

## **15.223, class #1: Whatever next for the global economy?**

**Where are we in the global economy?** The European debt crisis is not under control, European banks are contracting their balance sheets, and European growth is slowing – presumably this will have a negative impact on growth in other countries. There is a potential for financial contagion.

**What are the latest developments?** Greece will have a large debt restructuring. What about Italy – will they get a large and largely unconditional bailout (involving the ECB) or will they have to restructure their debts? See the [European debt map](#) for why Italy matters – and for alternative scenarios. Portugal has abandoned “fiscal devaluation.”

**Who’s in charge?** The G20 comprises countries with 2/3 of the world population and 90 percent of GDP; the latest summit for heads of government is in Cannes, November 3-4.

**What can be done?** Not much by the G20. The problem is intra-European, really between the Germans (as creditors) and the Italians (as debtors), but other eurozone countries also matter.

**How should we think about the eurozone?** The eurozone is a mini-international system, with a bias towards adjustment by debtor countries; all the systems ever devised have had this characteristic (think about the gold standard). The eurozone countries gave up their right to have their own central banks; we are now seeing the implications of that decision.

**How about a big international loan?** The eurozone does not need this: the euro is a reserve currency and, overall, it does not have a current account deficit. Still the Europeans seem taken with the idea that China can help support the European government market. China might be willing to do some of this, for symbolic reasons. But why would they do enough to make a difference? Direct, bilateral loans from China to Europe could become awkward.

**Can the US show leadership?** It’s not clear what the US can do that would make a difference in the short-term. Further fiscal stimulus is unlikely and monetary policy is already in uncharted waters. Even if the US could push the dollar to depreciate – for example through pro-inflation statements from the Fed – would that be a road worth taking?

**How about more money for the IMF?** This was done with some success for the April 2009 London G20 summit. But now the US is not willing to put up substantial commitments – these would not play well in Congress or more broadly at present. This makes it awkward for the IMF to create some sort of special purpose vehicle into which China, Russia and others would invest. The US does not want to lose its leading role at the IMF. And the role for the IMF is unclear – given that the Europeans do not really need a great deal of external financing.

**How did we get into this mess?** There was a big credit boom. Financial deregulation encouraged the build-up of debts. In the US, this was around residential mortgages – when that bubble burst, there was “fiscal damage”, meaning a large increase in government debt relative to GDP. In retrospect, parts of the financial sector lobbied for the ability to take on excessive risks – and to become “too big to fail.” In Europe, some governments borrowed too much (Greece, Italy, Portugal), while financial institutions lent heavily to real estate elsewhere (Ireland, Spain).

**Have we fixed the underlying problems?** Are major banks still too big to fail? Is management still rewarded for return on equity, unadjusted for risk?

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