



OPPORTUNITIES AND RISKS IN THE GLOBAL ECONOMY

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Opportunities and risks in the global economy

“Let China sleep, for
when she wakes, she
will shake the world.”

Napoleon Bonaparte

Prologue

- Osama bin Laden could neither have timed nor executed his assault of 9/11/2001 better.
- But if his aim was to lay the world's globalising economy low, he failed.
- The world economy recovered sharply and integration proceeded.
- Even the shape of the cycle was the same as the previous one, with rising US external deficits initially supporting world demand.

Prologue

- We have seen that terrorism, collapsing stock markets, wars, soaring oil prices, protectionist pressures, a failing round of multilateral trade negotiations and huge global imbalances have failed to halt the dynamism.
- It is a remarkable story.
- Could anything go wrong?
- Yes.

Outline

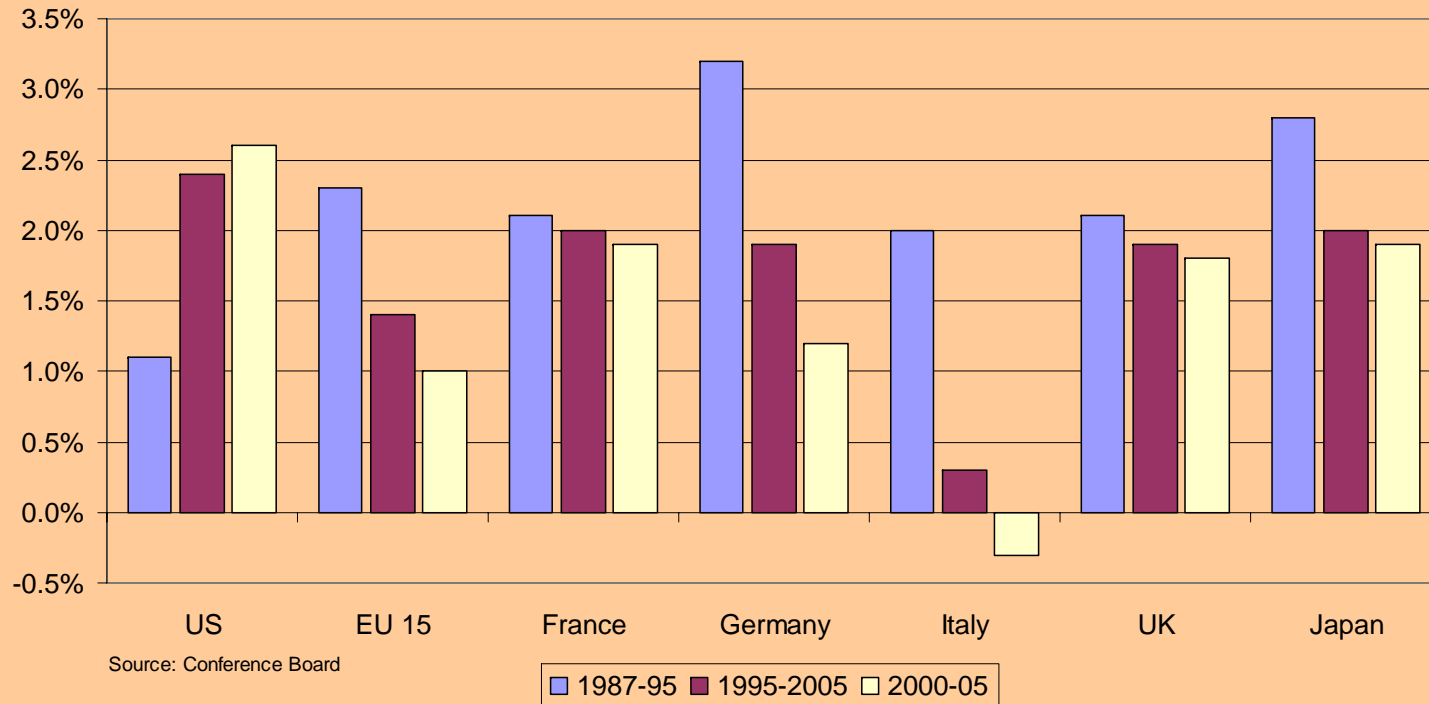
- Drivers of the world economy
- Prospects for the world economy
- Risks to the world economy

1. Drivers of the world economy

- The underlying real drivers of contemporary economic growth are three:
 - Rising productivity at the frontier of the world economy;
 - Globalisation; and
 - Entry of billions of people into the world economy.

1. Drivers of the world economy

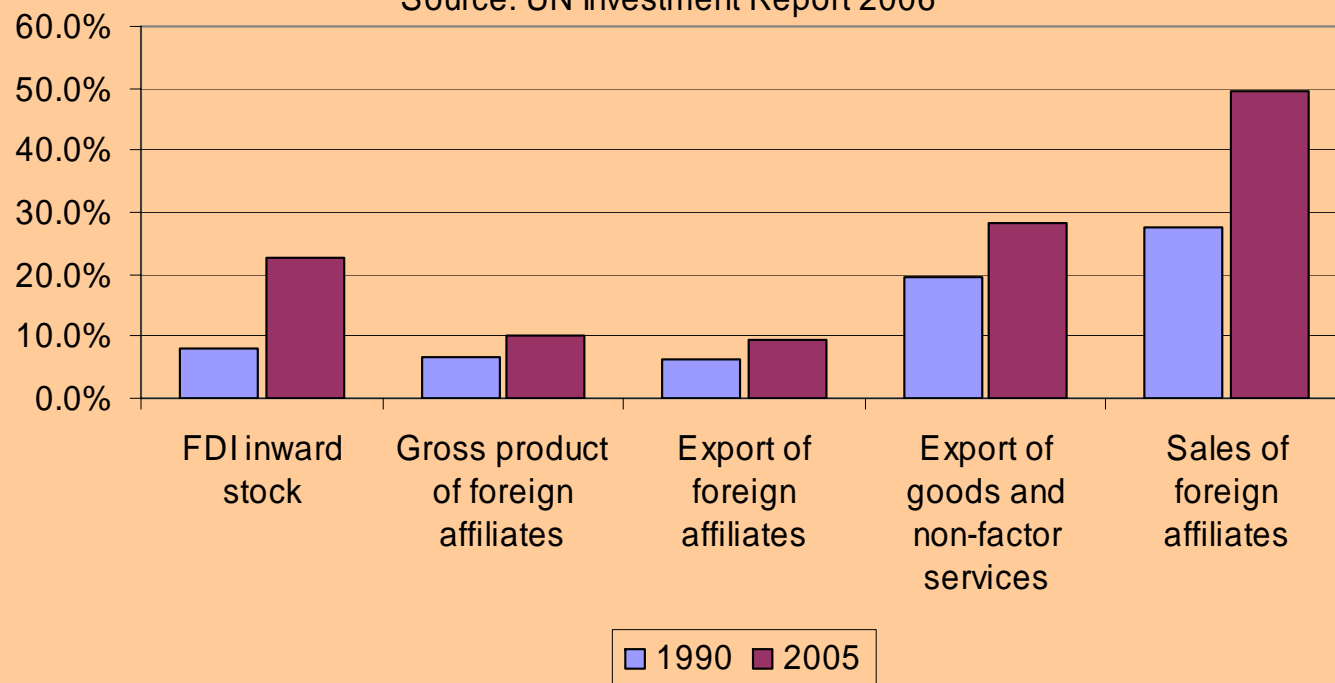
PRODUCTIVITY PERFORMANCE
(Growth of output per hour)



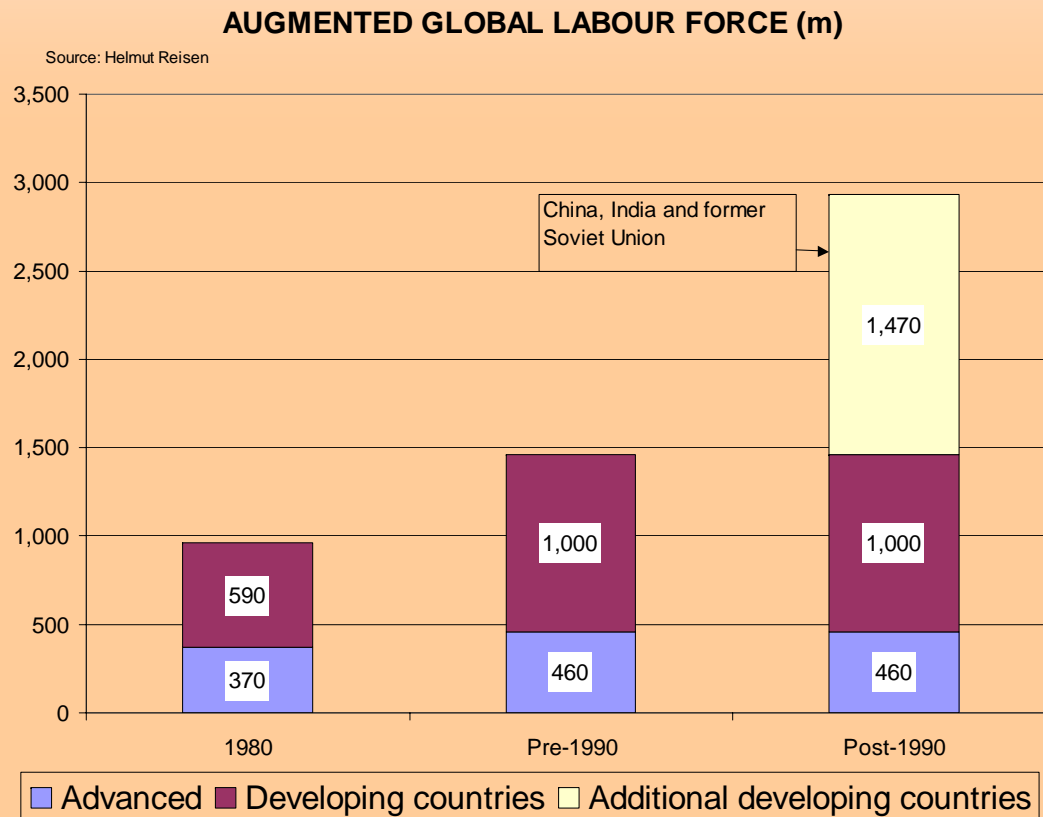
1. Drivers of the world economy

INTEGRATION OF WORLD ECONOMY (as share of global GDP)

Source: UN Investment Report 2006



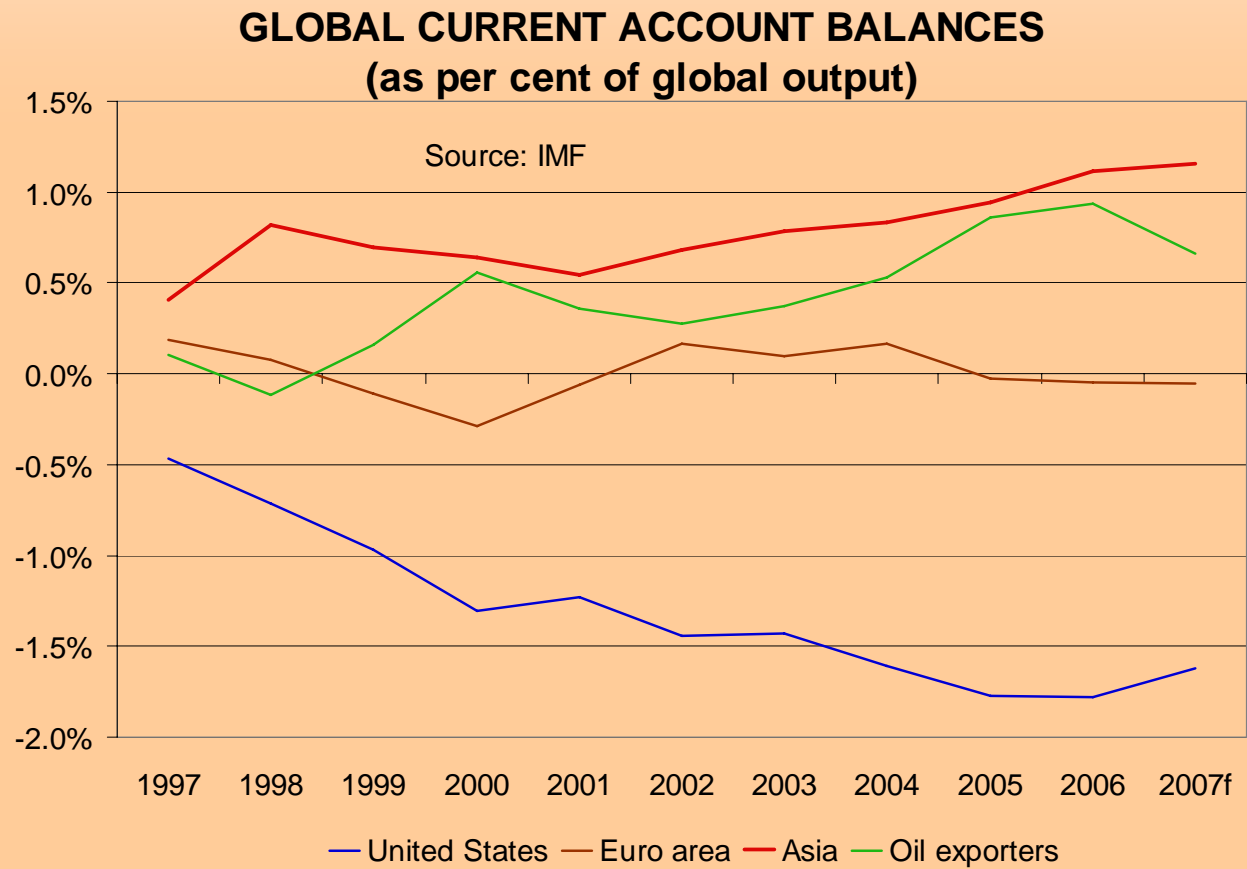
1. Drivers of the world economy



1. Drivers of the world economy

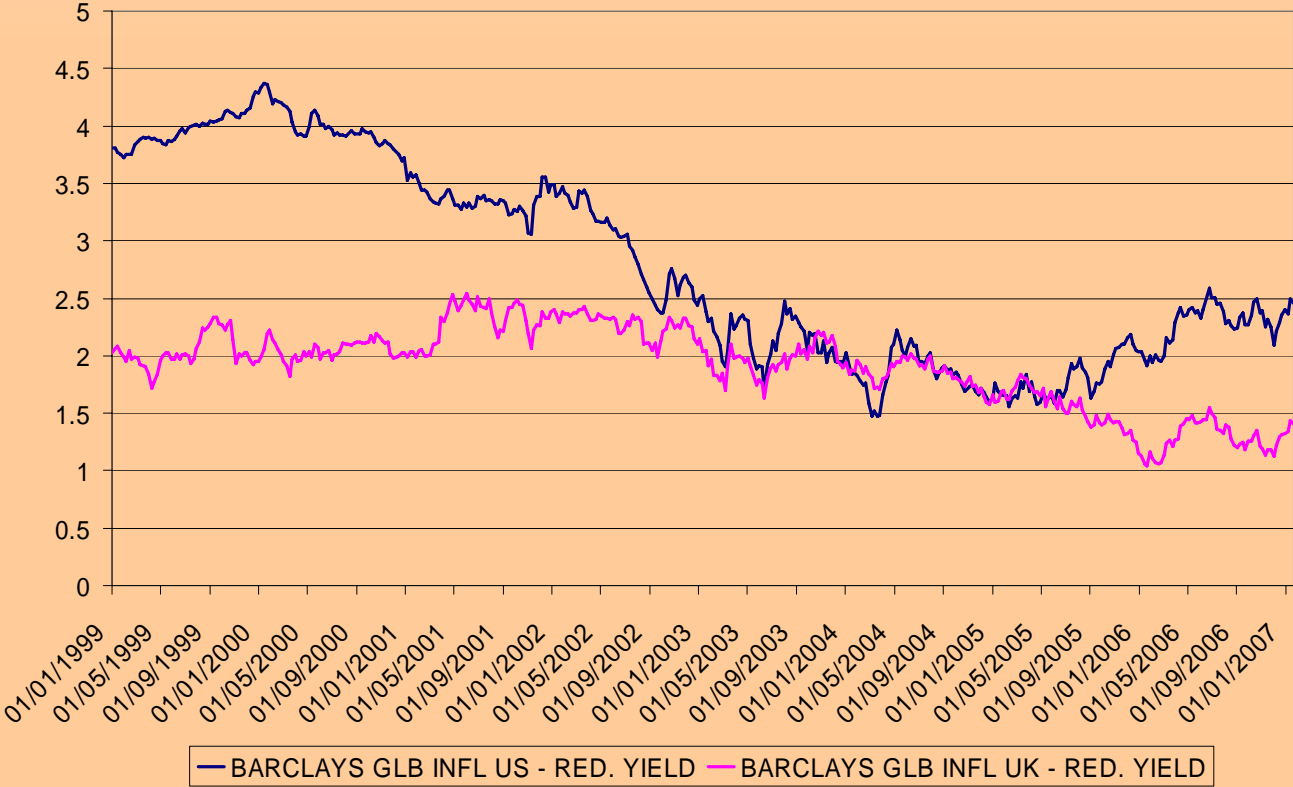
- Also important are three macroeconomic conditions:
 - US role as borrower of last resort;
 - Low real interest rates;
 - Low inflation, itself partly the result of globalisation and partly the result of monetary policy credibility

1. Drivers of the world economy



1. Drivers of the world economy

INDEX-LINKED YIELDS IN THE US AND UK



1. Drivers of the world economy

**THE DISAPPEARANCE OF INFLATION
(G7 weighted average, year-on-year)**



2. Prospects for the world economy

- In sum:
 - The world has been enjoying a well-balanced economic expansion;
 - Imbalances may even have reached a peak;
 - Inflation remains under control;
 - Interest rates are low; and
 - The most likely outcome should be sustained economic growth in line with global potential.
- Yet there are also big risks.

3. Risks to the economy: short term

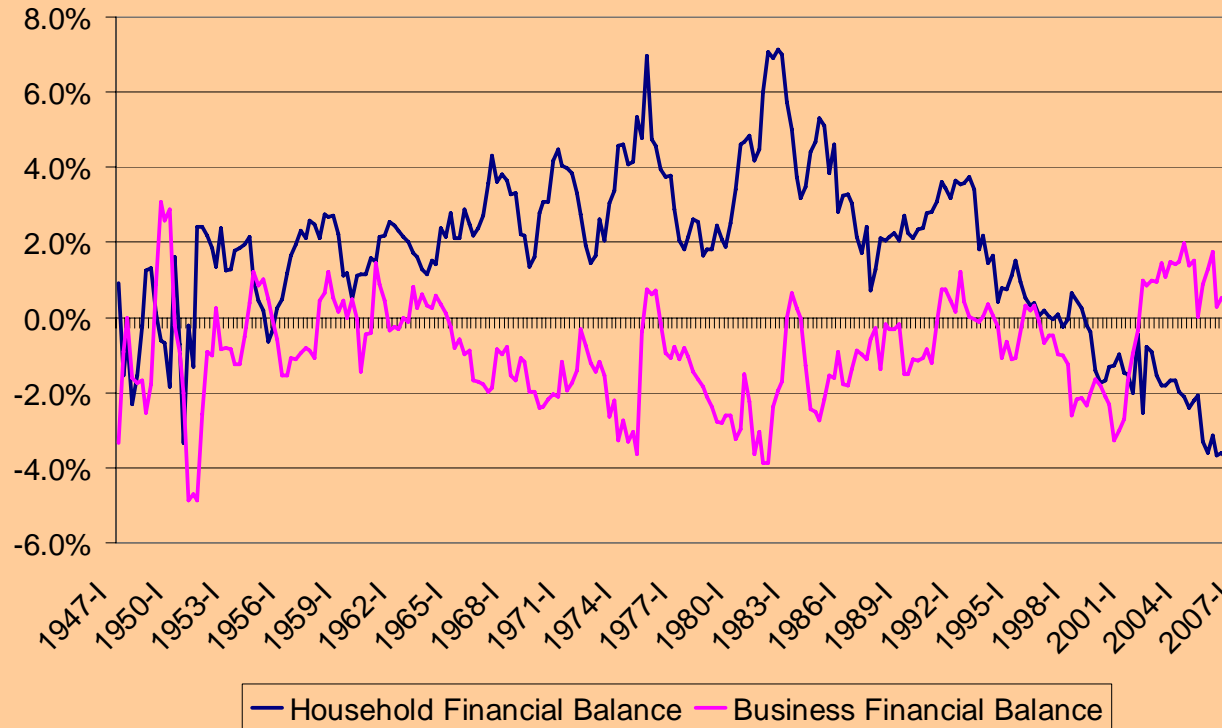
- One set of short-term risks is in the US:
 - Demand weakens as the Fed runs out of asset price bubbles to blow;
 - US households have been running very large financial deficits for the last decade; if this stopped, the US would slow sharply;
 - “Credit crunch” makes this more likely.
- A second possibility is adjustment in risk spreads and large-scale defaults among over-leveraged borrowers across the world.

3. Risks to the world economy: short term

- A third set of short-term risks is of a global crisis, perhaps involving a collapsing dollar and a brutal reduction in the US external deficit:
 - But the creditor countries have a strong economic and political interest in avoiding such a calamity;
 - That makes this risk modest in the short run; and
 - The dollar is more likely to sink than collapse.

3. Risks to the world economy: short term

**COMPOSITION OF US PRIVATE FINANCIAL BALANCES
(per cent of GDP)**



3. Risks to the world economy: longer term

- A return to massive protection in the high-income countries:
 - But this time the interests of workers and companies in seeking protection are more likely to be divided than united, since the latter look to global markets and global sourcing;
 - Moreover, despite the disappointment of the Doha round, the World Trade Organisation exists. Nobody has suggested repudiating their obligations;
 - So a return to protectionism would involve a repudiation of the world economy by major states;
 - This still seems very unlikely.

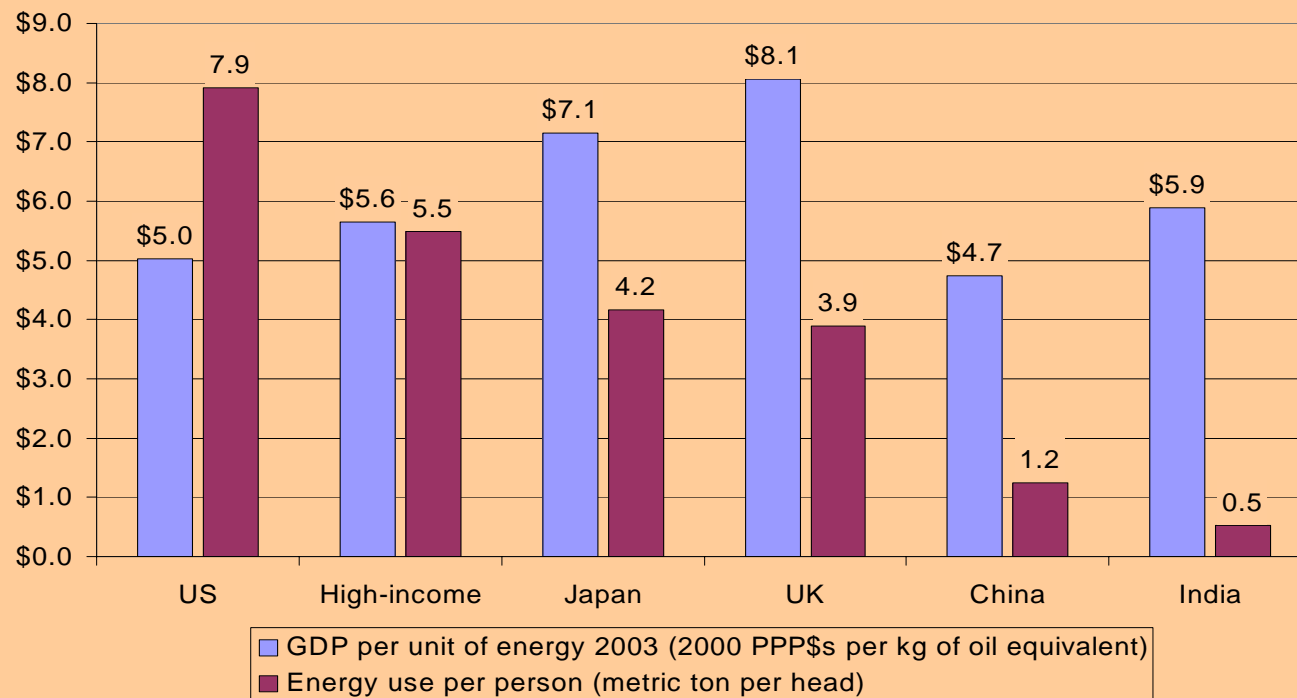
3. Risks to the world economy: longer term

- Far higher oil prices:
 - Perhaps as a result of a war in some producing region, in the context of soaring demand.
 - Many analysts believe prices are already well above their longer-term equilibrium levels and so are more likely to fall than rise.

3. Risks to the world economy: longer term

ENERGY EFFICIENCY AND ENERGY CONSUMPTION PER HEAD 2004 (ranked by consumption per head)

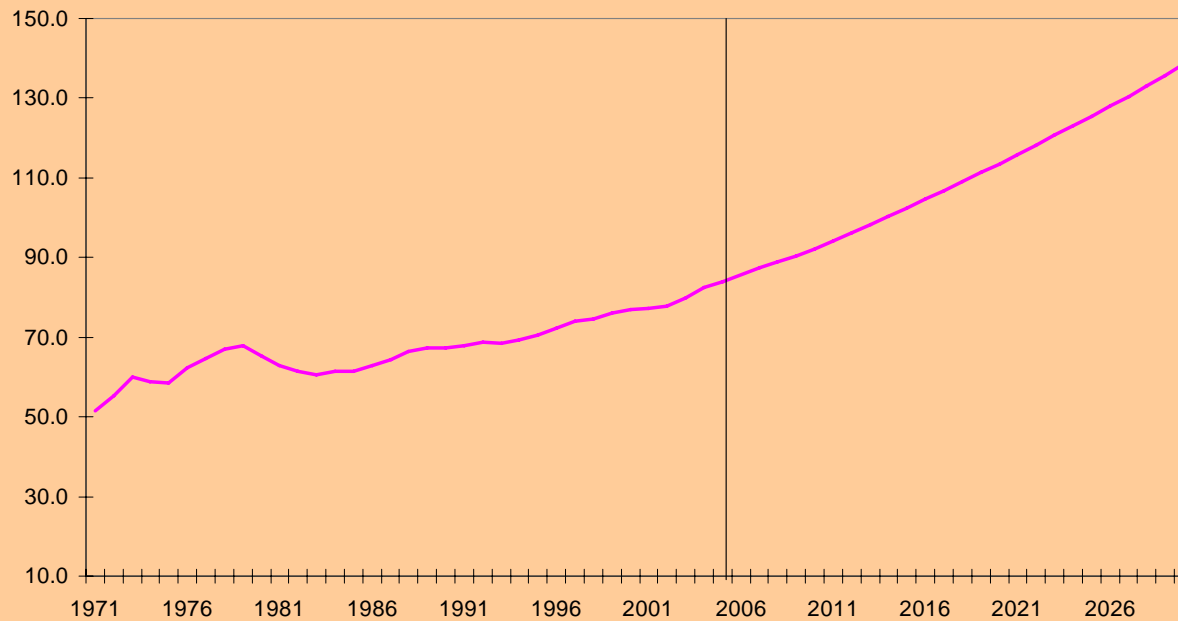
Source: World Bank, *World Development Indicators 2006 and 2007*



3. Risks to the world economy: longer term

GROWTH OF DEMAND FOR OIL

PROSPECTS FOR OIL DEMAND
(millions of barrels a day)



Source: IMF

3. Risks to the world economy: longer term

- A terrible one-off event:
 - global flu pandemic;
 - a successful act of nuclear terrorism, with hundreds of thousands of casualties;
 - Either could disrupt the world economy and halt the flow of people and goods, but the effects are likely to prove temporary, even if “temporary”, in this case, might prove a matter of years.

3. Risks to the world economy: longer term

- War among the great powers:
 - Might Iran be our Sarajevo?
 - Or Taiwan?
 - Might there be conflict over energy resources?

4. Conclusion

- The world economy seems to have decoupled from its bad politics
- This is for a good reason: the drivers of growth are very powerful
- But there are also some big risks