



Course 15.014

Global Economic Challenges

Study Questions

FINANCIAL CRISES: CAUSES, LESSONS, AND SOLUTIONS

I. History of Financial Crises

In the middle of 2007, the outlook for the global economy was extremely positive. Even after the subprime crisis began to unfold, most forecasters predicted a quick recovery in the United States and expected the rest of the world to “decouple” and continue its strong performance. In mid- and late-2008, however, global economic forecasts began to be rapidly revised downward—often within weeks of the last downward revision—as the depth of recession and global effects of the credit crunch became apparent. Some forecasters are now comparing the current situation to the Great Depression. The first two readings reflect this sharp reassessment of predictions for the global economy. The third reading provides a brief overview of recent crises. The last reading presents a historical analysis of the typical duration and depth of recessions after major banking and financial crises—suggesting that even the current forecasts may be too optimistic.

Why were economic forecasts so positive in 2007 and completely missed the current crisis?
Are economic forecasts currently too pessimistic (just as they were previously too optimistic)?
Will the U.S. crisis be as severe as the historic comparison predicts?

II. The Mexican Peso Crisis and BB-NN Model

This case describes the background to and direct aftermath of the 1994 Mexican peso collapse. After 1987, Mexico embarked on a program of macroeconomic stabilization and structural reform. Financial capital flooded into the country. In 1994, however, the government suddenly faced a severe financial crisis and was forced to devalue the peso. The resulting recession, capital outflows, and collapse in the value of the peso was much more severe than anyone predicted. This class uses the Mexican crisis to develop the basic framework and model for analyzing crises that will be used throughout this course. The last reading applies the core model (the BB-NN model or Salter-Swan model)—to the current situation in several emerging markets. Warning: this is the most technical, model-oriented session for the entire class.

What caused the peso to collapse in December of 1994? How important were short-term external influences versus structural problems internal to Mexico?
Could Mexico have avoided the peso collapse in 1994? If so, how?
What could Mexico have done differently after the initial devaluation in December to minimize damage to the economy?
Where are major emerging markets currently positioned in the BB-NN model?

III. The Asian Crisis, Moral Hazard, Speculative Bubbles, and Contagion

The Blustein book provides an excellent (and fun-to-read) description of the crisis that swept across Asia and surprised the world in 1997-98. If you do not have time to read the Blustein book, a shorter summary is provided in the first reading in the packet by Eichengreen. This article summarizes the countries affected by the crisis, the causes of the crisis, and why the impact was so severe. The next articles discuss contagion, a slightly different view of bubbles, and a retrospective of the crisis and Asia's current situation. The final short article shows that contagion during today's crisis has been even more global than during the Asian crisis. This series of readings focus on financial causes of the crisis—such as bubbles, inefficient bank lending, moral hazard, and the role of speculation—factors which have also played an important role in the current crisis.

What caused the East Asian crisis? How important were short-term external influences versus structural problems internal to the region?

Were the current account deficits in Asian countries (before the crisis) a cause of concern?

Why is the banking sector so important in affecting the likelihood and duration of a crisis?

What causes speculative bubbles? Are there benefits? Can anything be done to avoid them?

What is contagion? How are crises transmitted across countries?

Is it surprising that there was contagion during the current crisis?

IV. Predicting and Avoiding Currency Crises

Capital controls are often discussed as a means of reducing vulnerability to crises—although they have only had mixed success and can generate substantial economic costs and distortions. The first two readings discuss the advantages and disadvantages of capital controls. The third article discusses Thailand's recent (and brief) experiment with new capital controls. The next article discusses some of the steps emerging markets have taken to minimize the effect of the current crisis and evaluates their existing vulnerability. The final reading provides a brief historical review of currency crises and then presents a description of several unidentified countries that could be vulnerable to a crisis. Skim the historical material, but then study each example and be prepared to discuss which countries you think will experience a crisis.

What are the costs and benefits of capital controls?

Why did Thailand recently implement controls on capital inflows?

Should China and India be lifting their capital controls more rapidly?

What statistics would you suggest monitoring as early indicators of a crisis?

Which of the countries in the last reading are most likely to have a crisis? Why?

V. The Crisis of 2007-?: Causes, Lessons, and Responses

In 2007 most commentators believed that the U.S. subprime crisis would be contained to the U.S. housing market, with only minor spillovers to other sectors of the economy and the rest of the world. A year later, all major U.S. investment banks had collapsed or been restructured or bought, the U.S. government had basically nationalized the GSEs and invested billions of dollars in banks and insurance companies, and the Federal Reserve Board was buying a range of non-conventional securities. The entire global economy has slowed sharply and several emerging markets are on the verge of a crisis and/or have had to approach the IMF for additional lending. While two years ago people wrote about the "taming of the business cycle", now people frequently compare the current environment to the Great Depression. The ability for traditional macroeconomic tools to resolve the crisis appear limited. For example, In the United States interest rates are already near zero and the proposed stimulus package of close to \$1 trillion will place severe strains on an already massive budget deficit. This series of readings begins by discussing the causes of the crisis and why it took the world by surprise. Then several articles focus on policy responses to avoid this crisis becoming another Great Depression.

What caused the crisis? Were the causes of this crisis substantially different than past crises?
Why did a crisis which began in the United States have such a global impact?
What is the role of monetary policy in ending the crisis? What are the challenges?
What is the role of fiscal policy? How should a stimulus be designed? What are the advantages and disadvantages of different approaches?
Will this be a repeat of the Great Depression? Or of Japan's "lost decade"?
What are longer term implications of the crisis for regulation and U.S. financial markets?

VI. The U.S. Current Account Deficit, Global Imbalances and Sovereign Wealth Funds

The U.S. current account deficit was almost \$900 billion in 2006 (6.5% of GDP)—the largest current account deficit that any country has ever run—and a factor which some analysts link to causing the current crisis. It has shrunk somewhat to \$700bn in 2008 (4.5% of GDP), but is still massive by any historical precedent and reflects the continued dependence of the United States on foreign borrowing. This U.S. deficit is balanced by large current account surpluses in other economies—especially in Asia and oil-producing nations. Foreigners have been willing to finance this U.S. deficit at a low cost—but have recently been earning significantly lower returns than if they invested in their own countries (even after adjusting for risk). Sovereign wealth funds have played an important role in financing U.S. deficits—but are now hesitant to invest in the United States after recent losses. These deficits and surpluses reflect imbalances between savings and investment in different countries. Many analysts are worried that this system of global imbalances cannot go on, and that the adjustment process will aggravate the current economic slowdown and lead to higher interest rates and a further depreciation of the dollar.

Is the U.S. current account deficit a problem? Why or why not?
Are current account surpluses in other countries a problem? Why or why not?
Should developed countries seek investment by Sovereign Wealth Funds? Or discourage it?
How are national savings and investment rates related to global imbalances?
What policies should the major economies adopt to reduce global imbalances?

VII. The Rise of the BRICs and Frontier Economies

The emergence of the BRICs (Brazil, Russia, India and China) as major economic players and participants in the world trading system has been one of the major trends shaping the global economy. China has recently surpassed Japan to become the 2nd largest country in the world (as measured by PPP) and Goldman Sachs predicts it will be larger than the United States by 2027. Attention has recently shifted to the next set of emerging economies, frequently called the "frontier" economies, and their potential to replicate the Chinese "miracle." This rapid growth in the emerging world has substantial benefits—from supporting global growth to providing low-cost products for consumers around the world to providing low-cost production platforms for companies. This growth also raises concerns, however, about "unfair competition" and offshoring. Although there are some valid reasons for concern, many of the popular arguments about risks from the rise of the BRICs are fundamentally flawed. Moreover, the current financial crisis is having a much more severe impact on emerging markets than widely expected.

Are there any economies or regions that will be able to replicate China's economic success?
How has China's integration with the global economy affected global trading patterns?
Is China a major factor behind the U.S. trade deficit or manufacturing job losses in the U.S.?
What are the costs and benefits of offshoring to developed economies?
What policies would you recommend to respond to the rise of the BRICs globalization?
Will emerging markets' impressive economic performance withstand the current financial crisis?

VIII. Inequality and Poverty: What Matters and What Can We Do?

Poverty has fallen dramatically in many countries, while other countries seem unable to benefit from rapid global growth. Inequality in many countries—both developed and developing—has also increased, although global inequality has fallen. The middle class has grown rapidly in many developing countries—a trend widely viewed as positive—while developed countries such as the United States have become increasingly worried about the “middle-class squeeze”. What drives these divergent trends? How will these major shifts in income and wealth affect the world economy? What should policymakers be doing with respect to poverty, the middle class, and inequality? This selection of readings presents a range of different views on these issues. Some articles present different opinions on foreign aid, focusing on what role developed countries should play in fighting poverty and how aid can be most effective—an issue critically important to gain political support for increased aid flows. There is no easy answer to these difficult questions—and the selection of readings is meant to present a range of opinions from these heated debates.

Is the world winning or losing the fight against global poverty?

How will the rapid growth of a middle class in developing countries affect the global economy?

Should policymakers be concerned about increased inequality within countries?

Should developed countries increase aid flows to developing nations? If so, are there better ways to provide aid to ensure that it is effective?

Should developed countries be focusing on other mechanisms—such as debt relief, trade liberalization, or fighting global diseases (such as AIDS)—instead of (or in addition to) providing aid flows?

IX. The Economics of Climate Change

There is now little dispute that climate change is occurring and will present increasing economics costs in many regions of the world. Most countries agree that something must be done to reduce greenhouse gas emissions (GHG), but there continues to be little agreement on how. Many developed countries have already slowed their growth of GHG or committed to do so in the future, but worry this will have little effect unless developing countries—currently the greatest source of increases in GHG—make similar commitments. Developing countries believe developed countries should bear most of the cost of reduced emissions as they were the greatest contributors to global warming in the past and in most cases contribute substantially more on a per capita basis. All countries are worried that if they take unilateral measures to reduce emissions, it will significantly harm their competitiveness and economic growth. This selection of readings discusses the economic impact and challenges of global warming, including the leading policy options that could form the basis of an international agreement. One reading focuses on the United States—a country that is critical to reach any global agreement. Other readings focus on the impact of global warming on agricultural economies—the most vulnerable to these trends— and the devastating effects that global warming has already had on China.