event transcript

CEDA
COMMITTEE FOR ECONOMIC DEVELOPMENT OF AUSTRALIA

Opportunity and risks in the global economy

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Thank you very much for that astonishingly generous, frightening actually, introduction. I much prefer it when I have a dreadful introduction because there's much less likelihood of disappointing everybody instead just disappointing a few people. I should tell you, of course, that, however much the FT costs, it's cheap at the price because it is the best informed newspaper and the best newspaper in the world and how can you possibly pay too much for the best newspaper in the world? I'm paid enough, I think, to have to say that at this stage in the proceedings.

I have got a presentation and I hope some of you can see it. I don't know whether it's going to be possible to see from where you are, but what I want to do in these remarks, and I would like to keep them down to about 30 minutes - I often say things like that and I realise I get carried away, so I don't manage it, but it would be nice to keep it down that because I'd like to have an exchange with you. There are lots of things, particularly about the theme that I am talking about, which is the growth of the world economy and the rise of Asia that you in Australia know much more about and follow much more closely and are even much more directly by than in we in north west Europe and so I very much benefit from what you have to say and the questions to ask and, of course, the disagreements you wish to express. I particularly enjoy the disagreements that people wish to express. The main pleasure of my life is argument.

So I'm going to talk about opportunities and risks in the global economy and this is going to be a very broad and long term discussion, though I will make some reference at least to recent events in the financial sector because I think they do have some connection, possibly some substantial connection with the more recent events. Let's see what happens.

Okay, I like this quote. I love putting it up in Europe because it shows that the French are sometimes right, although actually, of course, Napoleon wasn't French. He was Italian and as Italians like to mention. In fact his family, I discovered, came from a very small town in Liguria, near where I have a house, it so happens. It's also disappointing to say that, wonderful though this remark was, it appears, so far as I can find out, to be apocryphal. It is possible that he never said it, but he should have said it and it's a very important remark. It was made, as I'm sure you know, if it was made, shortly after the very famous embassy of Lord McCartney to the third of great Ching emperors in 1792 - I think I've got the year wrong, but anyway the 1790s - and the Chinese response to the arrival of this upstart from that remote, miserable, little wet island in god knows how far away, was to say, "Go away. You have nothing to offer that we're in least interested in" and in fact that was perfectly true. They took all the presents or, as the Chinese would see it, the tribute that McCartney offered and put it somewhere, I think, in one of the palaces in Beijing and it then disappeared from view until the 20th century. So China really was very uninterested in anything the west had to offer and then, of course, the British forced China to wake up with the brutal and, I must say, completely outrageous action of the Opium War, the sort of thing, and there are many such, that the British do not like to recall in their history and we, of course, and you know this better than anyone, live in the era of China's awakening and, indeed, of Asia's awakening, more broadly, and, of course, this is the biggest geopolitical and geo-economic event of our lifetime. That is so obvious it hardly needs to be stressed.

Now I just want to start with a little prologue because I think it's worth remembering where we've been in the last five or six years. As I say here, whether by accident or deliberately the attack of 9/11 2001 was a superlatively timed assault, it was at the heart of Wall Street. It followed a very major stock market crash or, more precisely, was in the middle of a major stock market crash following a gigantic bubble in stock markets in the US and most of the rest of the developed world. So if you were going to time something to affect the globalisation process and the emerging integration of the world economic system through the market, you couldn't really have done it better and there were many people then - and I'm always very pleased when I remember when I was right and I like to forget all the times I was wrong. There have been plenty of those too, regrettably - many people then basically said in 2001, and I can give you quite a number of quotes, that globalisation is over. The integration process is over. We're now moving into a security dominated phase when integration will basically cease, but in fact this didn't turn out to be the case at all. We have lived now through - I'm not going to go through this in detail, for lack of time, but we have lived through a very strong recovering, starting in 2002 and building up through 2003. The last several years, the world economy, it's partly a matter of definition, but on some measures the world economy has grown faster than at any time, certainly since the very early 1970s and, if you use purchasing power parity measures, because of the weight of China and India, it's been growing faster than ever before. Trade, capital flows and all the rest of them have been growing much faster than world GDP. The integration process has proceeded very very rapidly throughout the last five or six years and, interestingly, so little has the disruption been that even the shape of the business cycle, as I'll come to in a moment, has been quite similar to the previous one, with rising US external deficits supporting world demand and those, in turn, being largely underpinned by rising household financial deficits in the US, a theme to which I will shortly return.

So this has been in many ways a surprising and certainly an astonishingly strong business cycle expansion process after a series of major shocks and I just list some of these shocks because I think they underpin the sheer strength of the dynamic forces in the world economy that I'm going to elucidate a little more in a moment. We've had, of course, terrorism. We've had collapsing stock markets. We've had a number of significant wars, two of which in Afghanistan and Iraq are still ongoing. We have had soaring oil prices. On some measures the real price of oil today is higher than it has ever been before. More plausibly, it is higher than it has ever been before. More plausibly, it's higher than at any time, except between 1979 and the mid 1980s. It depends on the deflators you use. So we've had massive oil price rises, very severe protectionist pressures, a failing round of multi lateral trade negotiations. Nobody believes the Doha round is going to be resuscitated, I'm afraid, whatever they do in Sydney this week. Huge global imbalances, which many people have worried about and I've been one of the people to write about this and none of these things has fundamentally halted the dynamism. It's a remarkable story. So could anything go wrong, and I wouldn't be an economist if the answer wasn't yes, but I want to take away the message at this stage, and I'll repeat it, that I don't think that the "yes" is really likely. I mean basically in these talks that I give on this subject I'm an optimist, but an optimist is somebody - I think an intelligent optimist is someone who is aware of what can go wrong and bases their analysis on the assumption that something will be done to make sure we continue on the right path.

I'm going to discussion basically three things: what is the underlying drivers of this fantastically strong world economy we've; why has it worked so well for so long; why has it go through so many stocks? Then I'm going to talk about the prospects for the world economy and, finally, I'm going to talk about the risks. So I argue - and this I not new. I'm afraid this banal, but it's worth underlining it. I think there are essentially three drivers of what's going on and I will mention something else that underpins two of them. First is simply the rate of productivity growth at the frontier of the world economy. The frontier of the world economy has been for the last century, in terms of productivity, levels the United States. There's nothing new about that. The second driver is the integration process and the third is the liberalisation which affects, of course, globalisation, but in particular means the expansion of the number of people engaged in or seeking to engage in the world economy by billions, essentially and above all, the entry of Asia into the world economy.

Underpinning those three elements are a couple of fundamental processes. Obviously one is technological innovation. We live in a very interesting technological age driven by the convergence of computers and communications technology, which has dramatically lowered, essentially eliminated the cost of collecting and, above all, disseminating information across the globe. That's just a gigantic transformation, which clearly runs through all three process and the second, of course, the second major background condition for all this, has been the move to the market, the liberalisation, domestic and external, which has affected and continues to affect most of the world and has not yet, in any serious part of the world, been reversed and in which, of course, the most important stage was the liberalisation stages, with the liberalisation of China after 78, of India after 91 and the collapse of the Soviet Union, three absolutely epoch-making events.

So I'll just give you a few charts which illustrate these themes. They're not designed to do anymore than that. This is a chart which shows what's happened to productivity performance in recent couple of decades and it's basically designed to illustrate the upsurge in US productivity growth and, unfortunately, the very dismal reverse performance. There are some signs in the last year or so that that maybe beginning to reverse itself, that the Europeans are beginning to improve their productivity growth, but the US performance has been very important, I think, in sustaining the dynamism of the US itself and confidence in the US. There has been a slow down in productivity growth in the last year or two in the US, but it is important to recognise that the long period of very weak productivity growth between about 1973 and 95 has been fully over. For the last 10 years it was Alan Greenspan's genius in some ways to recognise this before anybody else and it's a very significant background condition for the world economy as a whole, the resurgence in the US, productivity growth, which of course creates opportunities for other developed countries and, of course, to some degree other developing countries can exploit. It's clearly been located predominantly in the use, rather than the output, of information technologies, particularly in the service sector, though of course the production has been an element.

The second element in this, as I said, is the integration of the world economy. This is sort of a nice little chart which shows how across the board integration of the world economy has been. It comes from the UN's investment report and the denominator in all the columns, as it were, is global DGP, so its ratios to global DGP. So where the columns are higher in 2005 than in 1990 it's because the thing in question has grown faster than global DGP and, I point out, particularly dynamic over this period and I think that's a particularly significant element in our contemporary story, is inward investment and sales by foreign affiliates in the complete reversal, the total reversal, of the generally hostile attitude to foreign investment of 30 years ago and when I started my career almost every country in the world wanted to keep foreign investment out. It's difficult to remember this now. Almost every country, developed and developing country, both wanted to keep foreign investment out. The reversal of that has been one of the really big themes of our era and, of course, it's related to the rise of the multi national company and the integration of production systems in both services and manufacturing across the world that has gone along with that rise.

The third element, as I said, is the entry of the billions into the world economy. This is just one of many possible ways of thinking about it. It's put together. It's a very simple chart by a friend of mine, Helmut Reisen, who works at the OECD, and he argues, and it's at least a way of thinking about this, that since 1980 the number of people trying to engage in activities, which are part of as it were, broadly defined the global capitalist economy, has tripled. By the way, the same ratio increase emerges, as the IMF points out in a recent analysis. If you just look at those directly working for export or import substitution, it's also roughly tripled from about a billion to about three billion. You could argue about this precise number and that's the first thing that's happened and the other thing that's happened, of course, which is crucial, explaining wage trends, shifts to profits and things like that, which I'm not going to go into in great detail further today. Of course, all the increase has been in developing countries. So we've had a massive increase in the global labour force, even more significantly that massive increase has been in labour that's relatively cheap. So this has massively undercut the market position of relatively unskilled labour in developed countries and that's clearly one of the most important social and economic developments of our time.

So those are the great driving forces and if you think about these forces, productivity, globalisation, the entry of the billions and underneath those technological change and liberalisation, these are immensely powerful forces, fundamental economic forces of integration across the world and a technological advance and they aren't going to be very easy to stop.

Many people refer to this era as the globalisation of the post industrial era, the last one being 1870 to 1914. I suppose it was the era when Australia became, I think, the richest country in the world on the back of that. I believe it was the richest country in the world in 1900, was it not, on a per capita basis, though I presume the population was quite small in 1900, but still it was very much related to the opening up of the new world and one way of thinking about the difference between that period, the two periods, is a point I often make is that one way - there are many different ways of thinking about it - one way of thinking about that early period is that it was huge global land supply shock. We incorporate it because of the new technologies of the steamship and all the rest of it, the land area of the New World fully into an integrated production system with the Old World and what we are now living through is, I think, because it involves human beings, the even more potent fact of a huge labour supply shock, the incorporation of much of humanity at least potentially into the world economy.

But in addition to these drivers, there have been three macro economic conditions or macro economic events, if you like, which have supported growth over the last 25 years. These are not in historical order. They just happen to be in the order I'm going to deal with them. The first one is the role of the US, as I call borrower of last resort, in a world in which there is a extraordinary large number of saving surplus countries, just an astonishingly large number of saving surplus countries, that is to say, countries with current account surpluses or capital account deficits, which are the same thing, which are sending capital out into the world and the US has been the dominant borrower and that's very important in understanding what's been happening recently in markets, in my view.

The second factor that has been very supportive, particularly recently, of growth, relater to the former, has been a world of generally very low real interest rates, which encourage borrowing, encourage the risk taking, which we've seen in rather dramatic ways in recent years and, finally, in addition to that and perhaps more important than either of the other two, we've lived now for 25 years since Paul Vulcar in an era of generally low inflation and credible monetary policy and I like to point this out how extraordinary this is because this is the first period in the history of economics, so far as I know, in which fear money, that is to say government-made money, absolutely unbacked by any form of metal, has actually generated monetary stability and there were lots of people, and there remain lots of people, who believe that's impossible, but it has lasted for now a quarter of a century and that's been incredibly important in sustaining and growth and stability in growth and it's a big contrast, of course, with the first globalisation era, which was, of course, a gold standard era and, therefore, worked in terms of monetary stability. There was also monetary stability in a very different way.

Just to look at those three themes, this is the global current account picture. I've taken this from the IMF and how the balances work out and basically we have in the world today two very large surplus regions, Asia as a whole. This includes the developed and the developing countries of Asia, with Japan and China, of course, overwhelmingly the dominant sources of surplus savings and China, in absolute terms, is much the biggest single source of surplus savings in the world now. Their surplus savings are about 1.2 per cent of world GDP; the oil exporters with about 0.7. Europe, as a whole, is close to balance because it contains within it both large surplus and large deficit countries and the offsetting factor has been the US. The US deficit is shrinking a bit, but essentially the US has been the world's principal net borrower, offsetting and absorbing the surplus savings of the rest of the world and that's been, in my view, and I've argued this many times, a very important source of macro economic equilibrium in the world, the willingness and ability of the US to operate policies which have allowed that to happen.

The second thing, as I said, is real interest rates. I've put up US and UK real interest rates. The advantage of that is we actually know what the real interest rates are because we've got indexed linked securities, so these are direct measures of real interest rates and you will see that this about half way through 2007 - I haven't got the very latest figures - that real interest rates have generally been very modest in the UK, staggeringly so for very special reasons to do with our pension system, but basically most estimates suggest, and these are more difficult to measure because they are more remote, that real interest rates have been running at about 2 per cent or so in the last three or four years in the world as a whole, basic real interest rates in safe securities. That is a world in which borrowing is a sensationally attractive activity and we've seen an awful lot of it.

And the final element, as I said, is inflation and it's worth reminding ourselves what a sensational mess the developed world made of its monetary policy in the 70s, which is a pretty dismal decay, from this point of view, and how massively the quality of monetary policy has improved since then. This is not to deny - I won't have time to go into this further now - this is not to deny that the so-called The China Shop is not an element, as many economists would agree, in helping, in helping central banks to deliver low inflation, but I'm sufficiently a Freidmanite to believe that inflation is always ultimately a monetary phenomenon and if the central banks had really wanted to created inflation they could have done so even the help of a terms of trade improvement being generated for them by China. So I think we have to recognise that central banks have done a phenomenal job, helped by these background conditions, in delivering stable inflation for a very long time.

So what does all this mean put together? It means that things have gone really sensationally well. We've had a very well balanced economic expansion in terms of growth, at least across most of the world. In fact basically in the last two or three years every region of the world has been growing strongly. Even Africa and Latin America have been growing strongly in the last two or three years, though not, of course, in the stupendous way that Asia has been growing. Imbalances seem to have reached a peak, if one was worried about that. Inflation has remained under control. Interest rates are modest. There's been no real indication of significant changes in inflation expectations and I think it is really quite reasonable to believe that growth will continue to be sustained at the global level in line with potential. Famous last words, but there are some risks and I want to divide those risks and this is my last section. I'd better stay close to these mikes because they don't seem to pick me up when I move about three inches away.

I'm going to look at the short term and the long term. First of all, short term risks in the US, I just mention them because I'm not going to be able to discuss them in enormous detail now. Perhaps we can come back to the questions. One short term risk in the US is we're going to see a significant further weakening of underlying demand. There is a view, which I think has been greatly exaggerated, but it has some truth, that the Fed has sustained US demand, particularly household demand, by essentially pursuing a monetary policy that has driven a series of major asset price bubbles, or at least facilitated those asset price bubbles, first in stocks and now in housing and basically the US has now run out of these bubbles. The housing one is now well into deflation mode and some people are really very pessimistic about the future course of house prices in the US, at least over the next year, particularly after the shocks of recent weeks. That's not particularly difficult to see.

Associated with these strong asset prices, US households have been running huge financial deficits, that is to say they've been spending more than their income, over the last decade and they have become precisely, as I said, the borrowers of last resort. This has been historically unprecedented behaviour for US households, as I was going to show you in a minute, and a clearly since consumption by US households is 70 per cent of GDP, if this were to stop, if they started moving back into surpluses they normally have been in the past, that would certainly mean a significant slow down, if not recession, in the US and, of course, the credit crunch we're now seeing, which is located particularly in or originates particularly in mortgage finance, makes this more likely and, as house prices continue to decline and mortgage rates, as I understand it, are going to be reset in the United States, there's a risk that that's going to get a lot worse in the mortgage finance business in the US, with worse effects on US households.

And a second and, of course, essentially related possibility, but makes it broader, is adjustment in risk spreads, which have been extraordinarily low across the board and large scale defaults associated with that among overleveraged borrowers across the world. In other words, the scenario I'm giving you is the unwinding of leverage an the reduction, particularly the financial deficits, the difference between spending and income, of US households, which have played such a gigantic part in generating demand in the world economy. These are, I think, not insignificant short term risks. And a third set of short term risks, again not unrelated to what I'm talking about, is some form of global crisis, possibly linked to a falling dollar, even collapsing dollar, and a very swift reduction in the US external deficit.

It's worth thinking about how that might be related to what we've seen. One plausible view of what's now going to happen in the US, and it's already been discussed - I'm sure you followed what happened in Jackson Hole - the Fed will cut rates very very sharply, really sharply, much more sharply than anywhere else. This might well - and Barry Eichengreen has an article on that in the FT today, this morning, Barry Eichengreen of Berkeley - going to lead to a very swift reduction in the value of the dollar against floating currencies and, if that goes along with a big cut back in the spending by US households, American politicians will be very keen to see the reduction in the dollar. That will mean a big reduction in the net demand coming from the United States for the Rest of the World economy and that might affect, very significantly, the growth prospects in the Rest of the World, particularly for countries which will either have very large appreciations of their currency, like possibly the Euro zone, or countries that are very dependent on exports to the US and China, despite its size and dynamism, is very dependent on its exports for growth.

Now I tend to think these are going to prove manageable dangers. The creditor countries have a huge economic and political interest in avoiding a collapse of the dollar and I expect the Asians and the oil exporters, in particular, to continue to pile on US dollar reserves in such a situation. So China's reserves are going to shoot up, continue to shoot up, possibly well over two trillion even this year or certainly early next year and so I think it's probably going to be manageable and the dollar is more likely to sink than collapse, but I do think it's worth stressing that we do live in the era of a long term dollar bear market.

This chart just brings out - and I'm not going to stress anymore - how extraordinary the behaviour of US households has been by historical standards. I just focus on the blue line. I won't talk about the corporate sector, though that's very interesting too, the business sector. This is just a balance between income and expenditure of households and includes, by the way, expenditure on residential investment, residential housing in the GMP sense, so that's actual construction and as a share of GDP and you will see that this goes back to 1947. Where US households have been since 1998 is essentially unprecedented, except very briefly around the time of the Korean War and the shift between income and expenditure since the mid 1990s, the early 1990s, of US households is staggering. It's a shift of 8 percentage points of GDP and, as I said, if that corrected rapidly we would have a pretty big problem emanating from the US. I don't want to say the world is falling or anything like that, but I think it's important to stress this class of short term risks.

Now I'd like to turn to the longer term risks and that's sort of my conclusion. As always, I never manage somehow to meet my deadline, so I'm going to over five minutes earlier. One set of longer term risks, and that's clearly foreshadowed by the tone of the debate in American politics around the presidential election, the really quite strong protectionist sentiment emerging, particularly among democrats - I'm sure you've followed that - is a return to major protectionism in the developed world, probably triggered by such a move in the United States.

I'm not going to go through points I've made there. I tend to think that despite the failure of the Doha round, despite all the difficulties of pushing liberalisation forward, the chances of a major repudiation of the liberal world economy by a really big player like the US are very low unless something else very bad happens, like a huge recession or even a depression, but I think it's at least worth stressing that we do seem to have reached the point at which optimism about liberalisation and the general thrust forward has sort of come to an end.

A second set of risks relates to the oil price. There is obviously the possibility of some major shock. One of the subjects that I spent time discussing with Americans in the Hayman Island retreat I was just in was the chances that this administration will before it leave attack Iran and I think it's worth stressing these chances aren't small. This could perfectly well happen and that would obviously be a rather large shock to the world oil markets and could well end up, if things went bad enough, with oil prices well over $100 a barrel or even further north of that. We don't know what such a shock would do. The last time a war-related oil shock occurred was 1979 and that's a very nasty precedent. On the other hand, most analysts believe that prices now are at least somewhat above their longer term equilibrium level and so are more likely to fall than rise, but I think this is something to stress.

I'd also like to just mention, because this is a much longer term issue, the obvious point, the demand for oil in particular and commercial energy, above all, is going to explode over the next few decades as China and India grow. This chart, I think, illustrates very well where we are in terms of energy use across the major countries of the world and you will see that, interestingly, China and India use about as much commercial energy per unit of GDP at purchasing power parity as the developed countries. They're not different radically in efficiency. That is not seen when you look at GDP and market prices, but that's a very misleading measure of GDP but, of course, they use fraction of the commercial energy of the developed countries per head and you can assume they are going to converge on the developed country usage, unless we all are incredibly much efficient. Under almost any assumptions you can imagine there's going to be a very a big increase in demand for commercial energy from these huge developing countries and others and, for stability in the longer run, and here we're talking of beyond the 10 years, but in the longer run, somehow or other that energy is going to have to be delivered, otherwise prices will shoot up and we may have a problem.

One simple forecast of the future for oil demand - this came a couple of years ago from the International Monetary Fund - suggested that on current prices and current growth forecasts the demand for oil will rise from about 85 million barrels a day to about 135 million barrels a day over the next 20 odd years and, to just put that in context, that's roughly four new Saudi Arabias in the oil system. So the energy system, which I'm sure you know much more about than I do, is a very big question in terms of allowing this dramatic growth process, which I've described, to continue.

A third set of issues obviously is one-off events and I just put up a list of some of the really nasty one-off events that could make a mess of our globalised economy: a global flu pandemic, which people talk about; nuclear terrorism, now that's a sort of serious nightmare. I have no idea how significant these things are. I suspect we would manage to get through such events, but either would be a major disrupter obviously of the integrated global economy I've talked about.

And then, finally, if one really wants to be cheerful, on starts talking about war. By the way, I was very pleased to discover again in Hayman Island there was a distinguished Australian, Professor Paul Dibb, who I presume many of you know, who was talking in exactly these terms, with basically making the obvious point that we live in a globalising era in which everybody is increasingly interdependent, in which there is, in addition, a massive upheaval in relative power going on, an enormous shift in global relative power that looks very like the period before 1914. We all know what happened in 1914. Nobody, by the way - this is a point Neil Ferguson, a very well known British historian, now teaching at Harvard, made - nobody in 1910 or 11 forecast that this would happen. What happened would happen and there's a very famous book by Norman Angell called The Grand Illusion or The Great Illusion - I think it's The Grand Illusion - who made, I thought, the completely compelling argument, after you read the book, that we really shouldn't have a war because it would be so stupid. He didn't say it was impossible. He said we can't have a war because it would be so stupid and, of course, the world proceeded to prove to him that that's perfectly true. It was incredibly stupid, but we can do it all the same and so there a number of significant flash points in our world and you know them all and the history of humanity is we have a capacity for making blunders of this kind and do not underestimate the fact that there a number of people in the United States who quite like some of these wars to happen. There are quite a number of people who would like these wars to happen.

And that's the conclusion. We seem to have a world economy that is working very very well. It's decoupled from often politics. The drivers of growth are, both long and short term, very powerful, but I've tried to lay out some fairly big risks. I think we're going to manage them all. We'll go through the blips, as we did in 2000, 2001, 2002, but the risks are quite sizeable and one has to bear in mind in any thinking one has about the future. That's all I have to say. Thank you.

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