

# **The Current Trends and Challenges Facing the Global Economy**

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While the term 'Globalisation' has found common usage in recent years, only in the last two years has the term 'global financial crisis' or 'GFC' become the most common area of discussion in the news and the global economy. The aim of this paper is to look at the main aspects of Globalisation and the impacts of changes in the global economy in recent times and the challenges that they bring.

## **The Global Economy**

The Global economy is the world economy. It is the economic activity going on in the world. It is the combined economic activity that takes place in each individual economy plus the activity between countries. It includes all production, trade, financial flows, investment, technology, labour and economic behaviour in nations and between nations.

Economists try to predict trends in the world economy by applying models that demonstrate how changes in certain economic variables or factors have affected the domestic or global economy previously. In our current economic environment these tools are becoming more limited. In recent years the state of the domestic and global economies have been largely influenced by non-economic factors. Factors that economists could never predict. These include the terrorist attacks of September 11<sup>th</sup> and subsequent terrorist attacks, the outbreak and spread of the Severe Acute Respiratory Syndrome (SARS) virus, the bird flu and the war in Iraq. These factors have had great influence on the state of the global economy in the last 9 years, and these, and similar events, will continue to do so into the future. In the last 2 years the main factor to impact on the global economy has been the 'global financial crisis' and even more recently the problems facing Greece and other members of the European Union with their National Debt. In the future these issues will probably be overcome and then the main issues that may impact on global growth will include the aging population in many industrial nations and the environmental consequences of rapid growth. Since 2001 the global economy had steady growth until the onset of the global financial crisis in the second half of 2008 (Figure 1). While the global economy still managed to expand by 3.2% in 2008, it contracted by 0.6% in 2009. The situation has been even worse in advanced economies with GDP growth falling to negative 3.2% in 2009. The current financial crisis developed into the worst global recession since the great depression of the 1930's.

## **What problems in Europe are threatening the global recovery?**

There are growing fears especially among a number of European Union members that certain countries have debt problems that may lead to defaulting of these loans. There is an estimated \$3.9 trillion worth of debt owed by Portugal, Ireland, Italy, Greece and Spain to other European nations.

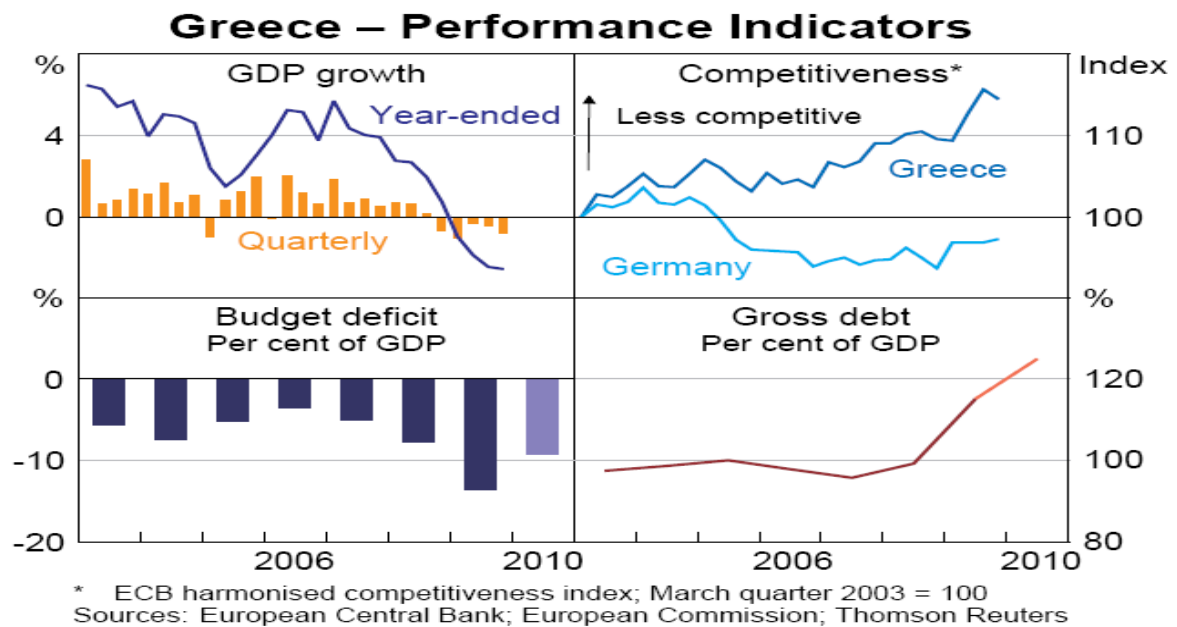
Figure 1 – Real GDP Growth (%)



Source: IMF, World Economic Outlook, 2010.

One of the main areas of concern is Greece. Greece has a large funding requirement for its National Debt, reflecting both its sizeable budget deficit (13½ per cent of GDP in 2009 and likely to be at least 8 per cent of GDP in 2010) and a need to refinance large volumes of maturing debt (outstanding debt in 2009 was 115 per cent of GDP) (Figure 2). The concerns created problems in the financial markets as Greece’s credit rating was downgraded by all three rating agencies in April. This has heightened the fear of a nation defaulting on their debt payments.

Figure 2 – Greece’s Debt Problem

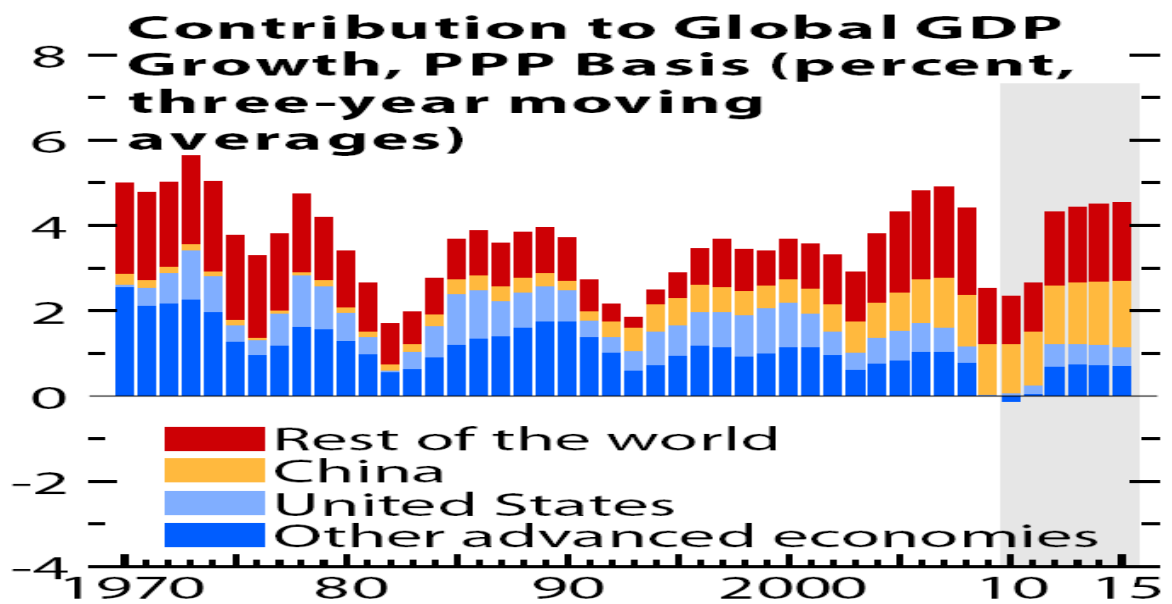


Source: IMF, World Economic Outlook, 2010.

## What are the factors driving growth in the global economy?

Despite these challenges the overall direction of the global economy is towards economic growth. Until 2008 the main sources of global growth were a result of the rapid growth in China, India and Russia which encouraged investment and rising global demand (Figure 3). The GFC slowed world output from 5.2% in 2007 to only 3% in 2008 and global growth fell to -0.6% in 2009. Growth in the advanced economies was even lower. Output fell from 0.5% in 2008 to -3.2% in 2009. Output is expected to be positive in all major regions in 2010. The IMF projects global growth to be 4.2% and growth in advanced economies to reach 2.3%.

Figure 3 - Contributors to Global Growth



Source: IMF, World Economic Outlook, 2010.

The big contributor to global growth is and will continue to be China. China's growth in 2009 was 8.7% and is expected to be 10% in 2010.

## What has been the impact of the Global Financial Crisis?

In examining the impact of the global financial crisis on the global economy, three key areas will be considered:

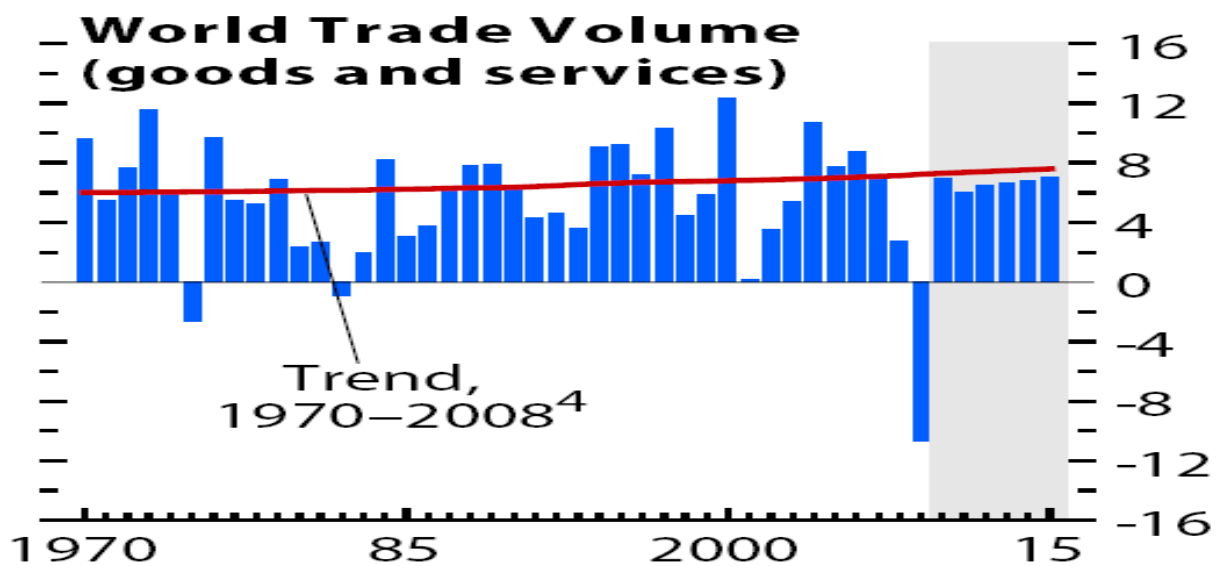
- Trade
- Investment, and
- Finance.

## 1. *The State of Global Trade*

The growth in global trade is generally more than double the level of world GDP growth. Despite a slowdown after 1997 due to the Asian economic crisis, world trade grew by 12.4% in the year 2000 but slowed after September 11<sup>th</sup> and the US share market crash. The volume of world trade has grown on average between 6-7% in the last decade but is expected to fall by 11% in 2009 (see Figure 4).

The growth in export volumes in advanced economies averaged 5.2% per annum from 2000-2008 compared to 9.3% for emerging and developing economies. The impact of the global financial crisis was to reduce export volumes in advanced economies by 11.7% and emerging and developing countries by 8.2% in 2009. A similar pattern is expected in regards to import growth. While this may suggest that the poorer countries will not be as badly hit by the global financial crisis, they are actually less able to deal with such a crisis because of their poor financial position. It also reflects the fact that world trade is dominated by the advanced economies. The IMF (2006) found that the richest 15% of nations had 70% of the goods and services exported in the world in 2005. This compared to less than 4% for the poorest 30% of nations. This dominance by the richer industrial nations also tells us that if demand in the industrial economies is slow, so will be the level of world trade growth.

Figure 4 - World Trade Growth in Goods and Services (%)



Source: IMF, World Economic Outlook, 2010.

## 2. *International Investment*

This relates to investment by Transnational Corporations (TNC's). This is also known as International Direct Investment (IDI) or Foreign Direct Investment (FDI). Now there are

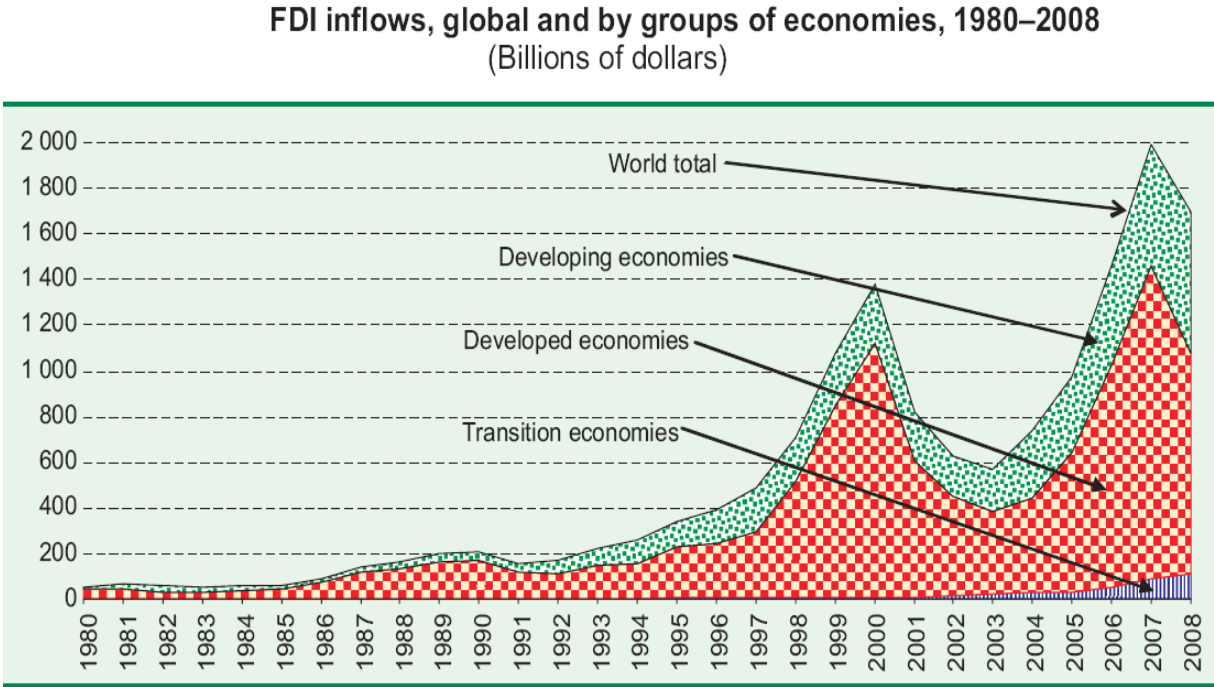
approximately 82,000 transnational corporations (TNC's) throughout the world with over 810,000 foreign affiliates.

The level of FDI flows has risen from 44 billion dollars US in 1985 to over 1941 billion dollars US in 2008. The global TNCs are dominated by firms from the USA, Japan and the European Union, homes of 85% of the top 100 TNC's. In recent years the areas of greatest new investment has been into the emerging markets in Asia, South America and the countries of the former USSR. In 2007, FDI grew by 70% in Russia and by 50% in the Latin American Countries. This has occurred due to their relatively low wage rates and growing economies.

In 2008, as a result of their global financial crisis, there was a turnaround in this trend with Global Foreign Direct Investment falling 15% (Figure 5.) The United Nations Conference on Trade and Development (UNCTAD) (2009) reports that the decline in FDI has increased in the early months on 2009 with FDI into China falling 26% and 38% into South Korea.

The IMF predicts that FDI inflows will fall to below \$1.2 trillion in 2009. The recovery is expected to be slow in 2010 (to a level up to \$1.4 trillion) and gaining momentum in 2011 (approaching \$1.8 trillion).

Figure 5 - Investment Trends in the Global Economy

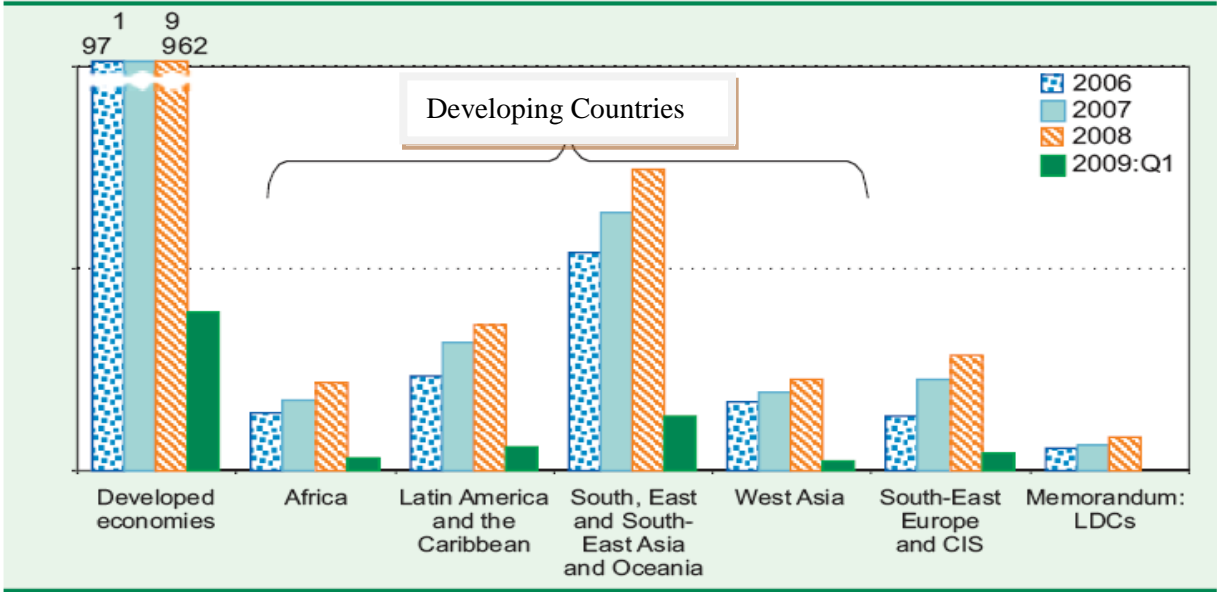


Source: UNCTAD FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)) and UNCTAD Secretariat estimates.

The withdrawal of FDI has not only affected the developed nations but many of the least developed nations have also been hit by the global down turn (Figure 6). The fall in FDI can have a major impact on these economies in terms of growth but also their ability to repay their debt and their financial stability.

Figure 6 – FDI Flows 2006-2009

(Billions of dollars)



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

**3. International Financial Flows**

International financial flows have grown most rapidly of all, at 10 times the rate of World GDP. Since the phasing out of controls on foreign exchange trading in the 1970's, international financial flows have grown exponentially. In 1980 global foreign exchange trading was 10 times the value of world trade. Foreign exchange trading is now estimated to be more than 100 times the value of world trade and growing. The level and direction of international financial flows are now the main determinants of the value of most nations' exchange rates. Trade in goods and services has little impact on the exchange rate today, except perhaps as a psychological influence on the behaviour of international financial traders.

Financial flows take many forms. The fastest growing area has involved interest rate, credit, currency, equity, and commodity derivatives. Interest rate, credit and currency derivatives make up over 90% of the total value of derivatives traded, see Figure 7. The turnover in the derivatives markets is now much larger than the cash markets. Only 1% of the foreign exchange market involves payments for trade. Most of it involves forms of derivatives trading.

## What are Derivatives?

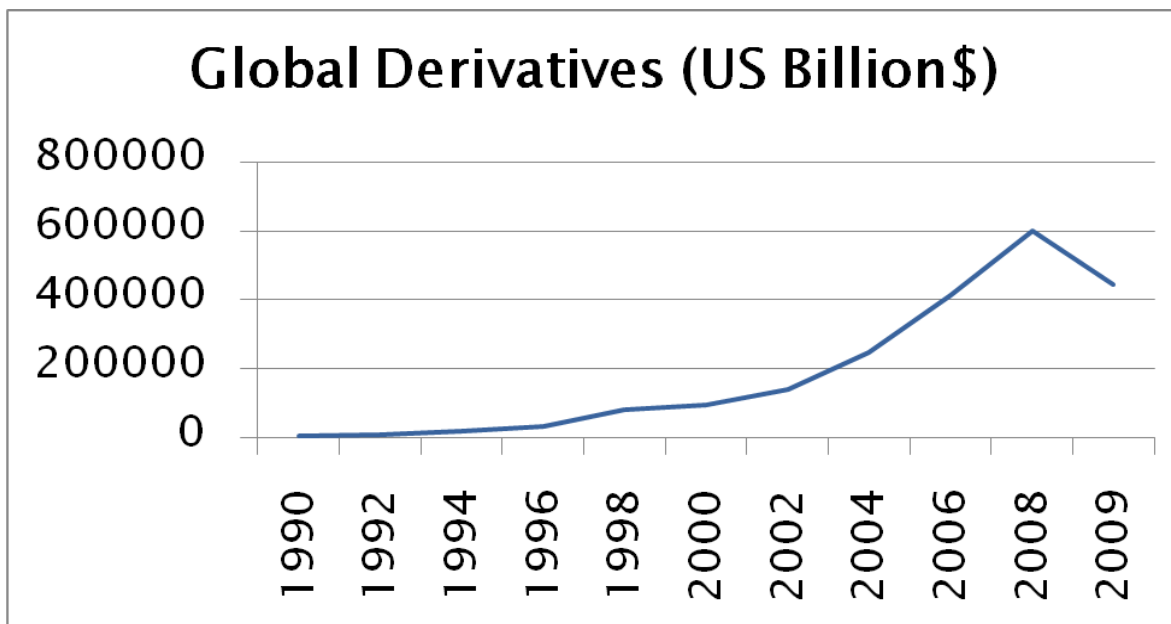
Derivates are simple financial contracts whose value is linked to or derived from an underlying asset, such as stocks, bonds, commodities, loans, and exchange rates. They are international financial instruments for spreading risk or hedging.

They include:

- futures,
- options,
- swaps,
- forward rate agreements and
- other hedging instruments, include issuing debt securities and undertaking repurchases.

An important point to note is the amount of foreign exchange traded in one day is greater than all the reserves of the world's Central Banks. This severely limits the ability of Central Banks to influence the flow of finance in the global economy and thus the impact these flows can have on a nation's exchange rate, as was seen in the Asian currency crisis in 1997. The amazing rate of growth in the financial flows, and as a result their ability to impact on the global economy, can be seen in Figure 7. The total estimated notional amount of outstanding derivative contracts stood at \$595 trillion at the end of December 2007, a rise of over 40% during the year. The global financial crisis lead to a decline in the volume of derivatives traded and for the first time there was actually a decline in the annual volume of trading so that contracts fell to \$593 trillion at the end of 2008. This fell further in 2009 to be only \$444 trillion.

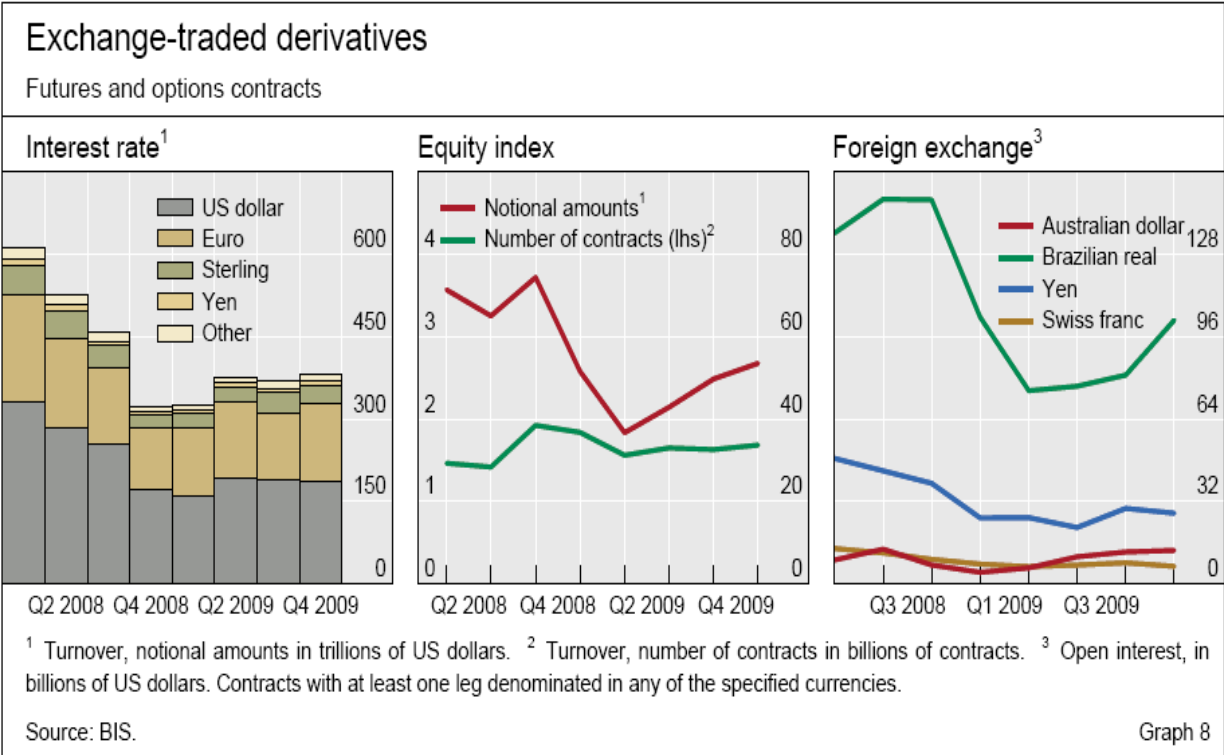
Figure 7 - The Growth of Derivatives



Source: BIS, Annual Reports (various)

Trading in interest rate, equity and foreign exchange contracts have all fallen (Figure 8). The largest decline has been in interest rate contracts. The Bank of International Settlement (2010) states that the decline in trading activity reflects a combination of significantly reduced risk appetite, expectations of stable low interest rates in major markets and lower hedge fund activity. In other words the markets are less inclined to take risks in the face of unstable and declining financial and economic conditions and are limiting their trading activities as a result. However, the worst appears to be over with a 5% growth in global finance in derivatives in the final quarter of 2009.

Figure 8 - Turnover in Derivatives Traded



Source: BIS, Annual Report (2010)

**Conclusion**

The global financial crisis has led to falling share markets, and instability in financial and foreign exchange markets. This uncertainty has discouraged investment and spending leading to falling economic growth rates and rising unemployment levels. Foreign Direct Investment declined and finance is more difficult to get for consumers and businesses.

There are signs however that the stimulus packages put in place by most governments and the low levels of interest rates are encouraging spending and the bottom of the downward slide in the global economy may have been reached. Recovery will be slow and economic growth levels are unlikely to contribute to improvements in unemployment in many

developed economies till the second half of 2010. However, concerns about sovereign debt in Europe may further slow the recovery.

While the market driven nature of globalisation does tend to provide benefits in the long term, it also has its flaws. There will always tend to be periods of financial instability and in these periods there is a need for greater government intervention in the economy. In between these periods there may also be a need to look at the current operation of financial markets to prevent or reduce the likelihood or magnitude of such occurrences in the future.

### References

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International Monetary Fund (1999-2010), *World Economic Outlook*, available at <http://www.imf.org/>

Reserve Bank of Australia (various years), *Reserve Bank of Australia Bulletin*, Sydney, RBA.

Stokes, A. (2009), *The Global Financial Crisis*, available at <http://homepages.ihug.com.au/~gep/economics.htm>

Stokes, A. and S. Wright (2008), *Globalisation and the Global Economy*, available at <http://homepages.ihug.com.au/~gep/economics.htm>

The United Nations Conference on Trade and Development (UNCTAD) (2010), *Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows*, available at [http://www.unctad.org/en/docs//diaeia20093\\_en.pdf](http://www.unctad.org/en/docs//diaeia20093_en.pdf)

### Internet Resources

*Bank for International Settlement (BIS)*, <http://www.bis.org>

*Greenacre Educational Publications*, <http://homepages.ihug.com.au/~gep/economics.htm>

*International Monetary Fund*, <http://www.imf.org/>

*Organisation for Economic Co-operation and Development*, <http://www.oecd.org/>

*Productivity Commission*, <http://www.pc.gov.au/>

*The Human Development Report*, <http://www.undp.org/hdro/>

*The World Bank Group*, <http://www.worldbank.org/>

The World Trade Organisation, <http://www.wto.org/>

The United Nations Conference on Trade and Development (UNCTAD),  
<http://www.unctad.org/>

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