

*State of the World Economy, 2011-2012:*

# Whither or Wither?

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On November 18, 2010, the U.S.-Korea Institute at SAIS and the Korea Institute of Finance, sponsored by the Asian Studies Program at SAIS and the *JoongAng Ilbo*, hosted the one-day conference, "State of the World Economy, 2011-2012: Whither or Wither?" at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C.

This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.



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## *The State of the World Economy, 2011–12: An Overview*

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The collapse in world trade and output that took place during late 2008 and early 2009 was terrifying. By the spring of 2009, it had taken on proportions that invited comparisons with the most devastating economic crisis of the twentieth century, the Great Depression. To be sure, the experience in individual countries was not always as bad: “Half a Great Depression” (which was, of course, bad enough) is how Paul Krugman described the U.S. experience in a widely cited comment (2009). But once one stood back and took a global view, the comparison with the Great Depression was not a fanciful one.

Figure 1 is an updated version of a chart that first appeared in April 2009 (Eichengreen and O'Rourke 2009). It plots movements in world industrial output from their respective global peaks, in June 1929 and April 2008. As can be seen, as of early 2009 the two indices were declining at a comparable rate; the pressing question was to know whether global policy responses would be sufficient to halt the decline.

As figure 1 shows, the answer to this question is in the affirmative. Whereas global industrial output continued to decline for three years after 1929, it was bottoming out by late spring 2009, just a year after the crisis had started. At the trough, output had fallen by about 12% relative to the April 2008 peak. By August 2010, the latest month for which data were available at the time of writing, industrial output had recovered to its pre-crisis level. The figure shows, however, that the speed of recovery has decelerated in recent months.

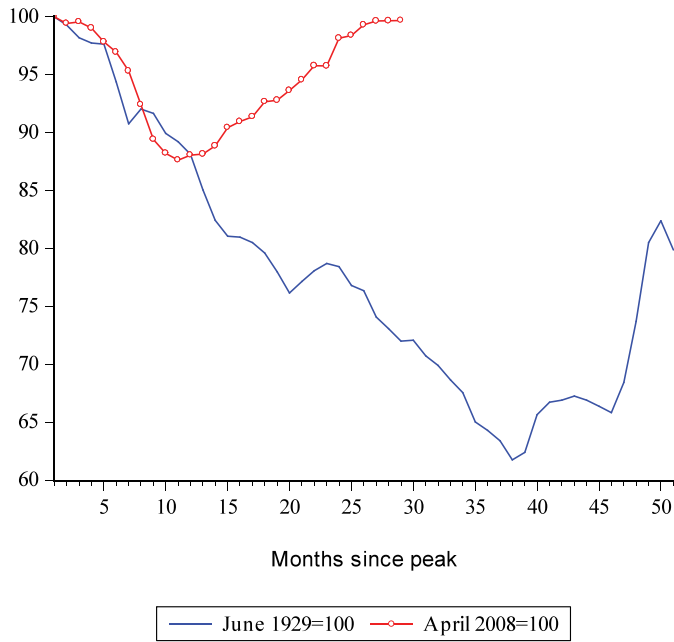
What was true for industrial production was true for international equity markets as well. Figure 2 shows that world stock markets fell much more rapidly after April 2008 than they did after June 1929, the Wall Street Crash notwithstanding. By February 2009, they had declined by slightly more than 50%. The recovery was equally dramatic, as can be seen, although there was a severe setback in late spring 2010, and world equity markets remained 19% below peak in October 2010.

One of the defining features of the Great Depression is the collapse in world trade after 1929, with the Smoot-Hawley tariff serving as the symbol of the rise in protectionism, and the breakdown of the multilateral trading system of the period. And so it was alarming to see world trade volumes declining at an even faster rate during the present crisis that they had done 80 years previously (figure 3). They fell by 20% in less than a year, an “accomplishment” that it took almost three years to achieve after 1929. Once again, the recovery was rapid, and world trade was less than 2% below its peak value in August 2010.

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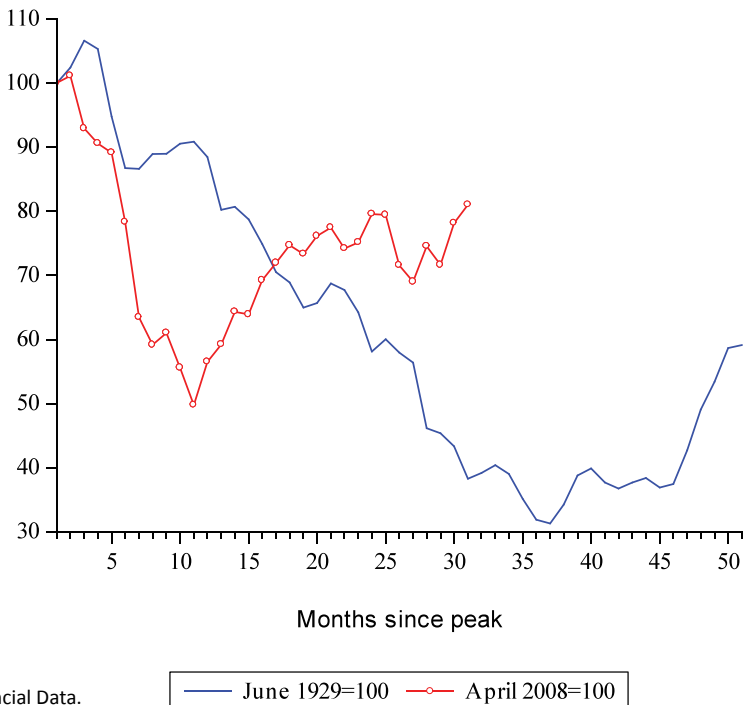
\* Presented at the State of the World Economy, 2011–2012: Whither or Wither? Workshop, SAIS, Washington, D.C., November 18, 2010. I am grateful to Barry Eichengreen, Alan Taylor, and conference participants for many useful comments. The usual disclaimer applies.

**Figure 1. World industrial output during two global crises**



Source: Data graciously provided by the IMF, and Wagenführ 1933, *Vierteljahrshefte zur Konjunkturforschung* (various issues), *Statistik des In- und Auslands* (various issues).

**Figure 2. World equity markets during two crises**

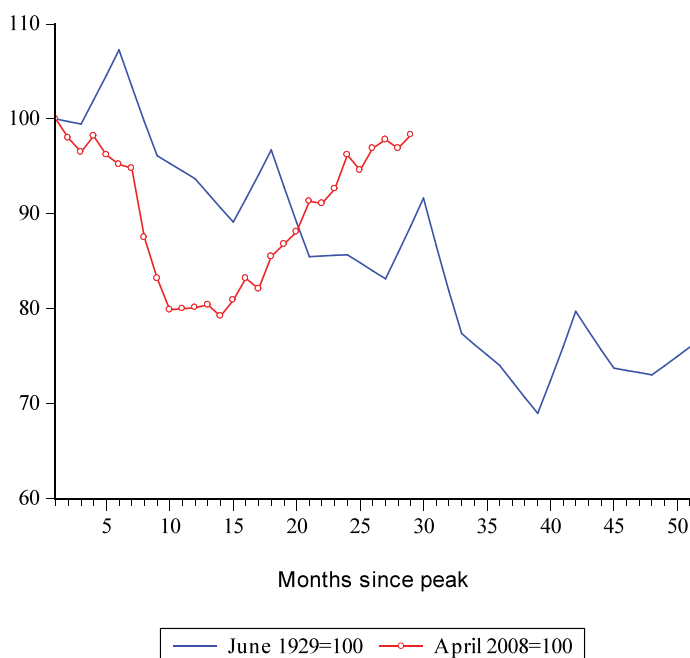


Source: Global Financial Data.

The reasons for the speed of this decline, and the apparent increase in the elasticity of trade to output that it implied, have been the source of considerable debate among trade specialists. One big difference from the situation 80 years ago is that the share of manufactures in world trade, which had been just 44% in 1929, was 70% in 2007. This matters, since manufacturing output is far more volatile than primary production. Eighty years ago, output in the developing world remained relatively stable during the crisis, since the developing world was for the most part specialized in primary production of one sort or another. It was in the industrialized economies of Europe and North America that output collapsed; the depression was transmitted to the developing world via a decline in their terms of trade. Since the 1960s, however, industry has spread across the globe; the decline in output was global; and the decline in world trade was correspondingly dramatic. There have also been compositional shifts within manufacturing trade: expensive consumer goods whose purchases can be easily postponed are much more important components of world trade nowadays, while cross-border flows of intermediate products helped to ensure that the decline in world trade and world output after 2008 was highly synchronized (Baldwin 2009). Of course, as the world economy recovered in 2009 and 2010, world trade recovered in a rapid and synchronized manner as well.

What figures 1–3 suggest is that, while the shock that hit the world economy was indeed a Great Depression–sized shock, the world has managed to escape a second Great Depression. Why did it do so? Eichengreen and O’Rourke (2009) and Almunia *et al.* (2010) argue that it was the different policy responses by finance ministries and central banks that made the difference. In the interwar period, respectable people signaled their adherence to economic orthodoxy

**Figure 3. World trade during two crises**

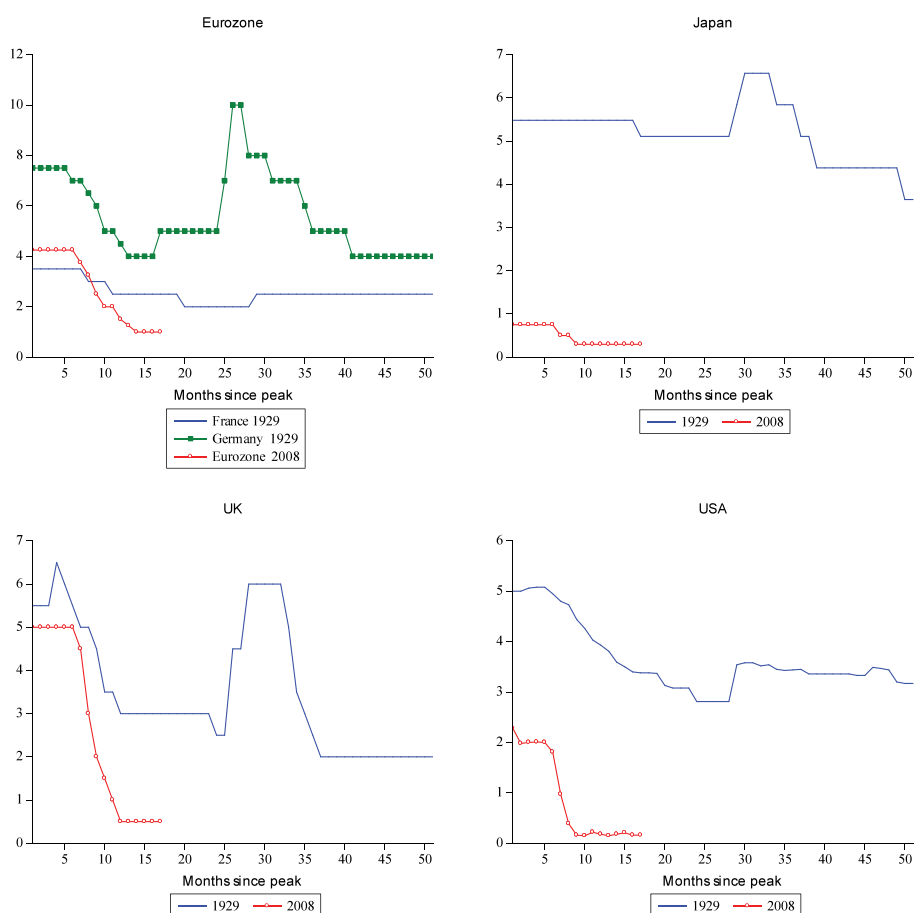


Source: *League of Nations Bulletin of Monthly Statistics* and <http://www.cpb.nl/eng/research/sector2/data/trademonitor.html>.

and a liberal international trading system by supporting the gold standard. This not only—by definition—made it impossible to respond to a serious economic downturn with expansionary monetary policy; it also made governments reluctant to adopt reflationary fiscal policies, since this could worsen the trade balance and lead to a drain of gold reserves. It was only when governments abandoned the gold standard that they regained the policy flexibility required to respond to the crisis and that their economies started to recover (Temin 1989, Eichengreen 1992). Up until that moment, they pursued perverse policies, tightening fiscal policy to try to keep deficits from increasing and raising interest rates so as to try to stave off outflows of gold. These perverse policy responses are ultimately what turned a severe recession into the Great Depression.

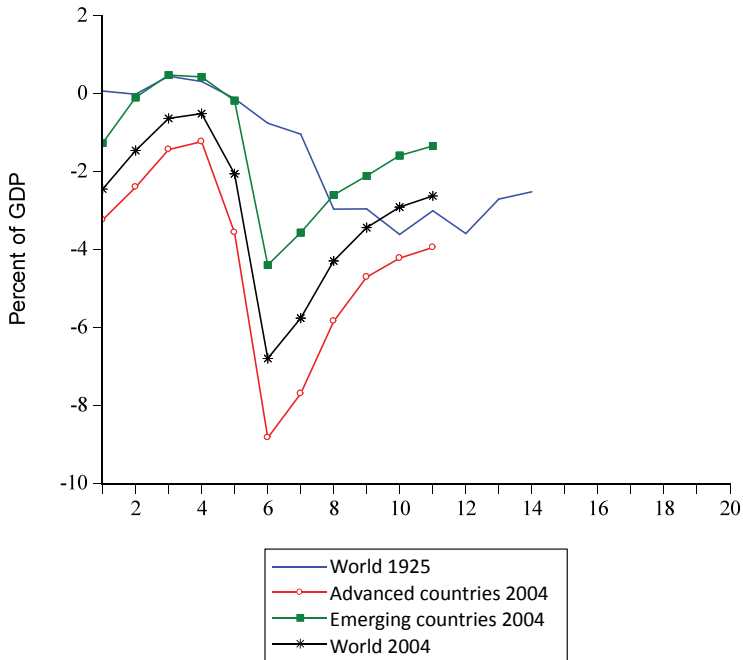
Policy makers have learned from these mistakes. Figure 4 shows the sharp contrast between the interest-rate policies pursued during the two crises. Figure 5 shows that while government budget deficits increased during both crises, they increased by a lot more after 2008 than after

**Figure 4. Discount rates during two crises**



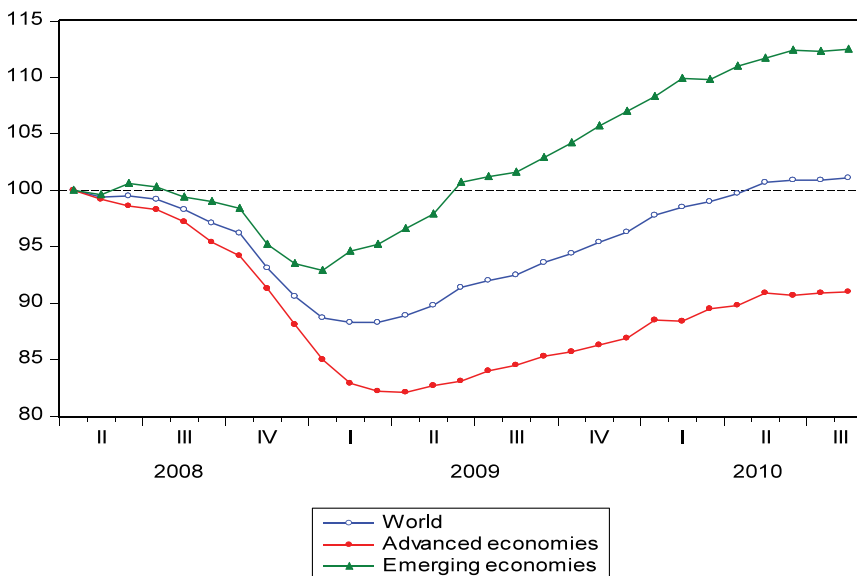
Source: Almunia *et al.* 2010.

**Figure 5. Government budget deficits during two crises**



Source: Almunia *et al.* 2010.

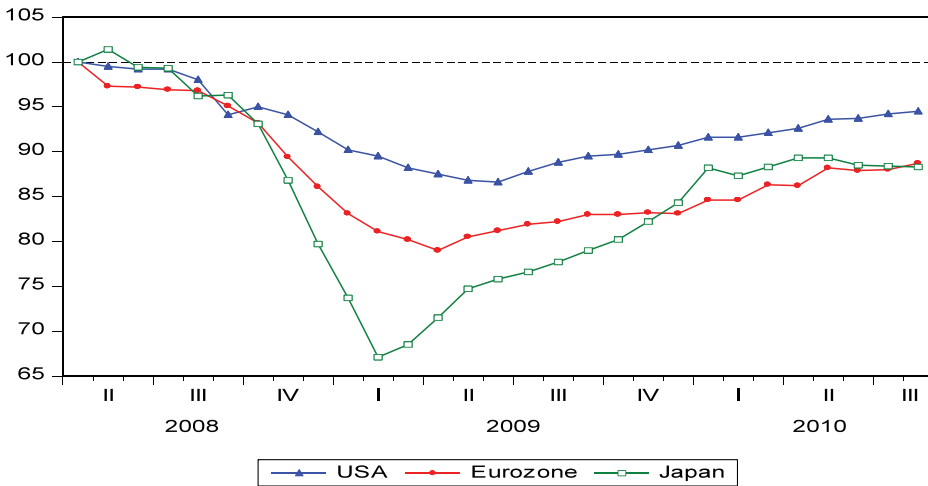
**Figure 6. Industrial output, 2008–10**



Source: CPB.

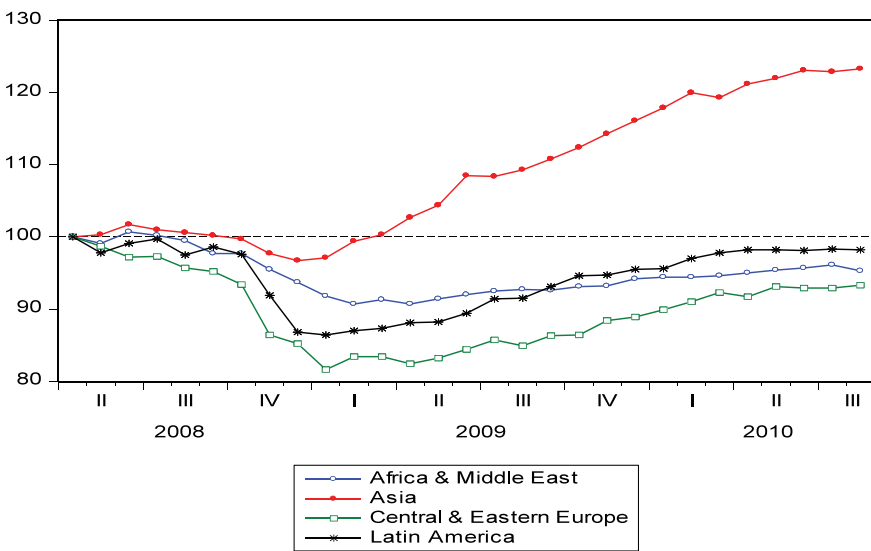


**Figure 7. Industrial output, 2008–10: advanced economies**



Source: CPB.

**Figure 8. Industrial output, 2008–10: emerging economies**



Source: CPB.

1929, especially in advanced economies. This reflects the greater willingness of governments today to allow automatic stabilizers to operate, as well as a certain amount of discretionary fiscal stimulus in various countries. The net impact has been a Great Recession rather than a Great Depression, and a recovery that was impressive, at least in late 2009.

This recovery was driven by events in the emerging economies, rather than by the advanced economies. The IMF (2010) is currently forecasting a growth rate of 2.7% for the advanced economies, slowing to 2.2% in 2011, which is disappointing given the 3.2% contraction experienced in 2009. By contrast, the forecast for emerging economy growth is 7.1% in 2010, slowing to 6.4% in 2011. Figure 6 shows that while emerging economy industrial output is now more than 10% above the previous peak level of production, advanced economy production is still more than 10% below peak. Within the advanced economies, the United States experienced a relatively shallow decline, and a relatively shallow recovery, outperforming both the Eurozone and Japan, whose industrial output fell by more than 30%. The Japanese recovery was equally steep, before it fizzled out in 2010 (figure 7). Within the emerging economies, industrial output performance has been strongest in Asia (figure 8), although when the focus is on GDP growth rather than industrial output growth, Latin America and sub-Saharan Africa have both been bright spots.

## The Immediate Outlook

Although the recovery from the Great Recession has been impressive when compared to the experience of the 1930s, it is important to note that it has been losing momentum throughout 2010. The Netherlands Bureau for Economic Policy Analysis, on whose data I am relying in figures 3, 6, 7, and 8, has been tracking this decline in momentum since the start of the year (figures 9 and 10). Momentum is defined as the growth rate between successive three-month periods; it has been declining since January for both industrial production and trade (figure 9). Alarming, the decline has been greatest for industrial production in the emerging economies—alarming, since as we have seen, the recovery has been strongest there (figure 10).

The OECD's composite leading indicators also suggest some causes for concern in the immediate future (OECD 2010). To be sure, they suggest expansion in the United States, Japan, and Germany, as well as the OECD as a whole, and Russia; but they also suggest that a slowdown may be in the offing in Brazil and China, as well as a downturn in India, France, Italy, and the UK. And as we have already seen, the IMF is forecasting that world growth will slow in 2011, with the major risks according to them being to the downside.

There are several good reasons why we would expect growth in the advanced economies to be restrained in the immediate future, despite the size of the recession in 2008–9 (IMF 2010). The first is that a reasonably large share of the recovery in the United States and Europe can be accounted for by inventory rebuilding. The most recent data for U.S. GDP indicate that the economy grew at an annualized rate of 2.5% in the third quarter of 2010, but that just over half of this growth (1.3%) can be accounted for by an increase in business inventories. By definition, this is not a long-run source of growth.

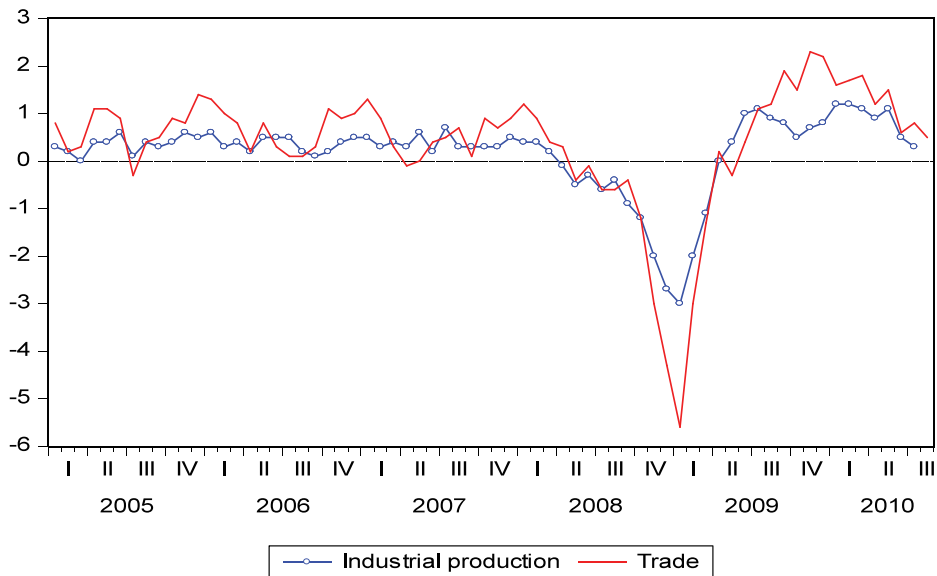
The second reason is that the fiscal stimuli of 2009 are being replaced by a switch to austerity across the advanced economies—not just in economies such as Greece and Ireland,

which are excluded from the capital markets, but in countries such as Germany, which are still able to borrow at low rates. Crucially, in the Eurozone periphery this austerity cannot be accompanied by nominal devaluations, which would in normal circumstances have cushioned the blow to output by helping these countries to price themselves back into foreign and domestic markets. Austerity in the core countries will further depress growth in the PIIGS, and make eventual default there more likely.

The third reason is that several forces will continue to constrain household consumption in the immediate future. First, while households have been busily deleveraging in such heavily indebted economies as the United States, the UK, and Ireland, the process is not yet complete. Second, on the other side of household balance sheets, house prices have been sliding across the OECD. In the two most important countries where it seemed that a bottom might have been reached—the UK and the United States—there are now fears of a double dip, with the double dip apparently well underway in Britain. Third, unemployment is directly constraining the expenditure of affected families, and is creating new mortgage-related holes in banks.

A fourth reason is, of course, the banking problems that persist in Europe, and the associated turmoil that this is provoking in financial markets. The failure of the European authorities to come clean about the scale of the problems in their banking sector is not only preventing the resolution of these problems, hence depressing lending and economic activity; it is adding to the general sense of uncertainty haunting financial markets. In the Irish case, an ill-considered blanket guarantee of bank liabilities, combined with continuing uncertainty

**Figure 9. Momentum in world industrial output and trade**

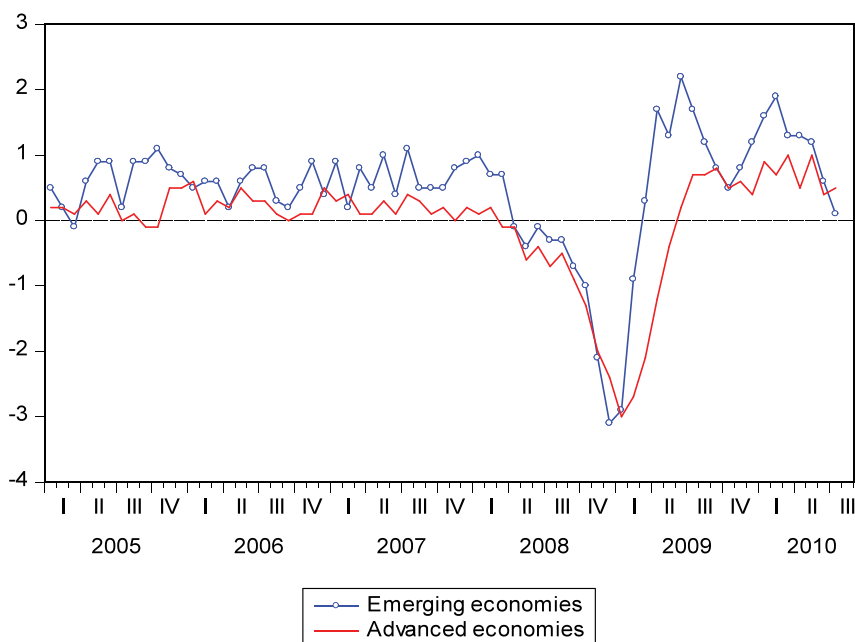


Source: CPB.

about the scale of bank losses, has pushed the country into the hands of the EFSF and IMF as fears about the country’s solvency grow. Unfortunately, the proposed “rescue plan” for Ireland, which is nothing of the sort, is only going to delay the inevitable restructuring of Irish debts, at the cost of considerable expense and hardship for ordinary people. A far better solution would be to restructure bank-related Irish debts, and if this causes problems elsewhere, to restructure there as well. Trying to fix solvency problems by assuming that they are liquidity problems is a dangerous strategy, not just because it will not work, but because of the political tensions within Europe that it is already creating, and will continue to create.

A further problem that will have to be faced going forward is the external imbalances that were such a feature of the world economy in the run-up to the crisis, and that appear to be widening again. We know what adjustments are needed in the long run to get these down to a sustainable level. In deficit countries, expenditure needs to fall relative to income—unfortunately, this will depress demand in the short run, which is not what the world economy needs. Deficit countries also need to see their real exchange rates depreciate, which can happen in three ways: nominal depreciation, foreign inflation, and domestic deflation. The first two are preferable to the third, which is economically costly in a world in which many prices and wages are sticky downwards. In surplus countries, the required adjustment is for expenditure to rise relative to income, and for real exchange rates to appreciate. Rising domestic expenditure is, of course, as helpful in the short run in sustaining demand as the falling expenditure in deficit countries is harmful. Once again, surplus countries’ real exchange rates can appreciate as a result of a nominal appreciation, domestic inflation, or harmful foreign deflation. If surplus countries do not wish to see domestic inflation, nominal appreciation is the least costly way of achieving

**Figure 10. Momentum in industrial output**



Source: CPB.

the required relative price adjustment.

The travails of the Eurozone periphery show clearly the problems of adjusting via domestic deflation. As in the case of the East Asian economies during the 1990s, a perception that risk was not an issue led to massive inflows of capital into economies such as Ireland and Spain; the result was rising wages and prices, appreciating real exchange rates, and falling competitiveness. As members of the Eurozone (for now at least), they do not have devaluation available as an option, and so they are relying on “internal devaluations,” or domestic deflation, in order to rebalance their economies. Since wages are falling, but household debts are not, this is proving to be a very painful process, involving increasing levels of unemployment and mounting debt problems of one sort or another. These feed back into the banking sector, and then into the real economy, from whence the cycle can recommence. At the global level, nominal exchange rates are flexible, and these costs can be avoided.

### **The Crisis and International Cooperation**

This crisis will definitively end one day, but the world will still be left with the same long-term problems that it faced in 2007. Among the most important of these are: how to manage the rise of China and India to superpower status; how to ensure that all nations retain confidence in the ability of the market to supply them with the food and raw materials that they need in order to feed their people and their factories; and how to deal with the shared challenge of global climate change. All of these problems have their origin in, or are made more acute by, the rise of Asia to its rightful place in the world. The solutions to all of them involve, in part, the development of more effective and inclusive multilateral structures. If this crisis leads to more effective patterns of international cooperation, then it will not have been wasted.

The early signs were promising, with the G-20 supplanting the G-7, and the London summit of April 2009 generally being regarded as a success. Since then, however, the process has run into difficulties, with deep divisions emerging between national governments regarding what the appropriate response to the ongoing weakness in the world economy should be. This transition is a logical one, given the economics of the situation. In 2009, fiscal stimulus was on the agenda. The problem facing governments was that one country's stimulus helped others: the temptation was therefore to free-ride off the stimulus packages of others. As the Irish minister of defense said in January 2009:

We tried the fiscal stimulus approach in response to the oil shock in the late 1970s. The increased spending power given to the Irish consumer largely leaked out on increased imports and left us in an even worse position. ...From Ireland's point of view, the best sort of fiscal stimulus are those being put in place by our trading partners. Ultimately these will boost demand for our exports without costing us anything.

The problem, of course, is that if everyone had taken the same attitude, then there would have been no stimulus at all, which would have been collectively costly.

There was thus a strong incentive for national governments to cooperate with each other. Keeping trade open was a logical part of the bargain, since it was trade that allowed countries to

benefit mutually from each other's recovery programs.

In 2010, however, the Greek fiscal crisis, which might reasonably have been regarded as *sui generis*, sparked a stampede towards austerity throughout the advanced economies. With fiscal policy no longer in play, stimulus measures inevitably came to increasingly involve monetary policy. Unfortunately, the spillovers associated with expansionary monetary policy are negative as well as positive. It is true that if quantitative easing in the United States, say, succeeds in stimulating the U.S. economy, then that is in and of itself a very good thing for the rest of the world. However, there are other side effects that are less positive. On the one hand, if exchange rates are allowed to adjust, then partner countries will find their exchange rates appreciating. As mentioned earlier, nominal appreciation is precisely what is called for in the case of surplus country exchange rates, but this spillover is certainly perceived as negative by many countries. On the other hand, if exchange rates are kept fixed, the result may be capital inflows and inflation. Allowing exchange rates to adjust would seem to be the first-best solution, with capital controls a possible second-best; in either event, international cooperation may be strained. It is strained even further by the radically different economic analyses prevalent in different countries—symbolized by some highly undiplomatic and well-publicized German comments about quantitative easing in the run-up to the Seoul Summit. This difficulty is all too familiar to students of the 1930s.

The world economy is thus entering a somewhat dangerous phase, with a halting world recovery, and the possibility of volatile exchange rates arising from an asymmetric process of monetary expansion. The lesson of the interwar period is that such swings in exchange rates can be dangerous, since countries pursuing more orthodox policies can find themselves with overvalued exchange rates and serious competitiveness problems. Their response in the interwar period was to erect higher tariff and non-tariff barriers to trade. While protection was not a crucial ingredient in making the Depression worse—flawed monetary and fiscal policies were primarily to blame—the fragmentation of the world economy and the search for self-sufficiency contributed to the poisonous atmosphere of the period, which culminated in war.

## Conclusion

After the traumas of 2008–9, the world economy has enjoyed a strong recovery driven by the performance of emerging economies. However, the recovery has been losing momentum all year, and there are several reasons why growth prospects in the advanced economies are not particularly bright in the short-term future. To the extent that these economies are still the engine of growth for the exporting economies of Asia, this matters for the emerging economies as well. And to the extent that Asia is a key engine of growth for Germany, it matters for the central Eurozone economy as well.

The most likely scenario for 2011–12 is probably the one sketched out in the October IMF *WEO*: a gradual slowdown in economic growth across the world, with the basic trends intact. This means continued fast growth in the emerging economies, below-par growth in the advanced economies, and a corresponding convergence in living standards and influence between rich and poor countries. Within the Eurozone, however, more of the same will mean divergence between core and periphery, with the latter falling ever further into depression. And

within the United States, it will mean continuing high levels of unemployment.

There are several downside risk factors however. The most obvious one right now is that the crisis in the Eurozone will continue to spiral out of control, and that policy makers continue to make the wrong calls. If the problem facing the periphery is one of solvency, then continued provision of liquidity so that peripheral taxpayers can continue repaying debts that are excessive and unaffordable, combined with austerity measures driving economies ever further into recession, will just make things worse in the long run. The Eurozone will then be faced with a series of unpalatable options: coordinated debt restructuring, fiscal transfers, or monetization of the debt. If none of these happen, then a Eurozone breakup will be in the cards, with unpredictable and dangerous consequences, political as well as economic, for the region.

Further risk factors include bank losses that still remain hidden in Europe, and the possibility of uncoordinated monetary stimuli that could place international capital markets—and, in a worst-case scenario, international trade—under serious political pressure.

These political risks will be higher to the extent that unemployment remains high in key economies like the United States. This crisis is coming after a period of several decades during which U.S. inequality soared, and median incomes stagnated. Survey evidence shows clearly that the unskilled are hostile to globalization, and it was blue-collar workers who were most likely to vote against EU constitutional reform in France in 2005 and Ireland in 2008. Anti-globalization sentiment was a factor in both these votes, and it is predictable that if unemployment remains high in the years ahead these sentiments will only increase. Even more alarmingly, there is evidence that support for extremist parties rises in advanced economies as economic growth slows. As Adam Posen (2010a) has recently pointed out, the biggest downside risk facing the world economy is of a political reaction “that could undermine our long-run stability and prosperity.” It is, he says, “just as important to future generations that we deliver them an intact democratic system and liberal world economy, as to consider the commonly spoken debt-burden concerns” (Posen 2010b). The onus for ensuring that this in fact happens cannot lie on the shoulders of the deficit countries alone.

Governments can help in several ways. Medium- and long-term reforms can help create much-needed fiscal space today, without subtracting from the level of demand; governments with fiscal space need to use this and not engage in kneejerk austerity measures; European leaders should be more honest about the bank losses on that continent, with the recapitalization needs of AIB and Bank of Ireland—two banks that passed European stress tests earlier this year—serving as a much-needed wake-up call; and the Asian economies can be rebalanced, leaving them less vulnerable to the slowing economies of the West.

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