

# The UK and eurozone in the shifting global economy

The UK's Economic Research Council invited me to represent the London School of Economics (LSE) in a panel discussion on near-term prospects for the UK economy. Lord Norman Lamont, the Chancellor of the Exchequer from 1990 to 1993, chaired the event. The other panellists were Prof John Muellbauer from Oxford and Prof Hashem Pesaran from Cambridge. The venue: the Royal Institution of Great Britain's Faraday Lecture Theatre, where in 1825 the first of the Royal Institution Christmas Lectures were delivered.

I argued the following.

First, the economic difficulties in the UK or the eurozone cannot be usefully analysed without look-

ing at these economies' positions in the world. Second, the UK and the eurozone have an immediate problem with debt and an ongoing problem with productivity. It is unlikely that Keynesian aggregate demand management alone will lead to long-run sustained growth.

What are the facts on the UK and the eurozone in the global economy? Time was the night-time sky was lit up pretty much just by the Transatlantic Axis — the US and Western Europe. But that was 30 years ago and the global economy has moved on. By 2010, the world's economic centre had shifted 5,000km — three-quarters of the Earth's radius — to the rise of the East, notably India and China.

As a consequence, hundreds of

millions of Asians have been lifted out of grinding poverty; soon these people will be the world's middle-income class.

To be clear, not all of Europe needs help in the same way. By the summer of 2011, a distinguished US economist had related to me how he and colleagues were surprised by Germany's economic growth out of the 2008 global financial crisis. While keeping its traditional high savings habit, Germany had its export markets — the US, the rest of the EU — mired in recession. Here's how Germany might have done it.

**Evolution of Germany's export markets:** The bulk of German trade remains, naturally, with the rest of the EU. But now the EU is deep in recession and is likely to remain so

for some time. Outside the EU? Germany today exports more to developing Asia than it does to the US. And that gap continues to widen.

Exports to China alone already appear as large as those to the US. Part of this obviously stems from US imports sharply falling right after 2008 — but that is exactly my point. China and developing Asia continued to grow, continued to import from Germany (and elsewhere) and thus continued to keep parts of the global economy afloat throughout the global financial and European sovereign debt crises (see Chart 1).

**The euro-sterling exchange rate:** This is not just because Germany enjoyed a cheap currency. Despite the weakness of the pound against the euro, the UK has not reoriented its exports anywhere as successfully as Germany has (see Chart 2).

**Evolution of the UK's export markets:** What the UK exports to the US remains double what the UK exports to developing Asia and four times what it exports to China. The UK has simply ended up with most of its exports going to economies that show no significant demand growth.

**Unpack the numbers further by breaking down the UK's 50 largest trading partners in 2009:** The UK had 56% of its exports go to the 10 slowest growing economies in that group (growth measured from 2000 to 2008). Across these 50, the correlation between exports and growth was -0.32: the UK systematically exported more to those trading partners growing slower.

The problems faced by the UK, or more broadly, by member states across the EU, while different in concentration, are no different in character from those in the 2008 global financial crisis. Large entities owe large amounts of debt and are likely to be unable to pay it all back.

Previously, the entities were financial institutions; now they are sovereign states. Quick fixes that seek to get around repaying this debt will undermine institutions of trust and responsibility, those same institutions the West tells emerging economies they must build if they too want to become developed economies.

When the first round of quantitative easing (QE1) happened in the US, output there rose and to a smaller extent elsewhere in the world as well. With QE2, the IMF's estimates show that the impact multipliers everywhere had diminished sharply.

Now? There are those who hope a rescue will come when the European Central Bank unleashes its own QE on eurozone sovereign debt. Or some optimistically ingenious scheme involving different coloured centrally issued eurobonds or where the discrimination occurs across member states, using some other indicator might work. With luck perhaps.

Longer term, some observers look to a fuller-fledged fiscal union, with Germany transferring likely more than 5% of its GDP to the eu-

rozone's lesser-performing periphery member states.

But the connection between this reorganisation and member states' fiscal positions cannot be ignored. While all attention now focuses on deficit/debt figures compared to those originally given in the Maastricht Treaty, pretty much totally neglected is the nearly contemporaneous Copenhagen criteria for EU accession. That list includes — after requiring member states be democracies that obey the rule of law, respect human rights and

protect minorities — the statement that candidate member states need to be market economies able to deal with "competitive pressure and market forces within the Union".

I do not think receiving a perpetual 5% German GDP transfer strong evidence of that capability. (And this is just for EU accession, not even for eurozone membership.)

Monetary or other financial rescues are short term; we need them the same way we need to kick-start an engine. But if that engine is worn out or is leaking fuel or in need of a complete overhaul, I do not see how we are going to get very far with that machine. We cannot mistake a short-term boom fuelled by exigent government actions for sustained long-term growth. Again, isn't this what the West tells emerging economies?

How would I propose to change matters? My suggestions at the event were general and therefore impractical. But here they are again:

1. Reboot the UK economy: Take the pain and turn around to engage fully with the emerging economies; do business with them as an economic partner — no more, no less. The emerging economies are now the world's engine of growth: deal with it.

2. Unleash its universities and other thoughtful, creative industries. This is not to raise government spending, but just to free up extant restrictions on their operations. UK higher education is hugely in demand by the emerging economies. If there is anything that is going to help rebalance the global economy, this is it.

3. Throw out long-standing aesthetics and principles — they are also called prejudices. Become enamoured of what works — whether it is guided capitalism under a bit of state control or anything else we previously thought completely nuts (that is outside the Washington Consensus of market fundamentalism, privatisation and deregulation).

Celebrate the virtues of working hard, raising productivity and saving for the future — not revile them as many do today for Germany or in the past China for that matter. ■



MY Say

BY DANNY QUAH

Chart 1: Germany

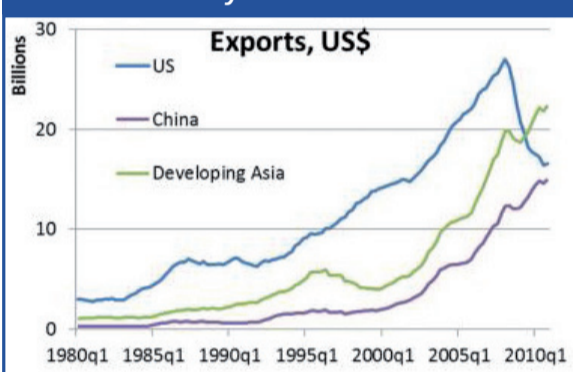
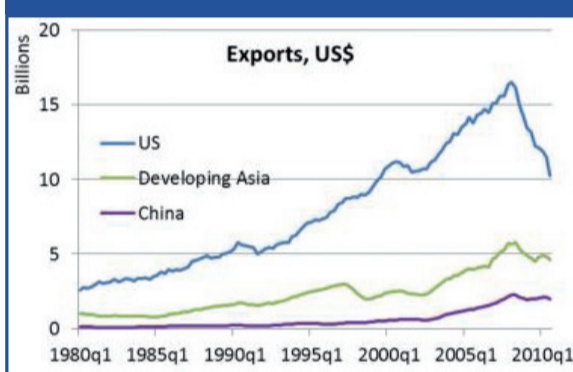


Chart 2: The UK



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