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Europe and the World Economy

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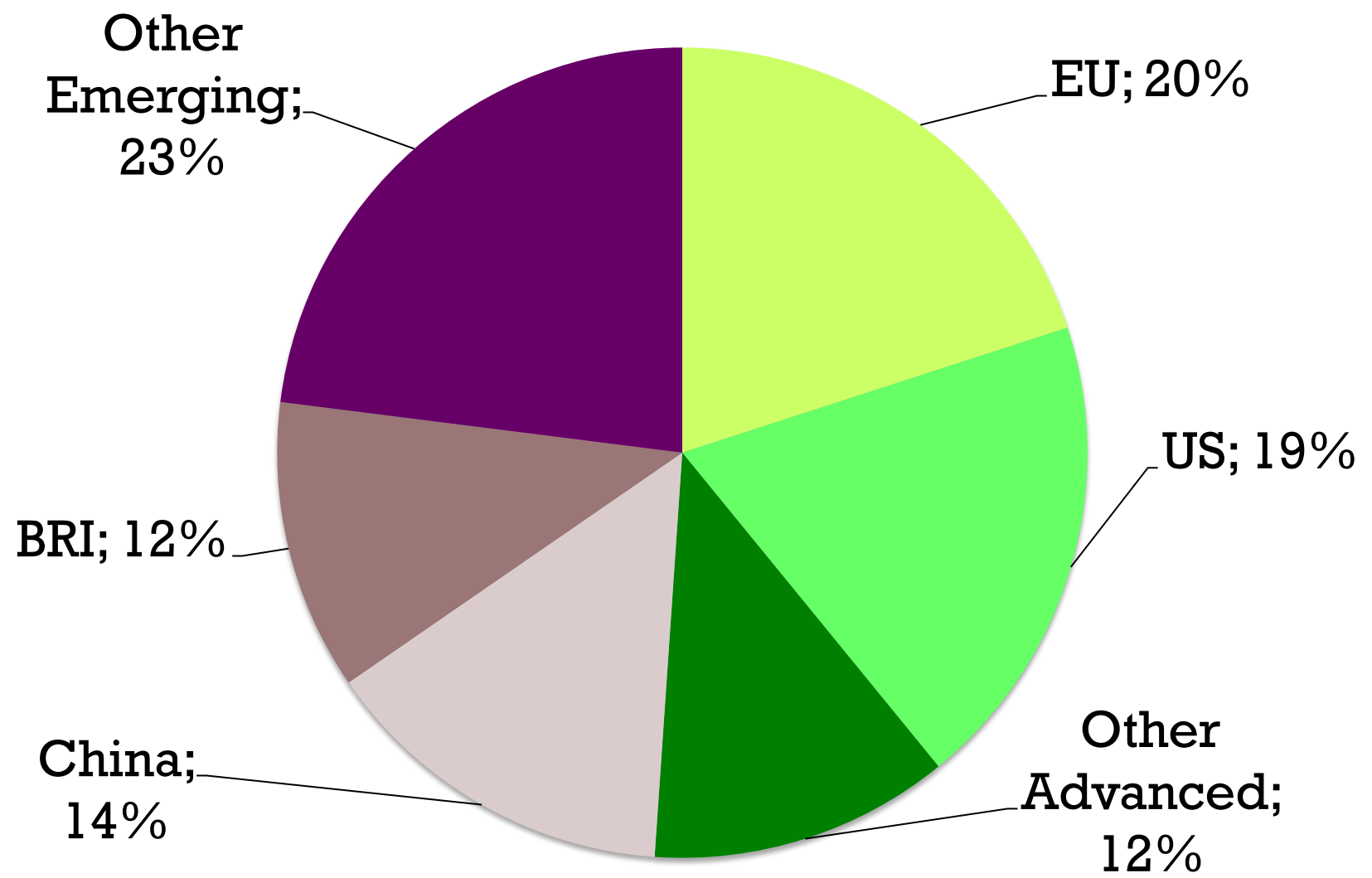
Lisboa - CCB - Centro Cultural de Belém
Sala Almada Negreiros

16.03.2012

The World Economy: Shifting Economic Power

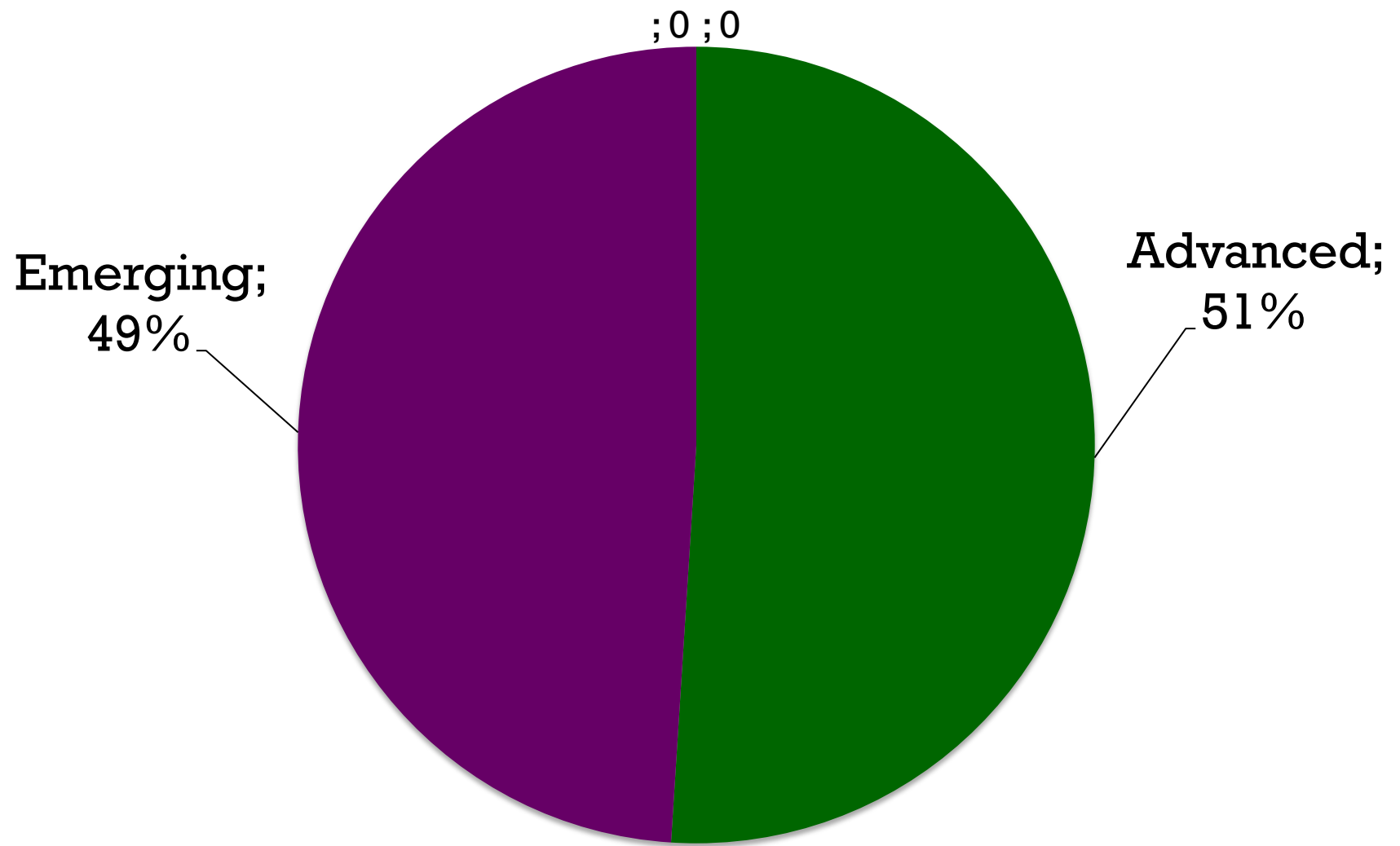
The World Economy

Share of Global GDP Year 2011



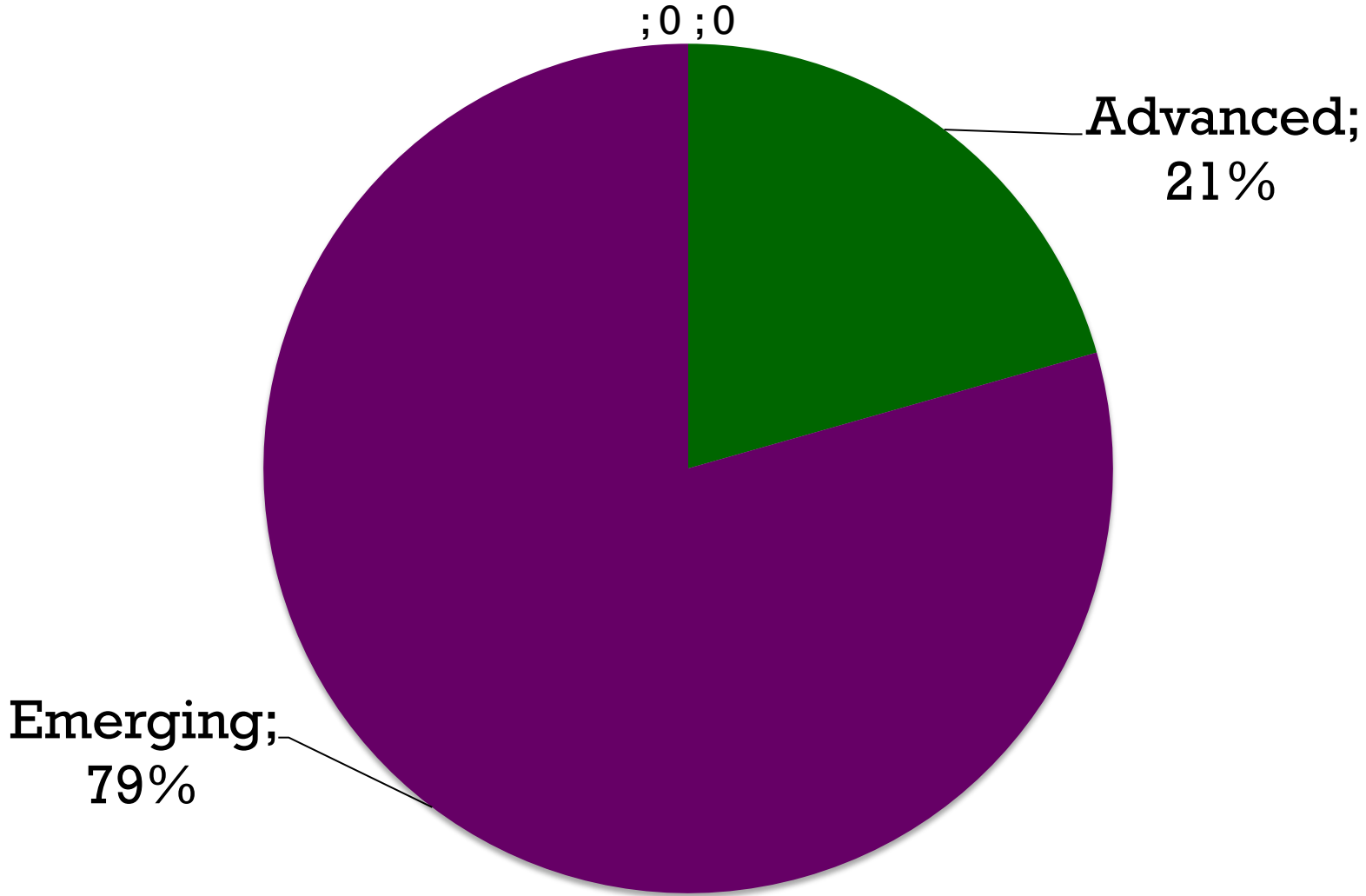
The World Economy

Share of Global GDP Year 2011



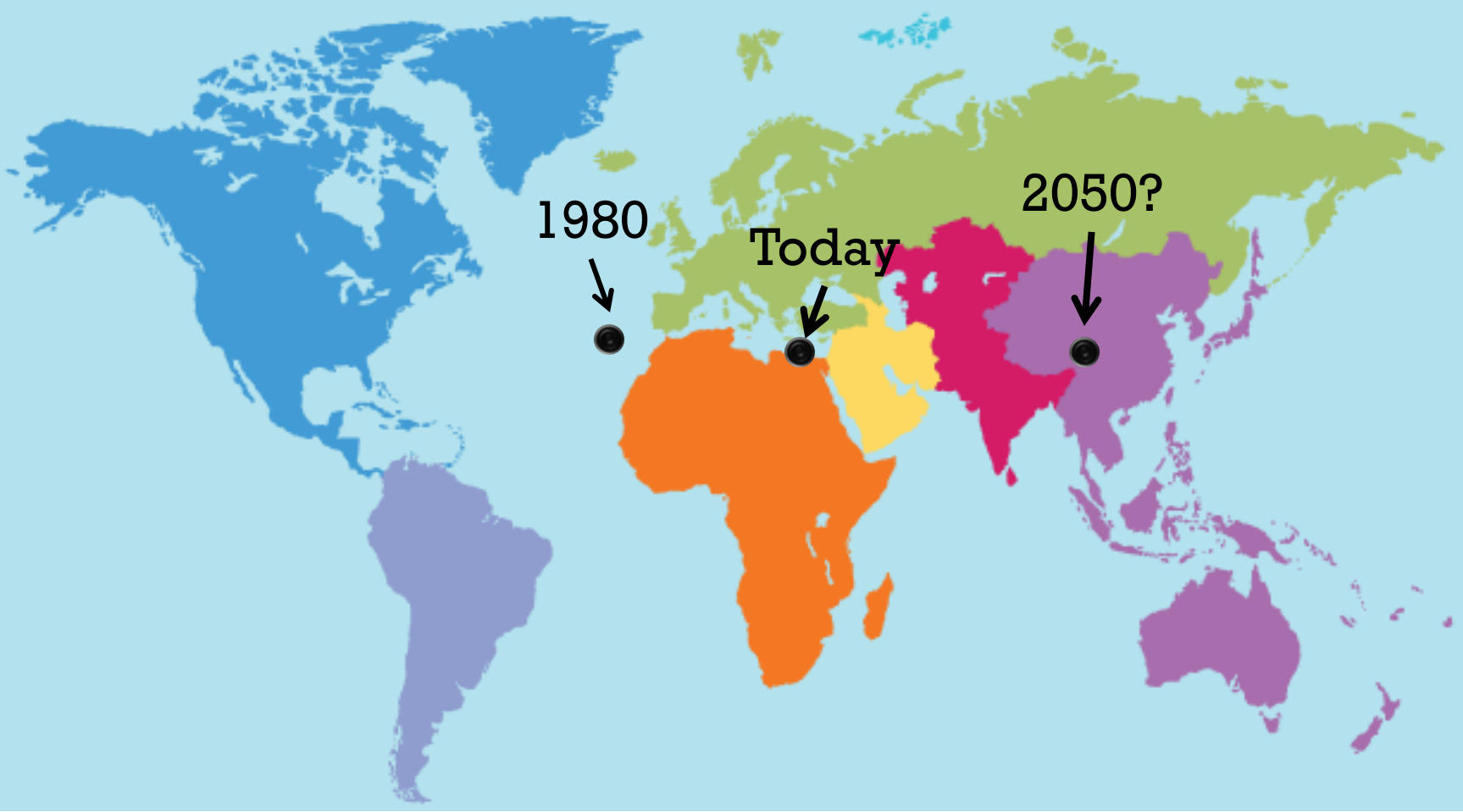
The World Economy

Share of Global GDP Year 1500



Shifting Economic Power

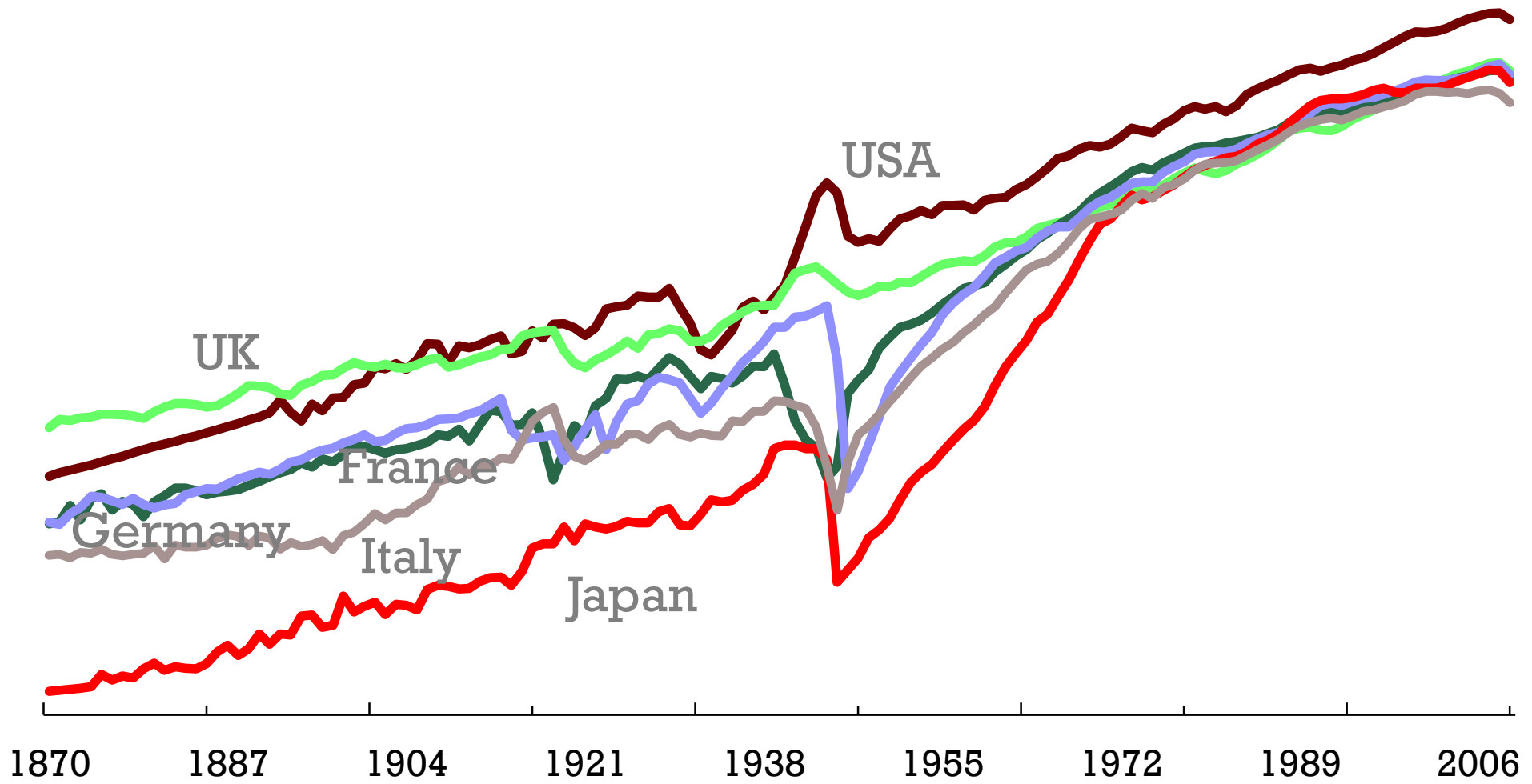
World Economic Center of Gravity



Source: Danny Quah (LSE)

Europe: Catching up with the Leader

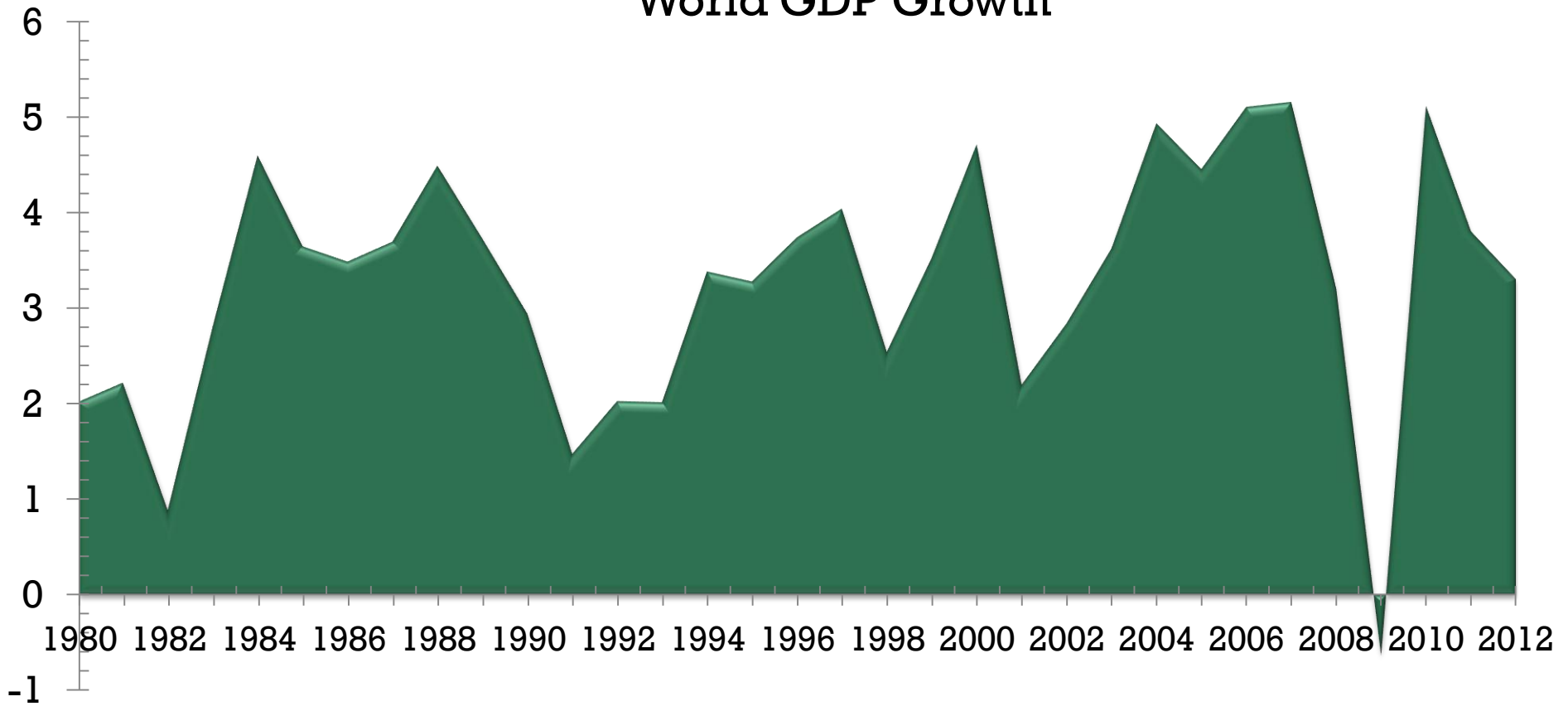
Real GDP Per Capita



The 2008-09 Great Recession: The Decline of Advanced Economies?

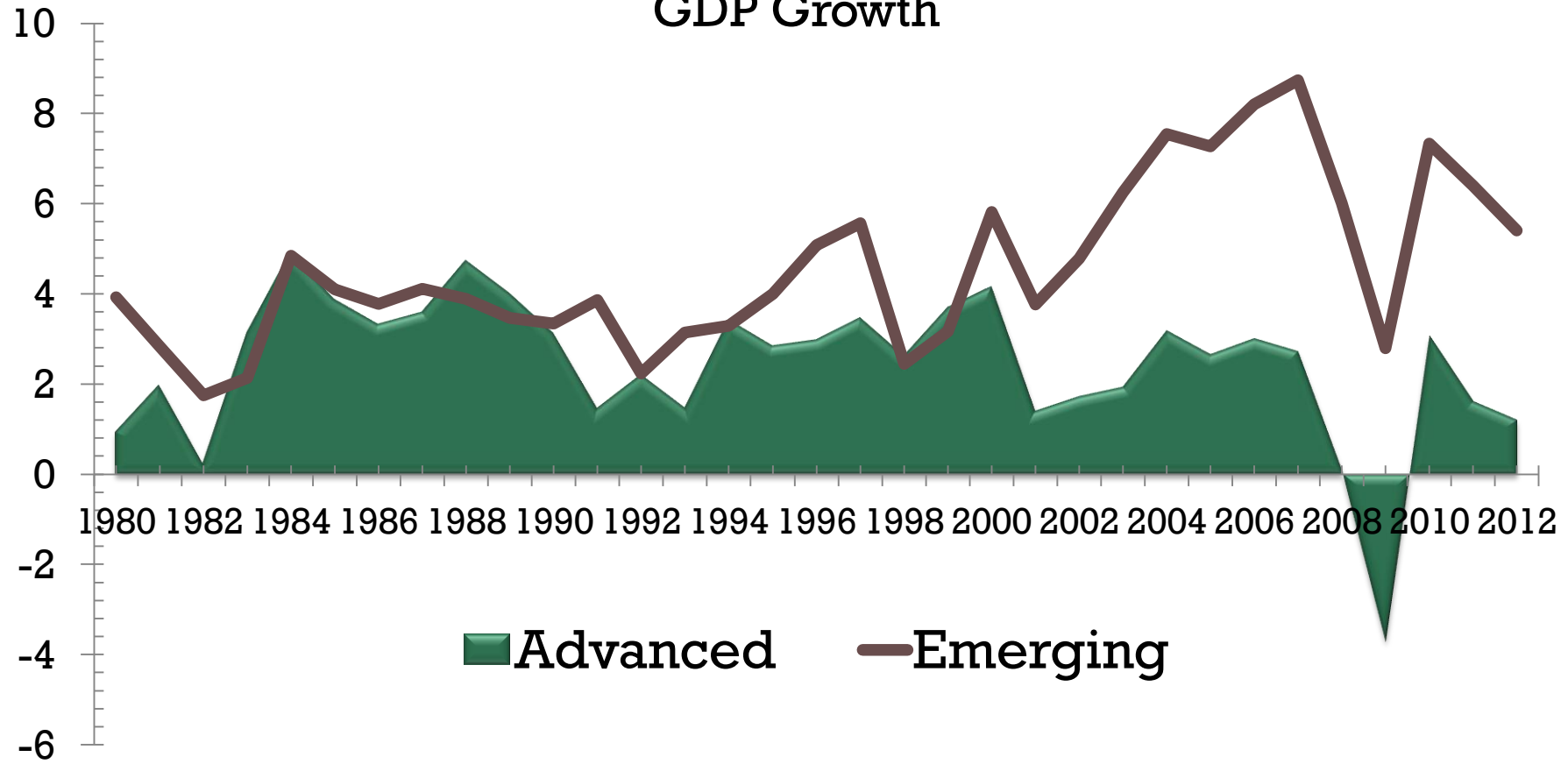
The “Great Recession”: 2008-2009

World GDP Growth



Advanced Economies Led the World into a Recession

GDP Growth



What Went Wrong?

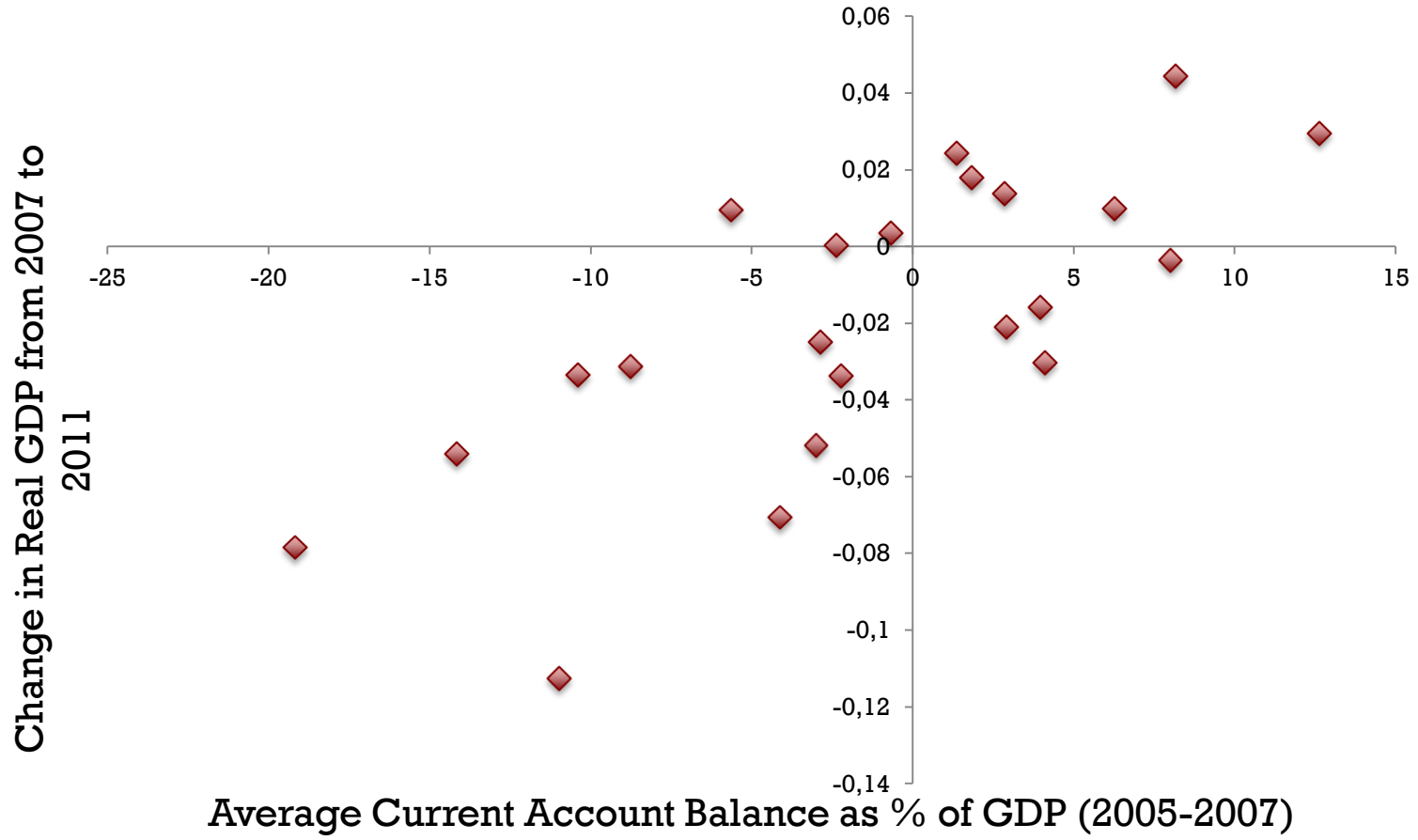
Imbalances and Recessions

While recessions are some times caused by large economic and political events (shocks), the last two recessions among advanced economies can be seen as the end of accumulations of imbalances.

In 2003-2007 some countries generated an imbalance between income and spending (accumulation of debt). This is the consequence of a combination of:

1. Asset bubbles (Illusion of higher wealth)
2. Lower income growth than expected
3. Overinflated expectations of future income growth

Spending-Income Imbalance and the Great Recession



Not Only a Recession

Europe:

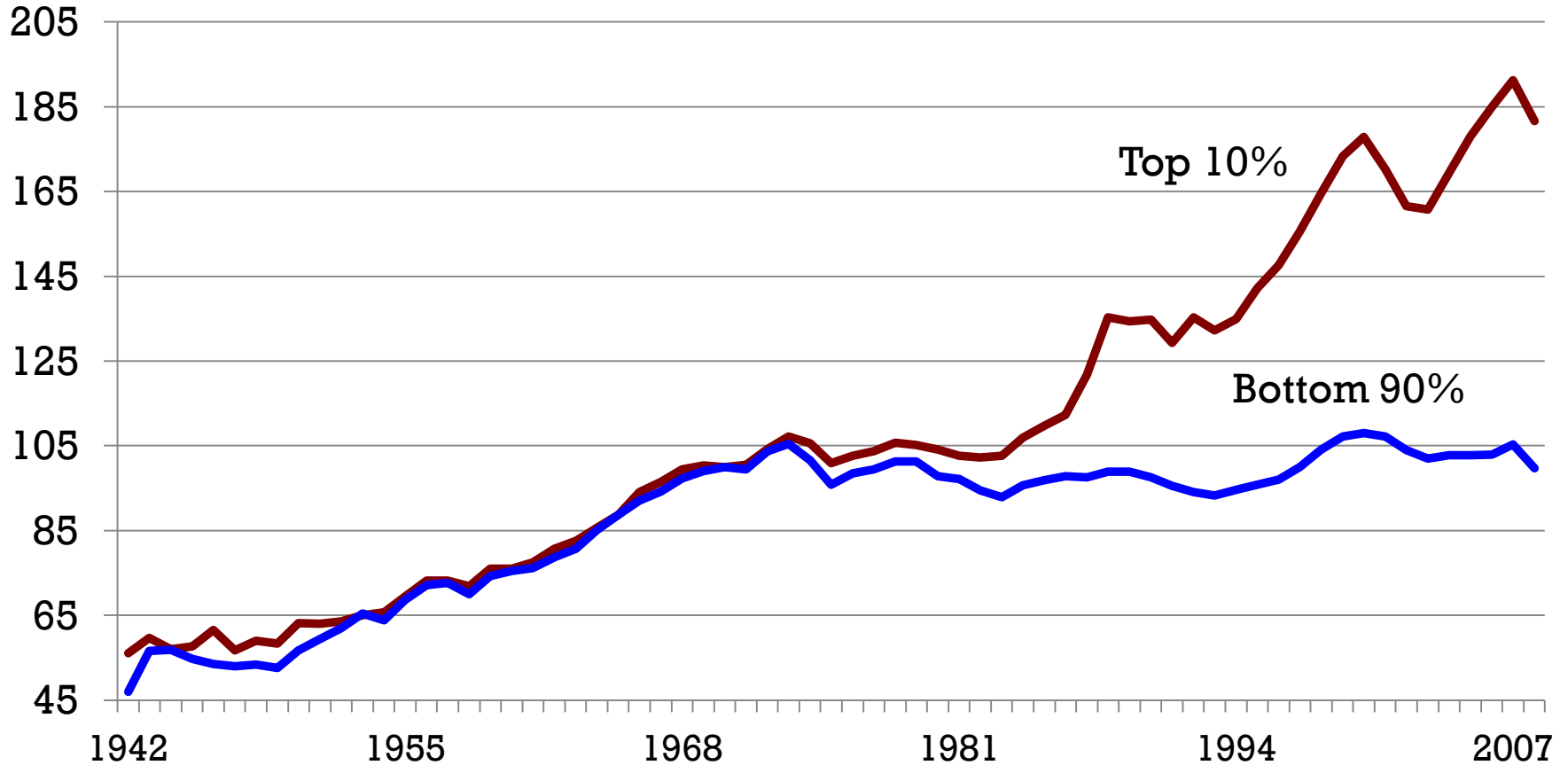
1. The end of convergence. Growth is harder.
2. Aging population
3. Growing inconsistencies between economic and social model

US:

1. The end of the American dream? Increasing income inequality
2. Instability created by very large and poorly regulated financial markets

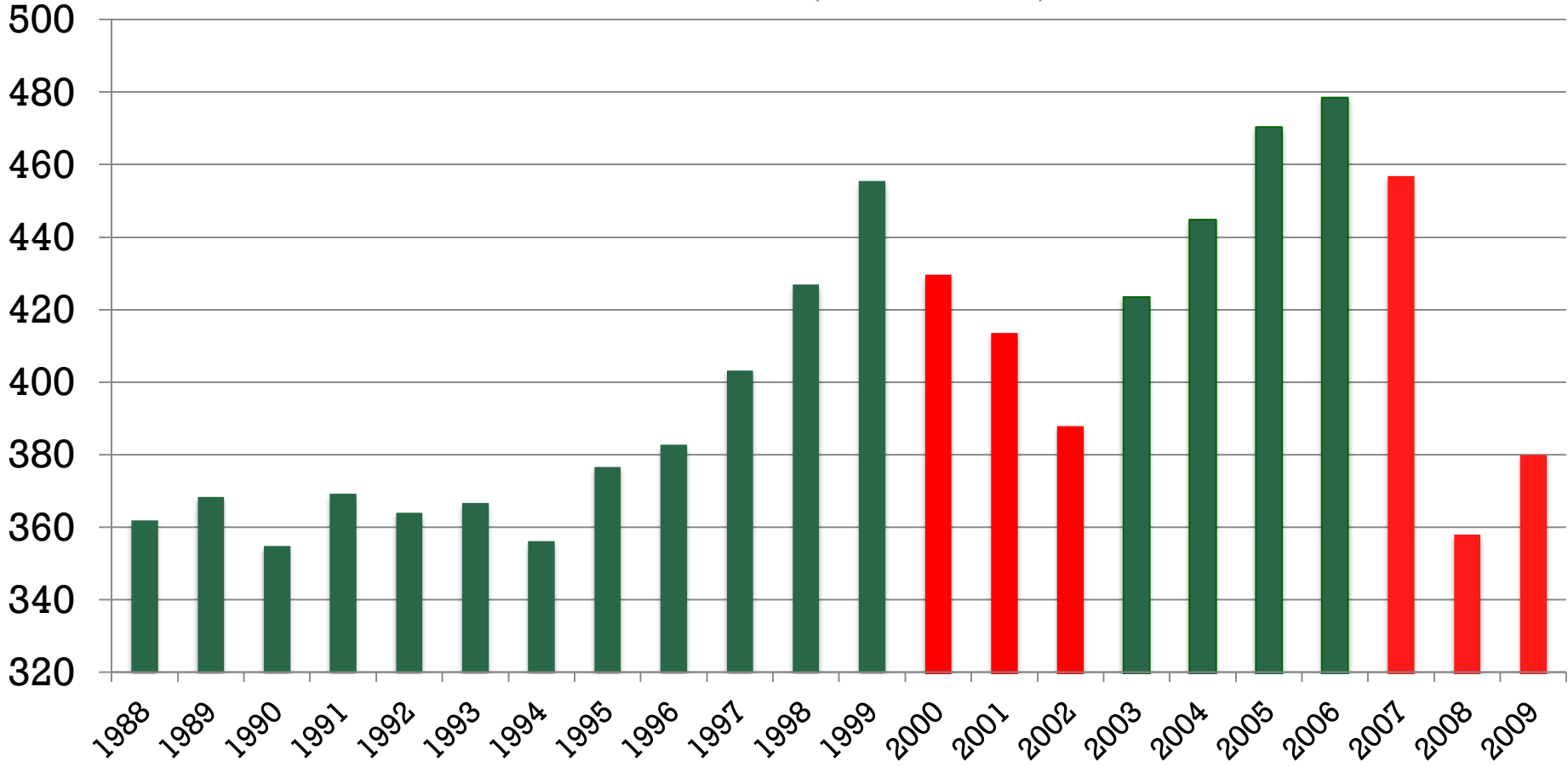
The End of the Dream for 90% of the US Population

Average Income (US). Index 1970=100

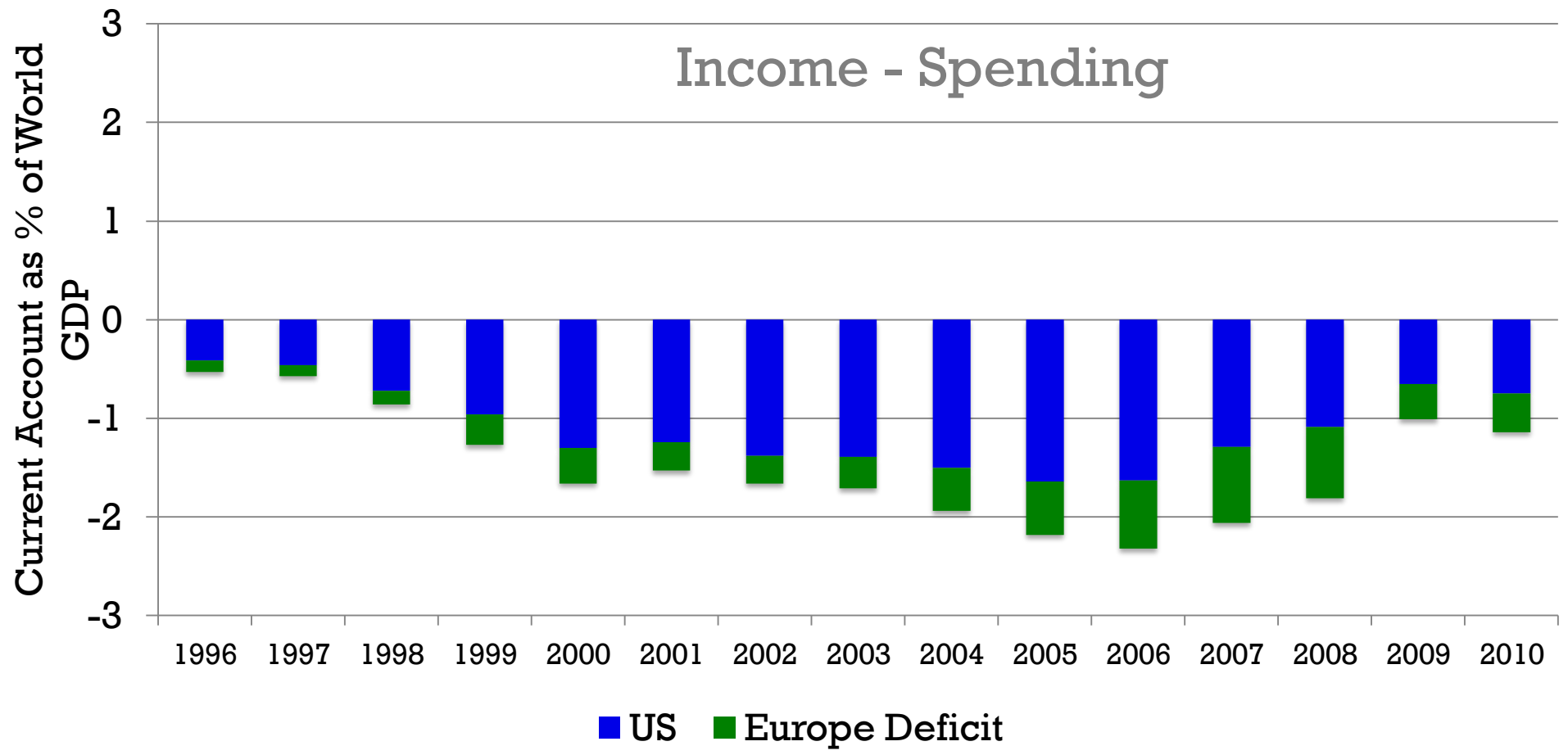


Hidden by Bubbles in Asset Prices

US Wealth (% of GDP)

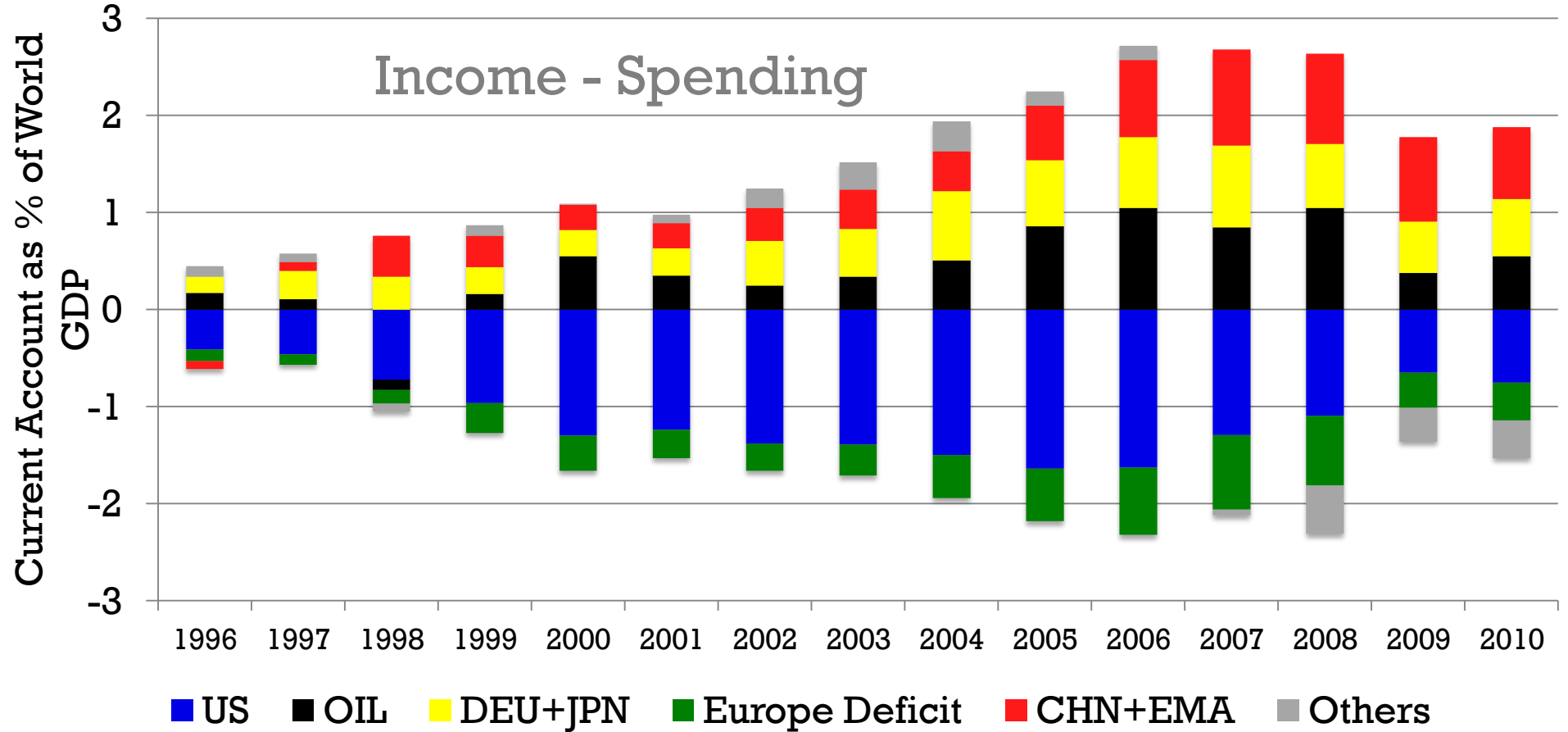


Spending without Income



Europe Deficit: Bulgaria, Greece, Hungary, Ireland, Portugal, Spain, United Kingdom,...

The Supporting Role of Other Countries



The global nature of the crisis

As an individual: I want to **work harder** to keep up my living standards and I need to **cut down** some of my expenses. Painful but doable.

For a country: my spending is your income. As we all save more our incomes go down. Saving does not increase and we are all worse off. **The paradox of thrift.**

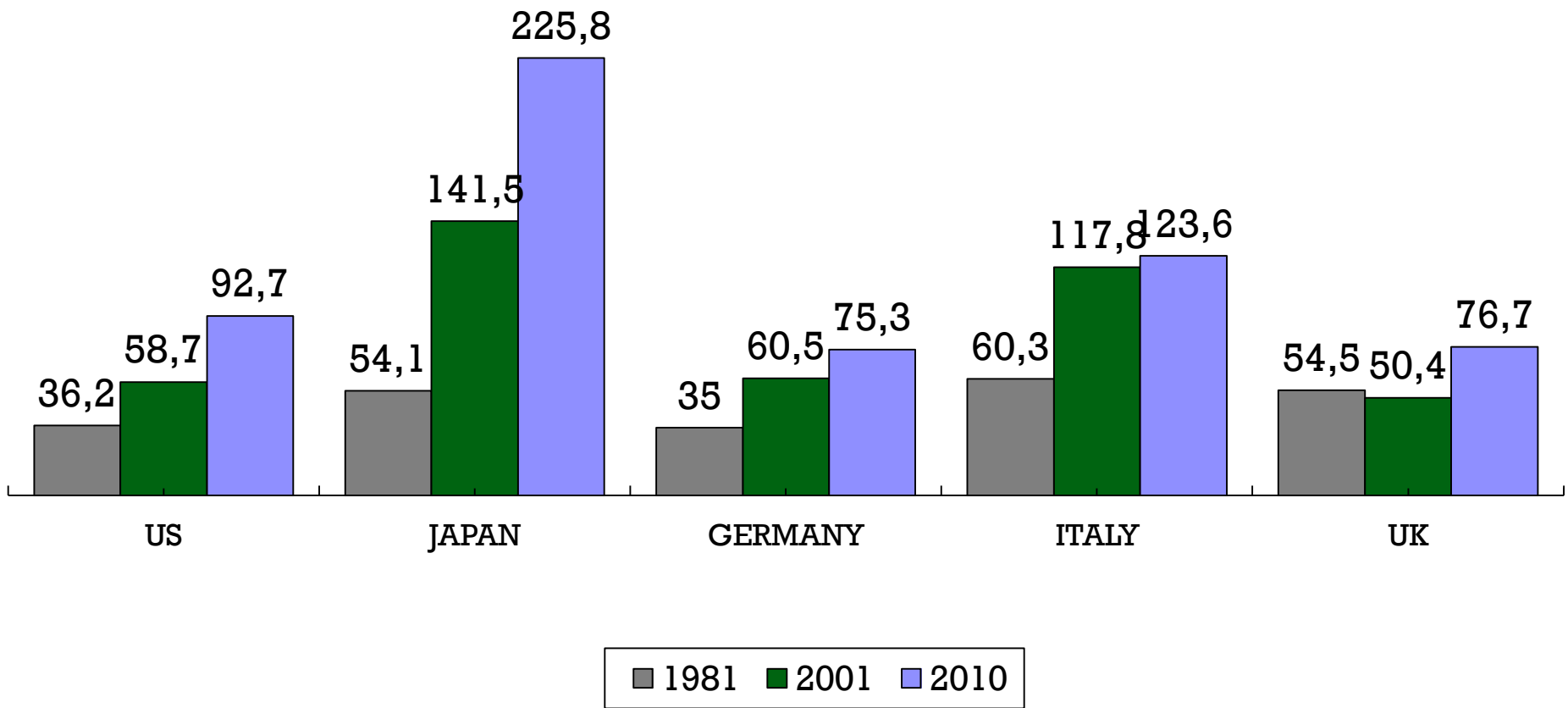
The global nature of the crisis

Solution: Reversal of global imbalances. China, Germany, Japan, Oil producing countries buy what the others produce...

Government Imbalances

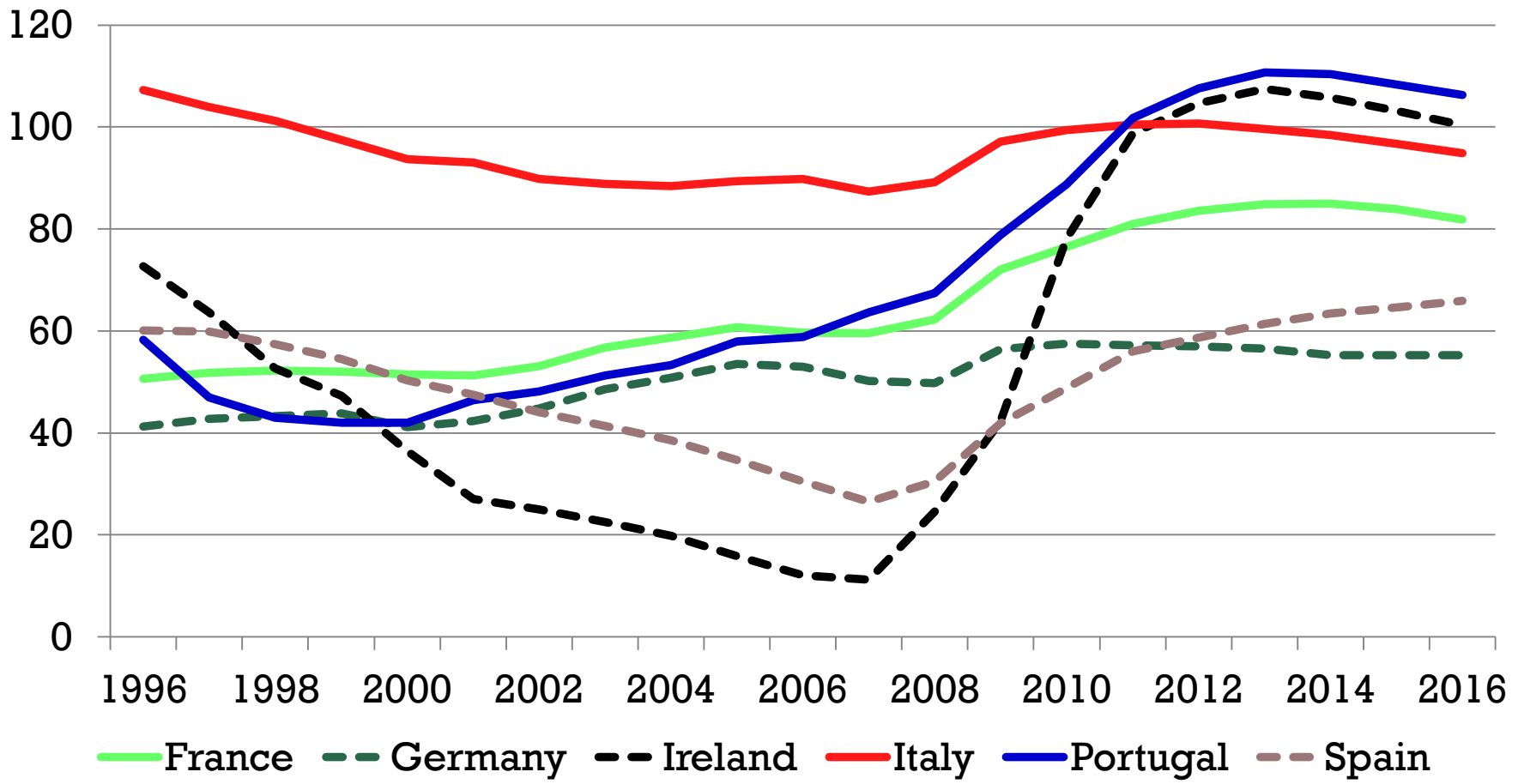
Government Imbalances Not a New Phenomenon

Government Gross Debt as % of GDP



Government Imbalances Business as Usual

Government Net Debt (% GDP)



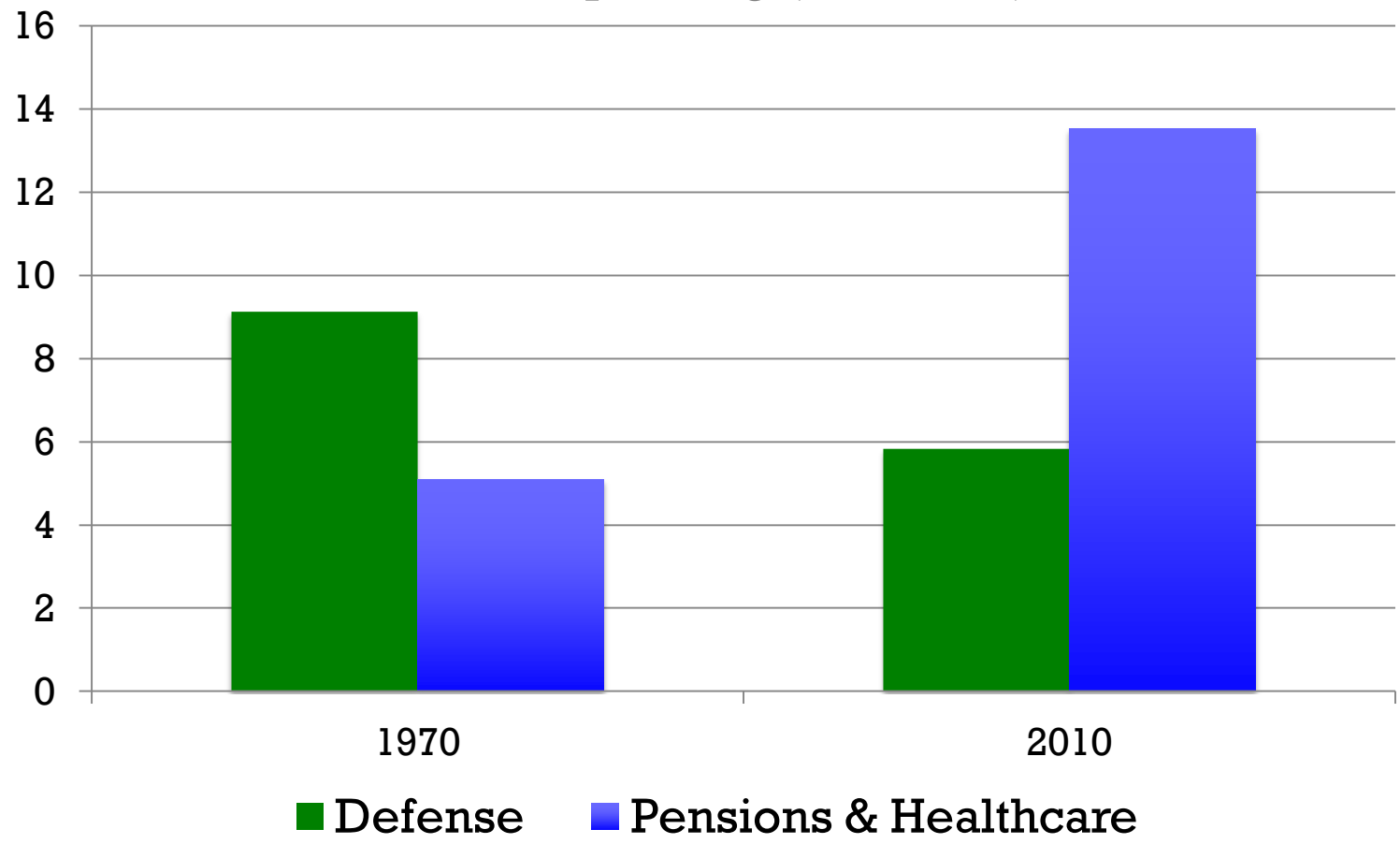
Addressing the Government Imbalance

As an individual: **I did not save enough** for my pension and I need to **spend more on healthcare**. I cancel a few vacations and work harder to maintain my living standards. Painful but doable.

As a country: I am **entitled** to the same pension and healthcare as the previous generation. And I will **not pay more taxes**. It does not work.

Deciding where to spend our income

Government Spending (% of GDP) in the US



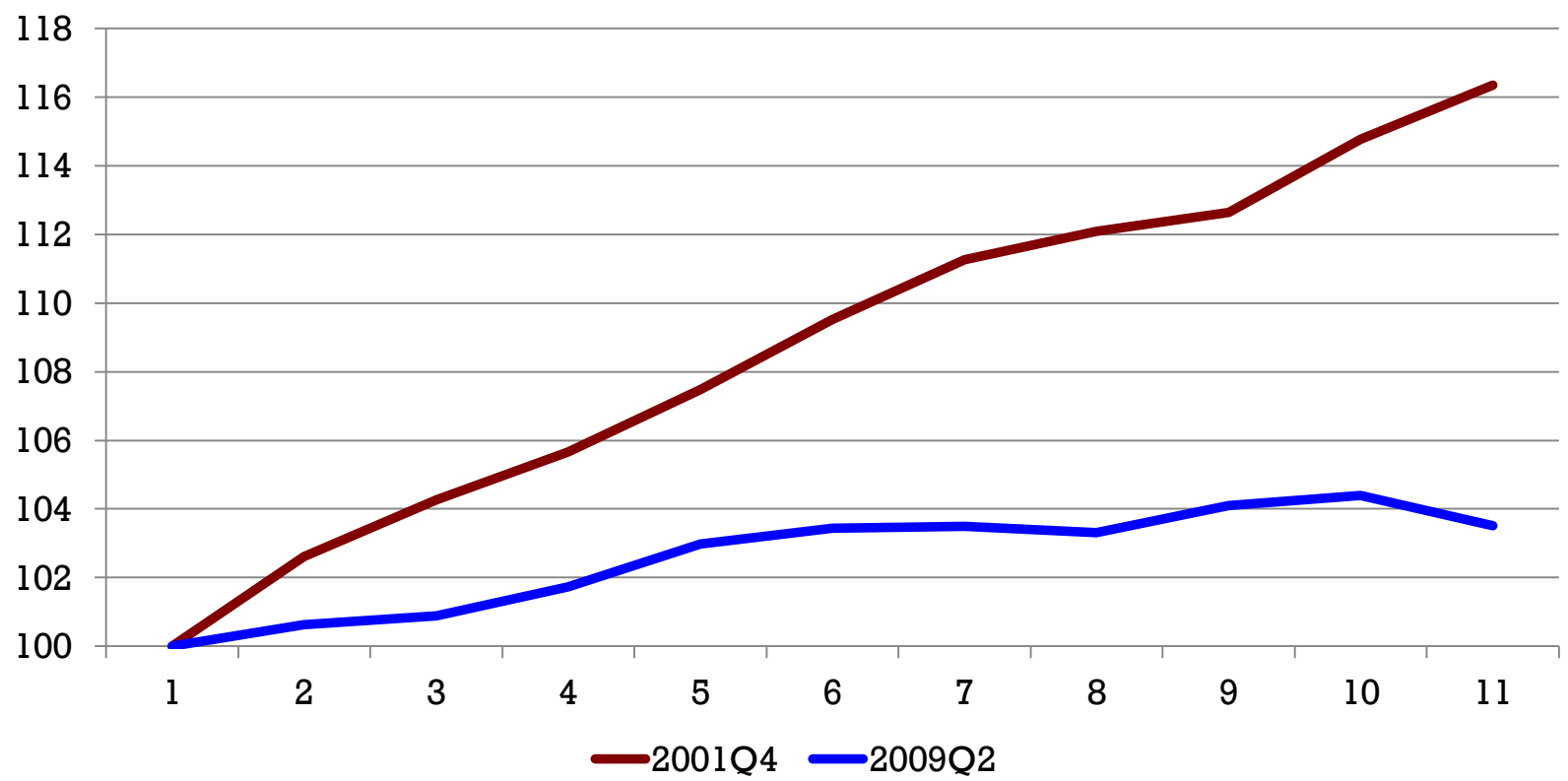
Addressing the Government Imbalance

A long-term problem: Countries live forever (with some exceptions). The optimal reaction to unusually high debt is to spread the pain over many decades.

The short-term overreaction: Need to show commitment by reducing spending at a time of weak economic growth. This is wrong.

Overreacting to High Government Debt

Government Consumption and Investment during the last two recoveries (US)



The Failure of Politics to Address Long-Term Sustainability

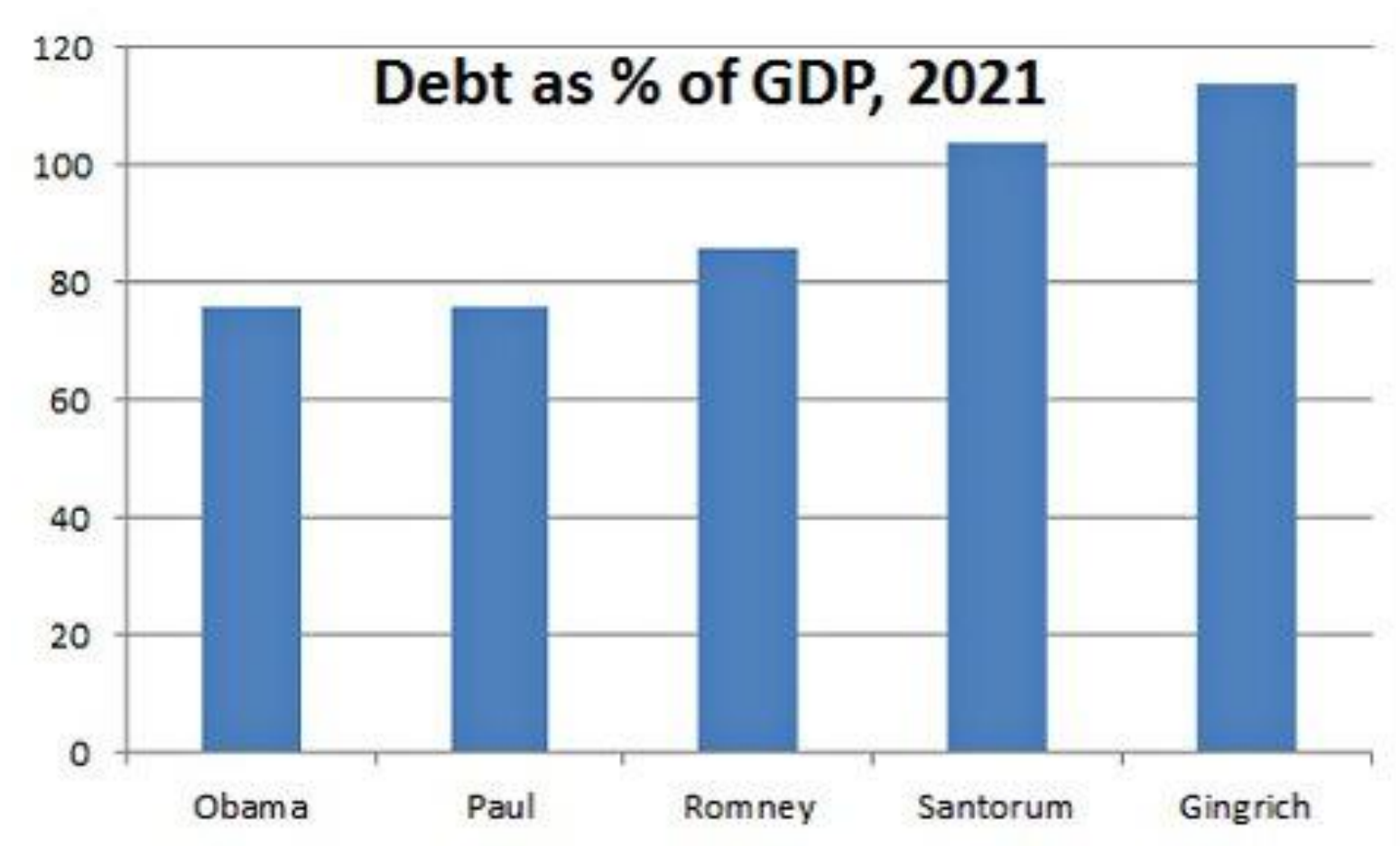
**“President Clinton on Monday proposed paying off the national debt by 2015 after issuing a new budget outlook that adds \$1 trillion more to the overall budget surplus over the next 15 years.”
CNN, June 26, 1999.**

The Failure of Politics to Address Long-Term Sustainability

"This is not at all the situation in our European economies. Our fundamentals are solid, we have a positive current account position, we have a level of savings in our economies that is the level required to finance our investments. We have a sound fiscal position."

**EU Economic and Monetary Affairs Commissioner
Joaquin Almunia. January 22, 2008.**

The Failure of Politics to Address Long-Term Sustainability

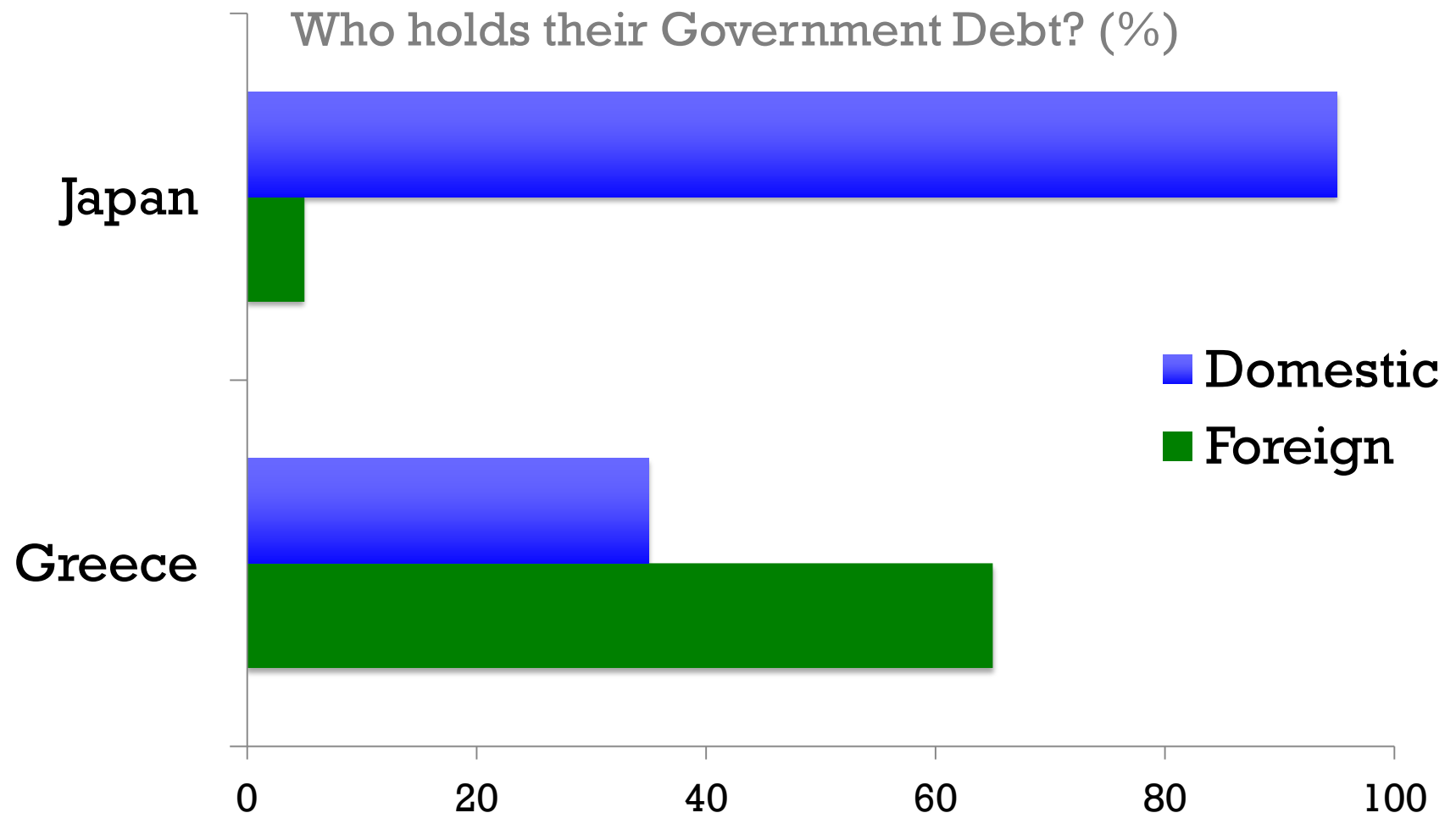


Default: Government \neq Business

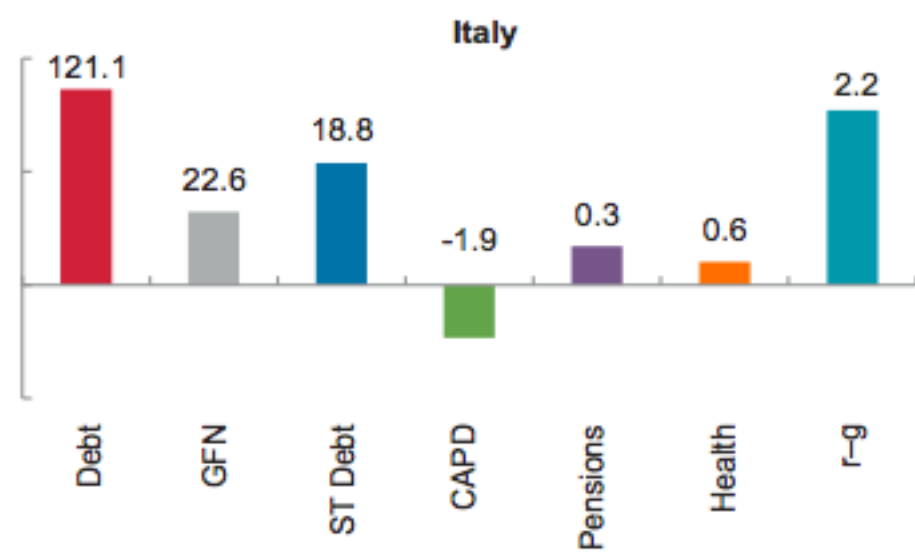
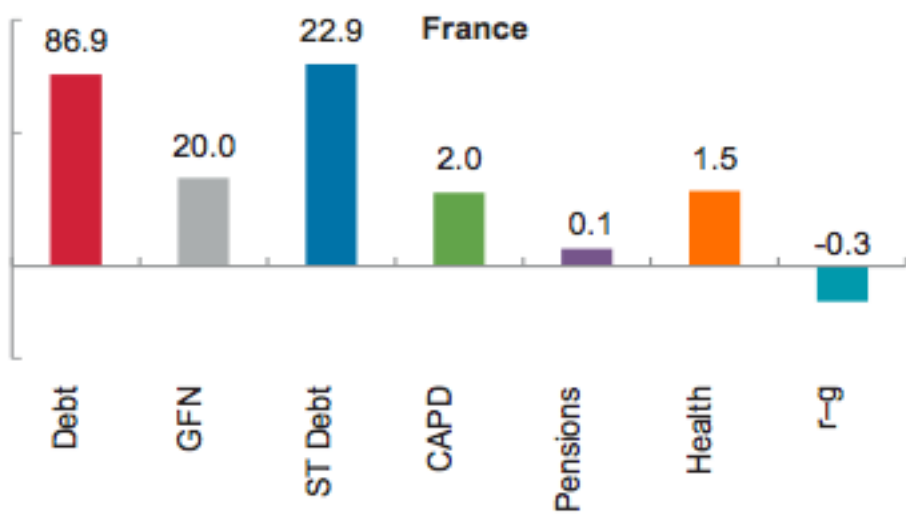
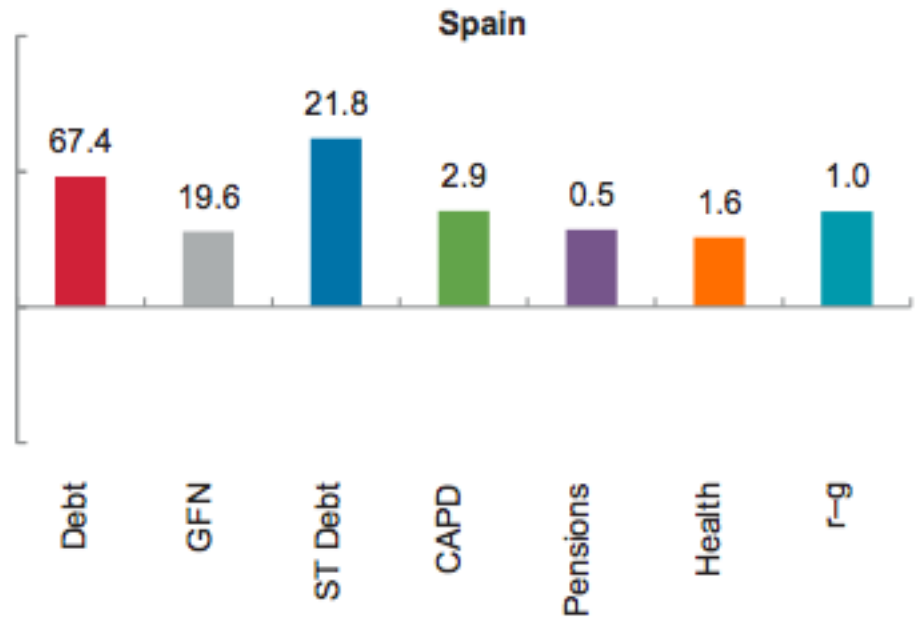
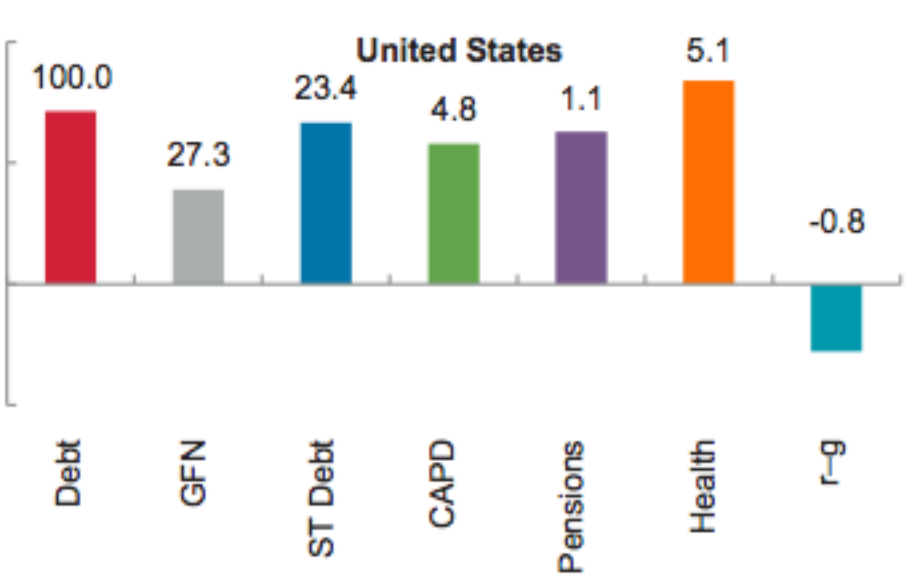
When a company defaults we learn that their business model is not viable. Our wealth and possibly future income will be lower. This is a “real” shock.

When a government defaults, it simply decides to change who will pay for the spending that it has already done. It is a redistribution of resources. Resources are not destroyed (although the crisis that follows can destroy some of them).

Paying for Government Debt Default or Taxes?



Who defaults first? The Fundamentals



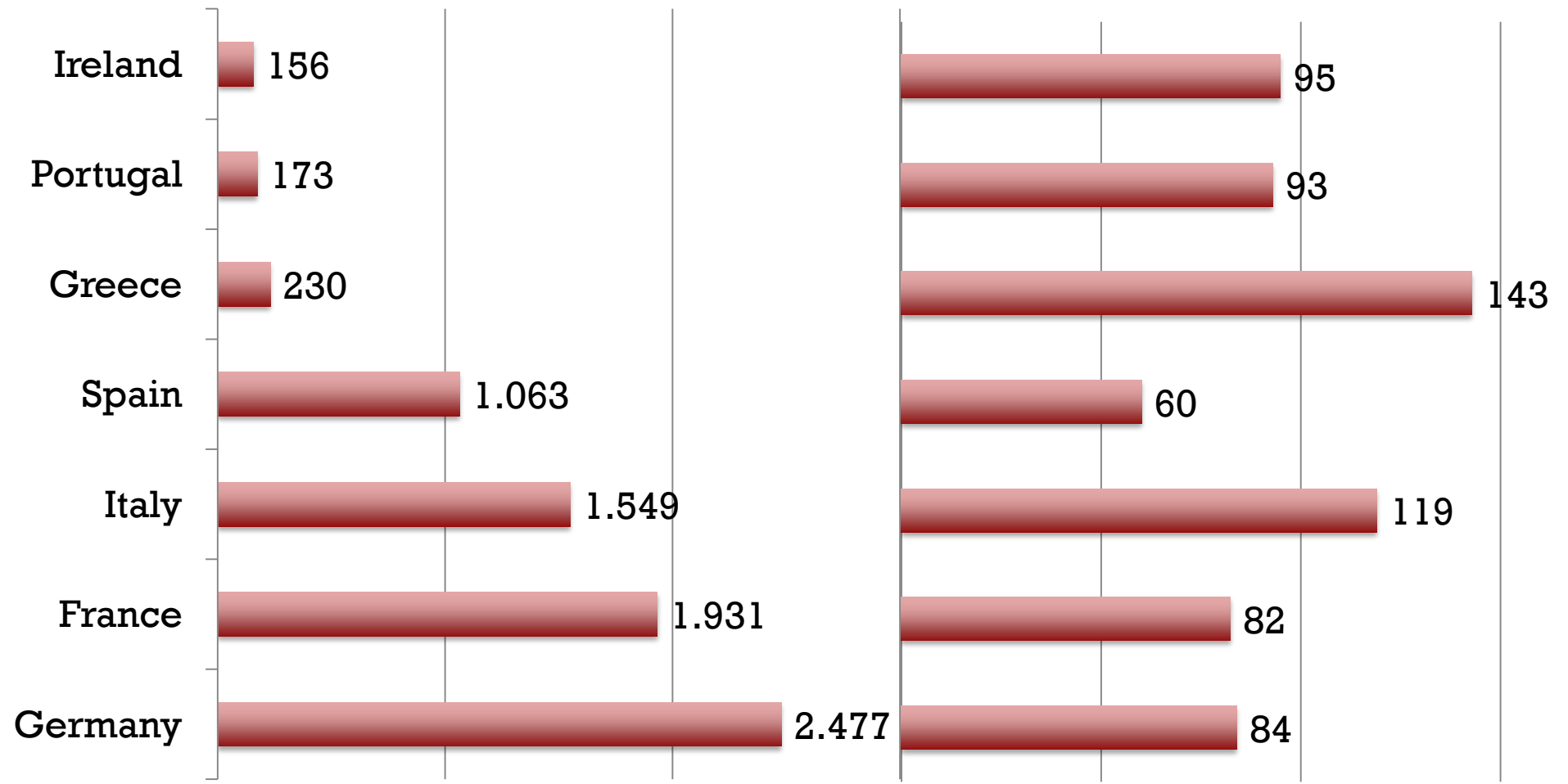
Is it really the government who makes the decision to default?

There is a self-fulfilling nature in sovereign defaults: when trust disappears, interest rates go up so the cost of paying back increases. Lack of trust can cause a default.

The size of the problem

GDP (EUR Billion)

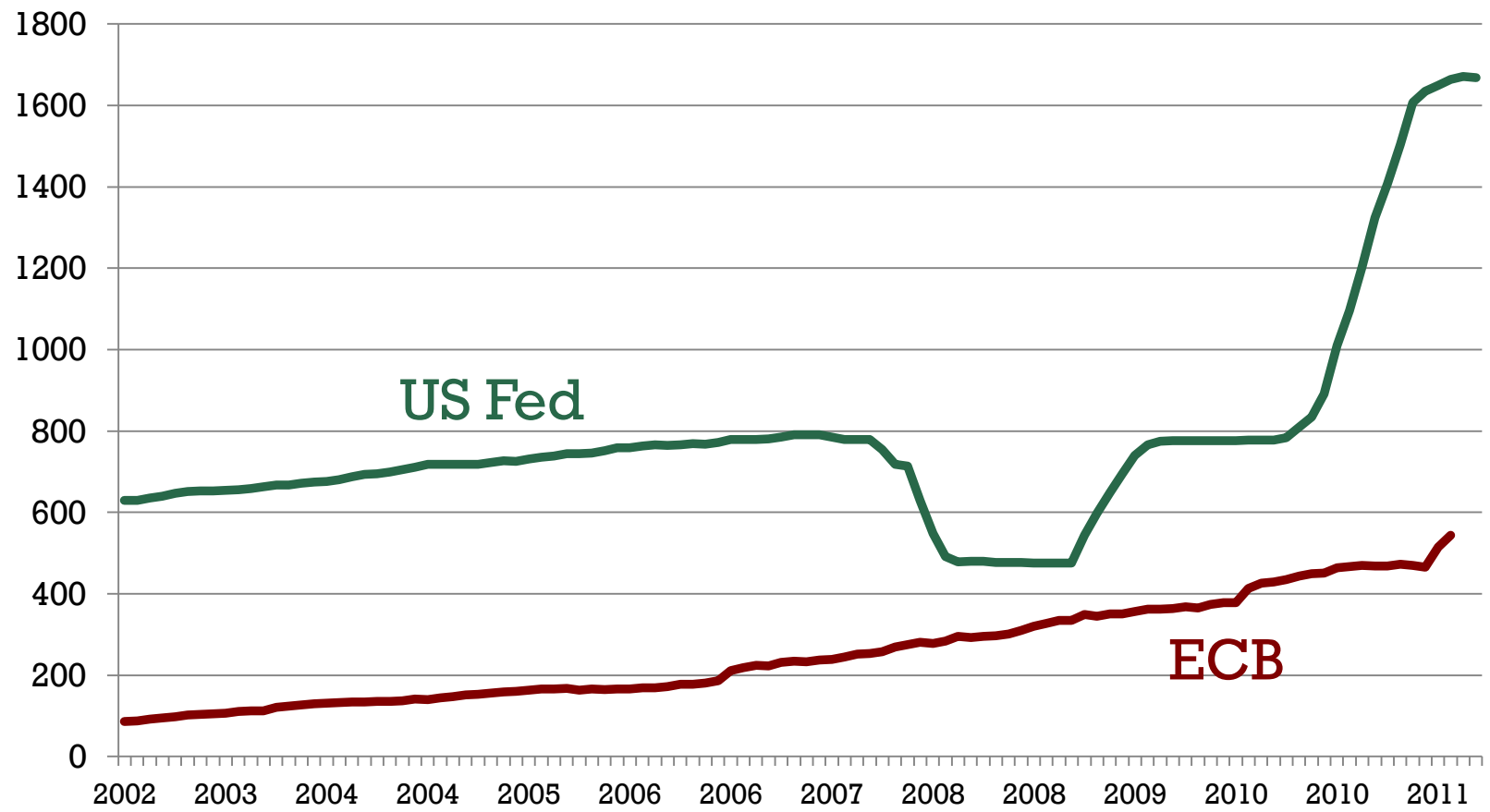
Government Debt (% GDP)



2010

Solvency or Liquidity? Central Banks and Sovereign Debt

Government Debt held at the Central Bank
In local currency (EUR or USD) - Billions



The Next 10 Years

We need:

1. Confidence, **risk-taking** investment, growth in advanced economies.
2. Solid **growth** in emerging markets that translates into **spending** to facilitate external **rebalancing**.
3. Political **leadership** in advanced (Euro) economies that **properly** addresses long-term sustainability.
4. Some **luck**.