CAGE
Competitive Advantage in the Global Economy

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Déjà Vu:
Today's sovereign debt crises have important precedents

Nicholas Crafts

Europeans have been shocked by the crises in Greece and Ireland. For the first time since the 1930s, it seems possible that western European governments may default on their debts. The IMF has been called in – something unknown in an OECD country since the 1970s. The continued existence of the Eurozone has been called into question.

The problems in Greece and Ireland have different origins. In Greece, a profligate government ran up budget deficits and a large ratio of public debt to GDP. In Ireland, excessive risk-taking by banks involving massive exposure to a property-market bust has revealed the inadequacy of bank regulation. The sequel has been near collapse of the Irish banking system, a horrendous recession and devastation of Irish public finances.

In turn, escalating deficits imply greatly increased borrowing costs and worries about fiscal sustainability. A sovereign default would potentially call into question the solvency of some banks and threaten banking crises elsewhere in Europe.

> The Eurozone is exposed to problems arising from its inability to impose fiscal discipline on its member countries and its inadequate regulation of the financial system.

The arithmetic of keeping debt under control in the medium term ('fiscal-sustainability') requires that the surplus of government revenue over expenditure other than debt on interest (the 'primary surplus') as a percentage of GDP increases with the ratio of public debt to GDP and with the difference between the interest rate on government borrowing and the rate of economic growth measured in current prices. So, the situation gets more difficult if there has been a lot of past borrowing, if the interest rate goes up as markets, fearing default, impose a risk premium, and if deflation leads to falling prices. There is a vicious circle here since rising interest rates and attempts at fiscal stringency discourage investment which slows growth etc. Obviously, actual default or forgiveness of the debt by creditors makes the arithmetic better.

Two past episodes offer important precedents – the 1930s great depression, of course, but also the sovereign debt crisis of the 1980s. In the earlier period, there was widespread default. Default was attractive because it removed the problems associated with the debt overhang and because the governments of lender countries took a relaxed attitude since private bondholders rather than banks took the hit. Default was good for growth although it did mean exclusion from access to foreign capital for some years.

In the latter period, there was no outright default, although there was a good deal of rescheduling of payments, and international agencies and western governments strove to find ways of protecting banks from having to write off non-performing loans until balance sheets could be strengthened. This 'muddling-through' strategy worked for American banks at the cost of a long period of stagnation in many Latin American countries, the so-called 'lost decade' resulting from low levels of investment that undermined growth.

> Strong growth only resumed after the 1989 Brady Plan led to the forgiveness of about $60 billion of debt across 16 countries thereby removing a major obstacle to investment and growth.

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The other important message from the 1930s relates to international monetary arrangements. The world entered the depression with all major economies on the gold standard, a system of fixed exchange rates with each currency tied to a par value in terms of gold. Within a few years, the gold standard had effectively collapsed. Early exit from the gold standard was very good for mitigating the threat of banking or debt crises and for moving to a rapid recovery from the slump. In the 1930s, this allowed countries to regain control of setting their own interest rates and to end deflation, helped restore international competitiveness, and, combined with default, made the fiscal arithmetic much less demanding. However, for Greece or Ireland to take a similar step now would, of course, entail leaving the Euro.

The 1930s precedent suggests that the Eurozone is under threat. Moreover, in addition to fiscal problems, since the Euro was established in 1999, the cost competitiveness of the weaker economies has been substantially eroded. Restoring competitiveness either means a long period of domestic deflation or a devaluation. But to address this through falling prices only makes the fiscal-sustainability issues harder to solve. Devaluation and default seems logical.

For Greek and Irish voters, the status quo of 'no bailout, no default, no exit' seems unsustainable.

If only quitting the Euro was as easy as leaving the gold standard in the 1930s.

In today's world of extremely mobile capital an attempt to do so might trigger financial collapse and could be at best a Pyrrhic victory. The implication is that some kind of 'muddling-through' solution has to be found to buy time for Europe's banks and to alleviate pressures on public finances in the worst-affected countries. In the medium term, it will be bailout and/or default; one way or another, this may start to look very expensive to German taxpayers.

This article draws on work presented at the CAGE conference on "Lessons from the 1930s". The conference papers have now been published in the Oxford Review of Economic Policy, 26 (3), 2010.

Visiting Fellow:
Professor Mark Thomas

We have been pleased to welcome Professor Mark Thomas during the Spring term. Mark is project director for the Leverhulme Trust funded research programme "Social Accounting in a Historical Context: Modelling the Atlantic Economy. 1850 -1940." This project is a major enterprise within the research agenda of CAGE and anticipated to produce significant results and publications over the next three years.

Mark Thomas is Professor of History and Economics at the University of Virginia. A native Briton, Mark received his BA in Modern History and Economics from Oxford University, he holds an MA in Economics from Cornell University, and completed his D.Phil. at Nuffield College, Oxford.

Mark is the author or co-author of five books, including Capitalism in Context: Essays in Economic Development and Cultural Change (with J. A. James), The Economic Future in Historical Perspective (with P. A. David), and The Disintegration of the World Economy between the Wars. His publications have won the T.S. Ashton Prize of the Economic History Society (UK), and (jointly with J.A. James) the Arthur H. Cole Prize of the Economic History Association (US).

Mark has given a series of lectures during his time with us – these are available to view on our website.

'Modelling the Atlantic Economy: A Social Accounting Approach, 1850-1940'

'The Mid-Victorian Economy; earning, making and spending in Britain in 1851'

'The Edwardian Economy: structure, performance and policy in early 20th century Britain'

Professor John Whalley

John Whalley, Professor of Economics at the University of Western Ontario, Canada, is a lead researcher at CAGE. He is a Distinguished Fellow at the Centre for international Governance Innovation (CIGI), Waterloo, Ontario. He is also a research associate of NBER (Cambridge, US) and joint co-ordinator of the global economy area for CESifo (Germany). He is a Fellow of the Econometric Society, a Fellow of the Royal Society of Canada, and a Foreign Fellow of the Russian Academy of Natural Sciences.

John is internationally known for his work in several diverse areas of economics. He was a founder of applied general equilibrium analysis in the 1970's building on his Yale thesis work, and became an expert on WTO issues, development strategies and tax policy. His recent work focuses on China, Russia, and climate change. During his time at CAGE this term Professor Whalley has been instrumental in developing and running the following workshops:

Climate Change Workshop

On January 25 CAGE held a joint workshop on global climate change policy with the LSE ESRC Climate Change Policy Centre. The focus of the workshop was the ongoing global climate change negotiations under the United Nations Framework Convention on Climate Change which followed from the December 2009 meeting in Copenhagen. CAGE and the LSE plan a further workshop in 2012 with a volume to follow.

International Trade Research Day

CAGE collaborated with the Department of International Trade, University of International Business and Economics (UIBE), Beijing to run this event at Warwick on February 23. Papers presented at the workshop spanned a range of topics covering trade theory and empirical work and Professors Yin Xiao Peng and Fan Hui from UIBE provided a briefing on research in the trade research community in China.

CAGE research generates media storm

Medieval Britons were richer than the modern poor

New research led by Professor Stephen Broadberry, and published by CAGE, generated interest in over 50 national and local newspapers including The Times, the Guardian, the Daily Mail, online publications and international publications from China, New Zealand, India and Canada.

People in Medieval England, illustrated here by a section of the Bayeux Tapestry

A period of wealth: Warwick Castle demonstrates the affluence of some aspects of medieval society

The research reveals that medieval England was not only far more prosperous than previously believed, it also boasted an average income that would be more than double the average per capita income of the world's poorest nations today.

In a paper entitled British Economic Growth 1270-1870 researchers find that living standards in medieval England were far above the "bare bones subsistence" experience of people in many of today's poor countries.

The figure of $400 annually (as expressed in 1990 international dollars) is commonly used as a measure of "bare bones subsistence" and was previously believed to be the average income in England in the middle ages.

However the University of Warwick led researchers found that English per capita incomes in the late Middle Ages were actually of the order of $1,000. Even on the eve of the Black Death, which first struck in 1348/49, the researchers found per capita incomes in England of more than $800 using the same 1990 dollar measure. Their estimates for other European countries also suggest late medieval living standards well above $400.

This new figure of $1,000 is not only significantly higher than previous estimates for that period in England – it also indicates that on average medieval England was better off than some of the world's poorest nations today.

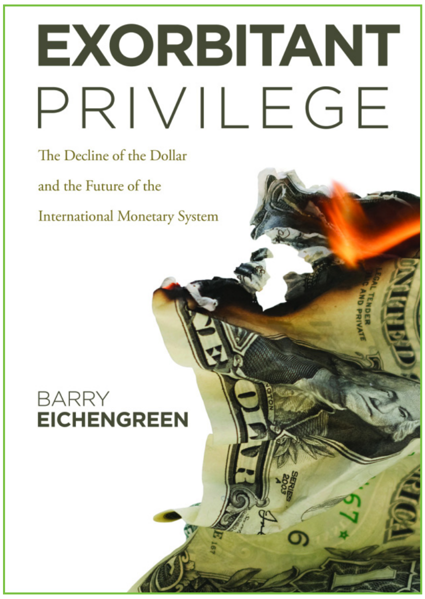
The full working paper and links to the newspaper articles are available on the CAGE website: go.warwick.ac.uk/cage

CAGE Seminar Series on the Emerging World Economy

CAGE is running a series of seminars this year on the emerging world economy. The seminars, held both at Chatham House and at the University of Warwick, will bring new academic ideas and insights to a wider audience. In the first of these we have focused on the rise of China and India and the implications for the UK, particularly for the design of policies for globalisation and development.

In February Professor Pranab Bardhan from Berkeley gave lectures on his new book 'Awakening Giants, Feet of Clay: Assessing the rise of China and India'. In March Professor Dani Rodrik from Harvard gave talks based on his book, 'The Globalisation Paradox: Democracy and the Future of the World Economy'. Barry Eichengreen, Professor of Economics at Berkeley, also visited us in March and gave two lectures on 'The Rise and Fall of the Dollar' based on his recent book, 'Exorbitant Privelege'.

These lectures are available as podcasts on our website.



Blue-sky Conference on Development Policymaking

6th June, The British Academy

CAGE has brought together leading thinkers to discuss the latest cutting edge ideas relating to policymaking for developing countries. This conference will challenge traditional views, stimulate innovative thinking and provide an opportunity for academic researchers, policy makers and practitioners, and journalists to engage in a creative discussion on development policy.

Speakers will include:

Paul Romer:
Charter Cities and Development

Sendhil Mullainathan:
The Packing Problem and the Behavioral Economics of the Poor

Paul Collier:
Harnessing the potential of natural resource extraction for development

Tim Besley:
State Capacity and Development.

Working Papers

CAGE publishes a series of working papers which are available online at **go.warwick.ac.uk/cage**

Recent papers include:

International Happiness

Authors: David G. Blanchflower and Andrew Oswald
No. 39/2011

Human well-being is of intellectual and personal interest to individuals, social scientists, and policy-makers. Understanding the determinants of something as complex as happiness is difficult; attempts to do so will, inevitably, continue to provoke disagreement. However, in the last few decades, and especially through the 2000s, a new literature has sprung up. In it, scholars use data on subjective well-being to explore the statistical determinants of happiness, life satisfaction, and mental health.

Currently, the main patterns that have been replicated persuasively in the data of large numbers of nations are the following. Happy people are disproportionately the young and old (not middle-aged), rich, educated, married, in work, healthy, exercise-takers, with high fruit-and-vegetable diets, and slim. Happy countries are disproportionately rich, educated, democratic, trusting, and low-unemployment.

Even bearing in mind the latter characteristics, some nations do noticeably well in happiness rankings. Examples include Denmark, the Netherlands and Ireland. Unfortunately, we do not yet know why these countries are so perplexingly happy. Smallness of a country seems in the data somehow to help it be a happy one. That may be a spurious correlation, or may indicate perhaps that a geographical or low-population country feels genuinely more like a single, friendly unit. It is likely that many other characteristics of nations matter, at a deep level, for human happiness; our knowledge here is sparse. Nor do we yet understand how the physical health and mental health of nations are connected. That fascinating research area lies almost uncharted.

By its nature, this multi-disciplinary research field is, and will remain, one of genuine significance to human society. Almost everyone is interested in happiness.

The Frequency of Wars

Authors: Mark Harrison & Nikolaus Wolf
No. 38/2011

Wars are increasingly frequent, and the trend has been steadily upward since 1870. The main tradition of Western political and philosophical thought suggests that extensive economic globalisation and democratisation over this period should have reduced appetites for war far below their current level. This view is clearly incomplete: at best, confounding factors are at work. Here, we explore the capacity to wage war. Most fundamentally, the growing number of sovereign states has been closely associated with the spread of democracy and increasing commercial openness, as well as the number of bilateral conflicts. Trade and democracy are traditionally thought of as goods, both in themselves, and because they reduce the willingness to go to war, conditional on the national capacity to do so. But the same factors may also have been increasing the capacity for war, and so its frequency.

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