

Global 197 – Special Topics (Mehta)

Global Economic Imbalances and Financial Crises: An Introduction

Objective: Provide an overview of global financial and trade imbalances, the forces driving them, the reasons they result in frequent crises, and what governments can do / have done about this. This opens up a discussion of national politics and policy, and their effects on the international economic landscape and on the global distribution of financial and economic power. To build foundations for this discussion, we will spend much of the course studying basic open-economy macroeconomics.

Storyline: A sequence of financial and balance-of-payments crises, picking up with Mexico in 1982, has hit countries around the world. The root causes have in each case involved excessive borrowing, which was made possible by a dramatic growth in the scale and scope of global financial intermediation. Perhaps tautologically, this tendency to excess has been ascribed to political causes. Regulatory lapses, implicit loan guarantees and other policy failures created incentives for borrowers to take on too much debt and for investors and their intermediaries to undervalue risks.

While these broad mechanisms have not changed too much over time, this constancy belies a much larger shift in the balance of global economic and political power: the identities of the borrowers and lenders have changed. Generalizing slightly, crises resulted from excessive borrowing by developing country governments in the 1980s; by developing country banks, firms and consumers in the 1990s; and by rich country banks, firms, consumers and governments by the 2000s. The finance fueling these loans, which had mainly come from the trade surpluses of oil producing governments and Western private interests in the in the 1970s, has increasingly come from the trade surpluses of export-oriented Asian economies starting in the 1990s. The US, UK and several other OECD countries have run growing trade deficits that make this possible. We will refer to these trade and financial surpluses as global imbalances.

This course is premised on the notion that loans are not simply business arrangements. Governments, firms and consumers borrowing excessively make a contingent transfer of power and resources to their creditors. The contingent nature of this transfer is important - it is only in a moment of crisis, when a debt cannot be repaid, that the extent, nature and implications of the power transfer become apparent. We therefore study global imbalances to understand shifting global power relations¹, and we study financial crises to understand how this power is likely to be wielded and the transition negotiated.

Similarly, international economic imbalances and crises reflect more than *international* power relations. After all, debts and finance must be raised domestically before they can be exchanged internationally. By examining who raises excessive amounts of debt, and who finances it and why, we can therefore shine some light on the domestic forces and dilemmas that lead some countries to surrender power on the global stage, and others to

¹A quick word of caution: Not all debt is excessive. Taking on a reasonable amount of debt involves a low probability of default, and therefore has fewer political implications. My intent here is not to imply that if country A finances the borrowing of country B, then A is strong and B is weak. Such inferences are only possible when B borrows “too much”, and so courts a serious risk of insolvency. Unfortunately, how much borrowing is “too much” is a matter of judgment, and a consensus on this only emerges ex-post.

acquire it. This approach will therefore lead us to consider a variety of important domestic political forces in major economies.

Approach: The course will proceed along two tracks in parallel: theory and “empirics”. By empirics, I simply mean articles that fill in the storyline provided above, and/or either illustrate or call into question the theories we are discussing. Each meeting we will cover one or two basic concepts in macroeconomic theory, and will discuss 1-3 empirical readings. A key device will be the use of accounting identities – simple, inviolable, atheoretic, relationships that governing the interdependence of key components of global and national economies (e.g., we will learn that the US trade deficit must exactly equal the net value of US assets purchased by the rest of the world – thus linking US production and consumption outcomes to foreign demand for a share of future US income). Next, we will review enough basic macroeconomic theory to be able to understand the likely effects of fiscal policy, monetary policy and exchange rate policy on elements of these identities. Third, we will contrast the actions of governments in the years preceding crises and their reactions to crises with actions that they could have undertaken, but did not. This will help us understand the socio-political and social forces behind these choices.

Materials: Please obtain the course reader from the Alternative Copy Shop, Raghuram Rajan (2011) *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, and Joseph Stiglitz (2010) *Freefall: America, Free Markets and the Sinking of the World Economy*. In addition I expect you to keep abreast of major developments in the global economy by reading a newspaper that has trained economists on its staff. Good options include The Financial Times, The New York Times, and The Wall Street Journal. The Economist magazine is an excellent additional resource. I will also occasionally post readings on Gauchospace.

Requirements: Grading will be based on: four homework assignments (8% each, or 32%); a final paper (35%); oral presentation (18%) and course participation (15%), which is assessed on the quality (not quantity) of your contributions, respect for your classmates and effort (including attendance, and my impression of whether you are doing the reading).

- The four homework assignments will be due on April 17, April 24, May 1 and May 8 respectively. I expect you to turn in the homework assignments in groups of 2-3 students. You may request an exemption to turn in your assignments individually if there is a mitigating circumstance (e.g. you live out of town, have a child, work too many hours to meet with a study group etc.). Working in groups is pedagogically useful – it will force you to use the language the course will introduce you to.
- The paper assignment is to select a country in Asia; show empirically how the accounting identities used throughout the course evolved in the case of this country (using charts and tables as appropriate); use these identities to guide the reader through a discussion of the country’s macroeconomic dilemmas; and, through a careful review of literature, explain the political-economy underlying some recent decisions regarding these dilemmas. Your paper, including the bibliography, may not exceed 6 pages of 11 point, 1.5 space Times New Roman font, with 1 inch margins. Cite at least 12 sources, at least 6 of which are not newspaper articles. Use standard journal referencing styles, with the author name and year in the text and full references collected in a reference section at the end (See the example of a paper for referencing style that I have posted on Gaucho). Note that I will expect perfect grammar and

spelling, and will heavily penalize papers that err in these respects. Be sure that all your graphs and tables are self-explanatory, include table and figure notes wherever necessary, and ensure that the source of all your data is properly presented. The paper is due in my mailbox by noon on Monday, June 17.

- The paper must be written individually. However, groups of students working on the same country are encouraged to work together on analysis, discussion, and interface with me.
- Final presentations will be given on Tuesday, June 11, 12-3 pm here in the class-room. These will substitute for a final exam. Each presentation will consist of PowerPoint overview of the points you wish to make in your papers. We will spend some time discussing what makes for a good presentation. Groups working on the same country are encouraged to prepare a combined powerpoint.

Mathematics: This course will require you to utilize arithmetic, including addition, subtraction and basic calculations using fractions, decimals and percentages. You will also be required to read graphs, work with the equation for a straight line, and be able to find the intersection of two straight lines. The course website includes links to websites that will help you to refresh your memory of these topics. I will not cover them in class.

How to Study/Read for this class: Always read my course notes *before* class. Read the B&B sections once quickly before class, and again in detail after class to make sure you got it all. I expect you to read all starred items before class. Concepts in this course are sequential, so you **MUST NOT GET BEHIND**.

Pedagogical Approach: The course content is tightly managed, leaving relatively little time for digressions. Other than a few minutes devoted to current events at the start of each session, I will not leave time for digressions. If you have burning questions about something that does not relate directly to the topics or readings for the day, either bring it to office hours, ask me after class, or write it down and raise it when we get to the relevant portion of the course.

Date	Topics	Readings
M 1 Apr.	<u>Introductions</u> - Course Administration - Crises & imbalances, an overview - The world economy today.	Rajan, Introduction (read after class) Friedman, Opening scene* IMF- World Economic Outlook 2012 (selection, read over weekend)
W 3 Apr.	<u>Introductions (2)</u> - Objectives (Productivity, employment, low inflation) - Potential GDP - 20 th century macroeconomic thought - Aggregate Supply & Demand	Baumol &Blinder Ch. 22 (skip pp. 472-5), Baumol &Blinder Ch. 23 The other-worldly philosophers. The Economist* Cyprus: A poor diagnosis, a bitter pill* Russian ties put Cyprus banking crisis on East-West fault lines*
M 8 Apr.	<u>Accounting Identities</u> - National income accounting. - Components of aggregate demand	Course notes on accounting identities* B&B, Ch. 22, pp. 472-5 B&B, Ch. 25, pp. 537-541, 552-557 Stiglitz, <i>Freefall</i> , Ch. 1.*
W 10 Apr.	<u>Accounting Identities (2)</u> - Internal and external (im)balance	Course notes on accounting identities* B&B, Ch. 25, 542-551

	- Components of GDP and what makes them move	Rajan, Chapters 1, 2*
M 15 Apr.	<u>Keynesian equilibrium (1)</u> - A simple conceptual model - Deriving aggregate demand	B&B, Ch. 26, 559-566 My notes on Keynesian economics, section A. Felipe et al. 2006, selection* Rajan, Ch. 3*
W 17 Apr.	<u>Keynesian equilibrium (2)</u> - Multipliers - Determinants of real expenditures	B&B, Ch. 26, 566- My notes on Keynesian economics, section B. The future of savings rates in Asia*
M 22 Apr.	<u>The Supply Side</u> - Aggregate supply - Low unemployment = high inflation? - Inflationary & Recessionary gaps again	B&B, Ch. 27
W 24 Apr.	<u>Fiscal policy</u> - Multipliers again (tax .or spend?) -	B&B, Ch. 28 - Stiglitz, <i>Freefall</i> , Ch. 3.* - Rajan, Ch. 3*
M 29 Apr.	<u>Monetary Policy</u>	- Colander, Ch. 28 - Course note on monetary policy (To be prepared) - Romer, Impact of the ARRA* - Rajan, Ch. 5
W 1 May	<u>Supply Side Economics</u> - Ricardean Equivalence - The Permanent Income Hypothesis	- Course note on supply-side economics (TBP)* - Barro, Voodoo multipliers.* - Determining the size of the fiscal multiplier.* - The Laffer Curve – past, present and future* - Krugman, <i>Peddling Prosperity</i> , Ch. 3
M 6 May	<u>Slack day</u>	
W 8 May	<u>The balance of payments (1)</u>	- Colander, Chapter 32
M 13 May	<u>The balance of payments (2)</u>	- Colander, Chapter 32* - Course note on the Marshall-Lerner conditions* - Course note on the impossible trinity*
W 15 May	<u>Europe</u>	- Levy institute working paper 122* - Lewis: beware of Greeks bearing bonds* - Readings TBD
M 20 May	<u>Structural transformation / Inclusive growth:</u>	- Inclusive Growth through full Employment (Felipe, 2008), pp. 161-177* - Iversen & Wren (1998) - Rajan, Ch. 4*
W 22 May	<u>The United States</u>	Rajan, Ch. 6-8* Stiglitz, <i>Freefall</i> , Ch. 4* Johnson & Kwak, <i>13 Bankers</i> , Ch. 6*
M 27 May	Memorial Day – No class	
W 29 May	Professor out of town: students' choice	
M 3 Jun.	<u>Asia</u>	- Stiglitz – <i>Globalization & its discontents</i> , Ch. 4 - TBD.
W 5 Jun.	<u>Russia</u>	- Stiglitz, <i>Globalization & Its Discontents</i> , Ch.5* - TBD.