

The Changing Global Economic Landscape: Opportunities and Risks

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September, 2007

MAJOR CHANGES IN GLOBALIZATION

- ❖ RISE OF CHINA and INDIA
 - More broadly, a half century after end of colonialism new role of developing world
 - New sources of economic growth
 - New political power
 - New patterns of trade
 - ❖ CHANGING GLOBAL FINANCIAL SYSTEM
 - ❖ ENERGY
 - Combination of scarcity and environmental concerns (global warming) will force changes in production and consumption
 - ❖ The adjustment of Global Economy to these changes poses major risks and opportunities
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New opportunities

- New markets
 - Access to the global marketplace means that expansion is not limited by the size of local markets
 - New sources of supplies of inputs
 - Again, firms are not limited to inputs available locally
 - Wider range of commodities, lower prices, higher quality, meeting specific needs
 - A global marketplace for talent
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New opportunities

- New sources of finance
 - Increasing flow of funds to emerging markets
 - From an ever-expanding set of sources
 - Most recently, growth of sovereign funds
 - In a wide range of forms (debt, equity)
 - Access to global technology
 - Means that “catching up” can occur quickly
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New risks

- Rapid changes in global comparative advantages
 - New competitors
 - New products, new technologies
 - Changes in global scarcities
 - Reflected in volatility in commodity prices
 - Especially in energy markets
 - Linking of energy and agriculture
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New risks

- Financial market volatility
 - Affects even countries that manage their own markets well
 - Sub-prime mortgage crisis
 - Large changes in risk premium
 - New rules of the game
 - International rules (WTO, IMF, Basel)
 - Domestic responses to the changing global landscape
 - Backlash against globalization
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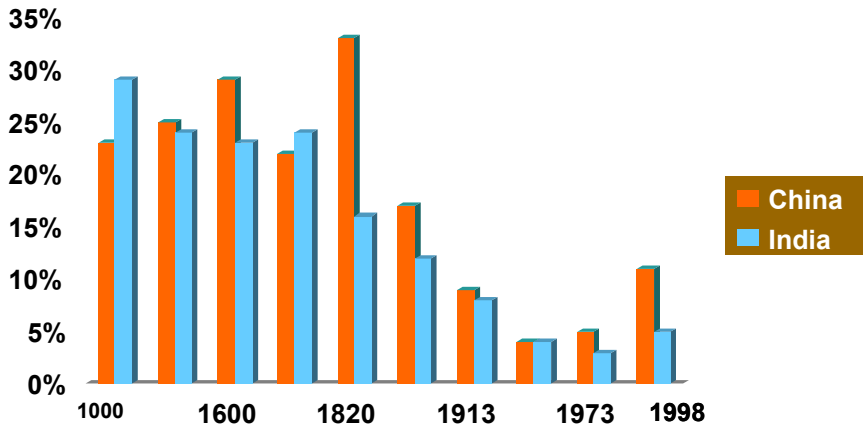
I. The changing role of developing countries

- ❖ China and India, with 2.4 **billion** people, have been growing at historically unprecedented rates
 - ❖ Countries that were marginalized, excluded from global economy are closing the gap between themselves and advanced industrial countries
 - ❖ China at close to 10% growth for 30 years
 - ❖ India recently at more than 8% growth
 - ❖ Engine of global economic growth
 - Global growth at 5% for past couple years has been almost unprecedented
 - Increased demand for commodities has helped developing countries
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Historical perspective

- ❖ In 1820, China had 1/3 global GDP, India more than 15%
 - ❖ Between 1814-1828 Industrial Revolution and tariff barriers knocked out Indian exports
 - Indian textile exports to Britain fell by two-thirds
 - British export of textiles to India rose five times
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China and India's Share in World GDP



Angus Maddison, World Economy, 2001

❖ Globalization has played a major role in their success

- Access to markets
 - Access to technology
 - Lower communication and transportation costs
 - 50 percent compounded annual decline in telecommunication cost in the 1990s
 - Fiber optic glut during the Internet Bubble slashed telecom cost
 - Scanners convert data to image file - 160 pages per minute.
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While the global landscape has changed, the world is still not flat...

- ❖ Growing disparity between richest countries and poorest countries
 - ❖ Growing disparities within most countries of the world
 - Threat of job loss in advanced industrial countries
 - Even for well-educated (outsourcing)
 - Even if economy maintains full employment, wages can be depressed
 - ❖ Globalization has played an important role in these disparities
 - Predictable effect on inequality within advanced industrial economies
 - Unfair trade treaties have compounded problems in developing countries
 - Problems compounded by asymmetric liberalization
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Consequences of failures of globalization

- ❖ Breakdown of Doha Round trade talks
 - But it was a misnomer to call Doha Round a *development round*
 - Worries about consequences of Doha failure are exaggerated
 - ❖ Bicycle metaphor inaccurate
 - ❖ No agreement is better than a bad agreement
 - Many of today's problems result from bad agreements of the past
 - ❖ Possible that some obstacles, like agricultural subsidies, may be resolved
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Consequences

- ❖ Plethora of bilateral trade agreements
 - Undermining multilateral trade system
 - ❖ Growing protectionist sentiment in advanced industrial countries
 - WTO created a rule of law
 - Will prevent retreat behind protectionist walls
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Further consequences

- ❖ New geo-politics: new power of developing countries and resolve to use it
 - Also evidenced, e.g. in China's new role in Africa
 - More assistance to infrastructure loans than African Development Bank and World Bank combined
 - Competition for resources will help developing countries—but drive up prices for commodities
 - And will impose new limitations on broader social agendas (Darfur, global warming)
 - G-8 will not work
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❖ Protectionism especially strong in areas of investment—Sovereign Funds

- Should not be a problem in most areas if there is appropriate regulatory framework in place
 - But there is a risk of a backlash if West is seen as hypocritical
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II. Lessons from successes and failures in development and transition

- No “magic bullet,” “secret recipe” to success
 - Different countries have taken different routes
 - Some have opened themselves to FDI
 - Some have not
 - Some had large firms
 - Some focused on small firms
 - Successes requires a comprehensive agenda
 - But a major mistake in a single dimension (like macro-policy) can cause failure
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Every country has a comparative advantage

- But discovering it may be difficult
 - China's success was *not* based just on low wages of unskilled labor
 - There were other countries with lower labor costs
 - Even in textiles, maintaining equipment requires skilled workers
 - China invested heavily in education
 - China also invested heavily in technology, infrastructure
 - And encouraged competition
 - China's success also based on "supply chain economics"
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Trade liberalization no guarantee

- NAFTA eliminated tariffs between Mexico and US
 - Providing access to largest market in world—next door
 - If ever a free trade agreement should have promoted growth, this was it
 - Large differences in wages
 - But gap between Mexico and US grew in first decade of NAFTA
 - And even jobs created in early days of NAFTA were lost to China
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What Mexico did wrong

- ❑ Weak infrastructure
 - ❑ Underinvestment in education and research
 - ❑ Monopolies (telecom, cement) raise prices of key inputs
 - ❑ Important problems in governance
 - Including physical security
 - ❑ Foreign banks took over banking
 - Supply of credit to domestic small and medium sized enterprises not engaged in international trade dried up
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What Mexico did wrong

- ❑ Mexico thought that NAFTA was its “magic bullet”—but was wrong
 - ❑ Globalization is important, but globalization is not everything
 - Its importance has often been exaggerated
 - Local knowledge (e.g. in finance, marketing) still critical
 - Countries must get their internal affairs in order
 - ❑ India’s success began not with external liberalization but with internal liberalization
 - ❑ Mexico also believed that key to success was keeping tax rates low
 - But with low tax rates, country could not afford investments in infrastructure and education required to attract FDI
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Scandinavia: success in meeting challenges of globalization

- Rapid economic growth, penetration of new technologies
 - But even more important, outstanding performance in broad-based measures, like UNDP Human Development Indicators
 - Highest tax rates in world
 - Success *because* of high tax rates, not *in spite of* high tax rates
 - Finances first rate education, infrastructure, research, and strong safety net
 - Safety net important in responding to risk
 - Risk taking critical for success in New Economy, Globalization
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Protecting against volatility

- Again, no magic bullet
 - In East Asia crisis, IMF talked about transparency
 - But previous crises were in Scandinavia, region with greatest transparency
 - Transparency important, but not sufficient
 - Large number of crises around world—including US Savings and Loan crisis
 - Good regulation important
 - Sub-prime crisis and its global contagion illustrates problems that arise with inadequate regulation and lack of transparency
 - Problems more often caused by too little regulation than too much
 - Economic and social costs of crises can be huge
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Transition economies

- Success in early days of transition has not meant success later on
 - Simple stories told by IMF early on have not been borne out
 - Shock therapy has not worked
 - Countries that privatized and liberalized rapidly have not outperformed other countries
 - Good macro-policy is important
 - But there can be rapid growth even with moderate inflation
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Major advantages of countries of Eastern and Southeastern Europe

- Proximity, access to huge market
 - Importance of supply-chain economics
 - Standards of governance being set by EU
 - Corporate governance
 - Competition
 - But there is still scope for national policies
 - Countries that have tried to conform to letter of corporate governance rules, but not spirit, have not done as well
 - Still scope for promoting access to credit—critical for success
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Major advantages of countries of Eastern and Southeastern Europe

- Most countries have highly skilled labor force, with very competitive wages
 - Makes more sense to move jobs to where workers are, rather than move workers to where jobs are
 - Important to study why this has not been happening more
 - Lack of infrastructure?
 - Domestic regulation?
 - Lack of access to finance?
 - Lack of access to non-traded inputs?
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Long run prospects

- Economic theory predicts rapid convergence
 - If policies are right, institutions will be put into place
 - And there is some evidence that this is already happening
 - Finance will facilitate this convergence
 - And at the same time should reap high risk-adjusted returns for providing a critical input
 - More than just money
 - Figuring out dynamic comparative advantage
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Figuring out “dynamic comparative advantage”

- Requires combining local knowledge and global knowledge—local knowledge of the strengths and weaknesses of the region and how these fit into the ever-changing global landscape
 - Banks, and especially regional and local banks, and other financial institutions, play an especially important role
 - Securitization can play an important role in spreading risks
 - But cannot replace the information-intensive role of banks
 - Problems illustrated by the recent sub-prime crisis
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III. The Global Financial System

- ❖ Problems highlighted by persistent global imbalances, high levels of instability
 - Feb 27, 2007 episode, where a rumor in China led to largest declines in stock markets since 9/11
 - ❖ Standard discussion involves shared blame
 - U.S. fiscal and trade deficit
 - Europe’s slow growth
 - China’s undervalued currency
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U.S. Shares Disproportionate Blame

- ❖ U.S. deficit is more than \$850 billion
 - China's multilateral surplus is only about \$150 billion
 - So even if eliminating China's surplus fully translated into a reduction in U.S. deficit, U.S. deficit would still be more than \$700 billion
 - Likely would have no effect—U.S. just buys textiles from Cambodia and Bangladesh
 - But Cambodia and Bangladesh less likely to be willing to finance U.S. deficits
 - **So global instability might actually be increased if China revalued its currency**
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China is trying to reduce multilateral trade surplus

- ❖ Through reducing savings
 - Unique problem—too high savings
 - One of key parts of 11th “five year plan”
 - Debate about best way to do this
 - But so far has failed
 - ❖ More effective than through adjustment of exchange rates
 - Huge disruptive adjustments might be required
 - Which could exacerbate some key problems, such as rural poverty
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Is this a problem?

- ❖ “Normal” economics has some countries borrowing from others. Why worry about U.S. borrowing?
 - ❑ Something peculiar about richest country in the world not being able to live within its means
 - \$500 billion last year flowed from poor countries to rich countries
 - ❑ Deficits OK when money is being spent on investments to make economy more productive
 - Problematic in the U.S.
 - ❑ Given demography, this is a period in which the U.S. should be saving, not borrowing
 - ❖ Worry is that there will be a disorderly adjustment
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Many reasons to worry

- ❖ Fears of U.S. economic downturn
 - ❑ Growth during last few years led by real estate
 - Investment
 - Taking money out of real estate through refinancing mortgages, home equity loans
 - US economy supported by low interest rates, consuming beyond its income
 - Household savings rate negative
 - US economy spending \$850 billion more than its income
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- ❖ With declining real estate prices and crisis in the sub-prime mortgage market, this is all coming to an end
 - Problems not limited to sub-prime mortgage market
 - Speculative real estate investment already stalled
 - Matters likely to get worse as new regulations are put into place to prevent abusive lending practices
 - What will replace it?
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Not consumption...

- ❖ Real incomes of average Americans have not been doing well
 - Median income of males in their 30s lower today than 30 years ago
 - Problems exacerbated in last five years
 - At the same time that real labor costs are increasing, we have:
 - Slowing rate of productivity growth
 - Increasing costs of health care
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❖ As America moves from -1% savings to more normal 3 to 4% savings, adjustment will depress aggregate demand

- Magnitude and duration of slowdown only question—short but deep decline versus longer but more limited one

Not investment...

❖ Investment is weak

- And likely to remain so, as long as there remains uncertainty about growth
 - The problem, however, is not lack of funds
- Risk of increasing interest rates
 - Fear of inflation

Anomalous juxtaposition

- ❖ Period of high risk with low risk premium
 - Added risk of return to more normal risk premium
 - Effects would be felt in many markets
 - Highly indebted developing countries
 - Medium and long term bond markets
 - Exacerbating problems in real estate
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- ❖ Bears have been predicting problems for some time
 - It did not happen last year
 - ❖ Two views:
 - Bears are wrong: downturn is unlikely
 - Bears are wrong in *timing*: downturn *more* likely, but has yet to happen
 - Recent events in credit markets make “negative” scenario more plausible
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Underlying problems (1)

- ❖ U.S. Dollar as global reserve currency
 - Risk of crises and IMF intervention has led countries to accumulate huge amounts of reserves, mostly in dollars
 - Basic economic identity
 - Capital inflows = trade deficit
 - U.S. exporting T-bills rather than automobiles
 - But T-bills do not create jobs—problem of aggregate demand
 - Trade deficit has been increasing for a quarter of a century
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- ❖ Some in Europe aspire for the Euro to become global reserve currency
 - Europe would have same problem—high price to pay for getting cheap loans
 - Worse—because Europe's hands are tied
 - EU Growth and Stability Pact
 - Central bank focusing only on inflation
 - Two-currency reserve system may be even more unstable
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What is needed

- ❖ Global reserve system
 - Keynes argued for this
 - Basic idea contained in SDRs
 - But U.S. has vetoed expansion
 - ❖ Current system is fraying
 - Process may be unstable
 - Growing lack of confidence in dollar
 - Feeding on itself
 - Asia is major source of global savings
 - Paying high price for re-circulating savings in West
 - Beginning to explore alternatives
 - Asian Bond Market
 - Chiang Mai initiative
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Underlying problems (2)

- ❖ Globalization has meant that the world is more interconnected; what happens in one part of the world has impact on other parts
 - ❖ There is greater need for collective (cooperative) action
 - ❖ But economic globalization has outpaced political globalization
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- ❖ We do not have the international institutions and arrangements with which to deal with these problems effectively and democratically
 - ❖ Sub-prime mortgage illustrates inadequacies in regulation and transparency of US financial markets have global consequences
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- ❖ Hard to imagine US without national regulation (only state regulation)
 - So, too, in Europe
 - But in an increasingly integrated world, that is what we are trying to do on a global scale
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IV. Global Warming

- ❖ Increasing evidence — it is real and it is happening faster than expected
 - ❖ Question is no longer whether we can afford to do something about it, but whether we can afford *not* to do something
 - ❖ Kyoto was a major step forward
 - Many countries put self-interest aside, to achieve a global agreement
 - But $\frac{3}{4}$ of sources of pollution are left out
 - And Kyoto framework not likely to provide guide for future
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Global warming is a *global* problem requiring *global* action

- ❖ Also a matter of global social justice
 - Major polluters are in North
 - Major costs are borne in South
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Kyoto was a major step forward but...

- ❖ It left out three quarters of the sources of emissions
 - US
 - Developing countries
 - Deforestation
 - ❖ And did not set ambitious enough goals, given what we now know about the risks
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Responding to climate change

- ❖ Almost certainly, the world will respond to the challenges posed by climate change
 - New regulations/standards
 - New taxes
 - Elimination of old subsidies
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Adjusting to climate change

- ❖ Cost of responding to climate change—if we do it efficiently—is relatively small, and much smaller than the cost of not responding
 - ❖ But certain sectors and firms will be hurt
 - Coal
 - Large car manufacturers
 - There will be large changes in some prices
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- ❖ But new industries will also be created
 - Firms that respond to new opportunities creatively will do well...
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Rising energy prices

- ❖ Problems of global warming will compound problems of energy insecurity and Mideast turbulence
 - China and India have large coal deposits, few oil and natural gas reserves
 - Problems in some of alternatives
 - U.S. corn-based ethanol very inefficient
 - Biofuels limited by water scarcity
 - Carbon storage technology unproven
 - Could dampen economic growth unless there is substantial increase in energy efficiency and conservation—changes in patterns of consumption and production
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Concluding Remarks

- ❖ Globalization presents new opportunities
 - ❖ But also new challenges...
 - Both to the developed and developing world
 - ❖ There are many ways that globalization has not been working well
 - Increasing inequality, increasing disparities between richest and poorest countries
 - Globalization is only one of factors contributing
 - Global instability
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Globalization presents new risks

- ❖ Changing comparative advantages due to rising economic power of China and India
 - ❖ New protectionism
 - ❖ Global financial instability
 - Disorderly adjustment of global imbalances
 - New risks posed by financial innovation
 - Re-pricing of risk
 - U.S. economic downturn
 - *In globalized world, what happens in one country affects all others*
 - ❖ Global warming
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- ❖ One of the objectives of banks and financial markets is to manage risks
 - But if that is to happen, there must be continued innovation in financial markets and products, continued changes in banking and banking regulations
 - Some innovations will increase risks, reduce transparency
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Globalization also presents new opportunities...

- ❖ One of objectives of banks and financial markets is not only to manage these risks but also to seize new opportunities, in part by anticipating these changing trends in the global landscape
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