

## 15.223, class #11: The Global System, History and Likely Future

**We face a global crisis arising from the structure of the world's financial system. Local responses, while potentially helpful, are unlikely to be enough. Unless we fix the underlying problems that cut across countries, we will repeat something like this experience with unfortunate regularity (the "doom loop") or we will have a major crash ("too big to save").**

### *Background*

- Countries trying to climb the productivity ladder: trade as the model (**Hong Kong textiles**)
  - Governance matters for sustaining growth (**Singapore**),
  - But anyone can have a boom (**diamonds: Botswana vs. Zimbabwe**)
- Trading system is not completely fair, yet still scope for new entrants (**Brazil: planes; pharma**)
  - Politics are everywhere, not just for fuel (**Unocal**).
  - Values have spread; global sensitivities increase (**Nike; Brent Spar**)
- Collapse of Bretton Woods fixed exchange rates in 1971 seemed like a big deal
  - There was high inflation in the 1970s; energy crisis; debt crisis in Latin America/Eastern Europe – attributed to "overheating" and/or "overborrowing"
  - By early 1980s, inflation under control: central banking without gold seemed to work
- The emerging markets crisis of 1997-98: foreshadowing and sowing the seeds
  - Globalized finance seeks the moral hazard trade – who will get a "bailout" of any kind?
  - Capital flows are volatile
- Financial development supports growth; everyone needs intermediation (**Porter**)
  - But boom-bust-bailout cycle is not getting smaller and not confined to emerging markets
- World out of balance: China savings and the US borrowing, 2000-2007
  - Capital flows (net and gross); reinforced by central bank policies, "credit easing"
- The international financial system: still Bretton Woods (with some floating exchange rates)
  - Global banks + local regulators = anything goes (**13 Bankers**)

### *The Crisis of 2008-09*

- The pre-crisis and how it spread, from June 2007-September 2008: problem mortgages
  - Central banks: innovating without big ideas; protecting creditors always
- Desperate times quietly - the international struggle to come up with a solution, 2008
  - Incrementalism, denial, Not Invented Here
- The crisis of confidence begins, from September 2008
  - Lehman/AIG: tinder lit with dynamite; great uncertainty about who will fail
- Final response: use government balance sheet to implicitly guarantee most large banks
  - TARP plus stress tests; then back to incremental reforms

### *The Crisis of 2010-11*

- European countries have high debt relative to GDP; low growth
  - European Central Bank is not at the national level; does not necessarily back-stop debt
  - Germans want to break the moral hazard regime; impose losses on creditors
- The IMF: always present at the destruction; continue incremental approach
  - Is austerity the answer; reluctance to restructure debts (unlike for emerging markets)
- Will Europe re-affirm moral hazard (the "big bazooka") or deal with the consequences of default?
- The Rise of China complete: Will the US dollar lose its reserve currency role? (**Arvind Subramanian**)

MIT OpenCourseWare  
<http://ocw.mit.edu>

15.223 Global Markets, National Politics and the Competitive Advantage of Firms  
Fall 2011

For information about citing these materials or our Terms of Use, visit: <http://ocw.mit.edu/terms>.