

ANALYZING GLOBAL TRENDS
for Business and Society

Week 4

Global
Economic and Financial
Imbalances

Mauro F. Guillén

Mini-Lecture 4.1

- This week we will cover the global economy and financial architecture.
- We will seek to understand global economic and financial dynamics from the point of view of how countries interact with one another.
- We will also examine two crucial issues: the European crisis and the U.S./China relationship.

Balance of Payments in 2012

(US\$ billion)

Concept	Formula / Notation	U.S.	China	India	Brazil
Trade balance in goods	$(X_g - M_g)$	-741.5	+321.6	-189.8	+19.4
Trade balance in services	$(X_s - M_s)$	+206.8	-89.7	+64.1	-41.0
Trade balance goods & services	$(X - M)$	-534.7	+231.8	-125.7	-21.6
Net income from abroad	$(INF - IFF)$	+223.9	-42.1	-16.0	-35.5
Net transfers from abroad	Z	-129.7	+3.4	+63.5	+2.8
Current account	$(X - M) + (INF - IFF) + Z$	-440.4	+193.1	-78.2	-54.2
Net capital transfers to/from abroad	F	+56.8	-16.8	+67.8	+70.2
Net foreign loan (reserve change)	SF	-389.5	+96.6	-12.8	+18.9
Capital account	$F - SF$	+446.3	-113.3	+80.6	+51.3
Statistical discrepancy	SD	-5.9	-79.8	-2.4	+3.0
Balance of payments	$(X - M) + (INF - IFF) + Z + F - SF + SD = 0$	0.0	0.0	0.0	0.0

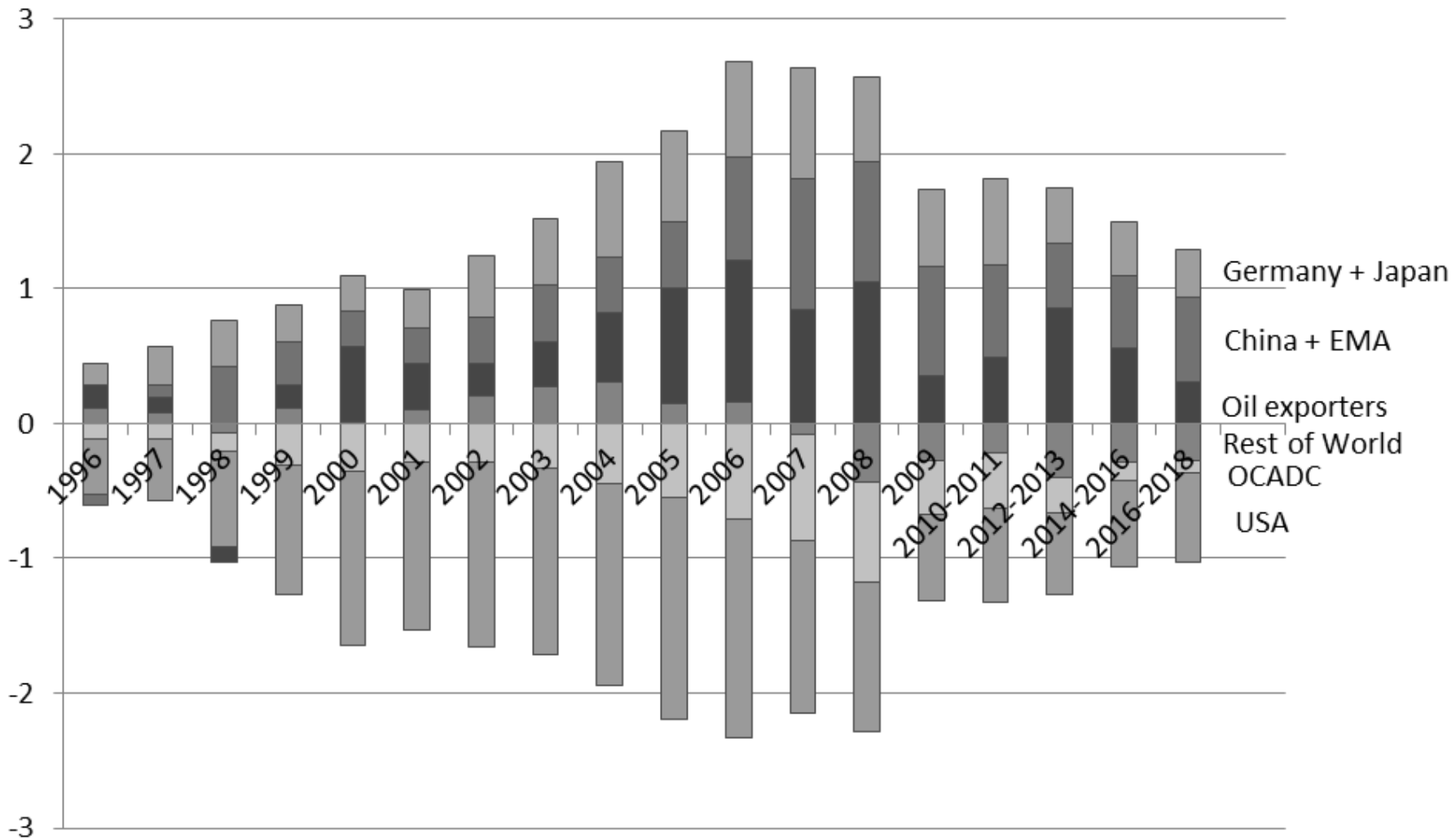
Source: Re-calculated by M. Guillen with data reported by BEA, State Administration of Foreign Exchange, Reserve Bank of India, and Banco Central do Brasil.

Two Basic Considerations

- If a country exports more than what it imports, it's a **surplus** country.
- If it imports more than what it exports, it's a **deficit** country.
- If one country runs a surplus, that necessarily means that at least one other country runs a deficit. This is only true in the absence of inter-planetary trade.

Global Imbalances

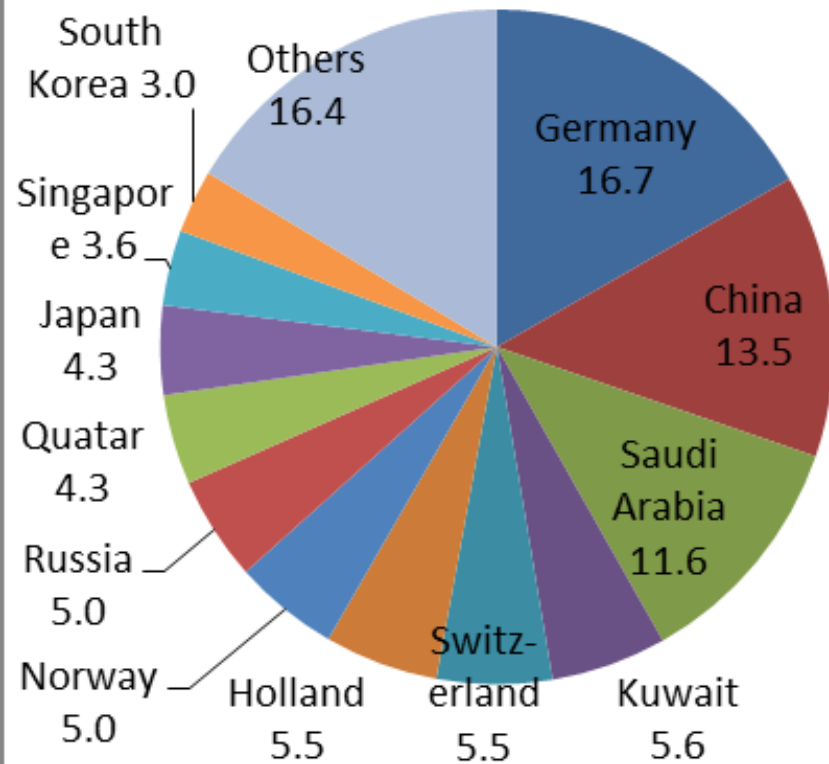
(Current Account, % of Global GDP)



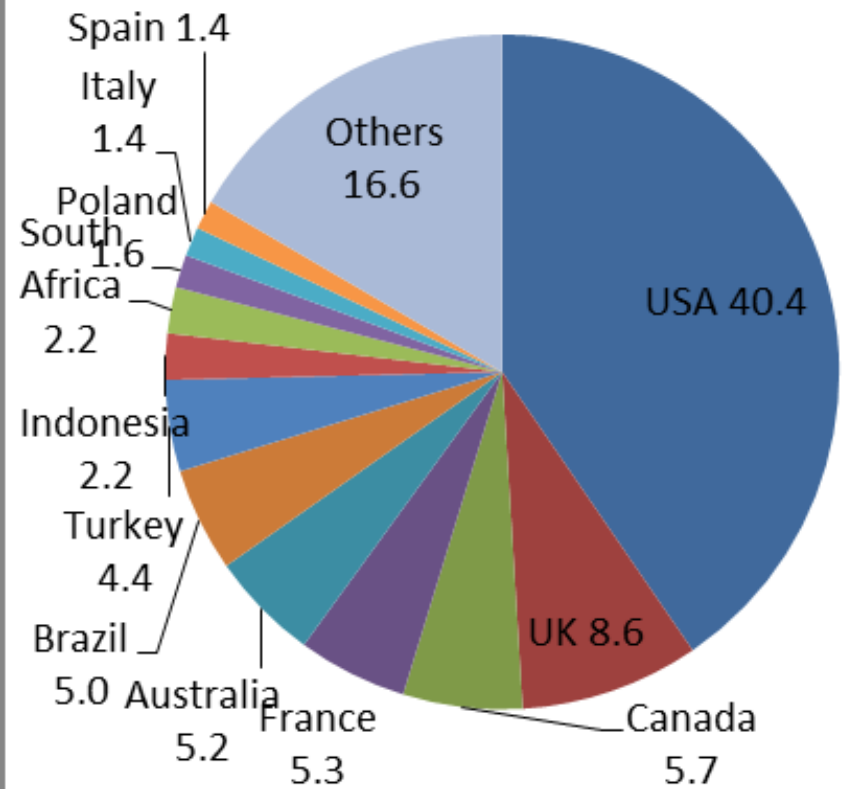
EMA: East and Southeast Asia. OCADC: Europe, excluding Germany.
 Mauro F. Guillén. Data from the IMF, *Global Economic Outlook*.

Current Accounts

Surplus Countries 2012



Deficit Countries 2012



1000,000

1000,000

7 5/8%
TREASURY BOND
OF 2002-2007

Dated February 15, 1977
 Due February 15, 2007

CUSIP 912810 BX 5

Redeemable on call on and after
 February 15, 2002
 CIRCULAR No. 4-77



1586F

THE UNITED STATES OF AMERICA

FOR VALUE RECEIVED PROMISES TO PAY TO THE BEARER THE SUM OF

ONE MILLION DOLLARS

ON THE DUE DATE, AND TO PAY INTEREST ON THE PRINCIPAL SUM FROM THE DATE HEREOF, AT THE RATE SPECIFIED HEREON. THIS BOND AND INTEREST COUPONS ARE PAYABLE AT THE DEPARTMENT OF THE TREASURY, WASHINGTON, D.C., OR AT ANY FEDERAL RESERVE BANK OR BRANCH. THIS BOND IS ONE OF A SERIES OF BONDS, AUTHORIZED BY THE SECOND LIBERTY BOND ACT, AS AMENDED, ISSUED PURSUANT TO THE DEPARTMENT OF THE TREASURY CIRCULAR REFERRED TO HEREOF. ALL OR ANY OF THE BONDS OF THIS SERIES MAY BE REDEEMED, AT THE OPTION OF THE UNITED STATES, ON AND AFTER FEBRUARY 15, 2002, AT PAR AND ACCRUED INTEREST, ON ANY INTEREST DAY OR DAY, ON FIVE MONTHS' NOTICE OF REDEMPTION GIVEN IN SUCH MANNER AS THE SECRETARY OF THE TREASURY SHALL PRESCRIBE. IN CASE OF PARTIAL REDEMPTION THE BONDS TO BE REDEEMED WILL BE DETERMINED BY SUCH METHOD AS MAY BE PRESCRIBED BY THE SECRETARY OF THE TREASURY. FROM THE DATE OF REDEMPTION DESIGNATED IN ANY SUCH NOTICE, INTEREST ON THE BONDS CALLED FOR REDEMPTION SHALL CEASE. THE INCOME DERIVED FROM THIS BOND IS SUBJECT TO ALL TAXES IMPOSED UNDER THE INTERNAL REVENUE CODE OF 1954. THIS BOND IS SUBJECT TO ESTATE, INHERITANCE, GIFT OR OTHER EXCISE TAXES, WHETHER FEDERAL OR STATE, BUT IS EXEMPT FROM ALL TAXATION NOW OR HEREAFTER IMPOSED ON THE PRINCIPAL OR INTEREST HEREOF BY ANY STATE, OR ANY OF THE POSSESSIONS OF THE UNITED STATES, OR BY ANY LOCAL TAXING AUTHORITY. THIS BOND IS ACCEPTABLE TO SECURE DEPOSITS OF PUBLIC MONIES. IT IS NOT ACCEPTABLE IN PAYMENT OF TAXES.

WASHINGTON, D. C., FEBRUARY 15, 1977.

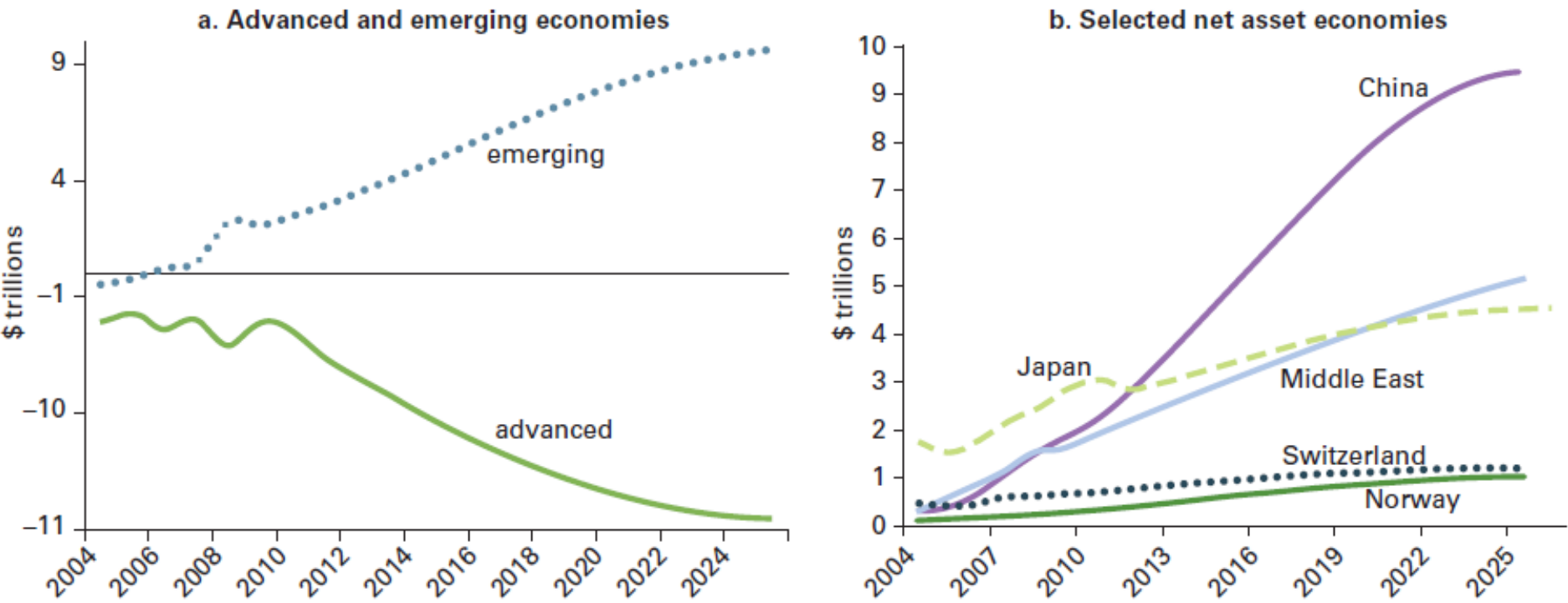
William E. Fisher
 SECRETARY OF THE TREASURY

1000,000

ONE MILLION DOLLARS

1000,000

FIGURE 1.20 Net international investment positions, advanced and emerging economies, and selected net asset countries, 2004–25 baseline



Source: World Bank staff calculations.

Note: The figures depict the baseline scenario. The net IIPs of the two groups do not net to zero because only the top 26 multidimensional polarity index economies were used in the computation. Advanced (emerging) economies thus include only the respective constituent economies within each category. The Middle East includes Mashreq Middle East and North Africa economies, of which Saudi Arabia is the largest economy. Net IIP calculations assume constant asset prices in U.S. dollars and a constant capital account-to-GDP ratio and are measured in constant 2004 prices relative to the basket of OECD exports (for emerging and advanced aggregates) and 2009 U.S. dollars (for individual countries). The net IIP for the Middle East economies was imputed from Saudi Arabia’s historical current account and reserve asset positions and scaled up based on Saudi Arabia’s GDP share within the group, and the net IIP for Japan reflects a 10 percent reduction as a consequence of the 2011 Tohoku earthquake and tsunami (based on the upper bound of Japanese government estimates of reconstruction costs, assuming that all costs are borne by reductions in foreign asset positions due to repatriation, and imputing all costs to one year).

Source: *Multipolarity: The New Global Economy* (The World Bank, 2011).

Mini-Lecture 4.2

- The changing geography of capital investments.

Capital Investments 1914

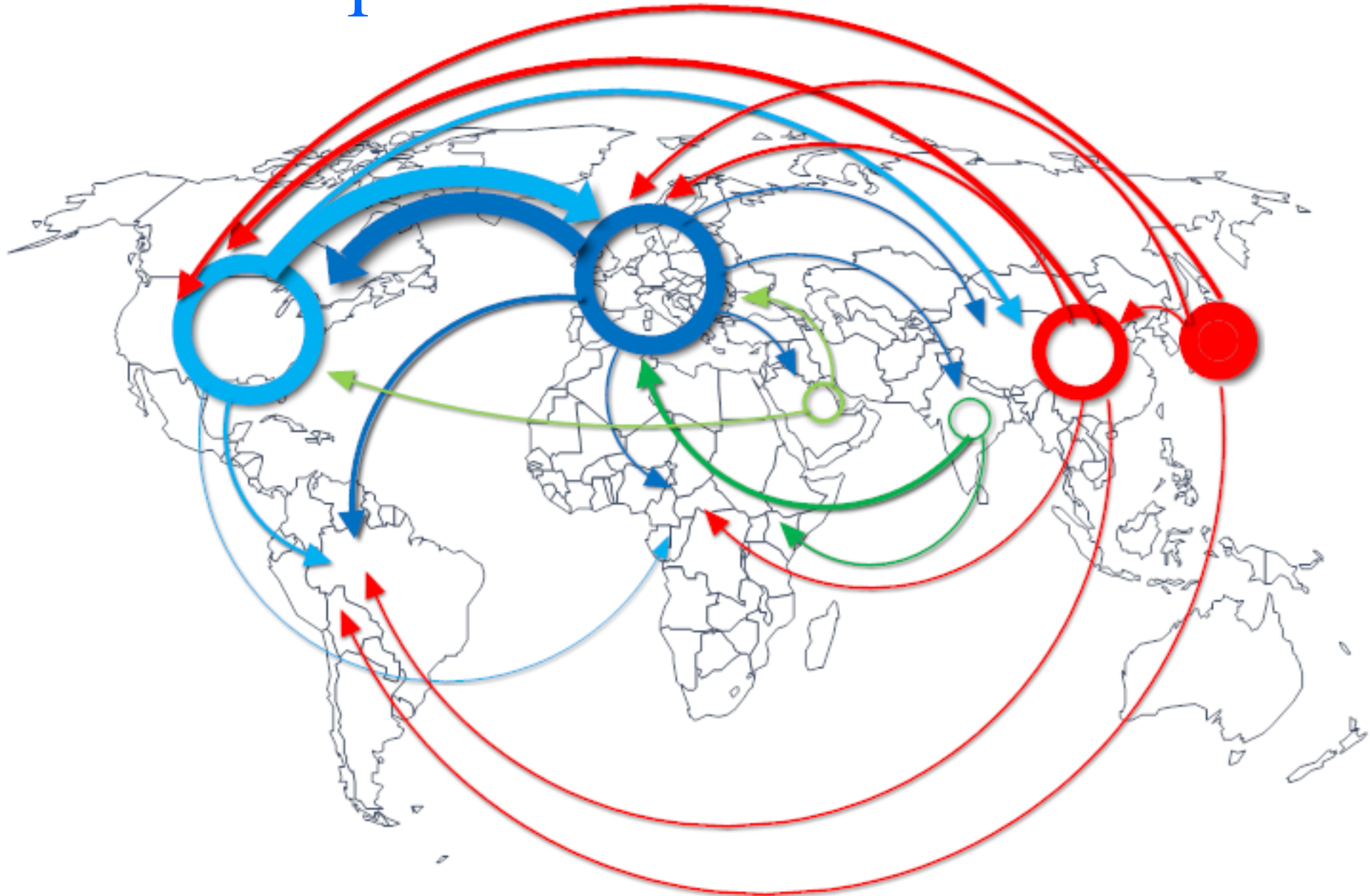


Mauro F. Guillen. Source of the data: W. Woodruff, *Impact of Western Man* (1966).

Capital Investments 1967

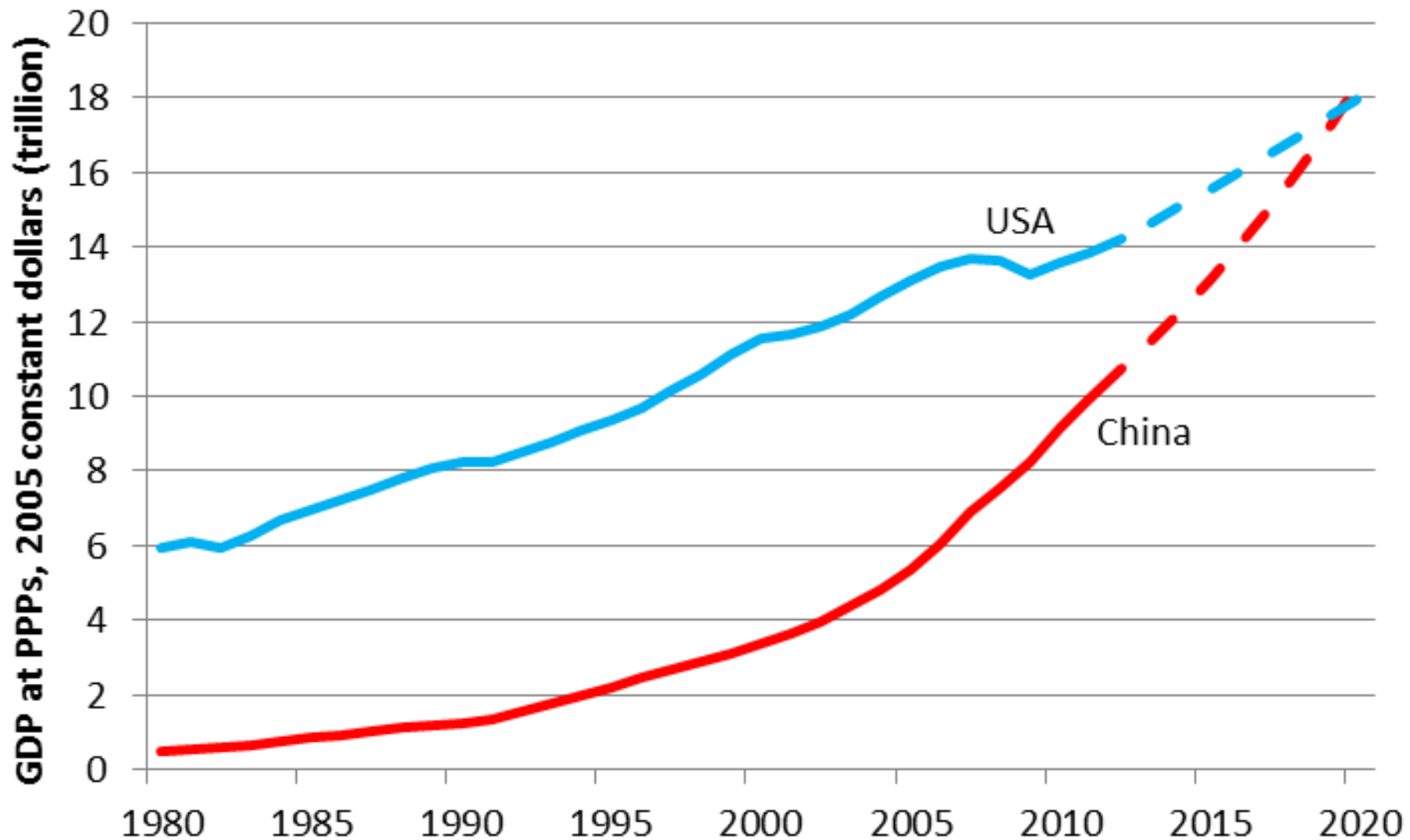


Capital Investments 2012



Mauro F. Guillen. Source of the data: *World Investment Report*; *World Investment Directory*.

US and China: GDP Projection to 2020



Actual data 1980-2012. Assumes 7% growth rate in China, and 3% in the US.
Mauro F. Guillén. Source of data: World Development Indicators.

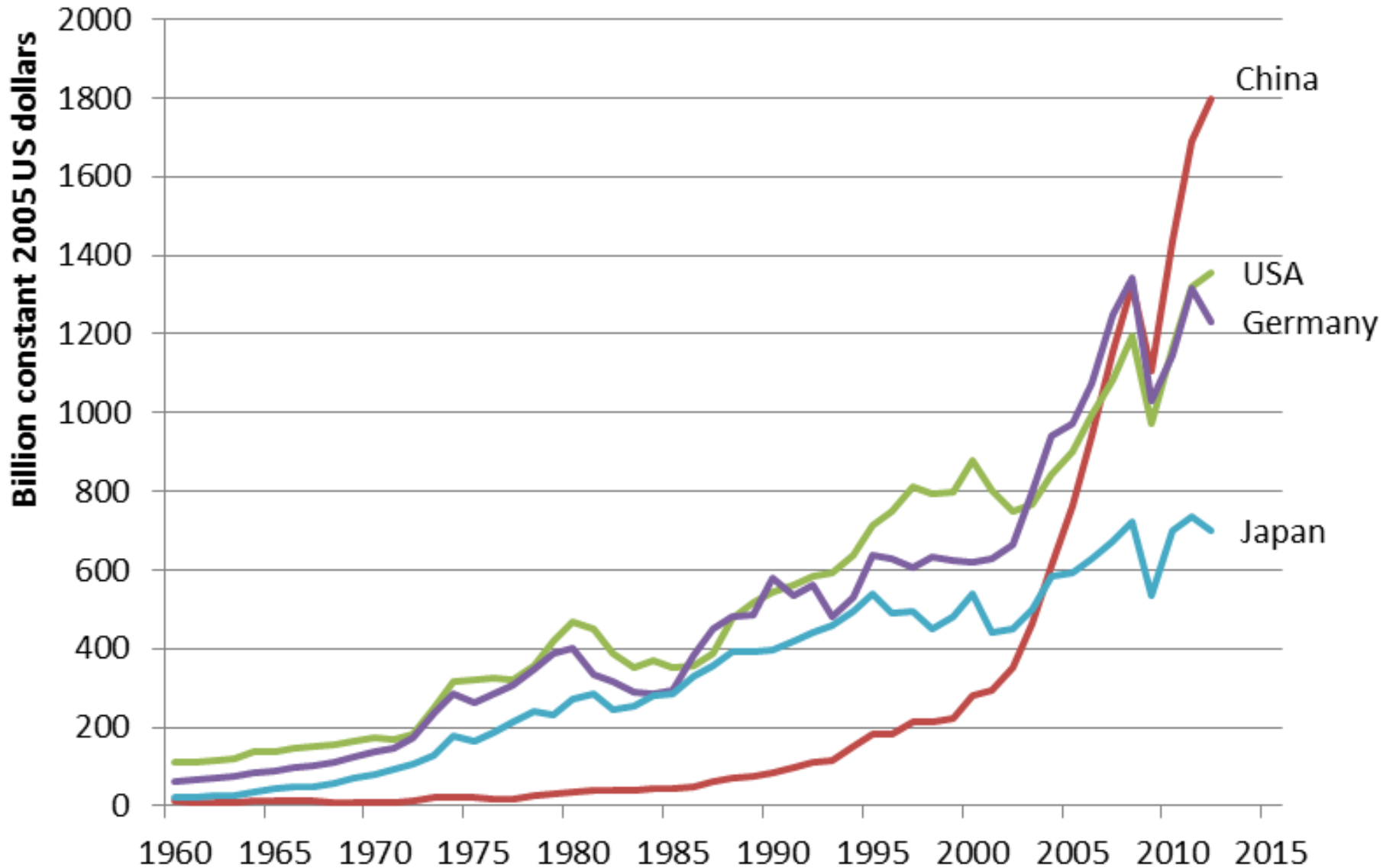
Manifestations of Global Power

	1800s-1914	1945-1990s	2000s-
Largest economy			
Largest trading country			
Largest navy			
Dominant reserve currency			

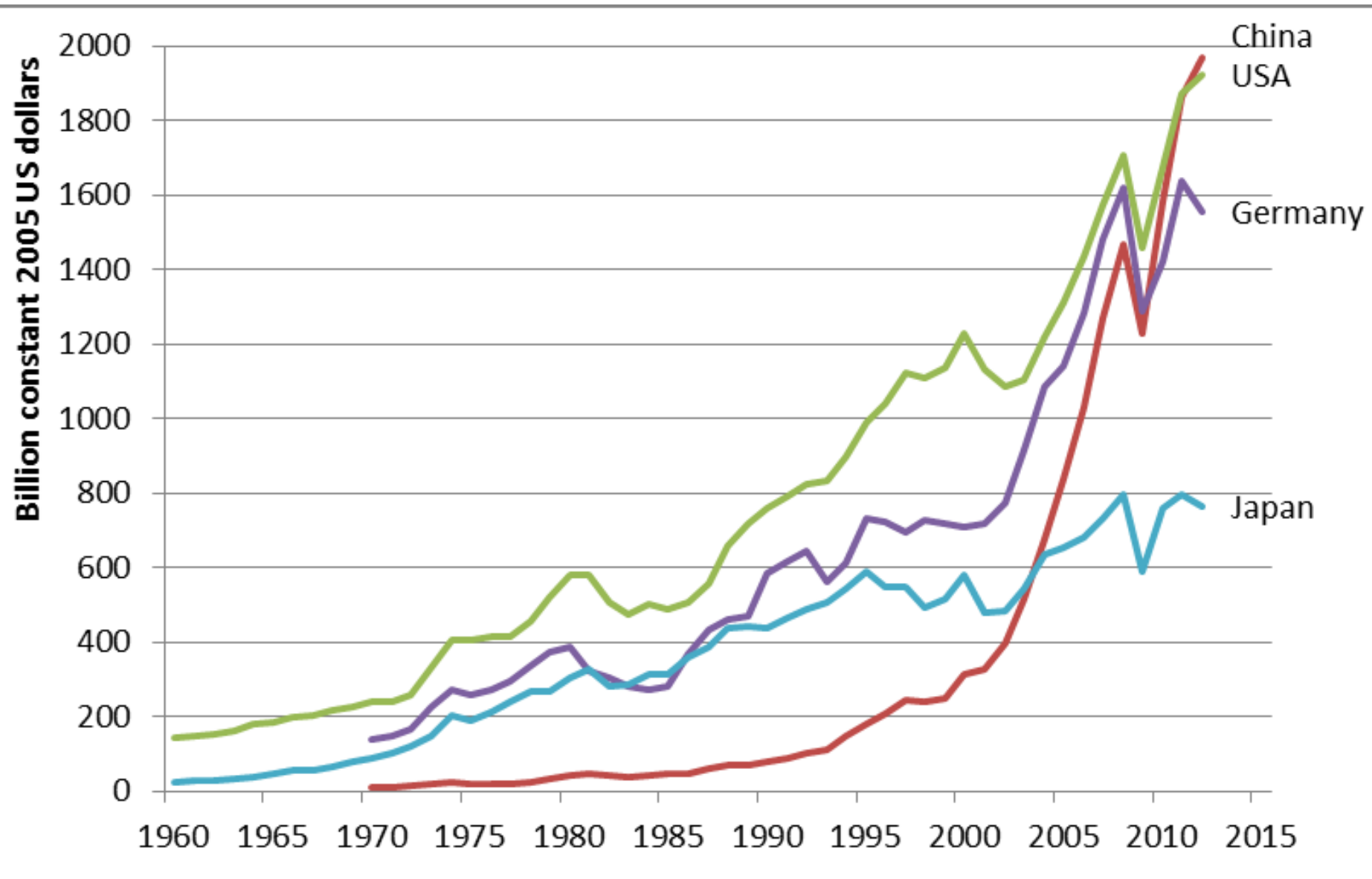
Biggest Economies

- 1 - ca.1500: India.
- ca. 1500 - ca.1888: China.
- ca. 1888 - present: United States
- 2020? onwards: China.
- The UK was never the largest economy. It was the second largest 1820-1872. Before 1820 France was bigger, and after 1872 the U.S. was bigger. Germany became bigger than the UK in 1908.
- Western Europe as a bloc was the largest economy ca. 1840-1942.

Biggest Merchandise Exporters



Biggest Exporters of Goods & Services



Mauro F. Guillén. Source of the data: World Development Indicators.

Manifestations of Global Power

	1800s-1914	1945-1990s	2000s-
Largest economy	China until 1888, then USA	USA	USA for now, China soon
Largest trading country	UK	USA	China (since 2007 in merchandise, since 2012 in both goods & services)
Largest navy	UK	USA	USA
Dominant reserve currency	Pound Sterling	Dollar	Dollar (and Euro)

FEDERAL RESERVE NOTE

THE UNITED STATES OF AMERICA

THIS NOTE IS LEGAL TENDER FOR ALL DEBTS, PUBLIC AND PRIVATE

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2 *Rosa Gumataotao Lio*

Treasurer of the United States



WASHINGTON

SERIES 2009

Timothy F. Geithner

Secretary of the Treasury

2

1

ONE DOLLAR

MAURO F. GUILLEN

3455 S. Broad Street
Philadelphia, PA 19234

1027

November 25, 2013

DATE

PAY TO THE
ORDER OF

Cash

\$ 1.00

One dollar 00/100

DOLLARS



Security
Features
Details on
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Mauro F. Guillen

FOR

⑆ 22222222 ⑆ 000 111 555 ⑆ 1027

SALVADOR DALÍ

214 Cadaqués St.

New York, NY 10001

DATE May 21, 1968

PAY TO THE ORDER OF Le Cirque \$ 351.27

Three hundred and fifty-one dollars 27/100 DOLLARS

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The Dalí Principle

- Until when do you think Salvador Dalí was able to enjoy a free lunch?

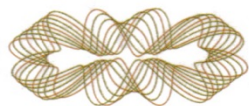


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毛泽东 1893-1976

1

Money

- Means of exchange.
- Unit of account.
- Store of value.

Issuing the Reserve Currency

- Benefits:
 - Lower transaction costs in trade.
 - Lower interest rates.
 - Prestige.
 - Power & influence.
 - You become an indispensable country.

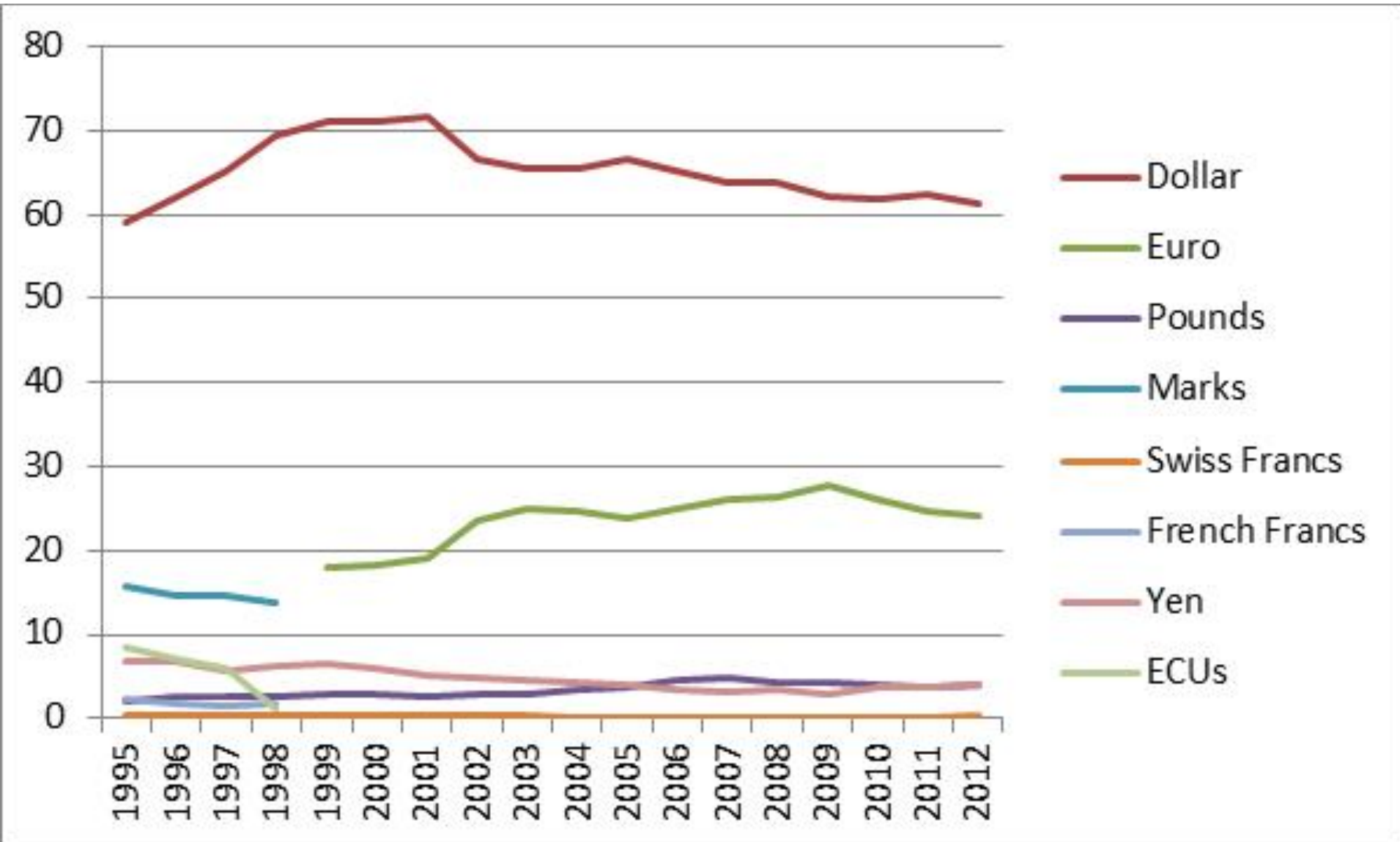
There's also requirements...

- Currency convertibility.
- Free capital flows.
- Rule of law.
- Large and liquid market for securities.
- Predictable government policymaking.
- Fiscal responsibility.

Remember the Spider-Man Principle

“With great power comes great responsibility.”

Currency Allocation of Reserves



Mini-Lecture 4.3

- Trade blocs have become an important feature of the global economic landscape.
- What are they?
- What are their effects?
- What's the future of trade blocs?

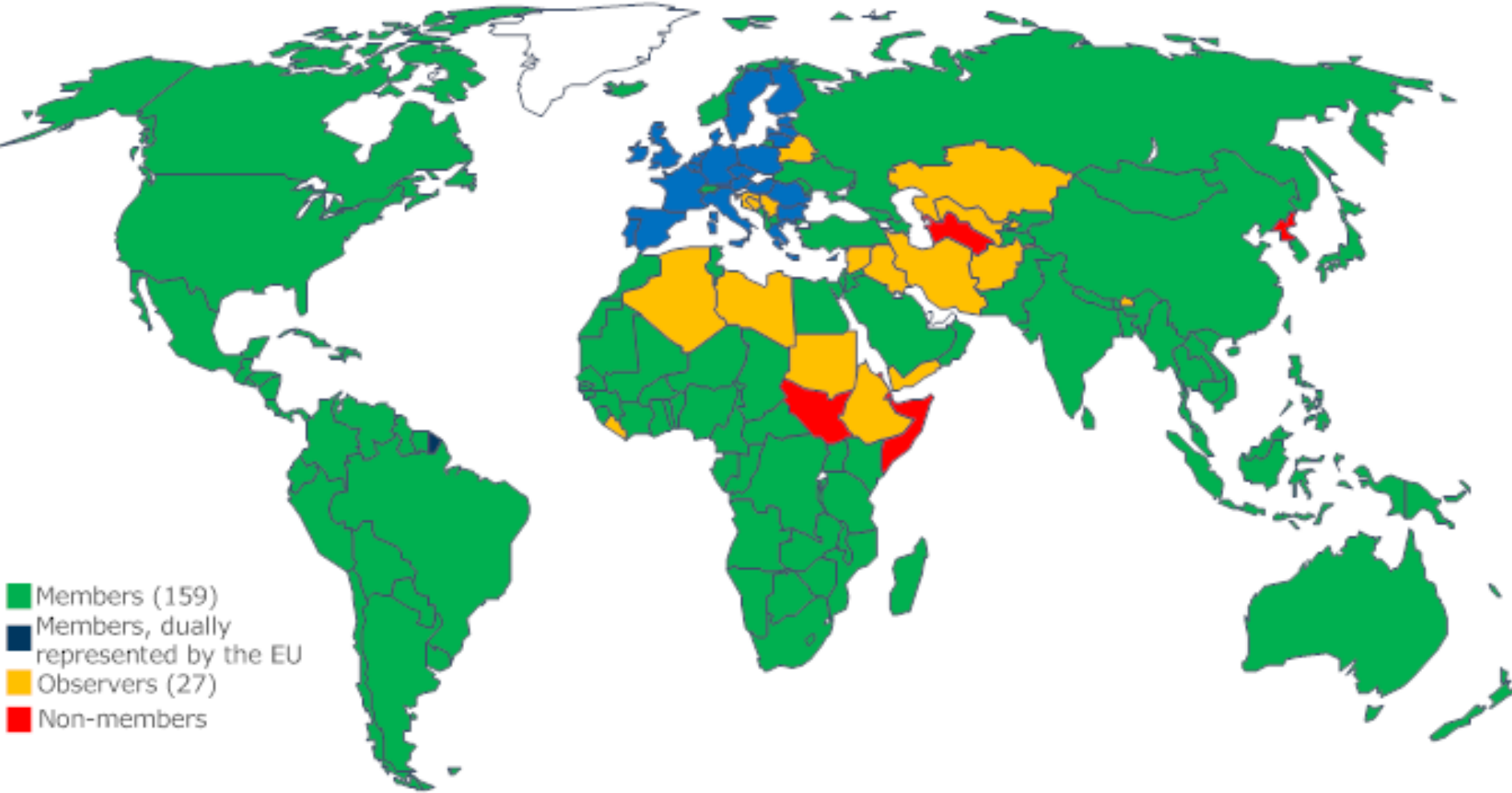
Multilateralism: The GATT Rounds

(General Agreement on Tariffs and Trade)

Name	Start	Duration	Countries	Subjects covered	Achievements
Geneva	Apr-47	7 mos.	23	Tariffs	Signing of GATT, 45,000 tariff concessions affecting \$10 billion of trade
Annecy	Apr-49	5	13	Tariffs	Countries exchanged some 5,000 tariff concessions
Torquay	Sep-50	8	38	Tariffs	Countries exchanged some 8,700 tariff concessions, cutting the 1948 tariff levels by 25%
Geneva II	Jan-56	5	26	Tariffs, admission of Japan	\$2.5 billion in tariff reductions
Dillon	Sep-60	11	26	Tariffs	Tariff concessions worth \$4.9 billion of world trade
Kennedy	May-64	37	62	Tariffs, Anti-dumping	Tariff concessions worth \$40 billion of world trade
Tokyo	Sep-73	74	102	Tariffs, non-tariff measures, "framework" agreements	Tariff reductions worth more than \$300 billion dollars achieved
Uruguay*	Sep-86	87	123	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc	The round led to the creation of WTO, and extended the range of trade negotiations, leading to major reductions in tariffs (about 40%) and agricultural subsidies, an agreement to allow full access for textiles and clothing from developing countries, and an extension of intellectual property rights.
Doha**	Nov-01	?	141	Tariffs, non-tariff measures, agriculture, labor standards, environment, competition, investment, transparency, patents etc	The round is not yet concluded. It focuses on agriculture, services, industrial goods, WTO rules, and development.

* Ended with the creation of the WTO. ** Started by the WTO.

WORLD TRADE ORGANIZATION



- Members (159)
- Members, dually represented by the EU
- Observers (27)
- Non-members

Types of Blocs

- A. A group of countries that agrees to one or more of the following:
1. Reduce tariffs for certain goods [**preferential trade area**].
 2. Remove internal trade barriers [**free trade area**].
 3. Coordinate external trade barriers [**customs union**].
 4. Allow for the free movement of capital
 5. Allow for the free movement of labor
 6. Coordinate indirect tax policy
 7. Coordinate regulatory & competition policies
- } [**common market**].
} [**single market**].
8. Coordinate macroeconomic policies [**economic union**].
 9. Introduce a common currency [**monetary union**].
 10. Merge treasuries and fiscal policies [**fiscal union**].
 11. Merge banking supervision and resolution policies [**banking union**].
- B. The European Union meets criteria 2-7 & 9 (8?).
- C. The NAFTA meets criteria 2 and 4.
- D. The Mercosur/Mercosul meets criteria 1-4.

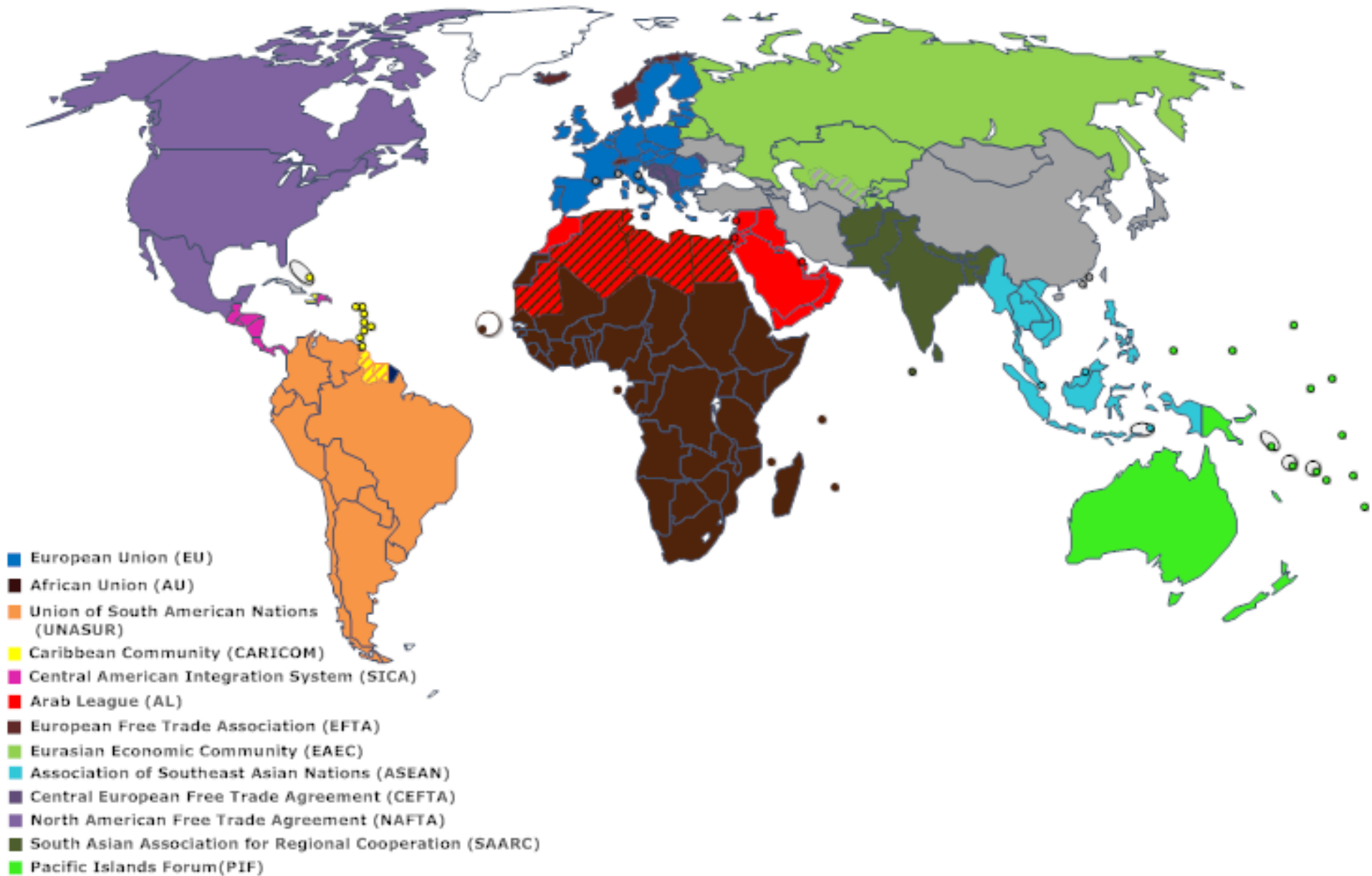
Trade Blocs Tend to Include Countries:

- At similar levels of development.
- Geographically close or adjacent.
- With similar trade regimes.
- Sharing a desire to organize regionally.

How Common are They?

- 1834: *Zollverein*, first modern trade bloc.
- There are **259** trade blocs presently in force, and registered with the WTO <http://rtais.wto.org/UI/PublicAllRTAList.aspx>
- 1990s: Trend towards continental-size blocs.

Main Trade Blocs



What are Trade Blocs, Really?

- People are very excited about trade blocs.
- Officially, an attempt to enhance trade.
- In reality, trade blocs destroy, divert, and create trade in complex ways.
- They can be an attempt to privilege insiders relative to outsiders.

NAFTA

- Only large trade bloc that includes both rich & developing countries:
 - Mexico is “so far away from God, and... ..”
 - Very controversial (“social dumping”).
- It’s a “free trade area” + free capital flows:
 - Origin & content rules are necessary.
 - Various unintended consequences/effects.
- External trade policies are not coordinated.
- Some product & environmental regulations.
- Trucking issue: first Mexican truck crossed the border in October 2011.



Mini-Lecture 4.4

- Why are trade blocs controversial?

Economic Controversies

- Competitive implications:
 - Economies of scale.
 - Improved terms of trade (through either bargaining power or specialization):
- Economic welfare implications: trade creation, diversion, and destruction, depending on the characteristics of the bloc (FTA vs. CU, level of external tariff(s), etc.).

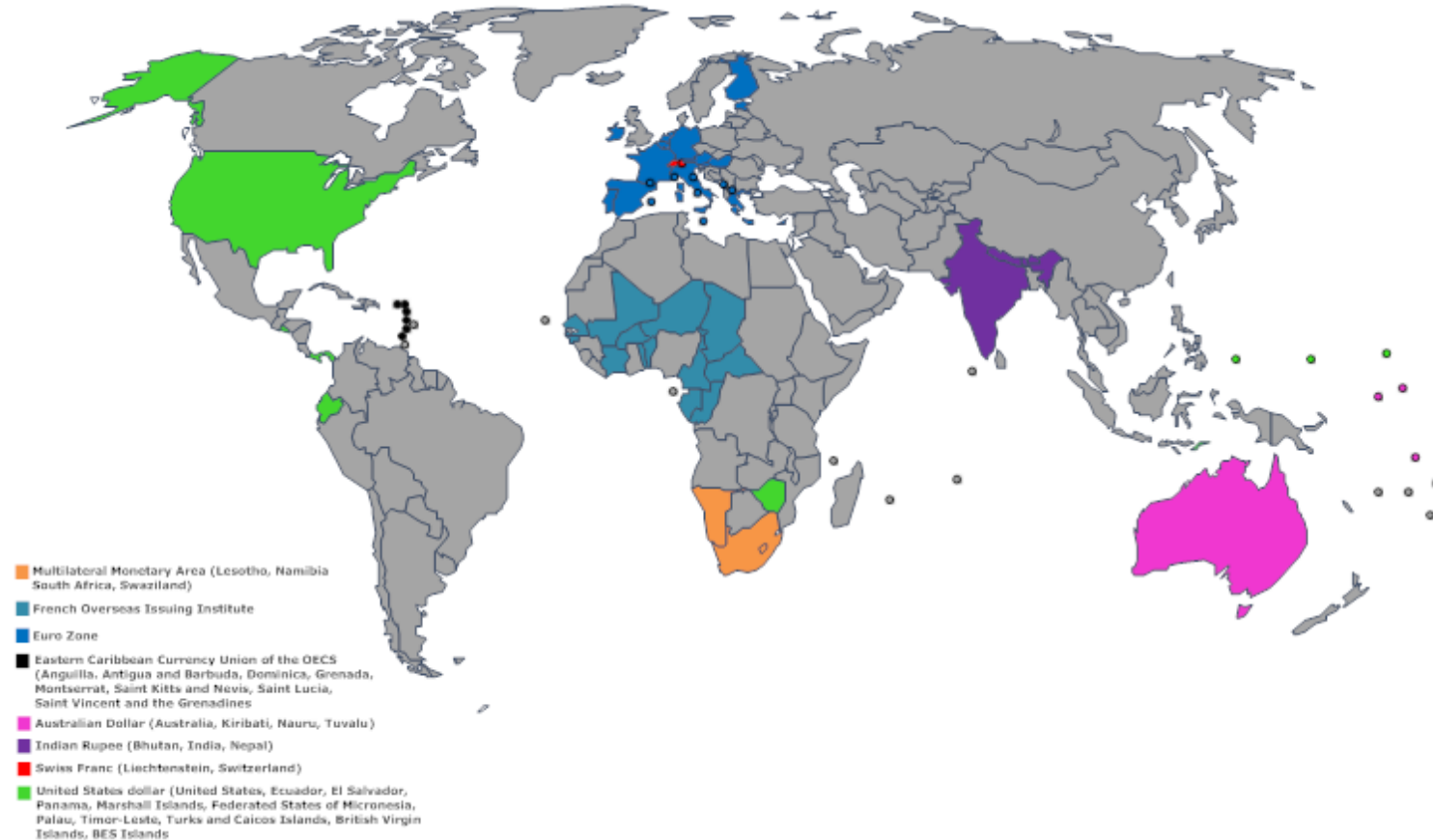
Political Controversies

- Domestic:
 - Who is in favor, and who is against? Small vs. large firms, exporters (L vs. K-intensive), import-competitors, consumers, investors, etc.
 - Justification for unpopular adjustment policies.
- International:
 - Pressures towards democratization (e.g. Spain, Portugal, Paraguay, etc.).
 - Enhanced power in multilateral trade negotiations.
 - Improved global governance.
 - Extension of influence over weaker states.

Mini-Lecture 4.5

- Monetary unions.
- What are they?
- What are their effects?
- The example of the Euro Zone.

Monetary Unions



Informal: One or more countries unilaterally adopt somebody else's currency (e.g. Nauru/Tuvalu/Australia, Bhutan/Nepal/India, US dollar area).

Formal: Two or more countries agree to adopt a common currency, sometimes supplemented by issuing a local currency pegged to the common one (e.g. Singapore/Brunei, San Marino/Vatican/Eurozone).

Formal + common monetary policy: (e.g. EMU, CFA franc, CFP franc, East Caribbean dollar, Lesotho/Swaziland/Namibia/South Africa).

Building Europe

- Number of member countries.
- Scope of the union.
- Depth of the union.

Stages & Milestones

- 1950s & 60s: 6 members.
- 1970s: 9 members, monetary instability.
- 1980s: The Club Med (EU-12).
- 1990s: Northern Europe (EU-15).
- Mid 1990s: Eastern Europe (EU-27).
- 1993: Maastricht (signed in October 1990).
- 1999: The euro.
- 2010s: The Balkans (EU-28).



European Union country not in the Euro Zone

European Union country in the Euro Zone

EU in 1957: 6 members



EU in 1973: 9 members



EU in 1981: 10 members



EU in 1986: 12 members



EU in 1995: 15 members



EU in 2004: 25 members



EU in 2007: 27 members



EU in 2013: 28 members





Waves of Speculative Attacks on Currencies

	1971	1973	1992		1994	1997
USA	1	1		South Africa		1
UK	1	1	1	Argentina	1	1
Austria	1	1		Brazil	1	1
Belgium	1	1	1	Mexico	*	1
Denmark	1	1	1	Peru	1	
France	1	1	1	Venezuela	1	
Germany	*	*		Taiwan		1
Italy	1	1	1	Hong Kong	1	1
Netherlands	1	1		Indonesia	1	1
Norway	1	1		South Korea		1
Sweden	1	1	1	Malaysia		1
Switzerland	1	1		Pakistan		1
Canada				Philippines	1	1
Japan		1		Singapore		1
Finland	1	1	*	Thailand	1	*
Greece	1	1		Vietnam		1
Iceland		1		Czech Republic		1
Ireland	1		1	Hungary	1	1
Portugal	1	1	1	Poland		1
Spain	1		1	Canada	1	
Australia	1	1		1 means currency suffered speculative attack		
New Zealand	1	1		* Denotes first currency to be attacked		

The Delors Way

- 1985-96: Jacques Delors at the helm of the European Commission.
- Dogma: Deepening of integration.
- Technocratic approach: Rules and standards for everything.
- Subsidies for the periphery:
 - Structural funds.
 - The euro subsidy.



Source: © European Union, 2014



Source: Courtesy Ronald Reagan Library



Source: SSGT F. Lee Corkran (DoD photo, USA)

EZ in 1999: 11 members



EZ in 2001: 12 members



EZ in 2007: 13 members



EZ in 2008: 15 members



EZ in 2009: 16 members



EZ in 2011: 17 members



EZ in 2014: 18 members





Mini-Lecture 4.6

- Why is Europe's Economic and Monetary Union not working?

EMU did not include...

- A banking union:
 - Supervision.
 - Resolution.
 - Deposit insurance.
- A fiscal union.

Consequences of Monetary Unions

- Member countries cannot print money to inflate their debt away.
- They cannot devalue the currency to regain competitiveness.
- In order for a monetary union to work:
 - Labor needs to be able & willing to move around in search of opportunities.
 - Fiscal union is advisable to cope with the effects of the business cycle.
 - A banking union may be necessary as well: supervision, resolution, and deposit insurance.

Nota bene: Robert Mundell won the Nobel Prize for his work on optimal currency areas.

The Way it Was Supposed to Be

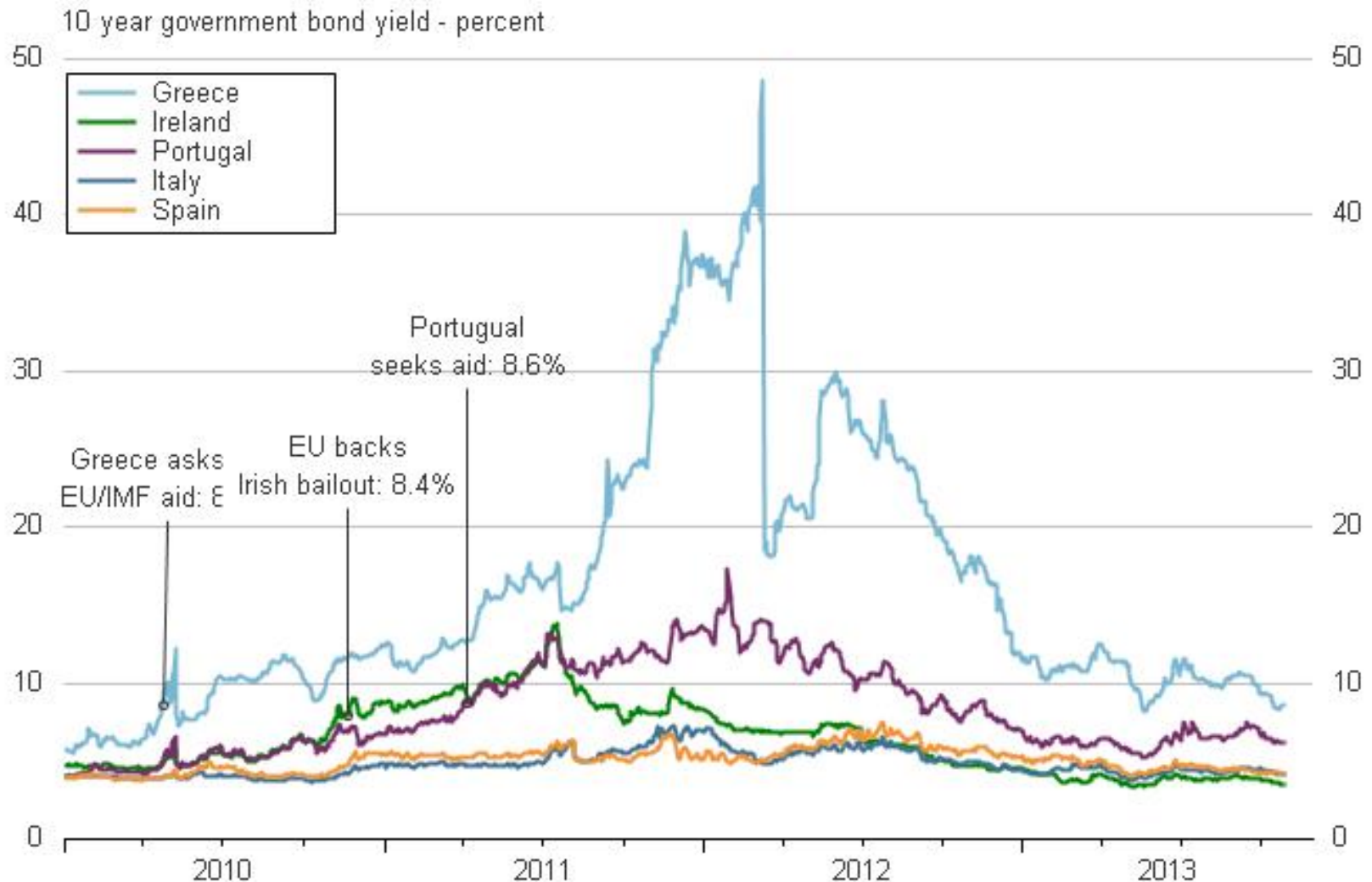
- The architects of the euro believed that a PIIGS-like problem would not occur because financial markets would have punished countries with excessive debt by raising the cost of borrowing. *They didn't until the global financial crisis started.*
- The European Central Bank (ECB):
 - Prohibits loaning money to service national debts.
 - Its no-bail-out clause discourages overspending. *It did not.*
- The Stability and Growth Pact should have prevented the situation from worsening:
 - Deficit/GDP $\leq 3\%$ and Gross debt/GDP $\leq 60\%$.
 - *It was not enforced, and in 2005 the rules were relaxed at the request of France and Germany.*

Mini-Lecture 4.7

- The European crisis.

Super-Draghi

Euro zone bond yields

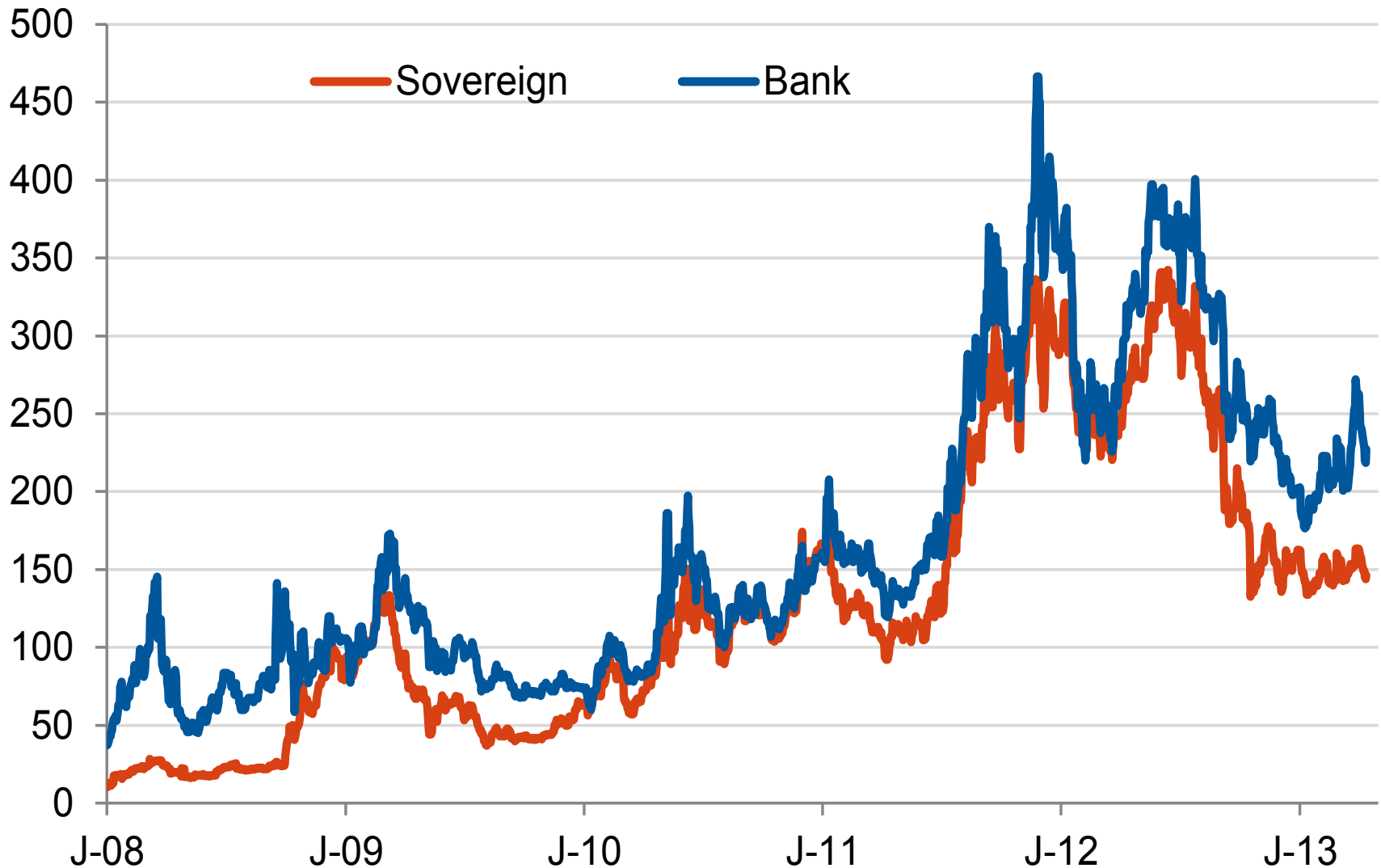


A question of emphasis?

- Normally, the analysis focuses on:
 - Sovereign debt.
 - Banks.
- I would like to bring to your attention:
 - Labor mobility.
 - Labor unit costs.
 - Unemployment.

Sovereign-Bank Risk

CDS Spreads for a Basket of European Countries and Banks
(basis points, weighted by gross debt)

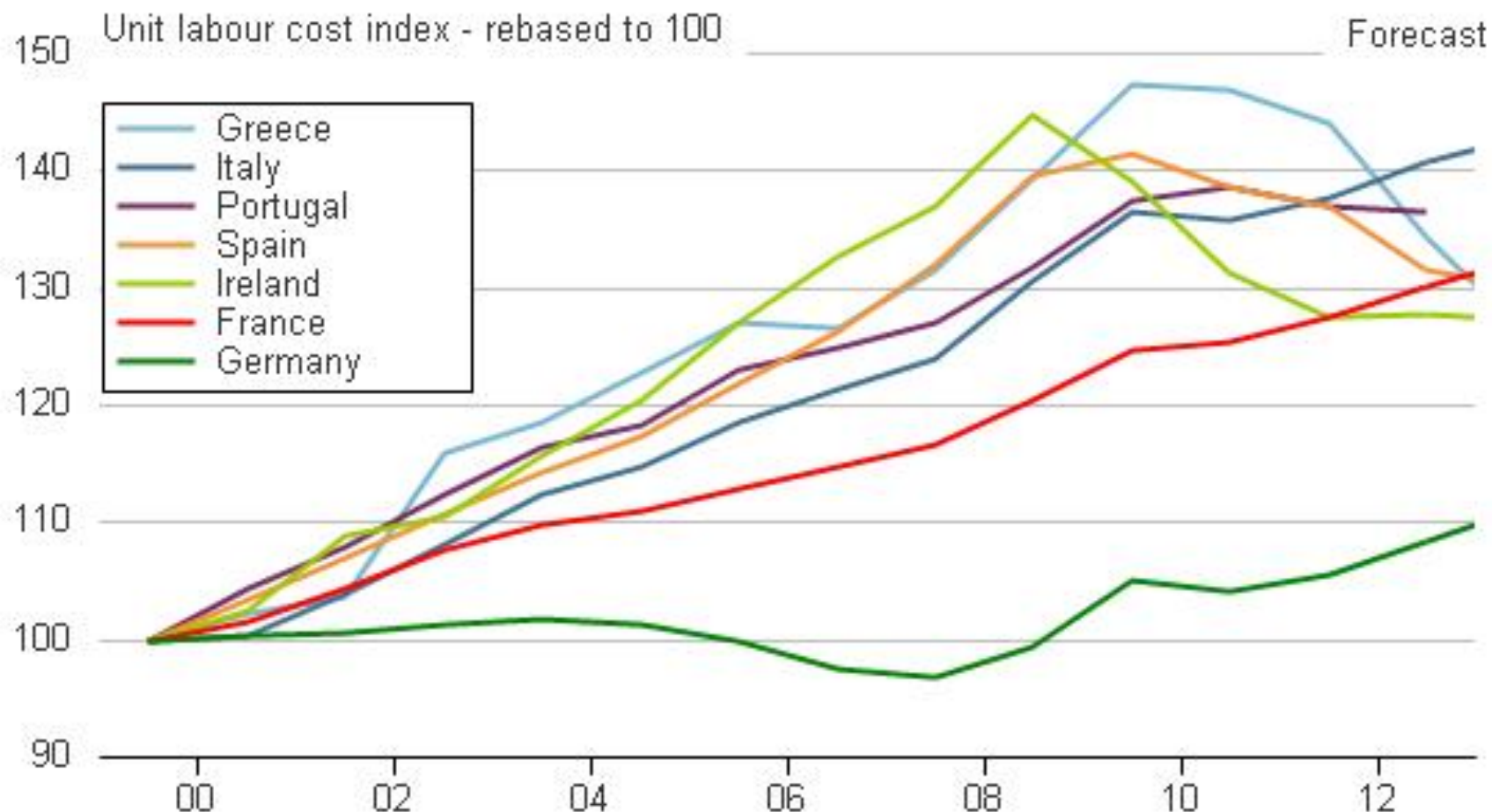


Labor Mobility

	% annual population
USA, inter-state	2.3
EU-15, cross-border	0.2
EU-15, cross-border ex Luxembourg	0.1
EU new members, cross-border	0.2
EU-15, cross-border commuting	0.6
EU-15, within-country inter-regional	1.0

Source of the data: European Commission, *Geographic Mobility in the European Union* (2008).

Euro zone unit labour costs

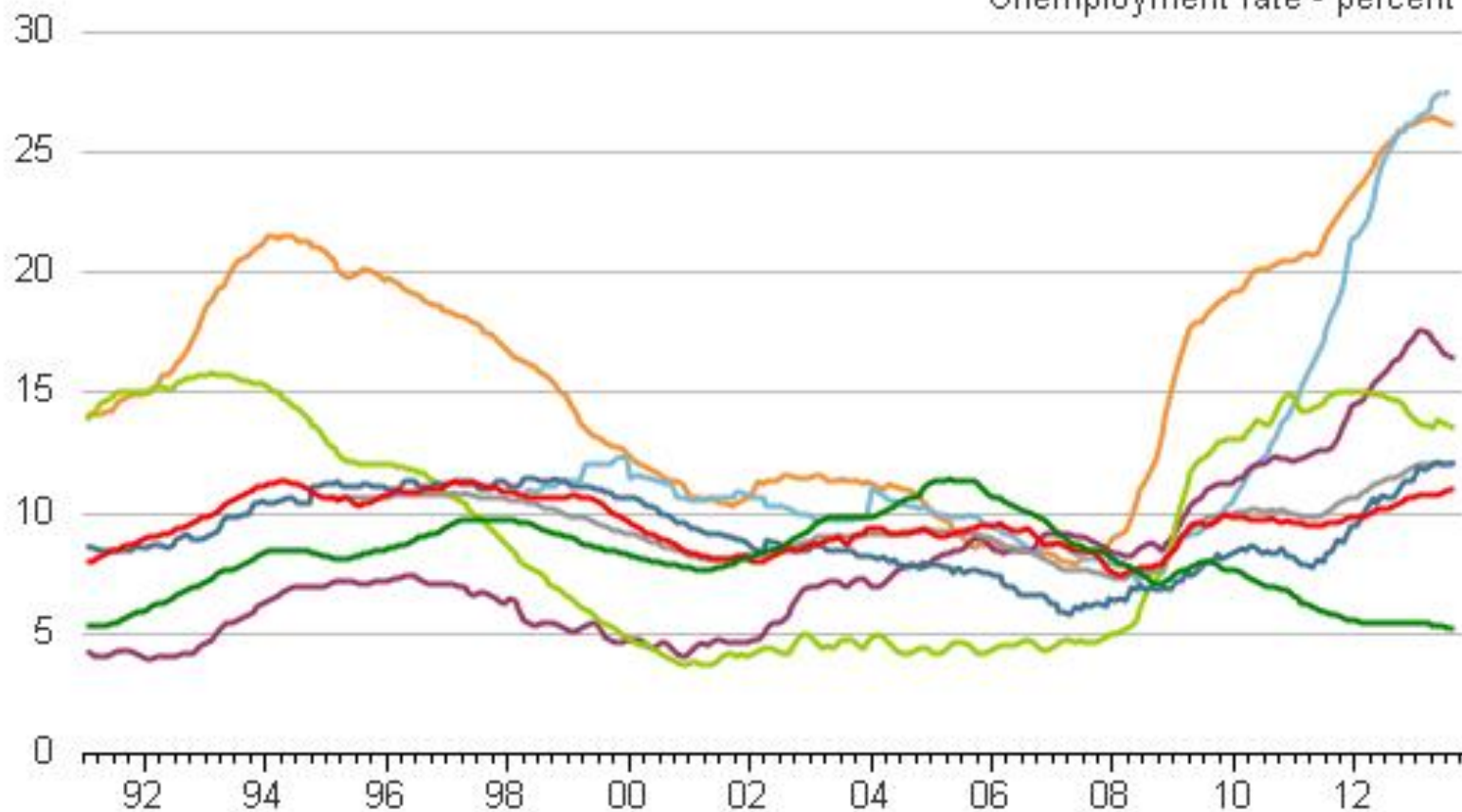


Source: Thomson Reuters Datastream, OECD

Reuters graphic/Scott Barber 29/10/2013

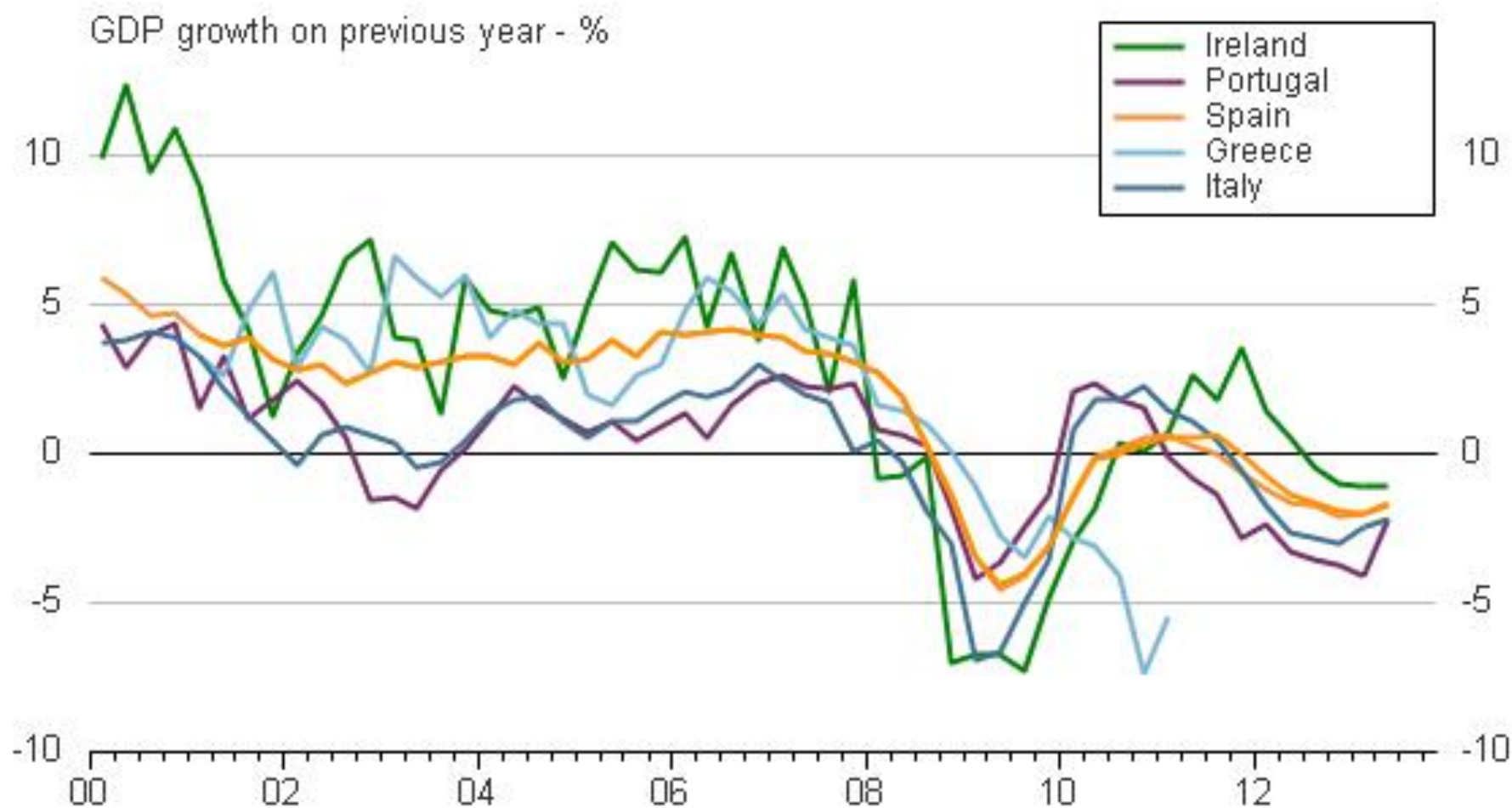
Euro zone unemployment

Unemployment rate - percent



- Spain 26.2
- Greece 27.6
- Portugal 16.5
- Ireland 13.6
- Euro area 12
- Italy 12.2
- France 11
- Germany 5.2

Euro zone GDP growth



Reuters graphic/Scott Barber 29/10/2013

Source: Thomson Reuters Datastream

Mini-Lecture 4.8

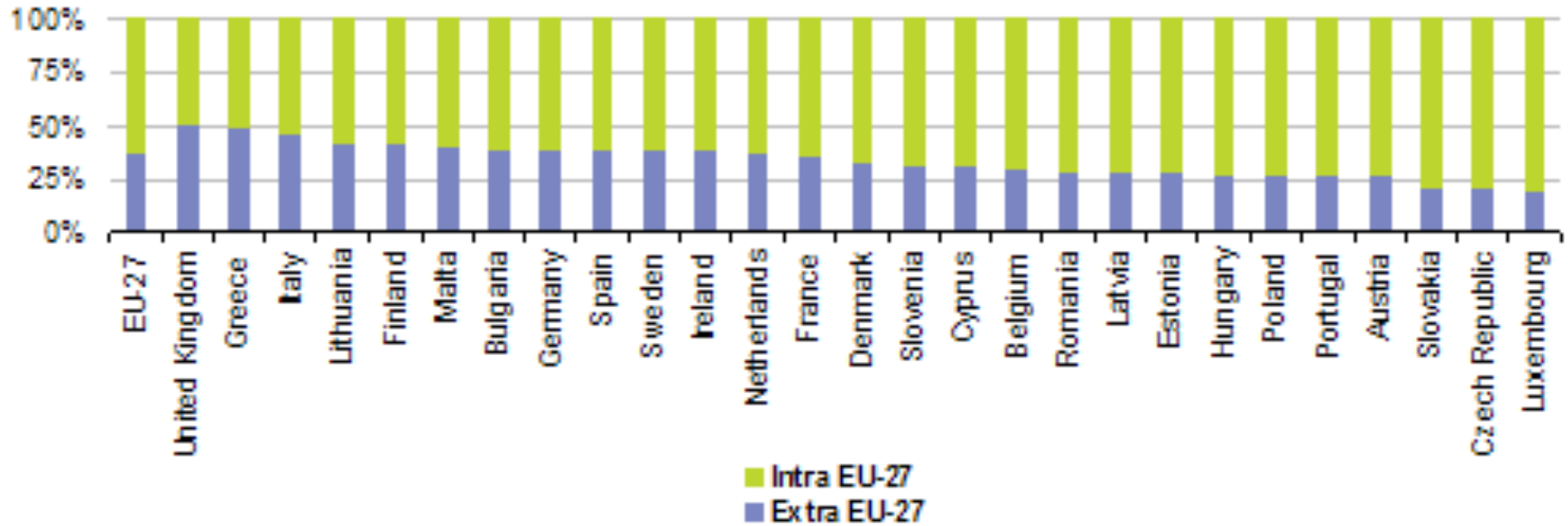
- The possible solutions to the European crisis.

Intra-Bloc Exports

	% total exports
EU	68
Euro Zone	48
NAFTA	48
Asia	49
Latin America	22

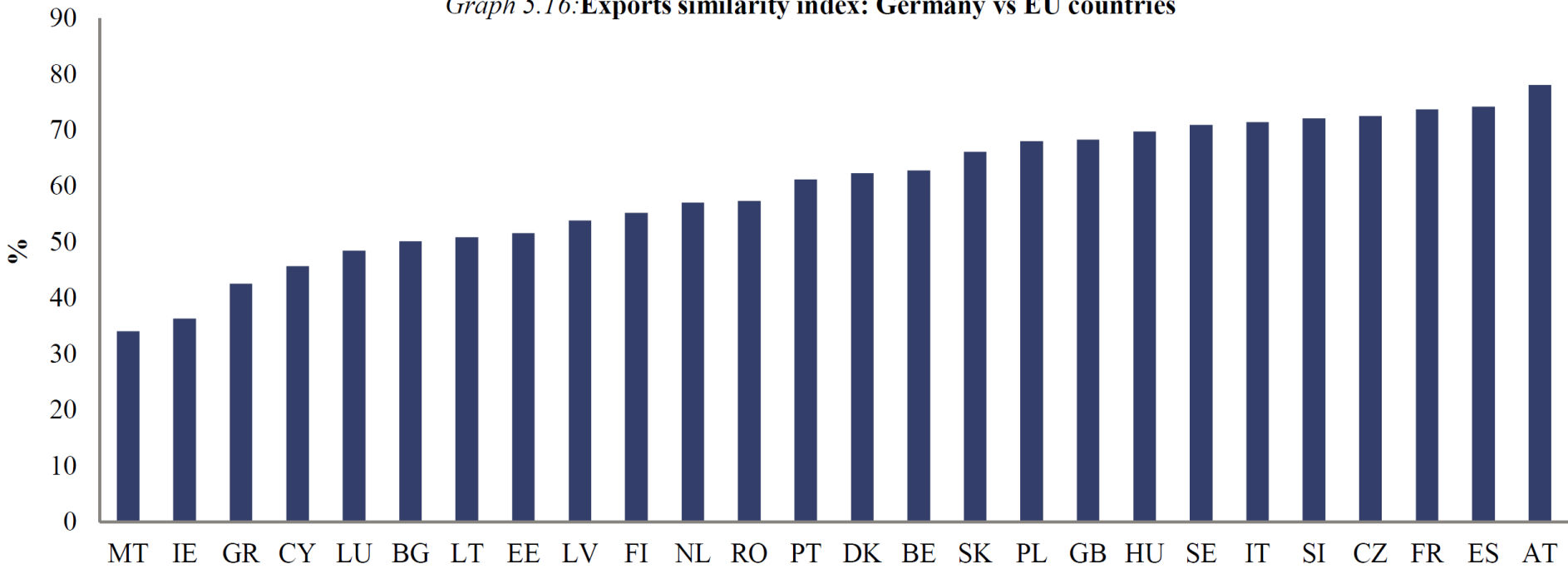
Source of the data: European Central Bank.

Intra-EU Trade is more than half



Source: Eurostat (online data code: ext_lt_intratrd)

Graph 5.16: Exports similarity index: Germany vs EU countries



Note: Finger-Kreining Index calculated over a breakdown of total exports into 279 products.

Source: Commission services calculations based on COMEXT.

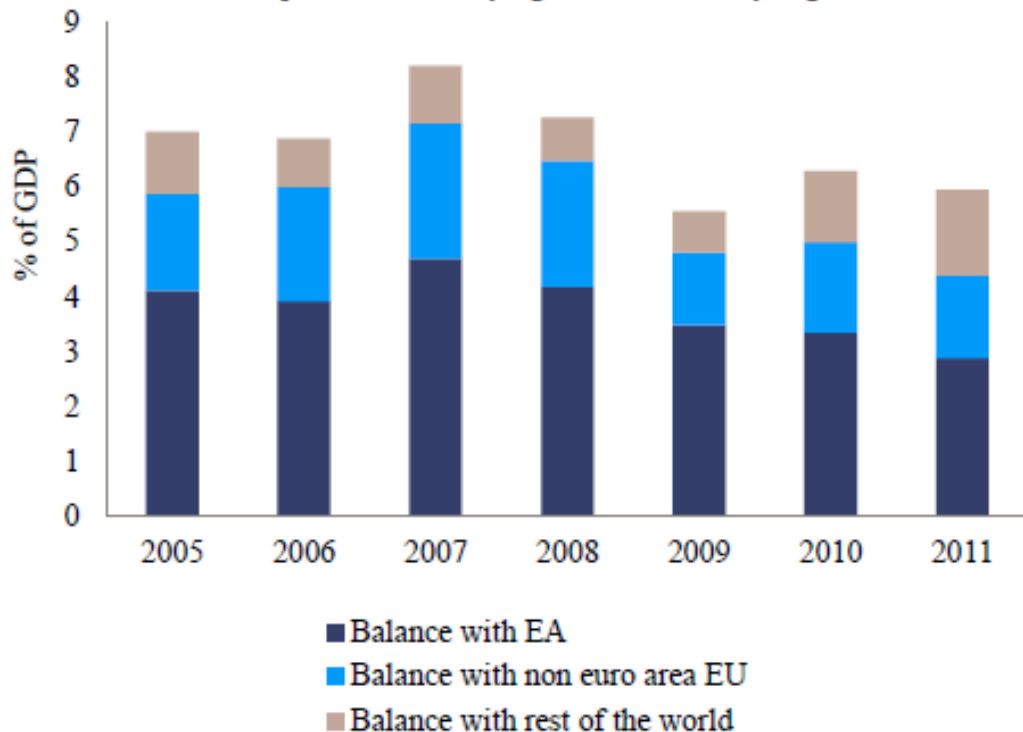
And the Germans...

- Are displaying an abundance of patience and understanding.
- But are divided as to how to proceed:
 - Savers.
 - Small firms (Mittelstand).
 - Large firms.
 - The Eastern Länder.

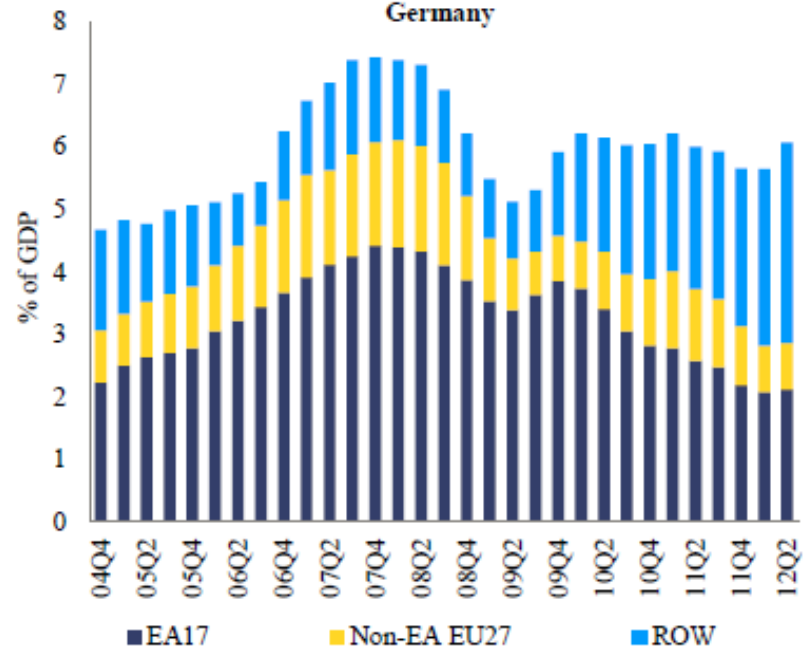
It does not add up...

- Not every country can be thrifty.
- Not every country can be frugal.
- Not every country can have a surplus:
 - Well, it depends on trade with RoW.
 - But Germany's surpluses are mostly with the rest of the EZ, the UK, and the US.
- *Nota bene*: In German, the same word is used for debt and for guilt: *die Schuld*.

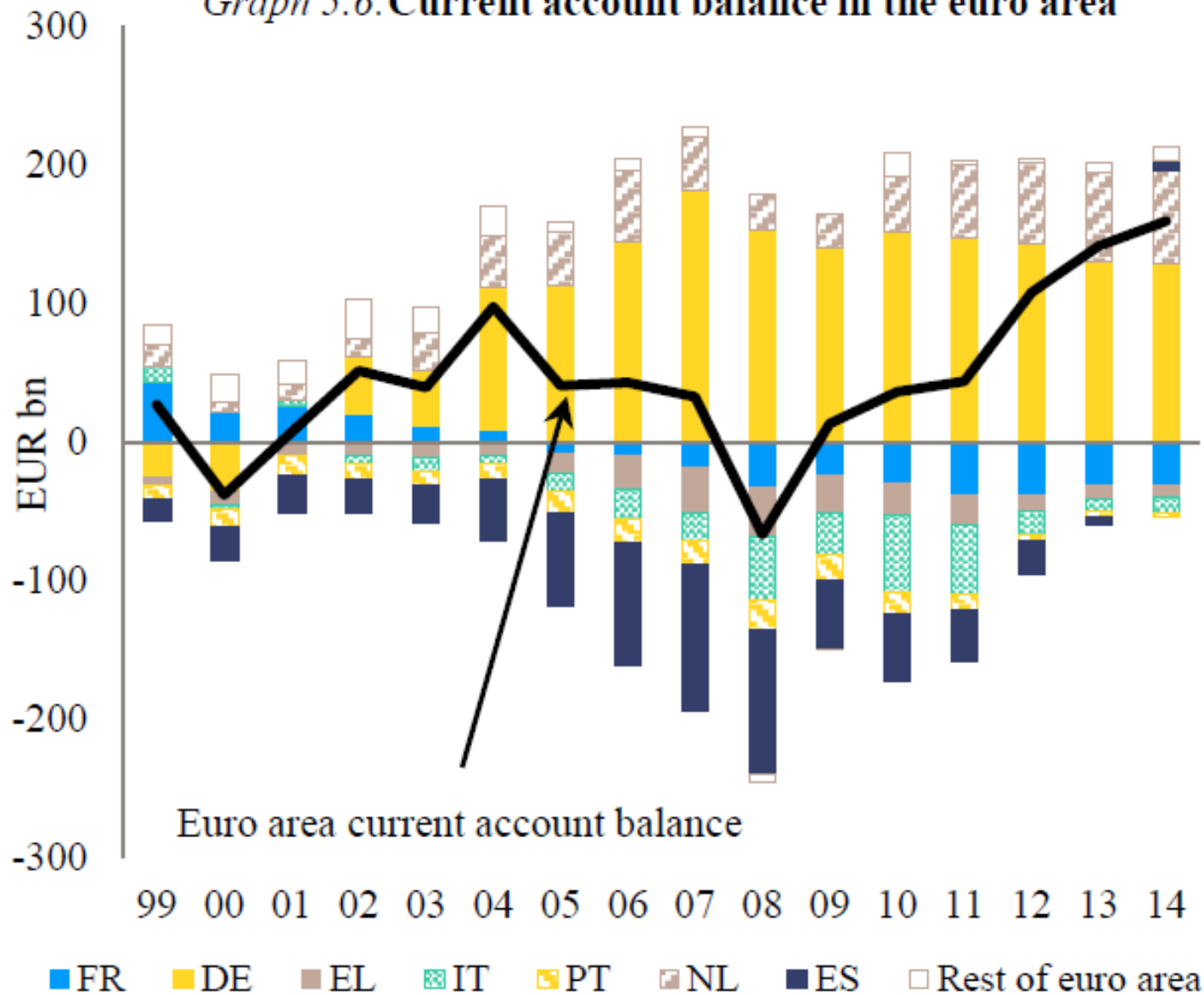
Graph 3.4: Germany - goods balance by region



Graph 5.5: Current account balance by partner-Germany



Graph 5.6: Current account balance in the euro area





Is the Euro Good for Germany?



- Eurozone: $\frac{3}{5}$ of German exports & $\frac{1}{2}$ of Germany's surplus.
- The crisis in the periphery of the Eurozone has depressed the value of the euro. The DM would be overvalued nowadays.
- German firms benefited from the investment boom in the periphery.
- Large German firms in favor of bailouts; Mittelstand firms skeptical.
- The rate of inflation in Germany has been lower than with the DM.
- Reserves in € $>$ [DM + FFr + Guilders].

What can be done?

- Short term:
 - Surplus economies must:
 - Provide stimulus.
 - Increase wages.
 - Allow marginally higher inflation.
- Medium term (if you want to save the euro):
 - Fiscal coordination or union.
 - Banking union.
 - A true European labor market.

Reading

- Please read the report by the Lauder Institute's Global TrendLab, *Global Risk: New Perspectives and Opportunities*.
- ALL READINGS ARE FREE AND AVAILABLE ONLINE.

Week 4 Test

- I hope you have enjoyed learning about the challenges facing the world in terms of global economic and financial imbalances.
- Now, please take the quiz. It only takes a few minutes to complete.