

# **Together alone in the world economy: 2 years after the Queen's visit to LSE\***

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# Outline

- Together alone?
- Globalization and Governance
- Culture-based vs. G-20  
multilateralism

# Fictional Q & A among Atlantic tribes

- On 5 November, 2008, during a visit to the London School of Economics (LSE, acronym dubbed *Let's See Europe*), Queen Elizabeth asked Luis Garicano, professor of management: **if these things were so large, how come everyone missed them?**
- On 31 March, during a visit of the UK Prime Minister to Brazil, President Lula made his celebrated comment about the crisis originating in rich countries: **this is a blue-eyed crisis.**
- Intermediated by science, and in particular by economists, the President's comment becomes an answer to the Queen's question:  
**Q: Why did no one see the global crisis coming?**  
**A: Because everyone who could see belongs to the tribe that suppresses (blue-eyed) crises.**
- The intermediation process shows how:
  - the interaction between globalization and governance (G&G) can be obscured by “group think” also known as “incestuous suppression”, calling for **innovation** and **mutual knowledge**
  - an attempt by Portuguese-speaking economists might transcend the “silo curse...in a world that is both highly connected and **tribal**” (Gillian Tett, **Financial Times**, 9 October).

# Together Alone?

- Specifically, negative G&G interaction comes from cooperation failures within and between countries.
- If it fosters **governance innovation**, peer pressure may promote the global common good rather than that of advanced countries.
- At the OECD and the EU, though, peer pressure did not prevent the negative G&G interaction which brought about the financial crisis.
- Examples of North Atlantic rivalry are evident in IMF reform (European seats) and global solidarity (MDG). They interact with US-China (sometimes called G2)
- Domestic politics (efficiency vs equity) play a role

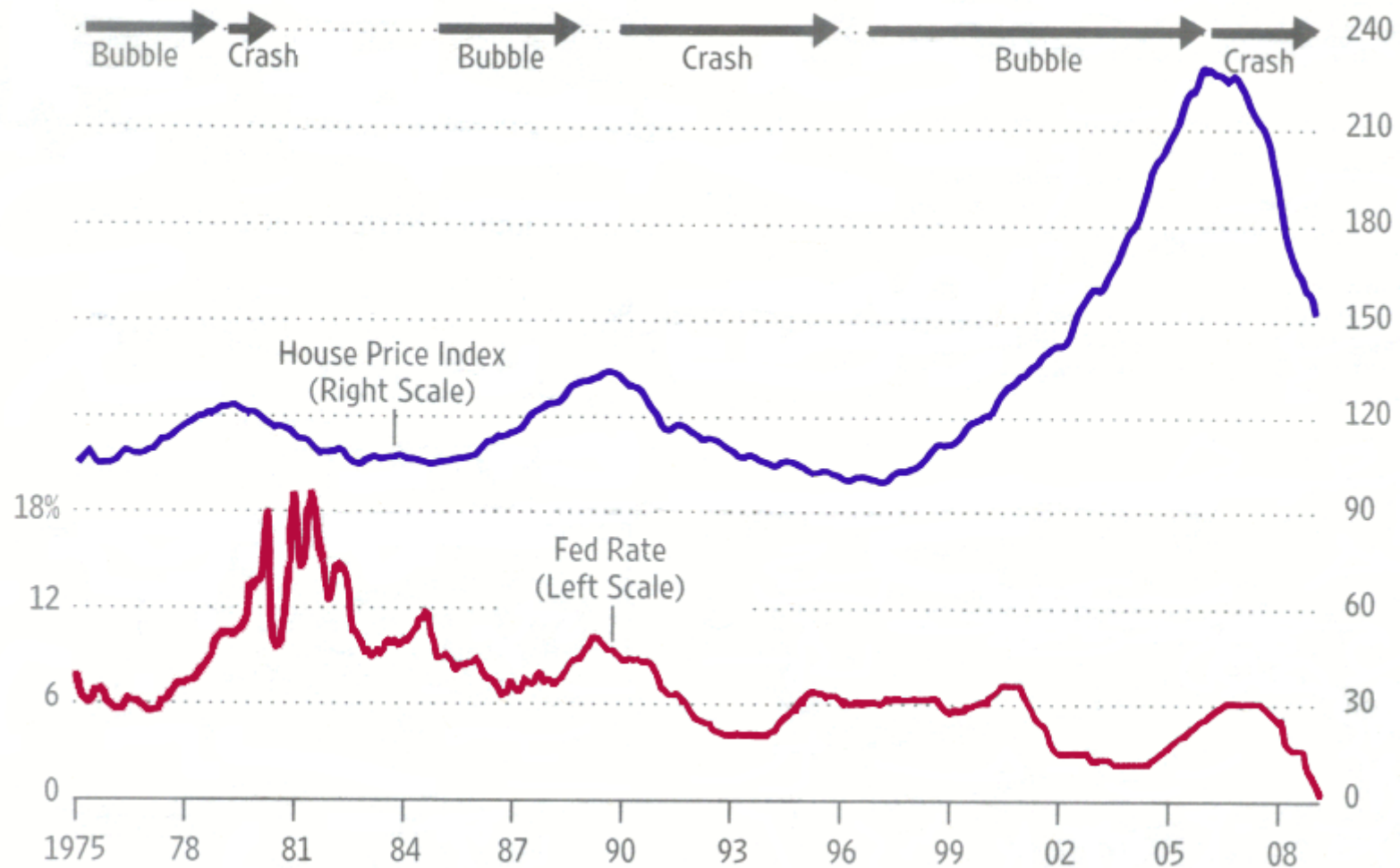
# Economists bicker, need humility

- On 12 October, 2009 (the day the Nobel prize in economics was announced), a “global insight” by Alan Beattie appeared in the *FT* concluding that the economics profession needed humility, and that “anyone who thinks otherwise is an idiot.”
- As the 2009 and 2010 awards testify, economics as a social science deals with institutional and governance issues.
- As popularized by articles in *Economist*, *FT*, *NYT*, etc, economists are often divided according to the location of their graduate training in the US:
  - freshwater (e.g. Chicago)
  - saltwater (e.g. MIT).
- Together with insights from natural sciences and humanities, this should help avoid “tribal” answers.
- Nevertheless, bickering goes on and perhaps even intensifies.

# Tribes in economics waterland

- Yet another tribe might be called “turgid economics”, from what my dear teacher Carlos Diaz Alejandro called “turgid economics” had he ventured into generalizing from the description of Arghiri Emmanuel’s **Unequal Exchange** in his Yale graduate course thirty years ago.
- The Portuguese edition of **The Black Holes in Economic Science** by Jacques Sapir, ten years after, follows a revival of methodological quarrels in economics.
- These were disappearing around the time Harry Johnson visited Yale from Chicago and LSE.
- In fact, the only methodological debate I remember, between Paul Krugman (then at MIT) and James Galbraith (then at LBJ, who were both at Yale at the time), happened in **Slate** some twenty years ago.
- Nobel prize winner Vernon Smith’s piece in *The Wall Street Journal* of 6 April includes the following picture, which certainly could motivate the Queen’s question.

# The Fed (left scale) and the housing bubble (right)



Source: Steve Gjerstadt & Smith: *The Wall Street Journal*, 6 April

# Globalization and Governance (G&G)

- The letter of the British Academy focuses on the advanced economies (especially US and UK) but mentions China and India in connection with the “global savings glut”. The point about seeing bankers as engineers pertains more broadly to “advanced economies” and leads to the ‘feel-good factor’ there as creating a “psychology of denial”.
- The “pressure for more lax regulation” was also greatest in US and UK since “some countries did raise interest rates” but the “psychology of herding” fed the *benign neglect* about rising imbalances in the US balance of payments. The view of the US and China as a *pseudo monetary union* reinforced the complacency about systemic risks.
- While the interaction between G&G became unsustainable in UK and US in early 2007, the spread of the crisis to the eurozone and the Rest of the World (ROW) is conventionally dated with the failure of Lehmann Brothers on September 15 of the following year. In late 2009 tensions began to arise within the eurozone.

# Global and Regional Dominance

- The first and even the second waves of globalization (15<sup>th</sup> century and 19<sup>th</sup> centuries) did not involve as many players as the current one, complicating G&G interaction.
- Joe Nye suggested a “multi dimensional chessboard” to describe the domains of US dominance. This can be adapted to illustrate the positive or negative G&G interactions by dividing world GDP in 2006 (1990 international dollars) into three quarters:
  - North America (US, Canada, Mexico);
  - European Union;
  - East Asia (ASEAN plus China, Korea and Japan).
- The Rest of the World (ROW) accounts for  $\frac{1}{4}$  of world GDP and  $\frac{1}{2}$  of the world population. It includes:
  - significant national actors, such as Brazil, Russia, India;
  - salient regions, such as Africa and the Middle East.
- These are the four columns of the dominance matrix.

# Dominance matrix

|         | US (NA)    | EU  | EAST<br>ASIA | ROW        |
|---------|------------|-----|--------------|------------|
| Defense | <b>YES</b> | NO  | NO           | NO         |
| Finance | <b>YES</b> | YES | NO           | NO         |
| Trade   | NO         | YES | <b>YES</b>   | NO         |
| Land    | NO         | NO  | NO           | <b>YES</b> |

# Regional and National Dominance

- The rows of the dominance matrix add to the three levels mentioned by Nye, security, diplomacy (intergovernmental cooperation) and civil society (transnational relations among private actors).
- Nye (2002) concluded that US dominance on security was accompanied by decline on the other two levels.
- A four dimensional chessboard in US, EU and EA illustrates the dominance of each one plus ROW on issues of defense, finance, trade and land, i.e. endowments both for agricultural and raw materials.
- The US dimension is key in the first two (in finance perhaps € getting close to \$) but in trade EA dominate (perhaps close to EU), whereas the most endowed in people, land and raw materials should be ROW.

# Financial reputation and peer review

- Taking a global (rather than a regional or national) view should foster **governance innovation**, but not enough is known about building global coalitions for change:
  - Dominant players generate free rider problems and this prevents cooperation.
  - The risk of cooperation failures is not just international but it is greater among abstract regions.
- Up until recently peer pressure was the preserve of advanced economies and such procedures were absent among emerging markets, in spite of the creation in 2003 of the African Peer Review Mechanism (APRM).
- Because regions are **historical** rather than **geographical** it is easier to interpret NA and EU than EA, also in terms of “peer review”.

# Kouri ratio and exchange rate volatility

- The average exchange rate is a weighted average of the long run equilibrium exchange rate and the short run equilibrium value of the exchange rate at time 0 on the other.
- The weight of the long run equilibrium exchange rate increases with time. It also increases with an increase in the exchange rate elasticity of the current account and with an increase in the level of trade in relation to the level of asset holdings, called the Kouri ratio. In the table below the elasticity is taken to be one.
- There is no data comparable to the table presented by Jean Pisani-Ferry at 8th ASEM EcoFin in South Korea adapted below to show the Kouri ratio.
- In 2006 annual trade flows are about 15% of external financial assets and liabilities in EA but only 5% in NA.

# Kouri ratio in three regions

|  | EA         | EA         | EU        | EU        | NA        | NA        |
|--|------------|------------|-----------|-----------|-----------|-----------|
|  | 1996       | 2006       | 1996      | 2006      | 1996      | 2006      |
| (Fgn assets + liab)/(Exports+Imports)  | 3          | 3          | 6         | 7         | 8         | 9         |
|  |            |            |           |           |           |           |
|  | EA         | EA         | EU        | EU        | NA        | NA        |
|  | 1996       | 2006       | 1996      | 2006      | 1996      | 2006      |
| X+M                                    | 18         | 32         | 15        | 20        | 13        | 16        |
| % GDP *                                |            |            |           |           |           |           |
| Fgn assets + liab                      | 53         | 104        | 85        | 136       | 98        | 147       |
| % GDP**                                |            |            |           |           |           |           |
| Trade %Finance                         | 34         | 30         | 18        | 14        | 14        | 10        |
| (Exports+Imports)/2(Fgn assets + liab) |            |            |           |           |           |           |
| <b>KOURI RATIO</b>                     | <b>17%</b> | <b>15%</b> | <b>9%</b> | <b>7%</b> | <b>7%</b> | <b>5%</b> |

[\*] Intra-regional foreign asset holdings and liabilities excluded; data available only until 2004; [\*\*] Intra-regional trade excluded;

Source: Cohen-Setton and Pisani-Ferry (2008)

## Cooperation – when everything else fails

- Successive bailout programs on both sides of the Atlantic were conducted in an haphazard and incoherent manner in the face of financial panic. They were accompanied or followed by stimulus packages. This was surprising given the strong financial links across the North Atlantic but reflect fault lines in national and regional financial supervision.
- The recapitalization of banks using taxpayers money was finally agreed by the UK and adapted to the eurozone but the different systems of financial supervision continue to prevent a common position in the EU. This is not an issue of monetary policy but rather of information sharing about systemic actors, part of the **macroprudential framework** called for by the BIS.

## Cooperation – when everything else fails

- The German model prevents central banks from acting as lenders of last resort because using taxpayers money might compromise their independence. Central banks are closest to commercial banks and other financial intermediaries, *yet the ECB does not have information on the systemic banks in the eurozone!*
- This is particularly serious because attacks on weak currencies were replaced by attacks on suspicious balance sheets of banks (*nothing in left is right and nothing in right is left*).
- The sovereign debt crisis in the eurozone followed from the absence of balance of payments support and sovereign debt restructuring mechanism (SDRM), the latter a problem the IMF tried unsuccessfully to tackle in 2001.

# Bankrupcies since independence

|          | 1300-812 | 1813-90 | 1891-008 | Total |
|----------|----------|---------|----------|-------|
| Spain    | 7        | 7       | 0        | 14    |
| France   | 9        | 0       | 0        | 9     |
| Brazil   | -        | 0       | 8        | 8     |
| Germany  | 3        | 3       | 2        | 8     |
| Austria  | 4        | 1       | 2        | 7     |
| Portugal | 1        | 6       | 0        | 7     |
| Greece   | -        | 3       | 2        | 5     |
| UK       | 2        | 0       | 0        | 2     |
| Netherl  | 0        | 1       | 0        | 1     |

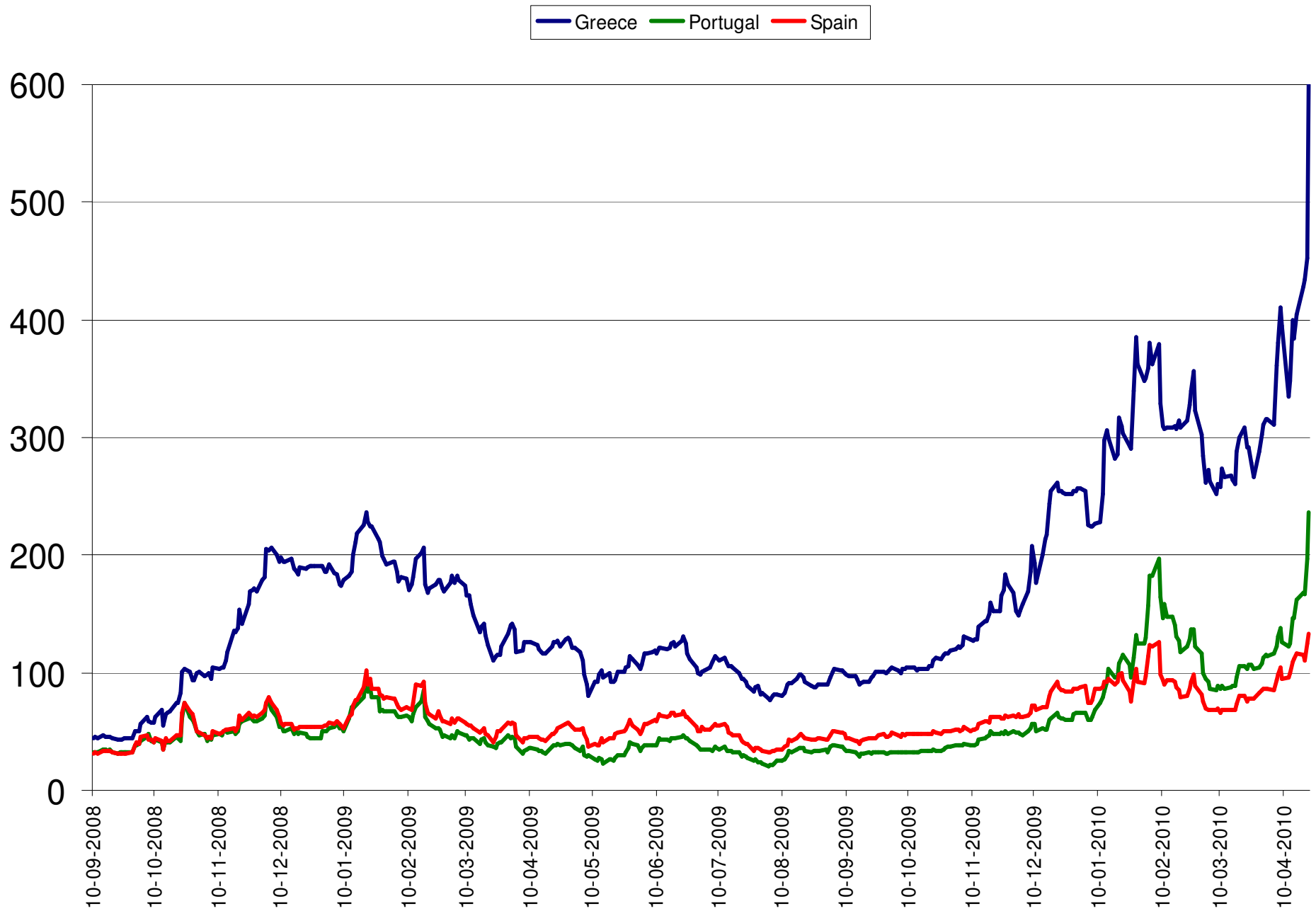
Source: Reinhart and Rogoff, *This time is different*, Princeton, 2009

## Years in Default (1800-), Credit Rating (1979-)

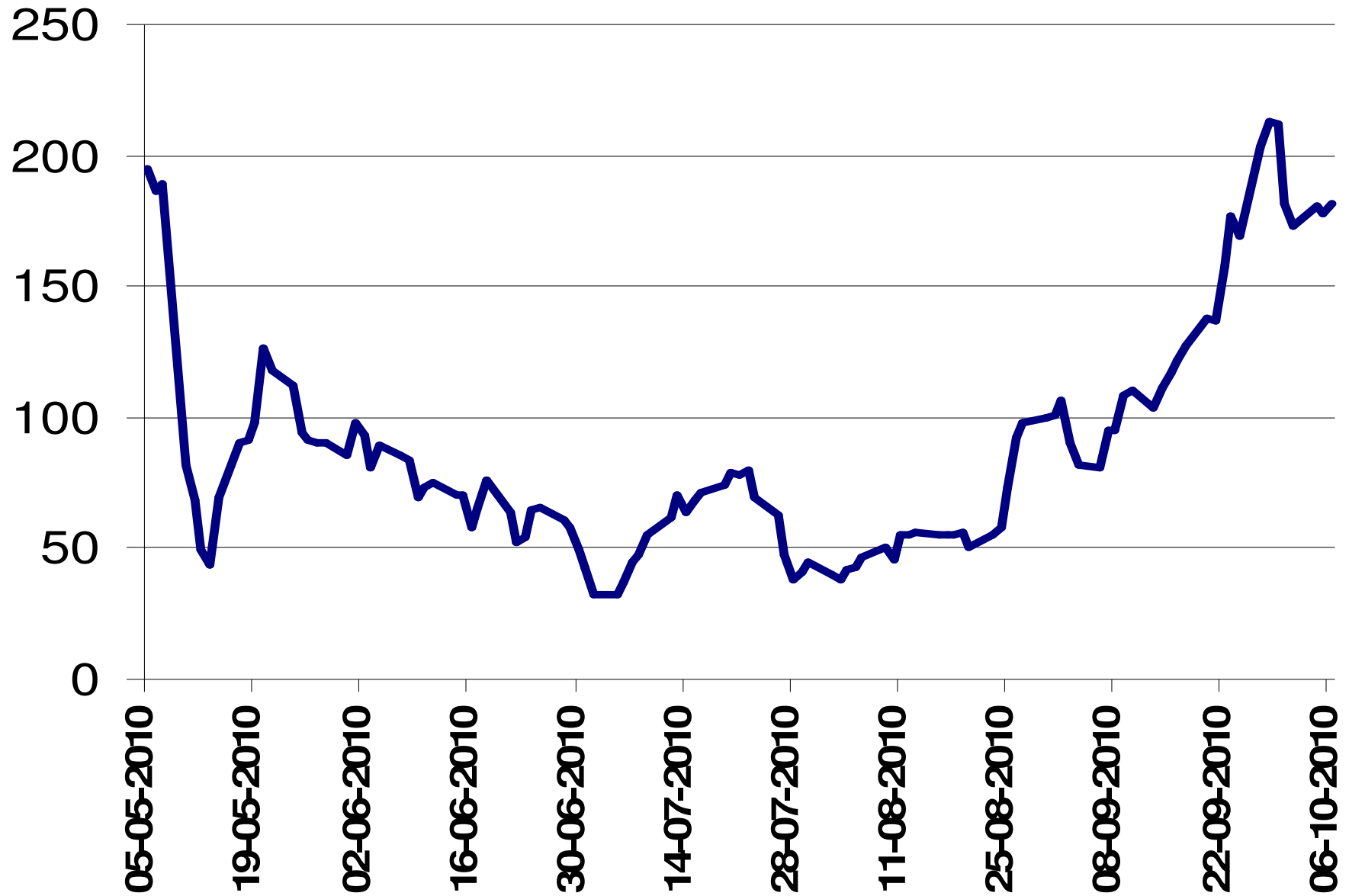
|          | Yrs Def | Yrs Bkng | Rating | $\Delta$ Rating |
|----------|---------|----------|--------|-----------------|
| Portugal | 11      | 2        | 85     | 33              |
| Spain    | 24      | 8        | 90     | 19              |
| Greece   | 51      | 4        | 81     | 19              |
| Austria  | 17      | 2        | 95     | 9               |
| Netherl  | 6       | 2        | 95     | 5               |
| Brazil   | 25      | 9        | 61     | 4               |
| UK       | 0       | 9        | 94     | 3               |
| France   | 0       | 12       | 94     | 3               |
| Germany  | 13      | 6        | 95     | -4              |

Source: Reinhart and Rogoff, *This time is different*, Princeton, 2009

Spreads relative to Germany on 5 year \$ CDS 10 September, 2008 - 22 April, 2010 (basis points)



**Spread of Portugal 5 yr CDS relative to Spain (bp)**



# CPLP mutual friendship & mutual knowledge

- CPLP has European headquarters, strengthening secretariat Portuguese presidency of the council 2008-2010. Like Portugal as a tourist destination in the early 1970s, CPLP remains a “well kept secret” of culture-based multilateralism: “the mutual friendship among members” mentioned in the treaty is not enough to build a *global partnership for development* (=MDG 8 or **global lusofonia** as the group is known).
- Contribution of Brazil decisive in creation, joint presidency of the secretariat and of the council in 2003/2004, creation of Business Council (CE) with a secretariat at ELO. The two more advanced members feared that an economic dimension would trigger expectations of larger development assistance towards PALOP (and Timor Leste since 2000). Yet Herfindahl number equivalent=1,4 – same as NAFTA and GDP shares of the 4 larger countries never smaller than 99.75%.
- The **Bissau declaration** aims at monitoring progress with respect to reaching MDGs. It emphasizes that the underlying philosophy is one of “genuine partnership for development”, based on “mutual knowledge”, an original concept which suggests **governance innovation**.

# From Lisbon to Luanda declarations

- Lisbon declaration (30 September, 2008) recognizes that academics, policy makers, the business community and civil society face the common challenge of learning, through joint endeavors, to use scientific knowledge for sustainable development to improve human well-being, based on effective governance for inclusive economic globalization;
- Maintains that governance responses to globalization are more likely to promote sustained development if they are rooted in local cultures and that shared values are critical for fostering cooperation based on trust and mutual accountability, as expressed in the vision of a “Global Partnership for Development”.
- Subsequently, ELO and CE/CPLP discussed the effect of the global crisis on the role of Science and Technology for Development, suggesting innovative responses.
- In December 2009, again in Bissau, the Council became a Confederation and this was inaugurated in July 2010 at the Luanda summit.

# State capacity, global governance and G-20

- At any level of income, state capacity can be looked at from an organizational economics perspective: less centralized organizations adapt less well to a changing environment. With respect to intelligence, decentralization will reduce herding, but it will also reduce sharing.
- The dangers of “group think” are apparent in this crisis but have not been analyzed in connection with global, or even regional, governance.
- It is in Lisbon that Paul Krugman first spoke of “incestuous suppression” in connection with resistance to health reform in the US (paper appeared in book edited by Francesco Franco).
- Global governance needs criteria for the system efficient procedures along the lines of what Robert Triffin proposed for the reform of Bretton-Woods (Martin Wolf, *FT* 14 October).
- The generalization of peer reviews contained in the G20 Pittsburgh communiqué has not progressed.

## A letter to the “global *lusofonia* queen”

- 2 years after the Queen’s visit to LSE, the ACL is preparing a seminar devoted to avoiding “group think” of advanced (blue-eyed?) countries. If a letter emerges from the endeavour, it would result from a debate encompassing:
  - humanities and social sciences as well as natural sciences;
  - a diversity of CPLP perspectives.
- Starting this debate in Funchal is a great pleasure for me as I remember vividly the 1984 conference on thinking about the future.