Chapter A: The world economy

(represents chapters: 1)

International economics is divided in two parts;

- **International real analysis**: trade and investment flows, imperfect competition, trade policy etc.
- **International monetary analysis**: demand and supply of money, interaction between nations trough the exchange rate and other means.

If you look at which countries are important for the world, these countries are usually the large countries. But large can be measured on different aspects.

1. *Land area and population*. One can look at the size of the land area and of the population. The latter is a better indicator than the first.
2. *Income*. Looking at the domestic or national product of a country. This is the best indicator for determining the size of a country. To compare countries we have to correct productivity differences by calculating the purchasing power parity (PPP).
3. *Income per capita*: The production value per person, the well-being of the average person.
4. *International trade*. In this trade we distinguish between merchandise trade and trade in commercial services. Looking at exports relative to imports or relative to production.
5. *Globalization*: The increased interdependence of national economies and the trend towards greater integration in goods, labor, and capital markets.
6. *Trade connections in the world economy*. Europe is the world's dominant trading partner. The majority of their export flows are **intra-European:** exports from one European nation to another European nation.

In 2008 the world economy was hit by a financial crisis. This crisis is known as the Global Economic Crisis. During this crisis the volume of global trade flows declined.

Since the second half of the century there have been four periods in which real world trade flows declined:

1. In the aftermath of the first oil crisis.
2. In the aftermath of the second oil crisis.
3. After the collapse of the internet bubble.
4. During the Global Economic Crisis.

The decline in the volume of the global trade flows during the Global Economic Crisis is often investigated for three economy regions; USA, Japan and the Euro area, and for four emerging regions; Asia, C&E Europe, Latin America and Africa & Middle East.

The largest import decline is found in C&E Europe while the largest export decline is found in Japan. There are also differences in the duration of the decline in trade flows. Import volume declines in USA sustained much longer than import volume declines in Japan.

The OECD did not see that there was a crisis coming and noticed this only after it had happened. There are three causal factors for the Global Economic Crisis:

- The housing bubble. Housing prices rose much faster than income levels.
- Financial innovation. Banks were taking on higher risks and the financial market became very complex. There was lack of adequate supervision of the banking system which led to financial instability.
- Large imbalances between countries. In several countries expenditure levels were inconsistent with long-run income levels.

The financial collapse affected the real economy. The volume of world trade increased more rapidly than the volume of global industrial production. Both global crises have occurred almost perfectly simultaneously.

Another thing to note is that during a global crisis, the percentage decline in trade volume is larger than the percentage decline in industrial production. When comparing different economy regions, there are substantial differences in the extent of the decline.

The longest duration of decline is found in the USA and the shortest duration is found in Japan and Asia.

The governments in Europe and America had to respond to the financial crisis and did this in three ways:

1. Central banks were forced to pump a lot of money into the credit market and committed a high amount of equity into their financial institutions. This is the largest monetary intervention in world history.
2. The governments committed to large stimulus packages.
3. Governments were more long-term focused.

These changes led to a recovery in 2009-2010. However, after that it became clear that there were still many structural economic problems. The EU, USA and Japan still have not recovered to their pre-crisis levels.

But recovery is unequally distributed around the world. In some countries recovery is faster than in others. In emerging regions in Asia recovery is fast and these regions currently have a much higher production level than they had before the crisis.

In countries that recovered fast we typically find low unemployment levels, low budget deficits and reasonable debt levels. In slow recovery countries we find the contrary.