product of external circumstances which delivered a classic case of countries being offered the choice of hanging together or hanging separately.

Now that the immediate pressures of the crisis have receded, the underlying policy disconnects of the divided world are exerting themselves and cooperation is proving much harder to come by.

Unfortunately, the need for that cooperation has also increased. **SF**

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