CONFCOMMERCIO
IMPRESE PER L'ITALIA

PRESENTATION BY RICHARD PORTES

AT THE FORUM:

"MARKET LEADERS AND SCENARIOS FOR THE 21ST CENTURY"

March 18 and 19, 2011
"Villa d'Este" – Cernobbio (Como)

GENERALI The European House Ambrosetti INTESA SANPAOLO

Uncertainties in the global economy

Richard Portes
London Business School and CEPR

CONFCOMMERCIO

'MARKET LEADERS AND SCENARIOS FOR THE 21st CENTURY'

Villa d'Este 19 March 2011

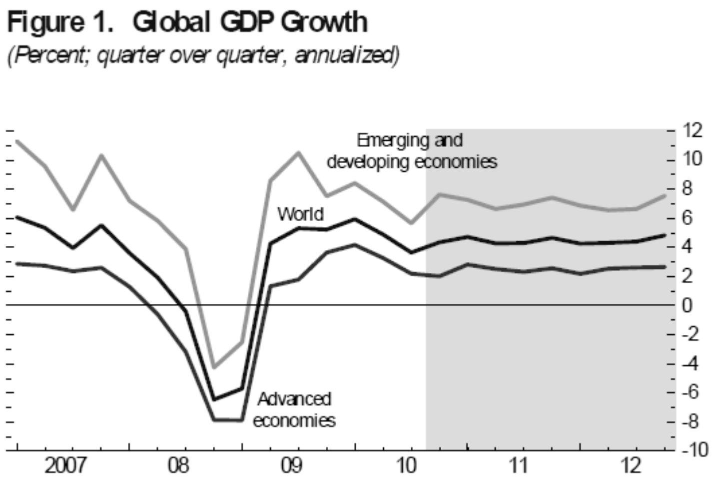
Road map

- Rebalancing: the 'new old thing' – but we won't go back to 'normal', nor find a 'new normal'
- No more 'normal' – the *new new things**: a shift of focus and power in the global economy
- But will this too end in a crash?

*Michael Lewis, *The New New Thing*, 1999, on Silicon Valley and the tech boom

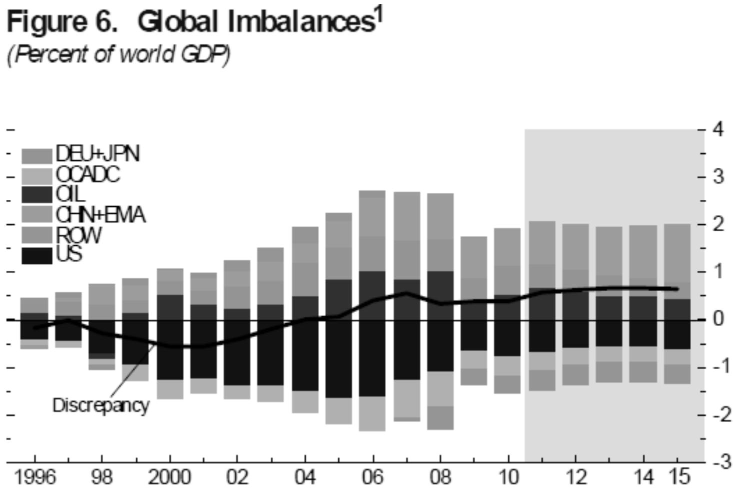
How things have changed…

Going forward: latest IMF projections



Source: *World Economic Outlook Update* January 2011

The new old thing: global imbalances continue



Source: IMF, *World Economic Outlook Update*, January 2011

But it's worse than that

- IMF too optimistic – OECD projects sum of absolute values of current accounts will rise to 4/5 of 2007 level
- And both IMF and OECD surely underestimate future Chinese and German surpluses – and underestimate US deficits (at 4% of GDP)

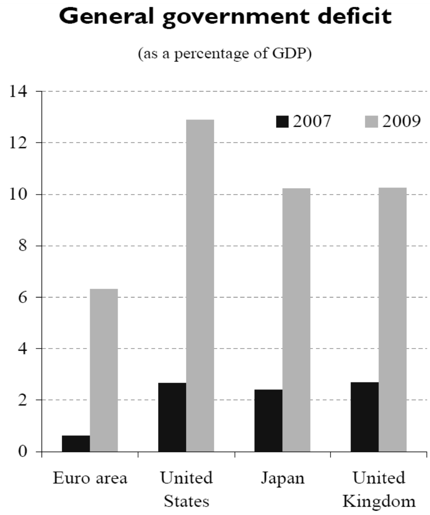
Why are global imbalances dangerous?

- They create huge cross-border flows, search for yield, overwhelming financial intermediation systems – *a major cause of the crisis*
- And the *present configuration of current accounts and exchange rates isn't sustainable*
- The inevitable dollar depreciation and changes in capital flows may be abrupt, if expectations change sharply
- This is a *new source of systemic risk*, especially from changing valuations of dollar-denominated assets

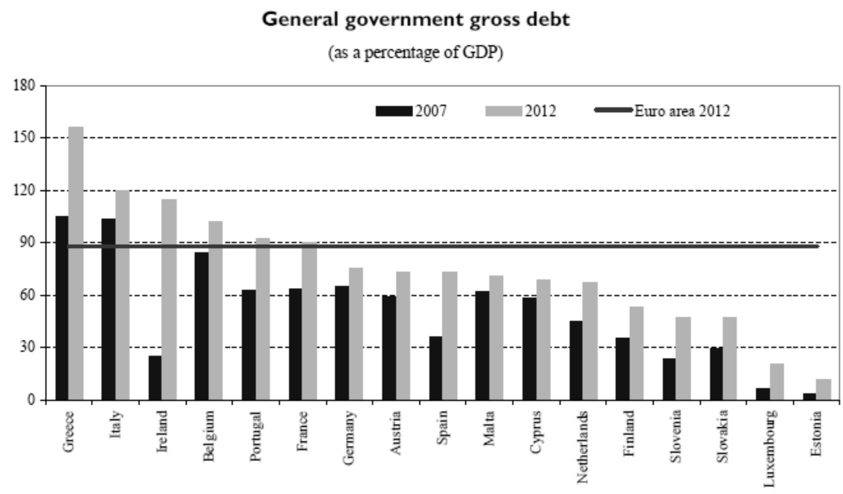
We won't return to 'normal' – and we don't know what it is! *The new new things…*

1. Long period of advanced country (AC) *fiscal consolidation, deleveraging*, and painful structural adjustments
2. Likely AC sovereign *debt restructurings* (but no breakup of euro area)
3. Shift of *dynamism and power in the global economy to EM*
4. New *spillovers of policy choices* between advanced countries and emerging market countries (EM)
5. Surge in financial flows to EM
6. Continuing unconventional monetary policies (zero interest rates and QE) in ACs – one way of fighting the *'currency wars'*
7. Prospective *end to dollar hegemony* in international finance
8. Commodity price instability and inflationary threats
9. *Will globalisation go into reverse?*

AC public sector deficits and debt way up, but wide dispersion in euro area

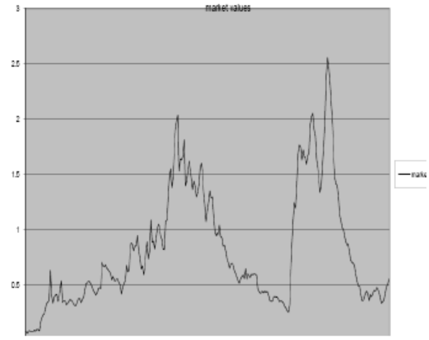


Source: IMF WEO October 2010

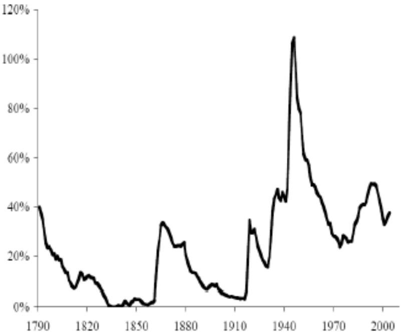


Source: European Commission - Autumn 2010 Forecast

AC *fiscal consolidation* will be slow – trying to do it faster risks 'double-dip'

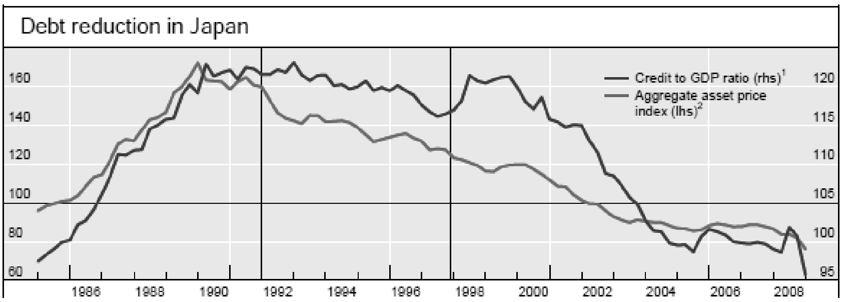


UK Government Debt
1700-2005



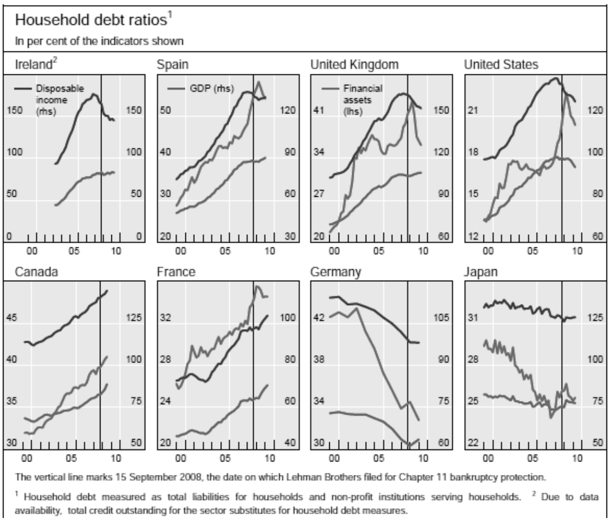
US Government Debt
1791-2003

Deleveraging slow too – and both deleveraging and fiscal consolidation will be painful



Source: Bank for International Settlements *Quarterly Review*, September 2010

Household deleveraging: a long way to go – and deleveraging is a drag on recovery

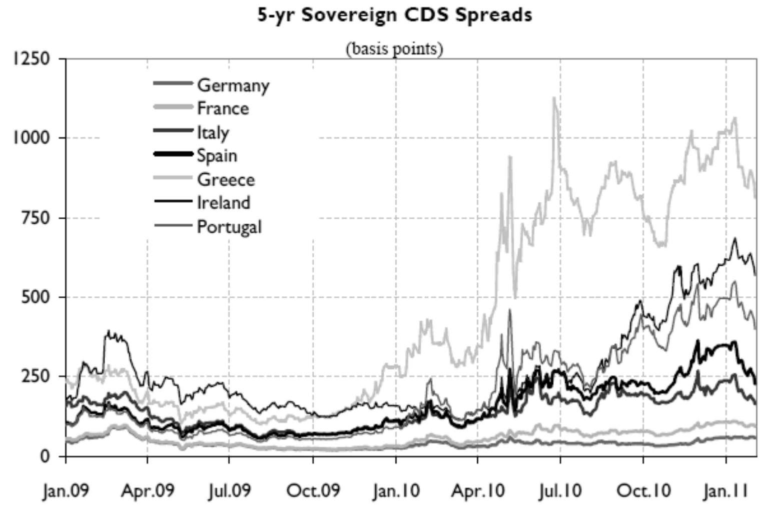


Source: Bank for International Settlements *Quarterly Review*, September 2010

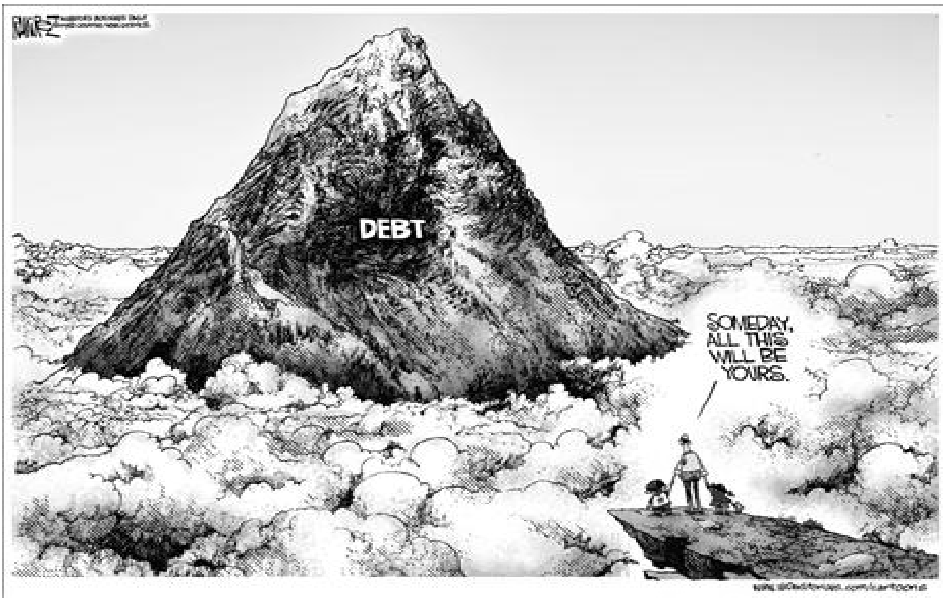
As if this weren't bad enough, *AC sovereign debt restructurings likely*

- Greece's IMF programme is simply not credible – getting to a *primary surplus of 6-7%* in 3 years (or even more) *is not feasible*
- Ireland has put the entire burden of bank bad loans on the taxpayer – none on creditors – *not sustainable*
- And if one restructures by agreement with creditors, others may wish to follow – Portugal? Danger of contagion in markets
- *The problem in Europe is in the banking system*, not (except Greece) a fiscal problem – but it has been made fiscal by 'socialisation' of banks' balance sheets

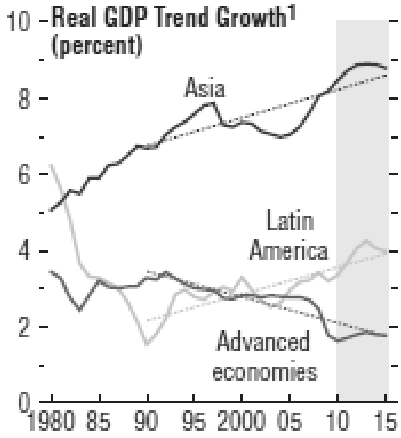
Expectations of haircuts?



Source: CMA DataVision via Datastream

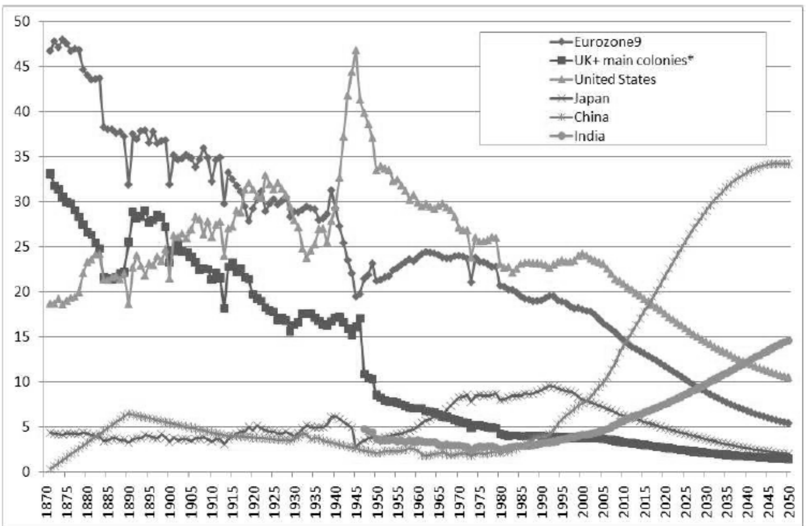


A *shift of dynamism and power* in the global economy



Source: IMF *World Economic Outlook* October 2010

Figure 3: Percentage shares of selected countries and areas in world GDP, 1870-2050 (At 2005 PPP exchange rates)



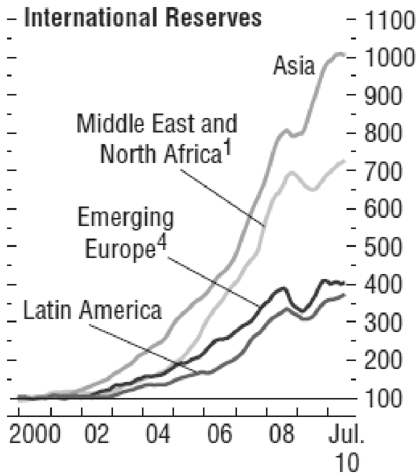
Sources: Angus Maddison's historical statistics and CEPII projections.

New spillovers of policy choices

- Greater interdependence through trade
- And much greater interdependence through asset markets
- Everyone seeks export-led growth – and so far, the EM countries are 'winning' that contest (but their households lose…)
- And they are accumulating foreign exchange reserves to historically unprecedented levels (but dollar devaluation could impose a big capital loss)
- Here come the 'currency wars'

Reserve growth: Asia up 10-fold in a decade, MENA up 7-fold, LA 4-fold

World total now almost $9 trillion, up from < $2 trn in 2000

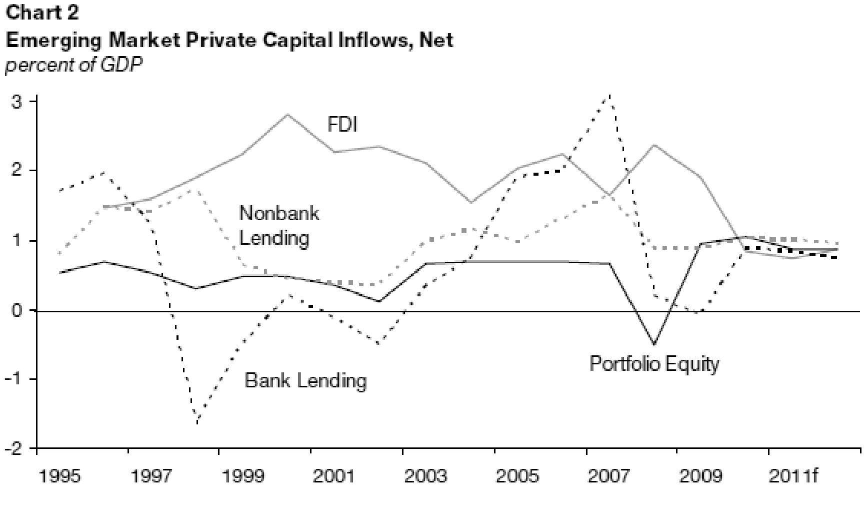


Source: IMF *World Economic Outlook* October 2010

Capital flows to EM rising

- Financial flows up substantially since the crisis
- Unconventional monetary policies in AC will keep interest rates very low – long rates too
- AC investors now don't hesitate to buy EM bonds
- A new form of 'recycling' EM current account surpluses: EM reserves rise, they go into short-term 'safe' securities in AC, and liquidity seeks outlets in riskier assets abroad

Both bank lending and portfolio investment in EM have recovered from crisis lows, stimulated by AC monetary policies



Source: Institute for International Finance, 'Capital flows to emerging market economies', 24 January 2011

Currency wars? – not nice, destabilising

- *Quantitative easing* at zero interest rates in several big AC *generates liquidity which flows abroad to EM* with higher interest rates
- So their currencies appreciate (and expectations of this make them even more attractive)
- And the rise in global liquidity exports bubbles to EM!

'…*housing prices in Singapore* rose to record high levels in the third quarter…real estate prices are at the highest level since the index began in 1975' *Top News Singapore* 2 October 2010

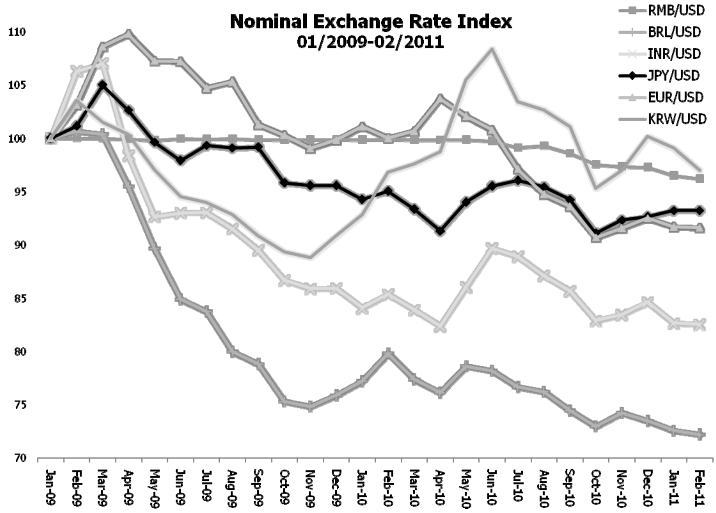
The *Bombay stock index* has more than doubled since June 2009.

'Brazil's benchmark Bovespa stock index hit a new high for the year on Friday as U.S. Fed Chairman Ben Bernanke said current economic conditions warranted further monetary policy easing.' Reuters 15.10.10

And the US will 'win' – in short run

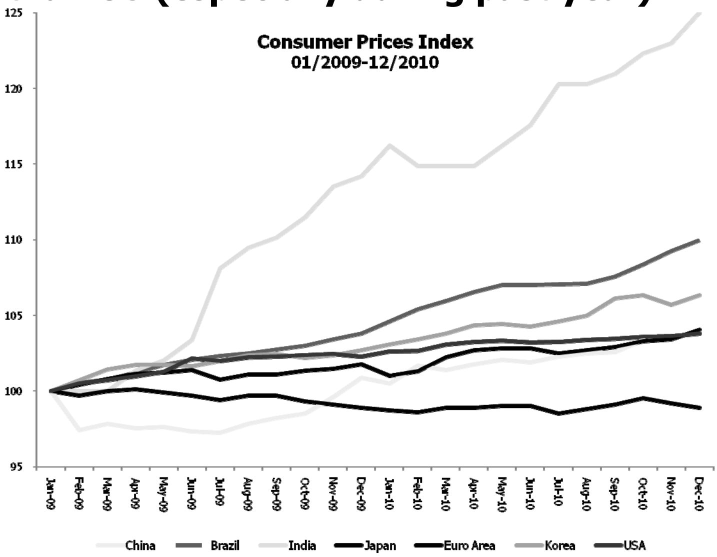
- If EM try to peg their exchange rates, they will have inflationary pressures – so capital inflow controls look tempting (Brazil, Thailand, …) – but not very effective
- 'The US will win this war: it will either inflate the rest of the world or force their exchange rates up against the dollar' (M. Wolf, *Financial Times*, 13 October)
- But there is a potential downside for the US – substantial *dollar depreciation will weaken the dollar's global position*

Indeed, US is winning – dollar falling…



Source: Federal Reserve Bank of St. Louis, FRED database

…and most key EM countries are inflating faster than US (especially during past year)

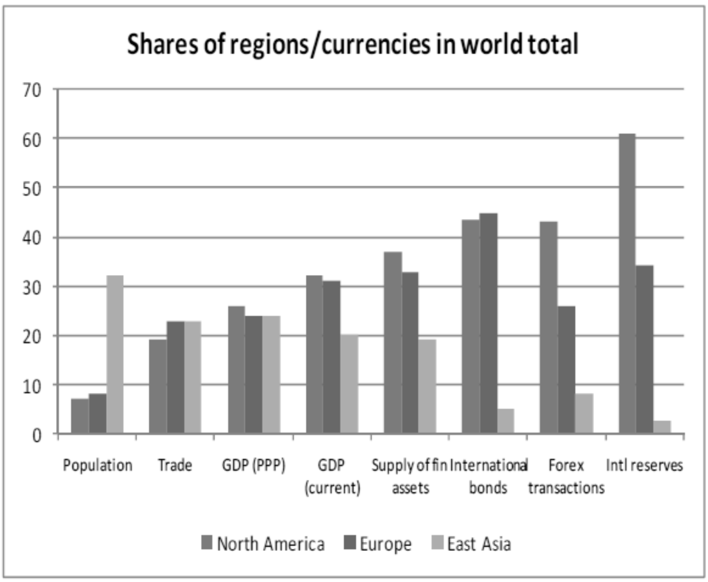


Source: IMF

The *dollar may lose its hegemony* in the international financial system

- $ still dominant in central bank reserves, but € share rising, and increasing use of € for invoicing
- US is still 'world banker', borrowing short and lending long – but € area foreign assets and liabilities now higher percentage of GDP than for US
- Unprecedented that main international currency is issued by country in substantial, *continuing current account deficit, with high net foreign debt*
- *What can't go on, won't…*
- Crisis may be a 'tipping point' – and if not now, then later

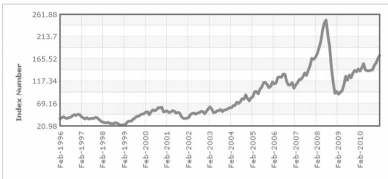
Hegemonic currency in a tripolar world – can't continue



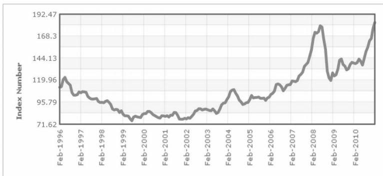
Source: Benassy-Quere and Pisani-Ferry

Meanwhile, commodity prices are spiking again – what goes up is likely to fall, but the *uncertainty is high*

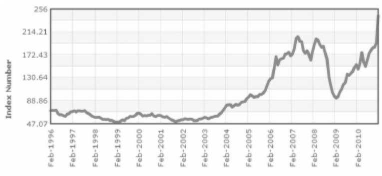
Commodity fuel prices (1996-2011)



Commodity food prices



Commodity metals prices



Source: www.indexmundi.com

Commodity prices: no simple story, so more uncertainty

- Normally, commodity price booms occur when global growth is especially strong and supply constraints bind – but that didn't apply in boom of 2007-08
- Focus on low real interest rates
  - Extract tomorrow not today
  - Demand for inventories up
  - Investors shift from T-bills to commodities
- Hard to find influence of financial market speculation – and little evidence of effect of futures on spot prices
- Commodity prices rise when dollar depreciates
- And now, political uncertainties affect oil market
- But food price inflation is equally dangerous

Maybe commodity price inflation reflects general inflationary pressures generated by quantitative easing – no one wants to hold money…

Banküberfall 2009

The biggest uncertainty: *Globalisation could go into reverse*

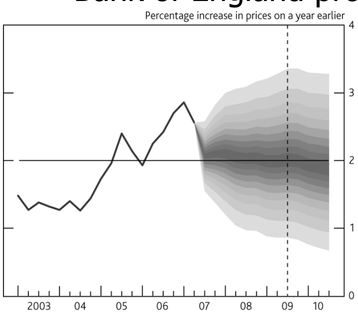
- A backlash?
- Trade protectionism blocks competition, creates inefficiencies, and can snowball into trade war with potential devastating effects
- Curbs on migration also economically bad: migrants fill labour force gaps and provide new young workers to ageing societies
- Capital controls may stop *desirable* exchange-rate appreciation (as in China)

These are very scary times!

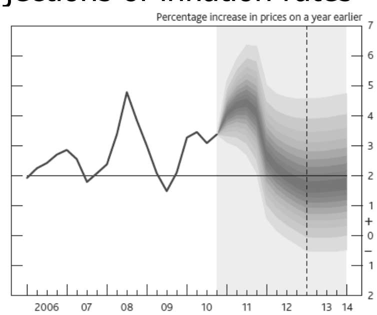
1. Global imbalances – another crisis brewing?
2. Fiscal consolidation – double-dip recession in UK?
3. Deleveraging – how far and how long will it go?
4. Sovereign debt restructurings ahead – more stress in euro area?
5. Shift of dynamism in global economy – destabilising?
6. Currency wars – how will EM countries respond?
7. Global dollar dominance ending?
8. Commodity price boom – consequences of oil and food price rises? When will they peak? Global inflation coming?
9. Serious backlash against globalisation, with protectionism?

The bottom line: *exceptional uncertainties* ahead

Bank of England projections of inflation rates



August 2007



February 2011

3 1/2 years ago, BoE estimated 90% probability that inflation 2 years later would lie between 0.75% and 3.3%. The corresponding range now at a 2-year horizon is -0.5% to 4.7% - almost *twice as great* ! (Similar increase in uncertainty of GDP projections.) Source: BoE *Inflation Report* Aug 2007, Feb 2011.