

1. TEMA

EL MUNDO LUEGO DE LA GRAN RECESIÓN: LA NUEVA REALIDAD ECONÓMICO-FINANCIERA PARA EL MUNDO DESARROLLADO Y MERCADOS EMERGENTES

2. INTRODUCCIÓN

La Gran Recesión ha cambiado el antiguo *status quo* del mundo y eso a su vez presenta nuevas y complicadas circunstancias y desafíos para los países desarrollados y emergentes. Casi no hay duda de que un nuevo orden mundial está surgiendo ante nuestros ojos.

Hay períodos cuando el sistema internacional experimenta cambios radicales en poco tiempo. El último período así fue 1989-1991. Durante esos años el imperio Soviético colapsó, el milagro económico japonés terminó, el Tratado de Maastricht creando la Europa contemporánea fue firmado, la Plaza de Tiananmen definió a China como una economía de mercado dominada por un Partido Comunista incuestionable, etc. Componentes fundamentales del sistema internacional cambiaron radicalmente, alterando las reglas para los próximos 20 años¹.

En la actualidad nos encontramos en un ciclo similar, uno que comenzó en 2008 y que todavía continúa. En estos años, la Unión Europea dejó de funcionar de la manera que lo hizo cinco años antes y aún debe ver su nueva forma. Por otra parte, la parálisis política y el nivel de confrontación entre políticos en Washington y Europa ponen en cuestionamiento el sistema democrático de Occidente. China se encuentra en una etapa social y económica difícil que pone en evidencia los desafíos de un crecimiento económico acelerado. Los cambios simultáneos en EEUU, Europa, China y los grandes mercados emergentes abren la puerta a una nueva estructura internacional, remplazando aquella creada en 1989-1991².

El presente trabajo de grado se enmarca en la idea de que estamos en medio de lo que podríamos llamar un cambio generacional en la manera que el mundo funciona. Este proceso todavía se está desarrollando, y por lo tanto se debe considerar la situación actual de EEUU, Europa y los grandes mercados

¹ STRADFOR GLOBAL INTELLIGENCE, *Annual Forecast 2012*, <http://www.stratfor.com/forecast/annual-forecast-2012>, Access: January 20th 2012, 16:21.

² Id.

emergentes antes de llegar a una conclusión. El período de tiempo entre 2008 y 2011 es único, pues señala una redefinición y una nueva manera de funcionar del mundo.

El 2011 quizá no marque el final de este proceso de transformación al igual que no lo fue 1991. Sin embargo, de la misma forma que 1991 fue el año en que se volvió evidente que el antiguo mundo de la Guerra Fría ya no funcionaba, el 2011 es el año en el que se volvió evidente que el mundo Post-Guerra Fría ha llegado a su fin, siendo remplazado por actores y dinámicas cambiadas³.

Así, al comienzo de la Gran Recesión, durante los días finales de la administración Bush, el Vicepresidente Dick Cheney se sentó a una entrevista con *Associated Press*. Se le preguntó por qué la Administración había fallado en anticipar la mayor crisis financiera desde la Gran Depresión. La respuesta de Cheney fue reveladora: “Nadie fue lo suficientemente inteligente para darse cuenta” declaró “Creo que nadie vio venir la crisis”. Difícilmente se encontraba solo en esta apreciación. Basta mirar las declaraciones de los “sabios” de la comunidad financiera y el *establishment* político durante el comienzo de la crisis. Invariablemente, se ofrece alguna versión de la misma pregunta retórica: “¿Quién podría haberlo anticipado? La crisis financiera fue, como lo sugirió Cheney en la misma entrevista, similar a los ataques del 11 de septiembre: catastróficos pero casi imposibles de anticipar.”⁴

No es cierto. Varios economistas y comentaristas advirtieron de los peligros en el sistema financiero que estaban a punto de llevar abajo a la economía mundial. Fueron ignorados, quizá debido a exceso de optimismo o tal vez porque otros tenían mucho que ganar del colapso, un hecho que dice mucho sobre el estado de la economía y finanzas en décadas recientes. La mayoría de gente en esos ámbitos ignoró las advertencias debido a una simple y anticuada creencia: que los mercados son entidades que se autorregulan, estables, sólidos y confiables. De acuerdo a este razonamiento, el capitalismo del siglo XXI y la innovación financiera, se autorregularían manteniendo un balanceado y autoajutable estado de equilibrio.

³ Cfr. STRADFORD GLOBAL INTELLIGENCE, *Annual Forecast 2012*, op. cit.

⁴ Cfr. ROUBINI Nouriel, *The White Swan*, <http://es.scribd.com/doc/36327721/Crisis-Economics>, Access: January 25th 2011, 20:10.

En retrospectiva, todo eso parece ingenuo, pero por décadas era sabiduría convencional. Era la base de políticas importantes y de estrategias de inversión a gran escala. Bajo este paradigma, las crisis económicas tenían poco o ningún lugar. Pero como la crisis actual ha hecho evidente, las crisis son la norma, no solo en economías emergentes sino también en economías industriales avanzadas. De hecho, de muchas maneras, las crisis son parte del genoma capitalista. Aquellas mismas cosas que le dan al capitalismo su vitalidad, sus poderes de innovación y su tolerancia al riesgo, también pueden producir burbujas de activos y crédito, y, eventualmente, colapsos catastróficos cuyos efectos retumban por mucho tiempo.

Para poder entender los profundos cambios que la crisis continúa produciendo es fundamental comprender el reciente desastre económico, comenzando con la pregunta más obvia: ¿cómo se formó la burbuja detrás de la peor crisis financiera en décadas?, ¿fue una combinación de tomar riesgos excesivos por parte de instituciones financieras, gracias a la débil regulación y supervisión? o ¿fue una consecuencia inevitable de los grandes desequilibrios globales?

El primer capítulo de este trabajo de grado trata de responder a estas preguntas a través de un análisis del crédito excesivo y la innovación financiera con el involucramiento tanto del sector privado como del público, y cómo éstos desataron la Segunda Gran Contracción del sistema financiero. Por lo tanto, el objetivo de este capítulo es establecer la conexión entre crédito excesivo y la formación de la burbuja que originó la Gran Recesión.

Por otra parte, la crisis financiera hizo necesaria la intervención de bancos centrales y gobiernos para salvar el sistema financiero. Lo cual a la vez, dañó las finanzas públicas e hizo evidente los insostenibles niveles de deuda en que incurrieron los gobiernos en el pasado. Los inversionistas están dejando de ver a los grandes gobiernos Occidentales como esencialmente libres de riesgo y, por lo tanto, están demandando mayores tasas de interés para ofrecerles crédito. En algunos casos particularmente alarmantes como Grecia, Irlanda y Japón, no será necesario un incremento pronunciado de las tasas de interés para que sus presupuestos sean consumidos enteramente por los pagos de intereses sobre la deuda.

Esto nos lleva al principal problema económico mundial al momento de escribir: la crisis del Euro. Es increíble que un país pequeño e irrelevante como Grecia comenzara la peor crisis en Europa desde la Segunda Guerra Mundial. El sueño europeo de integración y su moneda común están amenazados. Dos años luego del comienzo de la crisis el llegar a una solución aún es una meta lejana. El sistema democrático es tan disfuncional que tomar decisiones difíciles pero necesarias es casi "misión imposible". Europa y EEUU están atrapados en una parálisis política que pone en peligro la recuperación económica y daña la confianza en la capacidad del gobierno de hacer lo necesario para asegurar la estabilidad económica y financiera.

¿Podrían los niveles de deuda, finanzas públicas pobres y parálisis política acelerar el Ocaso de Occidente? Esta es una pregunta fundamental para el futuro del orden mundial. El objetivo en este caso es determinar si la Gran Recesión y la Crisis del Euro afectaron la condición hegemónica de Occidente. Para alcanzar este objetivo el capítulo dos analizará la situación económica y política actual en EEUU y también el rol de la Reserva Federal en su papel de banco central mundial de facto. Luego realizaré un profundo análisis de la crisis del Euro y, a continuación, finalizaré con una descripción de las circunstancias y hechos que hacen pensar a muchos que el Ocaso de Occidente es un fenómeno muy real en marcha.

Por otra parte, las reformas económicas llevadas a cabo por los tres mercados emergentes principales China, India y Brasil han producido un crecimiento económico tan alto que su papel en el sistema internacional ya no puede ignorarse. El principal país emergente es China, ya la segunda economía del mundo. Para muchos, este es el país que sucederá a los EEUU como el principal poder económico del mundo. Un "Siglo Asiático" está en marcha. Por otra parte, Brasil no puede ser ignorado. Este es un país que, de acuerdo a algunos estudios, ya es la quinta economía mundial, y al mismo tiempo es el único país en América Latina con verdadera proyección internacional.

Pero por supuesto no todo es crecimiento económico. Estas tres naciones enfrentan grandes desafíos en su camino de economías emergentes a desarrolladas. Siendo el principal la implementación de más reformas estructurales de acuerdo a los cambios producidos en años recientes. Las

principales amenazas que enfrentan son la inflación, corrupción y una desaceleración económica en el mundo desarrollado que podría dañar su situación económica, lo que a su vez produciría malestar social.

¿Produjo la Gran Recesión un cambio en el balance de poder económico hacia los grandes mercados emergentes, haciéndolos los nuevos centros de decisión y supremacía política? Para responder a esta pregunta, en el capítulo tres resaltaré el camino seguido por China, India y Brasil para convertirse en las nuevas estrellas de la economía mundial y de Wall Street. El objetivo en este caso es determinar cuales fueron las condiciones y principales reformas que ayudaron a convertir a estos países en potencias económicas, sacar a millones de la pobreza y ser los nuevos actores que están transformando el orden internacional.

Durante el desarrollo de los capítulos busco conseguir el objetivo general de analizar la nueva realidad económico-financiera luego de la Gran Recesión estableciendo los principales impactos en EEUU, Europa y los tres mercados emergentes más importantes: China, India y Brasil. Esto se logrará contestando a las preguntas de investigación y a los objetivos específicos que ya fueron señalados.

De esta manera, la hipótesis de trabajo queda claramente establecida: La severidad de la Gran Recesión creó una nueva realidad económico-financiera para las diferentes regiones del mundo, severidad que a la vez habría debilitado el sistema democrático de Occidente y deteriorado severamente los niveles de deuda y las cuentas públicas de EEUU y varios países del Sur de Europa, lo que habría tenido como consecuencia un cambio de los centros de poder económico y político hacia los mercados emergentes, principalmente China, gracias a la implementación de reformas estructurales radicales que permitieron alto crecimiento económico y saludables cuentas públicas.

Como dijo Jeffrey Immelt, el CEO de General Electric, en 2008: “Esta crisis económica no representa un ciclo, sino un reinicio emocional, social y económico. Quienes entiendan eso prosperarán, aquellos que no lo hagan serán dejados atrás”. Esta frase refleja cual es mi motivación para hacer este trabajo de grado. Nuestra generación enfrenta un desafío colosal y de acuerdo

a como lo hagamos frente dependerán las oportunidades de las futuras generaciones. Es fundamental entender que no hay posibilidad de cambio profundo sin sufrimiento y crisis. Cuando trasladamos este concepto filosófico a la economía tenemos el proceso de “destrucción creativa”.

Las diferentes economías del mundo requieren procesos donde lo obsoleto sea destruido para dejar lugar a lo nuevo. Mucho depende de saber manejar este proceso con eficiencia. En la medida en que lo que no funciona se deje morir, capital será liberado para financiar la creación de nuevos negocios e industrias. En cierta forma, cuando analizamos esta crisis y tratamos de anticipar cómo mutará, lejos de implicar una actitud pesimista, esta ofrece la perspectiva más positiva posible: aquella en que finalmente entenderemos las causas y veremos mejor las situaciones incoherentes que se han estado desarrollando lentamente como un tumor maligno que imperceptiblemente crece hasta hacer metástasis y poner en peligro a todo el organismo.

Por lo tanto, la contribución de este trabajo de grado es ayudar a entender mejor lo que está detrás de la mayor crisis económica desde la Gran Depresión, cómo la Gran Recesión esta cambiando el orden mundial con nuevos poderes surgiendo y el antiguo *status quo* aparentemente llegando a su fin. Quiero que se vuelva más evidente que la actividad financiera es la fuerza que mueve al mundo y cómo, cuando se abusa de las finanzas, el sistema económico puede colapsar. Por otra parte, espero que el lector pueda apreciar que un período de crisis no es necesariamente algo negativo. Es mejor verlo como una oportunidad para el cambio. Si tomamos ventaja del mismo saldremos más fuertes y mejor preparados para hacer frente a un mundo cambiante. Sino, la crisis creará otra aún peor con un potencial devastador.

Finalmente, la delimitación temporal para este trabajo de grado es el período 2008-2011 ya que estos fueron los años en que la Gran Recesión golpeo a la economía mundial. Escogí los casos de EEUU, Europa y los mercados emergentes más importantes: China, India y Brasil; pues estos son los principales actores mundiales cuyas condiciones económicas afectan al mundo entero y cuyas circunstancias actuales nos dan una idea clara de hacia dónde se dirige el Sistema Internacional en los próximos años.

CHAPTER I THE FINANCIAL CRISIS THAT CHANGED HISTORY

History is a record of "effects" the vast majority of
which nobody intended to produce.
- Joseph Schumpeter (1939)

The majority of economists, when they think about the Great Depression, consider that it was an unnecessary tragedy. If only Herbert Hoover hadn't tried to balance the budget during an economic downturn, if only the Federal Reserve had injected liquidity to the banks in trouble and calm down the bank panic, then the stock market drop of 1929 would have caused only a small recession that soon would have been forgotten. And, since the economist and policy makers had learned their lesson, nothing like the Great Depression could happen again. Or could it?⁵

In the fall of 2008, the US suffered a devastating economic collapse. Once valuable securities lost most or all of their value, debt markets froze, stock markets plunged and storied financial firms went under, millions of people lost their jobs, millions of families lost their homes, and good businesses shut down. These events cast the United States into an economic recession so deep that the country has yet to fully recover. It is now universally recognized as the worst economic crash since the Great Depression.⁶

The Great Recession was preceded by a whole series of lesser economic shocks, of growing magnitude, over the last two decades, most notably: the US stock market crash of 1987, the savings and loan crisis of the late 1980s and early '90s, the Japanese financial crisis and Great Stagnation of the 1990s, the Asian financial crisis of 1997-1998, and the New Economy (dotcom) crash of 2000. Yet the Great Financial Crisis has far outreached them all. Both the US economy and the economy of the world as a whole are in a state of deep decline, facing what is likely to be a prolonged stagnation.⁷

The world economy is not in depression right now and it probably won't fall in one despite the magnitude of the current crisis. Nevertheless, even

⁵ Cfr. KRUGMAN Paul, *De Vuelta a la Economía de la Gran Depresión y la Crisis del 2008*, Grupo Editorial Norma, First Edition, Bogota, 2009, p. 13

⁶ SENATE SUBCOMMITTEE ON INVESTIGATIONS, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, <http://es.scribd.com/doc/53174301/Anatomy-of-a-Financial-Collapse>, Access: September 4th 2011, 20:17.

⁷ BELLAMY John, MAGDOFF Fred, *The Great Financial Crisis: Causes and Consequences*, Monthly Review Press, First Edition, New York, 2009, p. 11

though depression itself had not returned, depression economics, meaning the kind of problems that characterized the 1930s, has made a sensational return. Fifteen years ago, no one believed that developed economies could endure severe economic contractions due to a financial collapse or that they will have to face painful austerity measures. The world economy turned out to be a much more dangerous place than we thought.⁸

Why did the world become such a dangerous financial place? In the following chapter I will try to answer this question. We are going to see that not only economic and financial circumstances were behind the Great Financial Crisis but also politics, imbalances and people culture.

IMAGE 1
WALL ST. CHASHES THE ECONOMY



Source: The Financial Times.
Made by: Ingram Pinn

⁸ Cfr. KRUGMAN Paul, *De Vuelta a la Economía de la Gran Depresión y la Crisis del 2008*, op. cit. 187

1.1. The Downfall of Lehman Brothers and the beginning of a systemic crisis.

1.1.1. Income and credit.

Credit is the brain of the capitalist system. It is a financial resource that can help people and companies to create wealth. Credit is deeply related to an open market economy, but when something goes wrong and credit disappears, the whole system is at risk of being completely and swiftly destroyed.⁹

One of the main fault lines that helped to create the financial bubble that almost caused a Depression is the abuse of the important tool of credit. The main reason for this abuse is the rising income inequality in the United States and the political pressure it has created to give easy credit. Incomes of those at the very top have gone up. The top 1 percent of households represented only 8.9 percent of income in 1976, but this share grew to 23.5 percent of income generated in the United States in 2007. In other words, of every dollar of real income growth that was generated between 1976 and 2007, 58 cents went to the top 1 percent of households. As an example, in 2007 the hedge fund manager John Paulson earned \$3.7 billion, about 74,000 times the median household income in the United States.¹⁰

Different factors are responsible for this growing differential. Perhaps the most important is that, although in the United States technological progress requires the labor force to have more and more skills, the education system has been unable to provide enough of the labor force with the necessary education. And as a result, the middle class receives a stagnant paycheck as well as growing job insecurity. Politicians feel their constituents' pain, but it is really hard to improve the quality of education overnight. Moreover, any real change will require years to take effects and therefore it will not address the current anxiety of the electorate.¹¹

The term education has been used so far when referring to employability, but a better term is human capital, which refers to the broad set of capabilities, including health, knowledge and intelligence, social aptitude, and empathy that make a person a productive member of society. Formal education

⁹ Cfr. ROSS, Andrew, *Too Big to Fail*, Penguin, New York, First edition, 2009, p.230

¹⁰ Cfr. ANDERSON J., *Wall Street Winners Get Billion-Dollar Paydays*, www.nytimes.com/2008/04/16/business/16wall.html, Access: August 10th 2011, 15:21

¹¹ Cfr. RAJAN, Raghuram, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, Princeton, First edition, 2010, p. 31

plays perhaps the most important role in forming an individual's human capital. But education is not only important in income or career terms, but studies show that educated people typically take better care of their own health, are less prone to criminal activities, and are more likely to participate in civic and political activities. And what is more important, they influence their children to do the same. So their education has beneficial effects on future generations as well. Therefore as it falls behind in education, the United States is diminishing the quality of its society.¹²

Paul Krugman's opinion about inequality points out that, in seeking explanations for the widening spread of incomes since the 1970s, researchers have focused overwhelmingly on broad structural changes in the economy: in particular, technological change, demographic shifts, and the rise of "winner-take-all" or "superstar" markets. But Krugman argues that these structural explanations are insufficient. Instead, or at least in addition, he points the finger at politics. For example: progressives, no doubt, attribute substantial weight to the growing income inequality to the antilabor policies followed by Republican governments since Ronald Reagan, whereas conservatives attribute much of the earlier wage compression to anticompetitive policies followed since Franklin Roosevelt. Neither side would, however, deny the importance of differential educational skills in affecting inequality.¹³

Other reasons for the increase of income inequality are: the increasing competition in the market that intensifies the demand for talented workers, which increases the dispersion of wages within any segment of the population. Also, the implementation of deregulation policies can lead to more entry and exit of firms, which increases the volatility of each worker's earnings. These effects may account for up to one-third of the increase in measured inequality.¹⁴

The *Newsweek* columnist Robert Samuelson has argued, "on the whole, Americans care less about inequality, the precise gap between the rich and the poor, than about opportunity and achievement". They feel that they have the possibility to be better off than the previous generation thanks to the

¹² Cfr. Ibid. p. 71

¹³ Cfr. BRINK, Linsey, *Nostalgianomics: Economic Policies, Social Norms and Income Inequality*, <http://www.cato.org/pubs/wtpapers/Nostalgianomics.pdf>, p. 4, Access: August 27th 2011, 15:40.

¹⁴ Cfr. GOTTSCHALK, Peter, *The Growth of Earnings Instability in the US Labor Market*, http://www.brookings.edu/~media/Files/Programs/ES/BPEA/1994_2_bpea_papers/1994b_bpea_gottschalk_moffitt_katz_dickens.pdf, p.225, Access: August 28th 2011, 16:53.

opportunities that their country can give them. But if Americans no longer have the chance to be upwardly mobile, they are less likely to be optimistic about the future or to be tolerant of the mobility of others.¹⁵

Many have lost faith in the idea of America as the land of great opportunity, which in the past created the public support that made the United States a bastion of economic freedom. Politicians, always sensitive to their constituents, have responded to these worrisome developments with an attempt at a panacea: facilitating the flow of easy credit to those left behind by growth and technological progress.¹⁶

The deregulation and rapid expansion of banking in the United States in the early years of the twentieth century was in many ways a response to the Populist movement, backed by small and medium-sized farmers who found themselves falling behind the growing numbers of industrial workers so they demanded easier credit. Excessive rural credit was one of the important causes of bank failure during the Great Depression.¹⁷

In the United States it has been truth for a long time that it is not income that matters but consumption. So, if somehow the consumption of middle-class householders keeps going up, if they are able for example to afford a new big car every few years and the occasional big holiday in an exotic destination, perhaps they will pay less attention to their stagnant monthly paychecks, to a society marked by increasing inequality, or to a country where, though there are dramatic exceptions, the statistical chances of a poor American making it to the top are lower than in “Old Europe”. By all accounts, several of the key economic sectors in the US besides finance are in trouble, including health, energy, and manufacturing.¹⁸

Since the early 1980s, the most attractive answer to face the constituent’s income problems, as previously said, has been easier credit. In some ways it is the path of least resistance. It does not generate so much confrontation on ideological criteria like taxation and redistribution. Politicians

¹⁵ Cfr. SAMUELSON, Robert, *Indifferent to Inequality?*, <http://www.thedailybeast.com/newsweek/2001/05/06/indifferent-to-inequality.html>, Access: August 27th 2011, 16:20.

¹⁶ Cfr. Id.

¹⁷ Cfr. RAJAN Raghuram, op. cit. 64.

¹⁸ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, W.W. Norton&Company, New York, First Edition, 2010, p.19.

love to have banks expand housing credit, since credit achieves many goals at the same time. It pushes up house prices, making households feel wealthier, and allows them to finance more consumption. It creates more profits and jobs in the financial sector as well as in real estate brokerage and housing construction. And everything is safe, as safe as houses at least for a while.¹⁹

Easy credit has large, positive, immediate, and widely distributed benefits, whereas the costs lie in the future. The problem in the United States is that politicians found a way around regulatory structures, and eventually public support for housing credit was so widespread that few regulators, if any, dared to oppose it. But when easy money encouraged by a deep-pocketed government comes into contact with the profit motive of a sophisticated and competitive financial sector, a deep fault line develops.²⁰

1.1.2. Subprime Lending and Securitization

Almost since the phrase “The American Dream” was coined in the early 1930s, it has been synonymous with homeownership. An aspiration that is not so widely present in other countries but that in the case of the US is something the vast majority of Americans aspire to. It represents upward mobility, opportunity, being a part of something that matters. So, not surprisingly, government policy in the US has long encouraged homeownership, with policies implemented with that aim having solid bipartisan support. Criticizing them was political heresy.²¹

Two very important agents for the implementation of the housing related policies were two government-sponsored enterprises. The first of them was Fannie Mae, born during the Great Depression. In 1968, Fannie was split into two companies, one nicknamed Ginnie Mae (later called Freddie Mac). Fannie and Freddie did two things to fulfill their mandate of supporting housing finance: they bought mortgages that conformed to certain size limits and credit standards, therefore allowing the banks they bought from to go out and make

¹⁹ Cfr. RAJAN Raghuram, op. cit. 84.

²⁰ Cfr. Ibid. 32.

²¹ Cfr. MCLEAN Bethany, NOCERA Joe, *All the Devils are Here: The Hidden History of the Financial Crisis*, Portfolio Penguin, First Edition, New York, 2010, p. 29.

more mortgage loans. The agencies then packaged pools of loans together and issued mortgages backed securities^{22 23}

Later on, they also started borrowing directly from the market and investing in mortgage-backed securities underwritten by banks. Because the mortgages were sound, these were fairly safe and extremely profitable activities. But much of the profit came from their low cost of financing, coming from the implicit government guarantee²⁴. All this led us to a surprising fact: it was the government, not Wall Street that first securitized modern mortgages.²⁵

The main problem for many potential homebuyers was the lack of cash available to accumulate the required down payment and closing cost to purchase a home. So during the Clinton administration, in an attempt to expand homeownership and the middle class, the idea was that the financial sector should find creative ways of getting people who could not afford homes into them, and the government would help or push wherever it could.²⁶

In 2000, the Clinton administration dramatically cut the minimum down payment required for a borrower to qualify for an FHA²⁷ guarantee to 3 percent, increasing the maximum size of the mortgage it would guarantee, and reduced the premiums it charged borrowers for the guarantee. All these actions set the stage for a boom in low-income housing construction and lending.²⁸

According to the Wall Street Journal, total household debt in America doubled, from 7 trillion to 14 trillion between 2000 and 2007. Debt related to housing was responsible for 80 percent of that increase. In the following figure we can see the increase of exposure from government agencies to subprime and Alt-A²⁹ lending.

²² NB. A security is a general term for stocks, bonds, options, subscription rights, warrants and other tradable investments that confer a right to income or ownership. Commodities and foreign exchange are not included under this term. Also, the collateral that is pledged to secure a loan.

²³ NB. This is a term used in Washington to refer to Fannie Mae and Freddie Mac. They were half government Enterprise, with the mandate from Congress to make housing more available to low and middle-income Americans, and half private enterprise; it had shareholders, a board of directors, and the structure of a typical corporation.

²⁴ Cfr. RAJAN Raghuram, op. cit. 92.

²⁵ Ibid. p.33

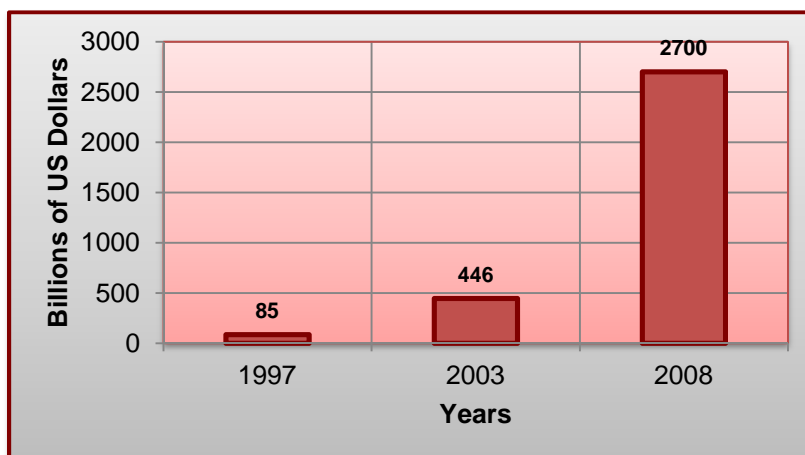
²⁶ Id.

²⁷ NB. The Federal Housing Administration (FHA) is a United States government agency created as part of the National Housing Act of 1934. It insured loans made by banks and other private lenders for home building and home buying. The goals of this organization are to improve housing standards and conditions, provide an adequate home financing system through insurance of mortgage loans, and to stabilize the mortgage market.

²⁸ Cfr. RAJAN Raghuram, op. cit. 94.

²⁹ NB. An Alt-A mortgage, short for Alternative A-paper, is a type of U.S. mortgage that, for various reasons, is considered riskier than A-paper, or "prime", and less risky than "subprime," the riskiest category

FIGURE 1
THE MORTGAGE GIANTS AND THE FHA EXPOSURE TO
SUBPRIME AND ALT-A LENDING



Source: American Enterprise Institute
Made by: Germán Guerra Silva.

And of course, housing prices themselves were going through the roof, which both enabled and exacerbated everything else. Since 1940, according to data compiled by the S&P Case-Shiller Home Price index, the average home increased in value was 0.7% a year. But between 2001 and 2006, fourteen of the twenty largest metropolitan areas in the U.S. saw home values rise by more than 10 percent a year. Median home prices in hot areas like Phoenix and Las Vegas increased by an inflation-adjusted 80 percent.³⁰

Unfortunately, the private sector, assisted by agency money, converted the good intentions behind the affordable-housing mandate and the push to an ownership society into a financial disaster. But for a while, the problems were hidden by growing house prices and low defaults, easy credit masked the problem caused by easy credit, until house prices stopped rising and the flood of defaults started.³¹

The main tool used by the financial industry to ensure that more and more credit could go into the financial market and mainly to low-income families was securitization. Securitization was introduced into the world of finance in the 70s. It is a process that would become so commonplace on Wall Street that in time it would be used to package not just mortgages but auto loans, credit card loans, commercial loans, etc. The process is called “securitization” because, as

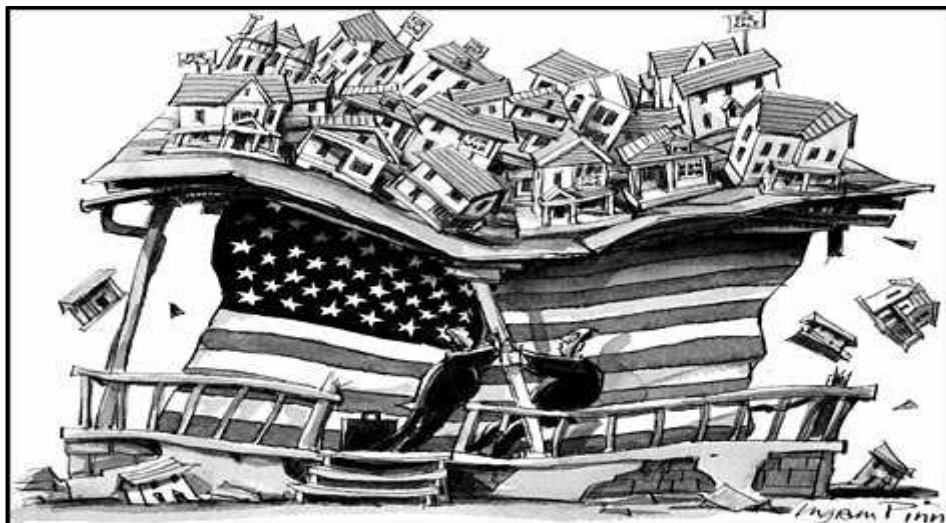
³⁰ KEDROSKY Paul, *Infectious Greed: Finance and the Money Culture*, <http://paul.kedrosky.com/>, Access: August 29th 2011, 20:32.

³¹ Cfr. Id.

described at the time, it was a technology that in essence enables to convert a mortgage into a bond, and that is “security”.³²

Securitization allowed a bank to package its risky housing or credit card loans together and sell claims on the package in the financial market, according to the level of risk appetite. It allowed a bank to get the risky loans off its books. At the same time, it permitted long-term investors, such as pension funds and insurance companies, to take on a small portion of the risky claims that they, by virtue of having longer horizons and holding a diverse portfolio of other assets, could hold more easily than the bank. In theory, the risk was better spread across the financial system. Which in due time proved to rather make it alarmingly more risky and unstable.³³

IMAGE 2 SUBPRIME MELTDOWN



Source: The Financial Times.
Made by: Ingram Pinn

Greed replaced fear, as it always does in a bubble. Here came into play another tool that proved to be, as Warren Buffet once said, “weapons of mass destruction”. These “weapons” are CDOs (collateralized debt obligations). CDOs, which had first been invented in the late 1980s but didn’t become wildly popular until the 2000s, were a kind of asset-backed securities on steroids. A CDO is a collection of just about anything that generates yield: bank loans, junk bonds, emerging market debt, etc. The higher the yield, the better. One

³² Cfr. MCLEAN Bethany, NOCERA Joe, op. cit. 28.

³³ Cfr. RAJAN Raghuram, *Has Financial Development Made the World Riskier?*, <http://www.kc.frb.org/publicat/sympos/2005/pdf/rajan2005.pdf>, p. 10, Access: August 30th 2011, 12:08.

astonishing fact is that the CDO managers didn't always have to disclose what the securities contained because those contents could change. When done correctly they could give investors broad exposure to different kinds of fixed-income assets at whatever level of risk they desired.³⁴

Initially, CDOs were backed by corporate loans, but later they were backed by mortgage-backed securities. One of the main things that CDOs provided was a good credit rating, in this way, the CDO machinery became the buyer of an infinite supply of triple-Bs rated bonds and then repackaged them into triple-A securities that everybody could then buy, banks and pension funds included.³⁵

Wall Street was both making the loans on which the subprime companies depended on and then buying up their mortgages and securitizing them. The Wall Street firms, in fact, were dictating what kind of mortgages they would buy and at what price. They wanted the riskiest subprime mortgages they could get their hands on, because those were the mortgages that generated the most yield. At the end, all this financial innovation led to the collapse of one of the oldest investment banks in the US, the infamous Lehman Brothers.³⁶

1.1.3. The end of Lehman Brothers.

Easy credit, as is typically the case, proved an extremely costly way to redistribute. Too many poor families, who should have never been persuaded to buy a house, have been evicted after losing their small savings and now are homeless. Too many houses have been built that will not be lived in and too many financial institutions have incurred enormous losses that the American taxpayer will have to absorb for years to come. These losses started when the housing market began a correction that many economists had predicted would happen sooner or later and that will be really nasty and severe.³⁷

Not far from the predictions of those experts, the correction in housing prices started, marking the beginning of an earthquake in the financial system.

³⁴ Cfr. MCLEAN Bethany, NOCERA Joe, op. cit. 182.

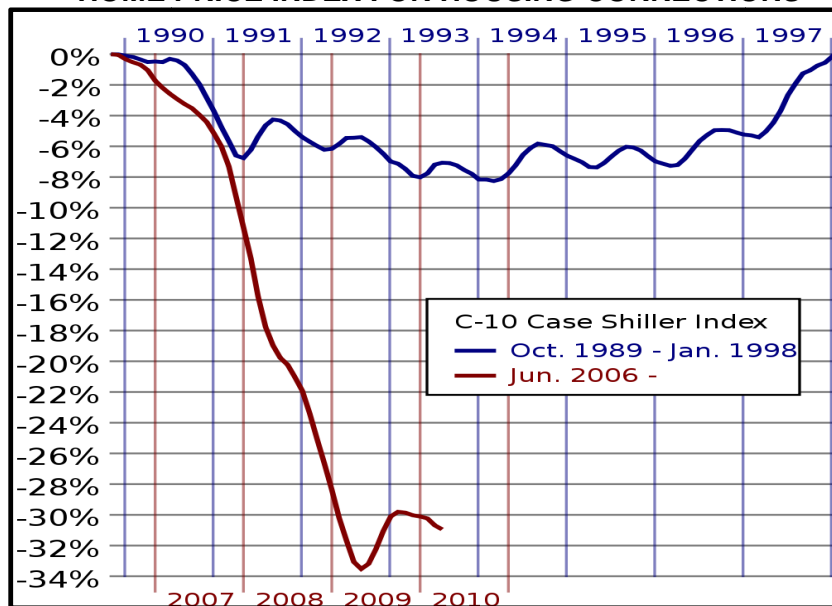
³⁵ Cfr. LUCAS Douglas, *Collateralized Debt Obligations and Credit Risk Transfer*, <http://www.usdrinc.com/downloads/Collateralized-Debt-Obligations.pdf>, p. 7, Access: August 30th 2011, 12:31.

³⁶ Cfr. CONNOR Kevin, *Wall Street and the Making of the Subprime Disaster*, http://showdowninamerica.org/files/wall_street_making_subprime_disaster.pdf, p. 6, Access: August 30th 2011, 13:11.

³⁷ Cfr. RAJAN Raghuram, op. cit. 103.

In March 2007, the United States' sub-prime mortgage industry collapsed due to higher-than-expected home foreclosure rates, with more than 25 sub-prime lenders declaring bankruptcy, announcing significant losses, or putting themselves up for sale.³⁸ The first big investment bank on Wall Street to be hit by huge losses was Bear Stearns.

FIGURE 2
COMPARISON OF THE % CHANGE IN THE CASE-SHILLER HOME PRICE INDEX FOR HOUSING CORRECTIONS



Source: The S&P/Case-Shiller Home Price Indices
 Made by: S&P Case-Shiller

On March 16th 2008, Bear Stearns was swallowed by J.P. Morgan Chase. On the final deal the shares were worth \$2. What is really astonishing is how fast Bear's collapse was. It took only a few days, a rising sense of panic and a critical e-mail where Goldman Sachs³⁹ told clients it would no longer step in for them on Bear derivatives deals, to provoke the end of the 85-year-old investment bank. That's a reminder that in a business based on confidence, when that confidence evaporates, so does the business.⁴⁰

Another old investment bank that discovered how devastating it can be when the confidence of the financial markets is lost was Lehman Brothers. It was a 158-year-old Wall Street institution that was among the leading

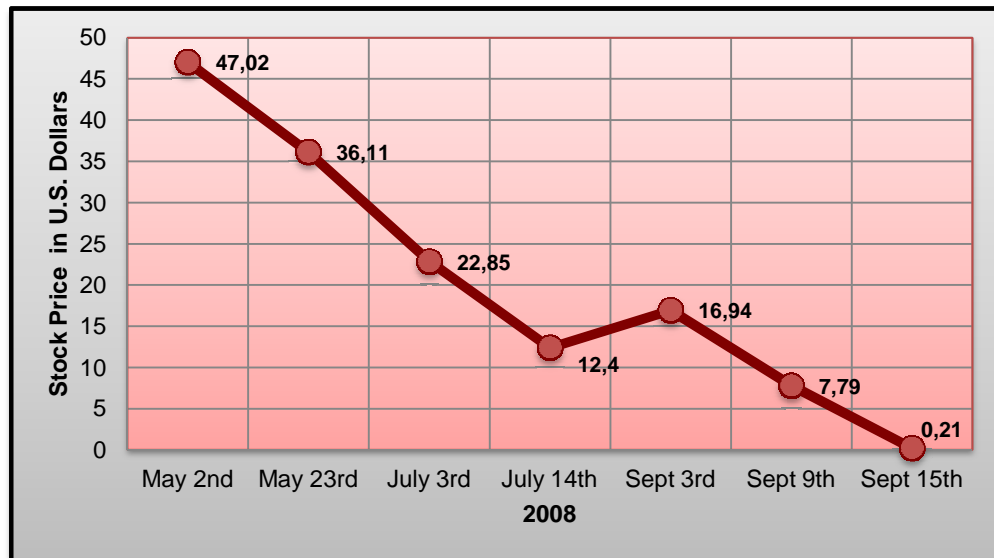
³⁸ Cfr. BLOOMBERG BUSINESSWEEK, *The Mortgage Mess Spreads*, http://www.businessweek.com/investor/content/mar2007/pi20070307_505304.htm?chan=rss_topStories_ssi_5, Access: August 30th 2011, 20:15.

³⁹ NB. Goldman Sachs is the biggest and most important investment bank in the world.

⁴⁰ Cfr. CNN MONEY, *The last days of Bear Stearns*, http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/, Access: August 30th 2011, 21:10

underwriters of mortgage-backed securities and was left with large holdings after the subprime crisis reduced investor appetite for the fixed income products. Its share price collapsed during the fall of 2008, after large write-downs on the bank's troubled mortgage portfolio.⁴¹

**FIGURE 3
LEHMAN BROTHERS STOCK PRICE DECLINE**



Source: Financial Times Market Data.
Made by: Germán Guerra Silva.

Lehman's management came under fire from investors and short-sellers⁴² after announcing a \$2.8bn second-quarter loss due to credit-related writedowns. Lehman chief Dick Fult (with a bonus of \$10 million)⁴³, expanded the bank's operations and built up its asset management and equities operations to balance its powerhouse of bond trading.⁴⁴

The stressed bank revealed in August 2008 to be holding exploratory talks with a variety of private-equity and strategic bidders about selling all or part of its asset management arm, a move that it had long resisted, as it sought to replenish its balance sheet. In the following chart we can see the final moments of Lehman Brothers before its collapse.⁴⁵

⁴¹ Cfr. THE FINANCIAL TIMES, *The end of Lehman Brothers*, http://www.ft.com/intl/cms/s/0/2c0c5d82-8344-11dd-907e-000077b07658,dwp_uuid=5e34aac4-8ae9-11dd-b634-0000779fd18c.html#axzz1Vi5cdLZZ, Access: August 30th 2011, 20:20

⁴² NB. A short sale is a trading strategy aimed at taking advantage of an expected fall in prices. An investor, normally via a broker, sells shares that are not actually held but have been borrowed from another investor or broker. This process is called short selling, selling short or shorting.

⁴³ Cfr. CONNOR Kevin, op. cit. 109

⁴⁴ Cfr. THE FINANCIAL TIMES, *The end of Lehman Brothers*, op. cit.

⁴⁵ Cfr. Id.

CHART 1
THE LAST DAYS OF LEHMAN BROTHERS

Sep-09	Sep-10	Sep-11	Sep-12
<ul style="list-style-type: none"> ● Lehman shares fell by 45%, sparked by a report that Korean Development Bank decided to pull out of talks to take a 50% stake in Lehman Brothers 	<ul style="list-style-type: none"> ● Korea Development Bank confirms it has pulled out of talks with Lehman. ● Lehman announces a third-quarter loss of \$3.9bn. ● Standard & Poor's warns it might downgrade the bank's single A credit rating 	<ul style="list-style-type: none"> ● Shares in Lehman plunge a further 40.8%. ● The cost of credit insurance for Lehman rises as high as 805 basis points. ● Several banks, including Bank of America and Barclays, are in talks to bid for Lehman. 	<ul style="list-style-type: none"> ● Top Wall Street executives meet to discuss ways to resolve the crisis. ● The Fed and the Treasury signal that the government would not use taxpayer money to facilitate a takeover of Lehman.
Sep-13	Sep-14	Sep-15	Sep-16
<ul style="list-style-type: none"> ● Discussions continue, and broaden to include problems associated with other institutions such as AIG 	<ul style="list-style-type: none"> ● Barclays abandons a potential rescue deal. ● Wall Street dealers hold an unprecedented emergency trading session ● Bank of America abandons Lehman talks, agrees to buy Merrill Lynch for \$50bn. 	<ul style="list-style-type: none"> ● Lehman officially files for bankruptcy. ● AIG stocks plummet. ● New York State insurance regulators allow AIG to access \$20bn of its own capital to avoid a liquidity crisis and credit downgrades. 	<ul style="list-style-type: none"> ● Barclays reaches a deal to buy selected parts of Lehman Brothers

Source: Financial Times
Made by: Germán Guerra Silva.

Lehman displayed confusion and ambiguity about how to address the credit crisis that was spreading across Wall Street that year. The filing marked the largest bankruptcy in U.S. history,⁴⁶ and marked the beginning of the financial crisis that caused the Great Recession. On September 20th, 2008 a revised version of the Barclays agreement was approved by the US Bankruptcy Court. The following week, Nomura Holdings announced that it would acquire Lehman Brothers' franchise in the Asia-Pacific region, including Japan, Hong Kong and Australia, as well as Lehman Brothers' investment banking and equities businesses in Europe and the Middle East. The deal became effective on October 13th, 2008.⁴⁷

1.2. From International Financial Crisis to Global Economic Meltdown.

1.2.1. Impact of the Financial Crisis on the Economy.

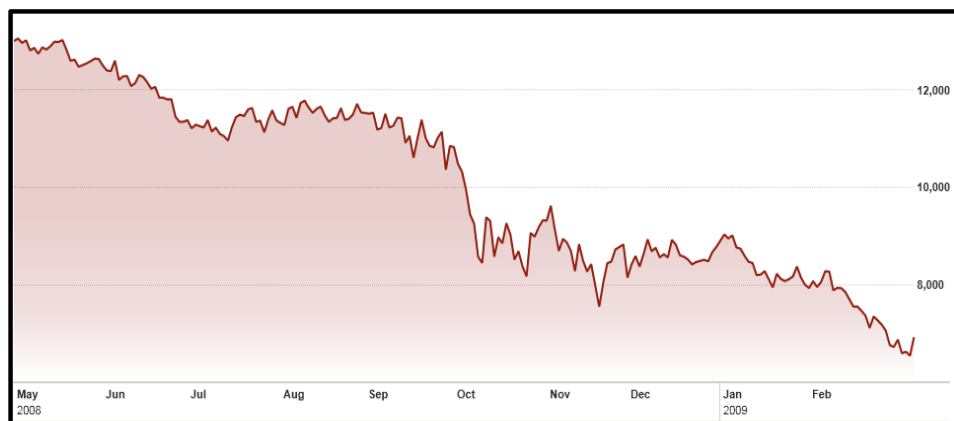
⁴⁶ MARKETWATCH, *Lehman folds with record \$613 billion debt*, <http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss>

⁴⁷ NOMURA HOLDING, *Nomura to close acquisition of Lehman Brothers' Europe and Middle East investment banking and equities businesses on October 13*, http://www.nomuraholdings.com/news/nr/europe/20081006/20081006_a.html, Access: August 31st 2011, 09:24.

A dramatic turning point in the crisis was the American stock market drop after the Lehman collapse, followed by steep drops on exchanges in London, Paris, Frankfurt, Shanghai, Tokyo and other smaller financial centers. This spread was partly a function of the remarkable degree of interdependence between international stock markets.⁴⁸

In a world in which traders can instantaneously track movements in markets halfway across the globe, investor sentiment can easily spill over from one exchange to the other. The stock market became the medium through which investors registered their growing aversion to risk, by dumping equities⁴⁹ for less risky assets.⁵⁰

FIGURE 4
DOW JONES INDUSTRIAL AVERAGE FALL FROM
MAY 2008 TO MARCH 2009



Source: Financial Times Market Data
Made by: Germán Guerra Silva

The stock market decline got really ugly after the U.S' Congress initially rejected a \$700 billion bank bailout plan. The Monday after the Lehman collapse, approximately \$1.2 trillion in market value was gone with the Dow Jones drooping nearly 778 points, in the biggest single-day point loss ever.⁵¹ From that day on, the world stock markets started a downturn that will last till March 2009 when it hit its lowest point.

⁴⁸ Cfr. ROUBINI Nouriel, MIHM Stephen, *Crisis Economics: A Crash Course in the Future of Finance*, The Penguin Press, New York, First Edition, 2010, p. 153.

⁴⁹ NB. Equity is a stock or any other security representing an ownership interest

⁵⁰ Cfr. Id.

⁵¹ CNN MONEY, *Stocks crushed*, http://money.cnn.com/2008/09/29/markets/markets_newyork/index.htm, Access: September 3rd 2011, 12:23

**FIGURE 5
DROP FROM OTHER WOLD STOCK INDEXES FROM
MAY 2008 TO MARCH 2009**



Source: Financial Times Market Data
Made by: Germán Guerra Silva

The U.S. economy is still the largest in the world, and it is hard for a downturn of this magnitude not to have a global impact. Moreover, global financial markets have become closely interlinked. When the bubble behind the mortgages securities popped, investors in the United States, Britain, France, and elsewhere simultaneously saw their portfolios go up in smoke. Invariable, they cut credit, stored cash, and triggered panic.⁵²

The crisis quickly became global, and not surprisingly, as nearly a quarter of U.S. mortgages had gone abroad. It was a classic case of contagion, in which the banking system served as the conduit for the US' subprime virus. In the end, the United States also exported its recession.⁵³

In October 2008, the economy of the United States was in freefall, poised to take down much of the world economy with it. This economy had stock market crashes, credit crunches, housing slumps, and inventory adjustments before. But not since the Great Depression had all of these come together. At that point, the US and the world were faced with both a financial crisis and an economic crisis.⁵⁴

⁵² ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit.151.

⁵³ Cfr. POUNDER Laurie, THOMAS Charles, *Foreign Exposure to Asset-Backed Securities of U.S. Origin*, <http://www.federalreserve.gov/pubs/ifdp/2008/939/ifdp939.pdf>, p. 25, Access: September 3rd 2011, 15:23.

⁵⁴ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit. 35.

The economic crisis had several components: there was an unfolding residential real estate crisis, followed not long after by problems in commercial real estate. Demand fell, as households saw the value of their houses (and, if they owned shares, the value of those as well) collapse and their ability and willingness to borrow diminished. There was an inventory cycle, as credit markets froze and demand fell, companies reduced their inventories as quickly as possible. There was also the collapse of American manufacturing.⁵⁵

What overseas investors called the “Lehman Shock” spread fear throughout global money markets, curtailing lending and eventually hitting global trade. When the U.S. fell in a severe recession, the effects echoed around the world, in countries as various as Mexico, Canada, China, Japan, Thailand, and the Philippines. China was particularly at risk, as much of its recent growth had depended on exports to the United States. Thousands of Chinese factories closed, and employees returned from urban to rural areas, casualties of a collapse half a world away.⁵⁶

Global trade came close to a standstill. The collapse of global trade that began with the U.S. recession and intensified with the demise of Lehman Brothers was unprecedented: only the Great Depression can compare. At the peak of the crisis in early 2009, exports fell, on a year-over-year basis, by 30 percent in China and Germany, and by 37 or even 45 percent in Singapore and Japan. All these countries but China slipped into a severe recession, and even China saw a dramatic collapse in its annual economic growth from 13 percent to approximately 8 percent, below the level of what’s considered sustainable in that country.⁵⁷

Finally, the crisis spread along paths taken not only by goods but by people too. As the United States plunged into recession, migrant workers stopped sending money back to their home countries: Mexico, Nicaragua, Guatemala, Colombia, Ecuador and the Philippines, to name a few gained regular work during the housing booms, not only in the United States, but in Spain and Dubai, and when these booms became busts, remittances back

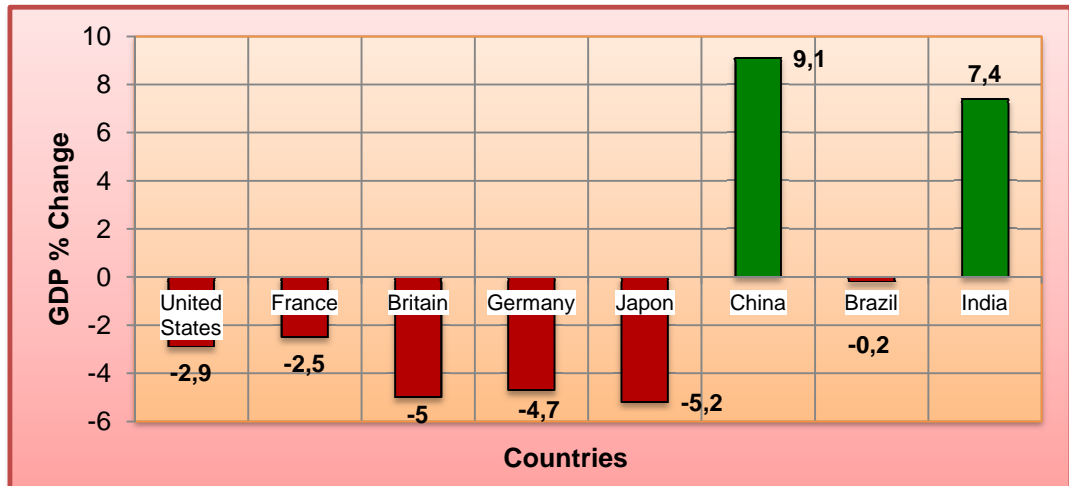
⁵⁵ Cfr. *Ibid.*, 26.

⁵⁶ ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit. 152

⁵⁷ *Ibid.*, 160.

home collapsed too. In this way, the crisis hurt countries that had never participated in reckless financial practices.⁵⁸

FIGURE 6
REAL GDP % CHANGE IN 2009 IN SOME DEVELOPED AND DEVELOPING ECONOMIES



Source: IndexMundi.
Made by: Germán Guerra Silva.

This financial crisis turned into recession and later called Great Recession due to its severity, marked the seminal moment of a change in the world's economic dynamics. Not since the Great Depression had the world been in such a critic economic and financial situation.

1.2.2. Initial Political Response to the 2008-2009 Global Economic Crisis.

The collapse of Lehman more than anything else helped to focus the minds of policy makers on the reality that the risk of another Great Depression loomed. At the end of 2008, they were looking to the abyss. They started deploying all the “weapons” in their arsenal. Some tactics, like cutting interest rates, came from the standard playbook. But many others seemed to come from another world, and in some cases another era like capital injections or central bank swap lines⁵⁹. But these and many other unorthodox weapons came off the shelf and were put into battle. Some had been tried before; others had not. Some worked, some did not.⁶⁰

⁵⁸ Idid., 178.

⁵⁹ NB. A central bank swap line is a type of currency swap used by a country's central bank to provide liquidity of its currency to another country's central bank.

⁶⁰ Cfr. ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit. 170

When the subprime mortgage crisis started to break down the banking system, and the risk of the financial system being frozen and the real economy paralyzed became all too real, Governments had to come to the rescue with very controversial bail-outs of several financial institutions and other companies outside the financial system. Direct government interventions took place in many develop countries.

By mid-October 2008, several Heads of State and Government were looking for a solution to save the world banking system. Gordon Brown, the British Prime Minister, announced that he would nationalize some of the biggest banks in Britain. The French President arrived to the conclusion that it will be necessary a massive aide to the French banking system. He authorized the disbursement of 360 million euros in aide credits. The crisis was quickly crossing borders.⁶¹

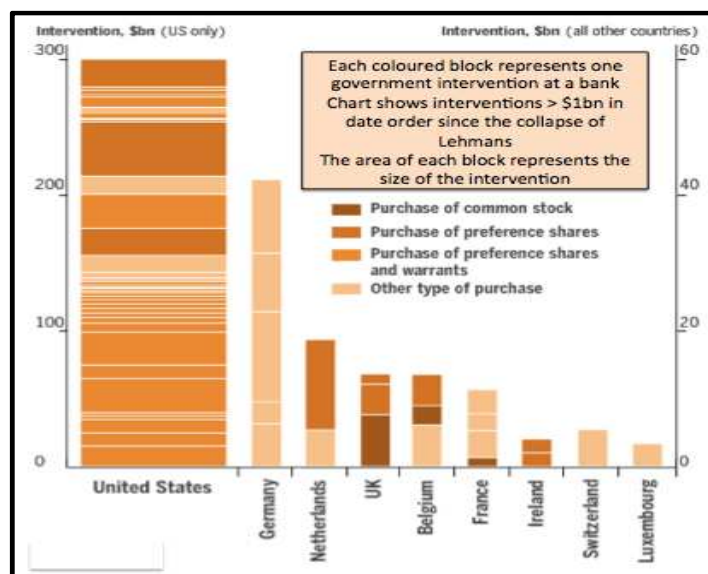
In the case of the US, one of the main actions taken in order to stabilize the financial system was the TARP (Troubled Assets Relief) Program proposal designed by Treasury Secretary Hank Paulson and the NY Federal Reserve President Timothy Geithner.

The plan aimed to use \$700 billion of U.S. taxpayer assets to stabilize markets. It also proposed a plan to buy troubled and difficult-to-value assets from the country's largest financial firms, value them, and resell them, in the hopes of restoring confidence in credit markets. Later, on November 12, Paulson will abandon the element of the plan aimed at buying toxic assets, focusing the remainder of the TARP assets on recapitalizing financial firms.⁶²

⁶¹ Cfr. PASTRÉ Olivier, SYLVESTRE Jean-Mark, *They lie to us: Truths and Myths about the Crisis*, Fayard, Paris, 2011, p. 35

⁶² Cfr. COUNCIL OF FOREIGN RELATIONS, *Timeline: Global Economy in Crisis*, <http://www.cfr.org/economics/timeline-global-economy-crisis/p18709>, Access: September 6th 2011, 17:39.

FIGURE 7
GOVERNMENT INTERVENTION AT BANKS



Source: Bloomberg
Made by: Germán Guerra Silva, Financial Times Limited

Among the biggest bailouts in the U.S we can find the one to JP Morgan with \$25bn with preference shares and warrants⁶³, Citigroup with \$45bn also via preference shares and warrants. The biggest U.S' block in the graph represents the bailout of AIG for \$40bn with preference shares. The grand total in bailouts for the U.S. is around \$300bn. In the case of Germany the biggest bail-out corresponds to Commerzbank for \$10bn with a bail-out total of a little bit more than \$40bn. Next we have the Netherlands with \$20bn, Britain with \$14bn, Belgium with around \$14bn too, France with \$11.3bn, Ireland with \$4bn, Switzerland with \$5.4bn and Luxembourg with \$3.3bn. All these countries combined had to spend around \$412bn of taxpayer money.⁶⁴

Governments around the world committed over \$512bn of the global economic stimulus to green projects, with 22 per cent spent in 2009, HSBC estimates. In this way, on February 17th 2009, during a wave of global spending on fiscal stimulus, President Barack Obama signed a \$787 billion stimulus package into law. The bill aims to boost vital sectors of the U.S. economy, including energy and health care. It won praise from some economists, who

⁶³ NB. A warrant is a security that entitles the holder to buy the underlying stock of the issuing company at a fixed exercise price until the expiry date.

⁶⁴ Cfr. FINANCIAL TIMES, *Government bail-outs*, <http://www.ft.com/intl/cms/s/0/251d855a-8ef7-11dd-946c-0000779fd18c.html#axzz1Wwj554gx>, Access: September 6th 2011, 12:38.

applauded Obama's recognition of the urgency of the moment, while others criticize the bill for inefficiencies.⁶⁵

Another measure taken by the then new government of Obama, was the program designed by the new Treasury Secretary Timothy Geithner, "Public-Private Investment Program," intended to facilitate private-sector investment in troubled assets, and the "Term Asset-Backed Securities Lending Facility," or TALF, designed to free up credit to consumers and small businesses.⁶⁶

IMAGE 3
THE US TREASURY PICKING UP TOXIC ASSETS



Source: The Financial Times.
Made by: Ingram Pinn.

Another measures governments took to prevent a more severe downturn in their economies where protectionism and new mercantilism⁶⁷: strikes against the use of foreign workers in the UK; French carmakers told to buy domestic components and not close factories in France; a minister in Spain urging consumers to buy Spanish, the U.S. with its "buy American provisions" in its economic stimulus package, limitations to imports and the encouragement of buying national products in developing and emerging economies. All this shows that protectionism was raising by the day during 2009. But as many scholars

⁶⁵ Cfr. FINANCIAL TIMES, *The greenest bail-out?*, <http://www.ft.com/intl/cms/s/0/cc207678-0738-11de-9294-000077b07658.html#axzz1Wwj554gx>, Access: September 6th 15:17.

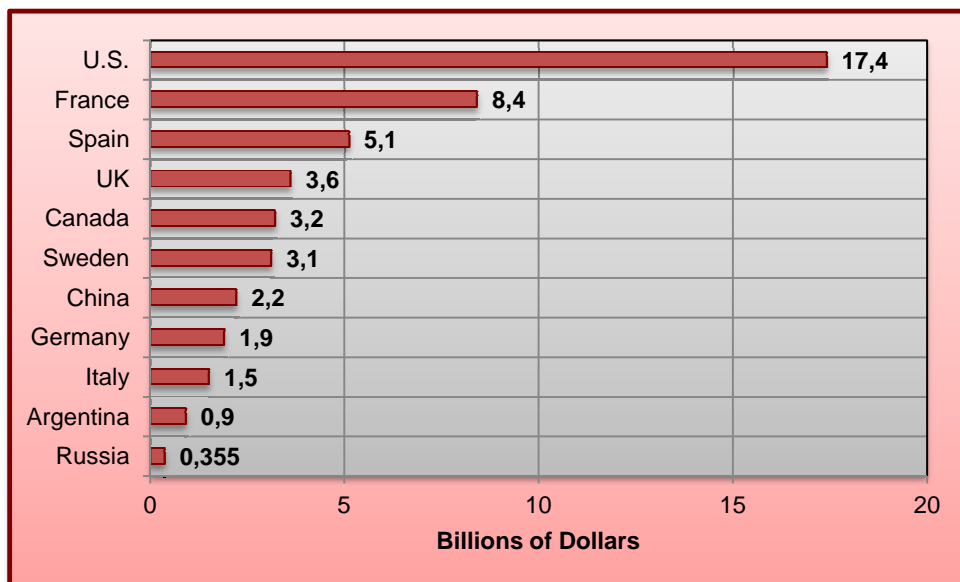
⁶⁶ Cfr. COUNCIL OF FOREIGN RELATIONS, *Timeline: Global Economy in Crisis*, op. cit.

⁶⁷NB. New mercantilism is the economic theory and practice that promoted government regulation of a nation's economy for the purpose of augmenting state power at the expense of rival national powers

and some government officials have said: “Protectionism would be a sure-fire way of turning recession into depression”.⁶⁸

The global economic downturn also hit carmakers particularly hard, with international auto companies announcing lay-offs and warning that they may have to close manufacturing plants; the governments of several countries had to step in. These bailouts were awarded in the way of loans, consumer incentives to buy a car, subsidies to change outdated car models and money that companies had to investment to become more competitive. The US alone awarded \$17.4bn in loans to General Motors and Chrysler from TARP.⁶⁹

**FIGURE 8
GLOBAL AUTOMOTIVE INDUSTRY BAIL-OUTS
IN BILLIONS OF DOLLARS**



Source: Financial Times.
Made by: Germán Guerra Silva.

The measures implemented by governments arguably prevented the Great Recession from turning into another Great Depression. Nevertheless, whether the cure will turn out to be worse than the disease is something that only time will tell.

⁶⁸ Cfr. MILNE Richard, *Each to their own*, http://www.ft.com/intl/cms/s/0/0705933c-f2f2-11dd-abe6-0000779fd2ac,dwp_uuid=2f146ad2-f122-11dd-8790-0000779fd2ac.html#axzz1Wwj554gx, Access: September 6th 2011, 17:49

⁶⁹ Cfr. BERNARD Steven et al., *Automotive industry bail-outs around the world*, <http://www.ft.com/intl/cms/s/0/28d25392-fcf2-11dd-a103-000077b07658.html#axzz1Wwj554gx>, Access: September 5th 2011, 16:36.

1.2.3. Regulation of the Financial System.

During the worst moment of the financial crisis, the Heads of State of many countries blamed the financial institutions of being reckless. They all demanded a strengthening of regulations and guarantees for a good performance of the financial system⁷⁰. Moreover, there is recognition among international regulators that it is in their best interest to create a strong financial framework with international cooperation and not a regulatory race to the bottom with the intention of making more competitive the different financial centers of the world.⁷¹

It is no accident that some countries have done better than others in this crisis. Some countries (such as Canada and Australia) had better financial regulation. Sometimes these regulations prevented bubbles from forming. It is remarkable that so long after the bubble broke, so long after the crisis began, reforming the global financial system is still a work in progress.⁷²

There are several plans for global financial regulatory reform in advanced economies, from the US, the Eurozone and some other major financial centers around the world. The Basel Committee, which is made up of central bankers and regulators from 27 countries, is the main body responsible for laying down global rules for bank governance.

But several countries have looked to impose their own restrictions on the financial system, with differences over areas such as short-selling, bonuses, derivatives and consumer protection. The main aspects the Basel Committee (under Basel III) and individual countries tried to regulated better are:⁷³

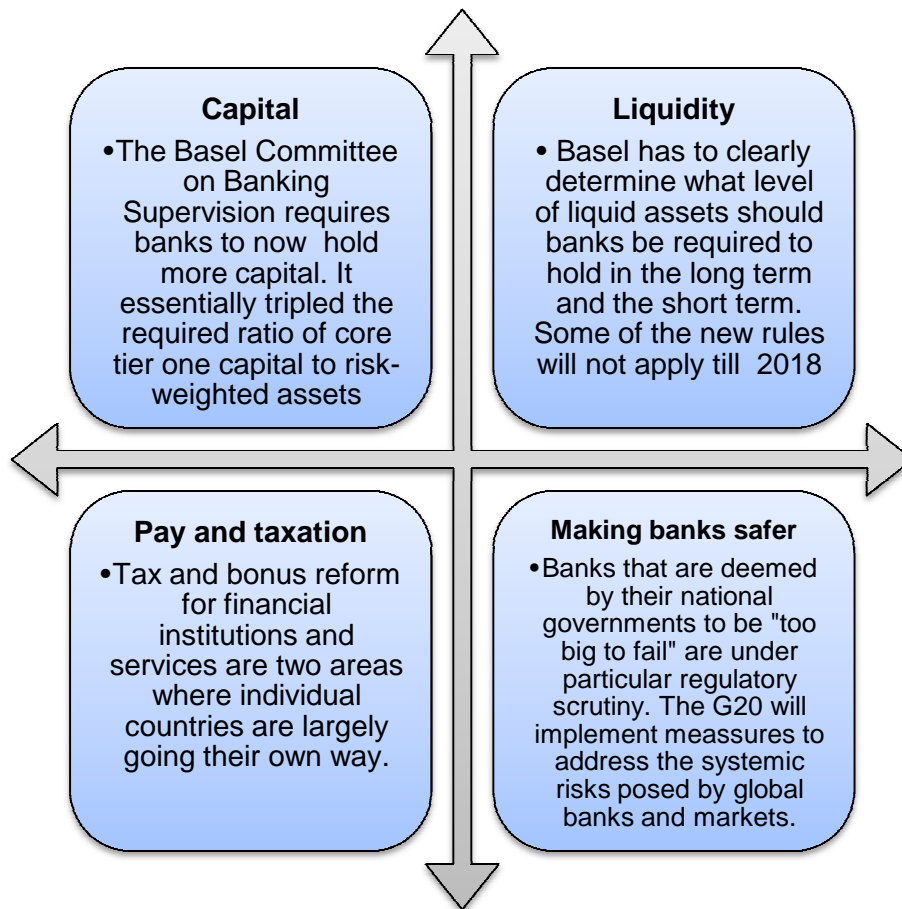
⁷⁰ Cfr. PASTRÉ Olivier, SYLVESTRE Jean-Mark, *They lie to us: Truths and Myths about the Crisis*, op. cit. 36.

⁷¹ Cfr. FRANK Barney, *We are on course to stop a new financial crisis*, <http://www.ft.com/intl/cms/s/0/52b9651e-b3cb-11e0-855b-00144feabdc0.html#axzz1Wwj554gx>, Access: September 7th 2011, 10:46.

⁷² Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit. 136

⁷³ FINANCIAL TIMES, *Reforming the Global Financial System*, <http://www.ft.com/intl/cms/s/0/f58d854e-82db-11df-b7ad-00144feabdc0.html#axzz1Wwj554gx>, Access: September 7th 2011: 14:21.

CHART 2 REFORMING THE GLOBAL FINANCIAL SYSTEM



Source Financial Times
Made by: Germán Guerra Silva.

In the case of the European Union, the Parliament, Council and Commission are responsible for drawing up legislation to cover financial institutions; supervision remains a member state responsibility. As for the US, its financial framework can be broadly categorized into those institutions that regulate and supervise banks, insurance, commodities and securities. The United States has a complex regulatory framework, with federal and state institutions sharing regulatory responsibility. I will focus more on the regulations for Wall Street since it is the main financial center in the world.⁷⁴

Thus, during the first months of 2009, the Obama Administration presented a proposal to tighten regulation on specific aspects of financial markets. The resulting bill was signed into law by President Obama on July 21st 2010. The regulatory reform bill, officially called the Dodd-Frank Wall Street Reform and Consumer Protection Act, is considered to be the biggest shake-up

⁷⁴ Cfr. FRANK Barney, *We are on course to stop a new financial crisis*, op. cit.

of financial regulation since the 1930s.⁷⁵ The Bill aims to allow financial institutions to perform the vital function of accumulating capital and making it available to the productive elements of society, while minimizing the likelihood of irresponsible practices that contribute little to productive economic activity. Each of the Bill's provisions recognized an important principle:⁷⁶

1. A stronger and independent financial product safety commission (called the Consumer Financial Protection Bureau) to protect ordinary Americans against abuses in the financial industry. It requires lenders to retain some risk. It also extends regulation over a host of entities that are unregulated at the federal level, including mortgage lenders.
2. A systemic regulator who sees the system as a whole in the form of a council that has the power to make recommendations to the Fed.⁷⁷
3. Controls on excessive risk-taking, since the act forces lenders to take responsibility, and make risks transparent. This discourages inappropriate risks, and requires the private sector (not taxpayers) to provide funds, in the form of more capital against retained risk, to cover liabilities.
4. Controls on derivatives since it gives the government powers to force more secretly traded derivatives into transparent markets.⁷⁸
5. The government obtains more authority to deal with failing banks. It actually prohibits any federal official from spending money to keep a failing institution alive. The law stipulates that any funds spent to minimize the harm caused by the death of an institution are recovered by a levy on other large institutions without cost to taxpayers.⁷⁹

But even as Barack Obama's administration celebrates the anniversary of the act (on July 2011) and Republicans lament it, plenty of economists, officials and congressional aides think the reforms have not shaken up Wall Street enough, and that both parties exaggerate its impact. Although, the stagnant economy has changed the mood in the US. There is a real question as to whether, more than three years after the height of the crisis, the pendulum of regulation is already swinging back. Some bankers say they are hopeful that officials might be starting to loose regulations with an eye on the anemic recovery. Those who favor reform are worried about the very same dynamic.⁸⁰

⁷⁵ Cfr. COUNCIL OF FOREIGN RELATIONS, *Timeline: Global Economy in Crisis*, op. cit.

⁷⁶ Cfr. FRANK Barney, *We are on course to stop a new financial crisis*, op. cit.

⁷⁷ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit. pp.136-137

⁷⁸ Cfr. Id.

⁷⁹ Cfr. Id.

⁸⁰ BRAITHWAITE Tom, VAN DUYN Aline, *Regulatory reform: A disappearing act?*,

<http://www.ft.com/intl/cms/s/0/9c61755a-b2c0-11e0-bc28-00144feabdc0.html#axzz1Wwj554gx>, Access: September 7th 2011, 21:42.

1.3. Global Imbalances and the Second Great Contraction.

1.3.1. The Great Recession vs. The Great Depression.

The current financial and economic downturn has been said to be the worst since the Great Depression. Many scholars, politicians and business people use the term “Great Recession” to refer to the 2008-09 recession. Both of these dramatic and costly economic crises came from the interaction of economic imbalances in the world economy and the ruling ideology of financial decision makers who confronted these imbalances. There are certain similarities but, in many ways, the two crises are fundamentally different.⁸¹

Financial crisis tend to be very damaging since most economies, even relatively poor ones, depend on the financial sector to channel money from savers to investment projects around the economy. If a crisis paralyzes the banking system, it is very difficult for an economy to resume normal economic activity. Ben Bernanke famously argued that bank collapse was an important reason for why the Great Depression of the 1930s lasted so long and hit so hard.⁸²

So, financial crises, particularly those that are large and difficult to resolve, can have profound effects. This strong connection between financial markets and real economic activity, particularly when financial markets cease to function, is what has made the Great Depression and the Great Recession such spectacular historic events. Consider, in contrast, the collapse of the tech stock bubble in 2001. Although technology stocks collapsed, the effect on the real economy was only the relatively mild recession of 2001. Bubbles are far more dangerous when they are fueled by debt, as in the case of the global housing price explosion of the early 2000s.⁸³

The 1929 crisis was caused by a frenzy housing and stock market boom, joined by a speculative crisis over commodities. These caused a monetary crisis due to the soaring gold prices since gold served as benchmark and guaranteed the value of the dollar. This crisis asphyxiated the banking system and then the industrial activities. It hit the U.S. and later on it contaminated the

⁸¹ Cfr. NATIONAL BUREAU OF ECONOMIC RESEARCH, *The Great Recession and The Great Depression*, http://www.nber.org/papers/w15645.pdf?new_window=1, p. 4, Access: September 13th 2011, 14:56.

⁸² REINHART Carmen, ROGOFF Kenneth, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, First Edition, 2009, p. 45.

⁸³ Id.

different regions of the developed world: Continental Europe, Britain and Japan. At that time, the rest of the world didn't count.⁸⁴

The main causes of both crises lie in actions of the U.S. federal government. In the case of the Great Depression, the Federal Reserve, after keeping interest rates artificially low in the 1920s, raised interest rates in 1929 to stop the resulting boom. That helped to halt investment. Also, President Hoover signed into law the sky-high Smoot-Hawley Tariff, which asphyxiated trade and damaged American exports throughout the 1930s.⁸⁵

The seeds of the Great Recession in contrast were planted, as already explained, when the government in the 1990s began pushing homeownership, even for uncreditworthy people, in huge numbers. Mortgage-backed securities built on suspicious mortgage loans became "toxic" when the housing market took a downturn, and many American banks verged on collapse. Both crises saw banking failures, although catastrophic collapses of more financial institutions in the Great Recession were stopped, thus saving the world financial system, thanks to the convenient intervention of the Federal Reserve and the Treasury of the U.S. through the TARP program.⁸⁶

The main measures undertaken that stopped the current recession⁸⁷ from becoming a depression⁸⁸ were:

1. Unemployment insurance, Social Security payments and larger government at the federal, state and local levels keep money flowing into the economy even as consumers and businesses pull back on their own spending.⁸⁹
2. The \$787 billion stimulus bill passed by Congress in February 2009 encouraged more economic activity and saved about 8.5m jobs.⁹⁰
3. In addition, the Federal Reserve, led by Great Depression expert Ben Bernanke, has pumped trillions of dollars into the economy with new lending

⁸⁴ Cfr. PASTRÉ Olivier, SYLVESTRE Jean-Mark, op. cit. 16.

⁸⁵ Cfr. THE FREEMAN, *Comparing the Great Depression to the Great Recession*, <http://www.thefreemanonline.org/columns/our-economic-past/comparing-the-great-depression-to-the-great-recession/>, Access: September 13th 2011, 17:19.

⁸⁶ Cfr. Id.

⁸⁷ NB. A recession is defined as a marked slowdown in economic activity, more strictly defined (in many countries) as at least two consecutive quarters of declining GDP.

⁸⁸ NB. A depression is defined as a prolonged severe drop in economic output accompanied by sustained deflation.

⁸⁹ CNN MONEY, *The Great Recession*, http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/index.htm, Access: September 14th 2011, 09:37.

⁹⁰ Cfr. RATTNER Steven, *The 2012 rivals can be named: Hayek v Keynes*, <http://www.ft.com/intl/cms/s/0/0cebaa1a-dd47-11e0-b4f2-00144feabdc0.html#axzz1XkvDLdsg>, Access: September 14th 2011, 10:58.

programs the central bank has never tried before. That has increased the supply of money. By contrast, the money supply tightened during the Great Depression.

4. There were many other policy mistakes made in the 1930s that were not repeated during the 2008-09 recession, including stiff tariffs that killed international trade and government imposed limits on prices and production levels.⁹¹

The main differences between today's crisis and the Great Depression is that the deflationary pressure is less than a third of what it was in the 1930s and policymakers today reacted much more swiftly and more appropriately than they did after 1929. Those who think the government should have done nothing, as all the Republican challengers to varying degrees now argue (2011), risked turning the current downturn into another Great Depression.⁹²

**CHART 3
COMPARISONS BETWEEN THE GREAT RECESSION AND THE GREAT DEPRESSION**

	The Great Depression	The "Great Recession"
Bank failures	9,096 – 50% of banks (Jan. 1930 – March 1933)	57 – 0.6% of banks (Dec. 2007 – May 2009)
Unemployment rate	25%	8,50%
Economic decline	-26.5% (1929 - 1933)	-3,3% (Second quarter 2008 - first quarter 2009)
Biggest decline in Dow Jones industrial average	-89.2% (Sept. 3, 1929 – July 8, 1932)	-53.8% (Oct. 9, 2007- March 9, 2009)
Change in prices	-25% (1929 – 1933)	+0.5% (Dec. 2007-March 2009)
Emergency spending programs	1.5% of GDP for 1 year (Increase in 1934 budget deficit)	2.5% of GDP for 2 years (2009 American Reinvestment and Recovery Act)
States' response	Raise taxes, cut spending	Federal stimulus plan gives fiscal relief to states and the unemployed and increases government expending
Increase in money supply by Federal Reserve	17% (1933)	125% (September 2008 – May 2009)

Source: CNN Money.
Made by: Germán Guerra Silva.

But what it is very important to notice is that the current crisis is, in certain ways, much more serious than the crisis of 1929 (although it is not as far as the macroeconomic indicators are concerned, till the moment of writing at

⁹¹ Cfr. CNN MONEY, *The Great Recession*, op. cit.

⁹² Cfr. FORBES, *The Great Depression And The Great Recession*, <http://www.forbes.com/2009/10/29/depression-recession-gdp-imf-milton-friedman-opinions-columnists-bruce-bartlett.html>, Access: September 14th 2011, 16:23.

least). Indeed, it is the first economic crisis in history that hits the whole world at the same time. Even worse, it marks a structural rupture, which means that it has unleashed a new world balance, with new relations of political and economic power. It becomes more and more evident a possible shift to the East of the power and decision centers, which so far, made the fortune, prosperity and glory of the West.⁹³

Finally, there are two lessons to be drawn from this comparison. The first is that the open American and western economy is prone to collapse every once in a while. Favorable conditions, such as a vigorous post-war expansion, can eliminate “great” economic contractions for a generation or so, but American exuberance appears to aggravate under these conditions. As the memory of past economic difficulties fades, economic and political pressure for change fades too. International economic imbalances are tolerated until they correct themselves, often very painfully.⁹⁴

1.3.2. Global Imbalances prior to the 2008-09 Recession.

If you were to ask people what caused the financial and economic crisis of 2008-09, most are likely to answer it was some mix of greed and incompetence. Bank bosses have been castigated for fee-seeking excess, reckless lending and failure to notice the risks to their institutions. Regulators have been accused of sleeping on watch. Central bankers once applauded for mastering inflation and the business cycle are no longer praised.⁹⁵

Few among the public would be likely to pin the blame on “global imbalances”. The damage done to the financial system by lax controls, rotten incentives and passive regulation is a common truth. Yet underlying the whole mess was the deeper problem of imbalances. A growing number of policymakers and academics believe that these lay at the root of the financial crisis.⁹⁶ But what are these economic imbalances? Well, essentially they are related to how much a country saves. This figure is made up of 3 elements:

⁹³ Cfr. PASTRÉ Olivier, SYLVESTRE Jean-Mark, op. cit. 17.

⁹⁴ Cfr. NATIONAL BUREAU OF ECONOMIC RESEARCH, *The Great Recession and The Great Depression*, op. cit. 16.

⁹⁵ Cfr. THE ECONOMIST, *When a flow becomes a flood*, <http://www.economist.com/node/12972083>, Access: September 14th 2011, 15:10.

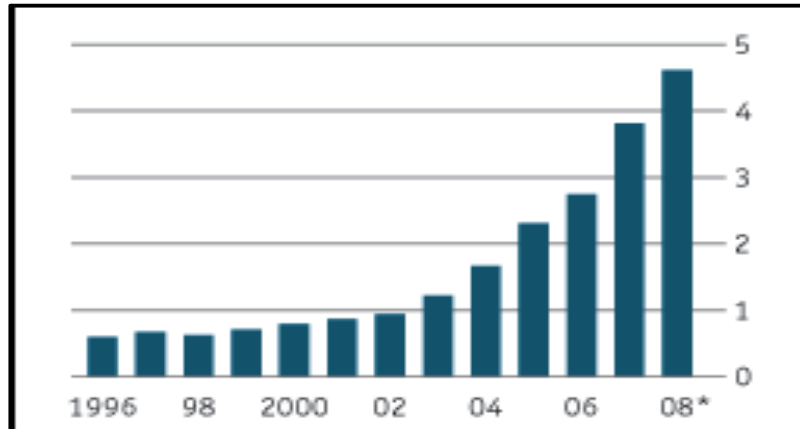
⁹⁶ Cfr. Id.

what people save from their incomes, what firms save from their profits and what governments can save if they spend less than they take in taxes.⁹⁷

The pattern of saving differs widely between countries. There is a very significant region of the world economy, with a permanent tendency to save excessively and then lend this money abroad. The original case of this was Japan but now it has being joined by Germany, Scandinavia, Belgium and also by China and the so-called Asian Tigers.⁹⁸ These countries amount a large part of the world economy that is saving heavily.

For the East Asian countries including China there is another dimension: they've built up vast reserves of foreign currency partly to protect themselves from a financial crisis, like the one they endure in the 1990s, and partly as a side effect of trying to stay competitive by keeping the value of their own currencies relatively low.⁹⁹

FIGURE 9
DEVELOPING ECONOMIES' INTERNATIONAL CURRENCY RESERVES IN
\$ TRN OF DOLLARS



Source: The Economist
Made by: The Economist

So there was a vast pot of savings and Asian currencies reserves needing to be invested. Here it is important to notice that these countries needed to acquire reliable stores of value that can be sold easily when trouble strikes. This idea has been developed by Ricardo Caballero of the

⁹⁷ Cfr. BBC, Analysis of the Global Imbalances, http://www.bbc.co.uk/iplayer/episode/p004jq1j/Analysis_Global_Economic_Imbalances/, Access: September 14th 2011, 10:04.

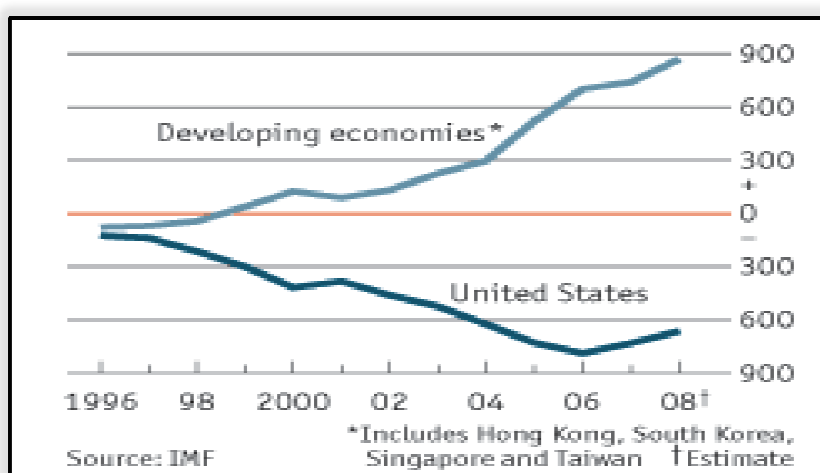
⁹⁸ Cfr. International Monetary Fund, *The Global Economic Outlook and Risks from Global Imbalances*, <http://www.imf.org/external/np/speeches/2005/093005.htm>, Access: September 14th 17:05.

⁹⁹ Cfr. BBC, Analysis of the Global Imbalances, op. cit.

Massachusetts Institute of Technology (MIT), Emmanuel Farhi of Harvard University and Berkeley's Mr. Gourinchas.

Their thesis is that emerging countries cannot create enough trustworthy saving vehicles to keep up with the pace of economic growth, because their financial markets are immature. Householders cannot rely on a ready supply of credit, or on government safety nets, so must save hard for a rainy day. But the domestic supply of financial assets is unreliable so the prudently invest in foreign assets instead. The US is the favored place because it has broad and liquid markets for securities.¹⁰⁰

FIGURE 10
CURRENT-ACCOUNT BALANCES IN \$ BN OF DOLLARS



Source: International Monetary Fund
Made by: The Economist

Excessive tendency to save in these countries is not excessive related to their own needs but relative to the ability of the rest of the world to absorb it. The money lend abroad by this countries had the effect of making money cheap, easy to borrow and the result is that people got themselves into debts way above their means and now we have the financial crisis as consequence.¹⁰¹

In this view of the crisis people in the U.S., Britain and other countries saved very little and borrow heavily because money was cheap and interest rates low. The reason for that was the savings excess that Asians and Europeans wanted to lend so they could make money out of these savings. To

¹⁰⁰ Cfr. THE ECONOMIST, *When a flow becomes a flood*, op. cit.

¹⁰¹ Cfr. THE GUARDIAN, *Beware global economic imbalances*, Mervyn King warns,

<http://www.guardian.co.uk/business/2010/jan/20/mervyn-king-internationaltrade>, Access: September 12th 2011, 18:28.

put the underlying problem right in this version of events Chinese and others need to save less while Americans need to save more. American households are indeed saving more and repaying debt. The savings rate in the U.S. has gone up from 0 to 4%. But in order to balance the world economy it has to go up at least to 7 to 10% for a number of years.¹⁰²

The other side of the imbalance is the high rate of savings in East Asia, and most notably China. This country sells much more to the U.S. than it buys from the United States. This trade imbalance is seen as American jobs loss to China. But for many that is just a symptom of the fundamental problem which is that the deep causes of the latest financial crisis lie in global imbalances, mainly, America's huge current-account¹⁰³ deficit and China's huge surplus.¹⁰⁴

US officials say it is now clear the rest of the world cannot rely on debt-fuelled US consumption to power global growth, and other sources of domestic demand need to be built up, particularly, but not exclusively, in emerging Asia. In this way, part of the long-run solution will involve further shifts away from the apparently perverse model in which poor but fast-growing countries finance current consumption in rich countries in return for claims on their future output.

America, Britain and other deficit countries have drowned themselves in cheap credit from abroad. Because the structural forces behind the global saving excess are unlikely to stop quickly, there is a real risk that the dangerous imbalances will persist: global imbalances could widen again as the recovery takes hold, with countries reverting to their old economic models: consumption-led in the US with America's public sector as the new consumer of last resort, and export-led in China, Japan and Germany.¹⁰⁵

The G20 countries are trying to identify the very deep roots of the current problems to reduce the risk of a repeat and correct these imbalances. But sadly an unbalanced global economy is one of the hardest problems to fix.

¹⁰² Cfr. International Monetary Fund, *The Global Economic Outlook and Risks from Global Imbalances*, op. cit.

¹⁰³ NB. The current account balance is the difference between a country's savings and its investment.

¹⁰⁴ Cfr. THE ECONOMIST, *When a flow becomes a flood*, op. cit.

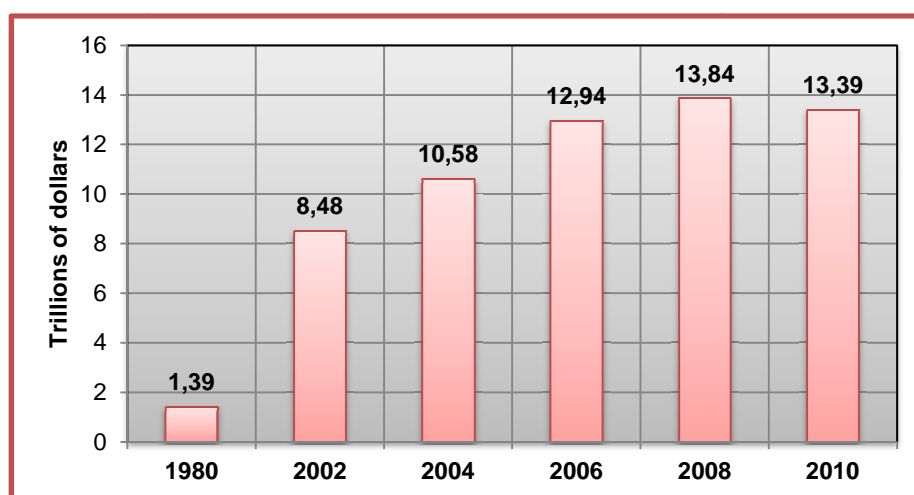
¹⁰⁵ Cfr. BLOOMBERG BUSINESSWEEK, *IMF's Zhu Warns Global Imbalances May Worsen on Chinese Exports*, <http://www.businessweek.com/news/2011-01-27/imf-s-zhu-warns-global-imbalances-may-worsen-on-chinese-exports.html>, Access: September 10th 2011, 19:28.

1.3.3. The Second Great Contraction.

Until this part, I have been referring to the 2008-09 recession as the “Great Recession” due to its severity. But maybe that is not an accurate term at all and even might be misleading. The phrase “Great Recession” creates the impression that the economy is following the lines of a typical recession, only more severe. Moreover, too many policymakers have the belief that, at the end of the day, this is just a deep recession that can be subdued by a generous helping of conventional policy tools, whether fiscal policy or massive bailouts.¹⁰⁶

But by far the main problem is that the global economy is badly overleveraged, and there is no quick escape without a plan to transfer wealth from creditors to debtors, either through defaults or inflation. The public and private sectors have huge debt burdens that create headwinds to quicker normalization of post-crisis growth, which is why post-financial crisis growth is typically very slow. It is better to think of the global economy as going through a “Second Great Contraction” a more accurate, if less reassuring term (the Great Depression being the first as emphasized by Anna Schwarz and the late Milton Friedman) involving credit and housing, and not just output and unemployment.¹⁰⁷

FIGURE 11
U.S. HOUSEHOLD’S OUTSTANDING DEBT



Source: Federal Reserve.
Made by: Germán Guerra Silva.

¹⁰⁶Cfr. PROJECT SYNDICATE, *The Second Great Contraction*, <http://www.projectsyndicate.org/commentary/rogoff83/English>, Access: September 15th 2011, 20:12.

¹⁰⁷Cfr. ROGOFF Kenneth, *The bullets yet to be fired to stop the crisis*, <http://www.ft.com/intl/cms/s/0/1e0f0efe-c1a9-11e0-acb3-00144feabdc0.html#axzz1XkvDLdsg>, Access: September 14th 2011, 22:07

Carmen Reinhart and Kenneth Rogoff from Harvard University proposed this name in their 2009 book *This Time is Different*, based on their diagnosis of the crisis as a typical deep financial crisis, not a typical deep recession. But, why so much importance to semantics? Because only by determining the true nature of the sickness the right medicine can be prescribed.

In a conventional recession, the resumption of growth implies a reasonably abrupt return to normalcy. The economy not only regains its lost ground, but, within a year, it typically catches up to its rising long-run trend. The aftermath of a typical deep financial crisis is something completely different. Broadly speaking, financial crisis are prolonged affairs. More often than not, the aftermath of severe financial crisis share 3 characteristics:¹⁰⁸

- First, asset market collapses are deep and prolonged.

- Second, the aftermath of banking crises is associated with profound declines in output and employment. With the duration of the downturn averaging roughly 2 years, is considerably shorter than that of the unemployment that normally persist very high for about 4 years¹⁰⁹

- Third, the value of government debt tends to explode. The main cause of debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system. Admittedly, bailout costs are difficult to measure. In fact, the biggest driver of debt increases is the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions and stimulus spending.¹¹⁰

But Great Contractions, as opposed to recessions, are very infrequent events, taking place perhaps once every 70 or 80 years. Also, History suggests that recessions are often renamed when the smoke clears. Perhaps today the smoke will clear a bit faster if we stop using the “Great Recession” label immediately and replace it with something more appropriate, like “Great Contraction.”¹¹¹

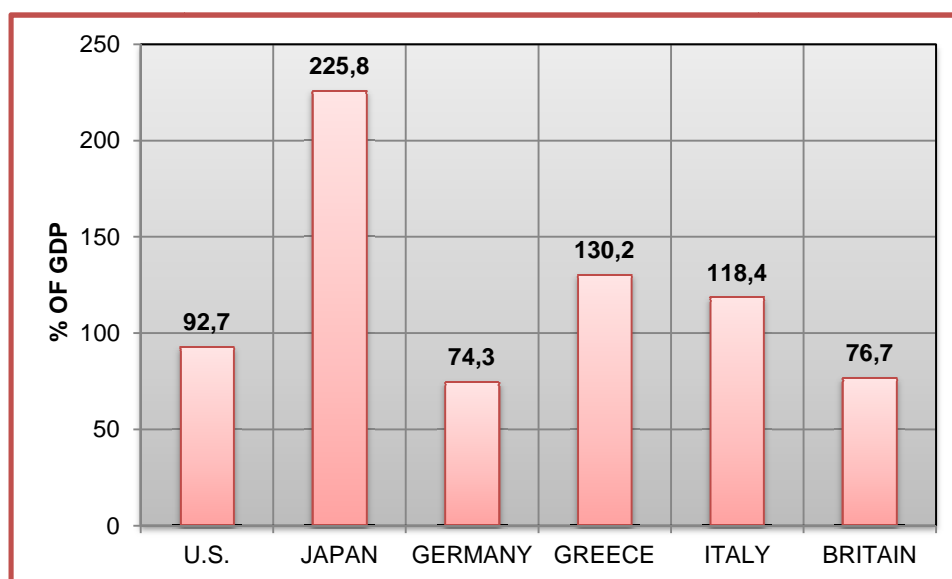
¹⁰⁸ Cfr. PROJECT SYNDICATE, *The Second Great Contraction*, op. cit.

¹⁰⁹ Cfr. REINHART Carmen, ROGOFF Kenneth, *This Time is Different: Eight Centuries of Financial Folly*, op. cit. 224

¹¹⁰ Cfr. Id.

¹¹¹ Cfr. ROGOFF Kenneth, *The bullets yet to be fired to stop the crisis*, op. cit.

FIGURE 12
GOVERNMENT DEBT AS % OF GDP



Source: IMF.
Made by: Germán Guerra Silva.

The wrong interpretation of the crisis has made that time and again, policymakers counted on rapid post-crisis recovery to help them avoid painful decisions on how to deal with badly overstretched private and public balance sheets, whether household debts in the US or sovereign debts in the periphery of Europe. Time and again, rapid growth did not materialize or, if there was a burst, did not last.¹¹²

If policymakers can at least get the diagnosis right, it would be a major step on the road to recovery. After a long series of half-steps and missteps, policymakers options are narrowing, but they are not out of bullets. At this critical moment, leaders must finally address the problems of a Great Contraction, not a large but otherwise conventional recession.¹¹³

Many ask whether high-income countries are at constant risk of a “double dip” recession. Maybe the answer is: no, because the first one did not end. For all intents and purposes, most European and US economies have never fully exited the downturn, with output per capita still below its pre-crisis peak. The question is rather, how much deeper and longer this recession or “contraction” might become. At the root of today’s credibility deficit is a failure to

¹¹² Cfr. DAVIES Gavyn, *What went wrong with the global recovery?*, <http://blogs.ft.com/gavyndavies/2011/08/18/what-went-wrong-with-the-global-recovery/>, Access: 23:16.

¹¹³ ROGOFF Kenneth, *The bullets yet to be fired to stop the crisis*, op. cit.

come to terms with the long, slow growth period that is typical of post-financial crisis recovery.¹¹⁴

IMAGE 4
BANKS SUNK BY DEBT



Source: Financial Times.
Made by: Ingram Pinn.

¹¹⁴ Cfr. WOLF Martin, *Struggling with a great contraction*, <http://www.ft.com/intl/cms/s/0/079ff1c6-d2f0-11e0-9aae-00144feab49a.html#axzz1XkvDLdsg>, Access: September 15th 2011, 0:24.

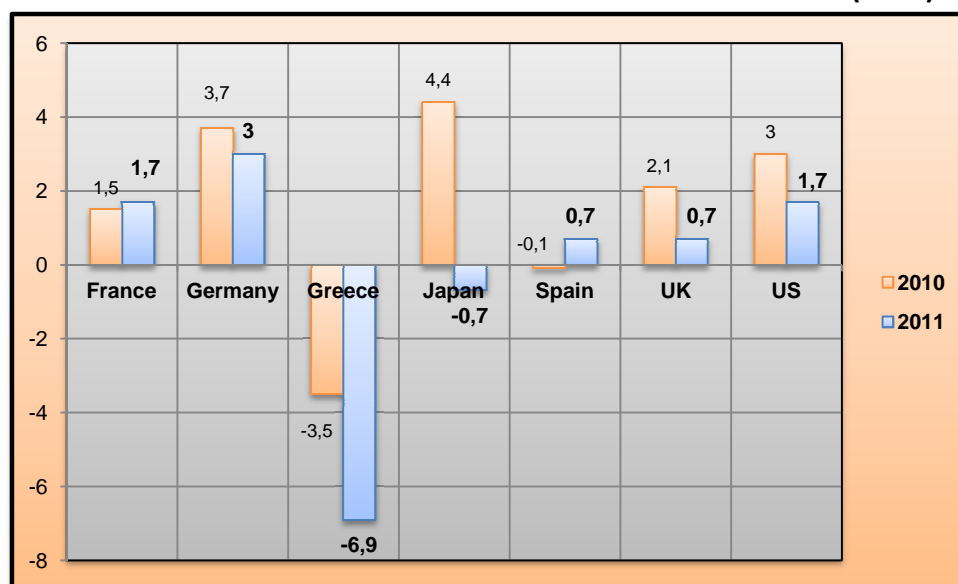
CHAPTER II DEBT AND THE SITUATION OF THE POLITICAL CLASS

*People only accept change in necessity
and see necessity only in times of crisis
- Jean Monnet*

The National Bureau of Economic Research, the official arbiter of the U.S. business cycle, said on September 21st 2010 that the recession ended in June of that year, making it the longest downturn since the Great Depression of the 1930s. The NBER said that its declaration did not mean the economy had "returned to operating at normal capacity" and cautioned that economic activity sometimes remains below normal well into expansion.

The "sometimes" of its statement, as it is now clear, should be omitted. The recovery in the industrial world turned out to be very weak. The expected high increase in output after a downturn failed to materialize. The key element that in other recessions had helped to speed up recovery was lacking: a strong housing market.

FIGURE 13
GDP REAL % GROWTH OF SOME DEVELOPED COUNTRIES (2011)

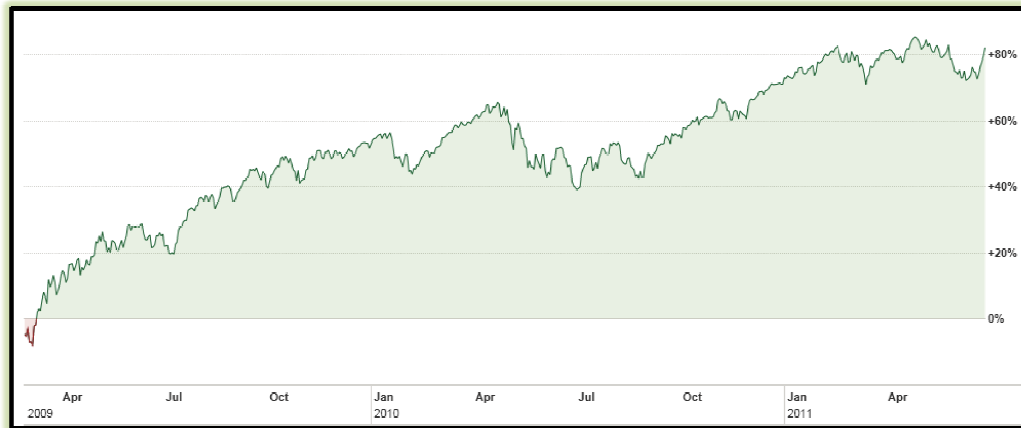


Source: Eurostat.
Made by: Germán Guerra Silva.

But if we take the world as a whole, thanks to the help of the emerging markets' growth, the increase in output looks better with the world growing around 5% in 2010. The stock market saw a better performance than the real

economy. As shown below, by July 2011 the main world indexes were 80% above its lowest point from March 2009.

FIGURE 13
VALUE INCREASE OF THE S&P 500 FROM MARCH 2009 TO JULY 2011



Source: Financial Times Market Data
Made by: Germán Guerra Silva.

The evaluation of the 2010 economy performance was that global output had increased faster than forecasters were expecting at the beginning of 2010. There was a new danger, the Greek debt crisis was creating concern around the globe but were believed to only affect the peripheral countries of Europe. Most of the dangers that frightened financial markets during that year failed to materialize: China's economy did not suffer a hard landing, the U.S mid-year slowdown did not become a double-dip recession. The euro zone as a whole grew at a decent rate for an ageing continent thanks to Germany, the fastest-growing big rich economy in 2010. Nonetheless, the troubles of the euro area's peripheral economies proved all too real¹¹⁵

But 2011 would tell a different story. The sovereign debt of the developed countries came to be the new big danger for the world economy. This crisis is proving to be of a different nature of the 2008-09 one because the States are less capable of using the "armory" they had in 2009. To make things worse the political class of the West is in a precarious situation incapable of whether to agree on anything or unwilling to take the necessary bold actions in order to handle a crisis that is becoming worse by the minute. These countries are burdened by debt, politically unstable, having a new normal rate of growth of just 2%, with an anxious and unhappy population and a growing and

¹¹⁵ Cfr. THE ECONOMIST, *Three-way split*, New York, December 11th 2010, Leaders, p.13.

scandalous inequality. This situation is proving to be strong evidence of the rise of a new Third World, and making more and more evident the long spoken demise of the West.

2.1. The Political Response to the U.S. Fiscal and Monetary Situation.

2.1.1. The U.S. Federal Reserve and its Contra-Cyclical Monetary Policy.

The Federal Reserve System (also known as the Federal Reserve, and informally as the Fed) is the central banking system of the United States. It was created in 1913 with the enactment of the Federal Reserve Act, largely in response to a series of financial panics, particularly a severe panic in 1907.¹¹⁶ Over time, the roles and responsibilities of the Federal Reserve System have expanded and its structure has evolved. Events such as the Great Depression were major factors leading to changes in the system. Its duties today, according to official Federal Reserve documentation, are to conduct the nation's monetary policy, supervise and regulate banking institutions, and guarantying price stability and full employment.¹¹⁷

The role of the Fed, in actions taken or omitted that helped trigger the recent financial crisis, are as controversial as the actions this institution has taken to face it. With the benefit of hindsight, it appears that the Federal Reserve made two mistakes that helped inflate the housing bubble. First, the jobless recovery from the recession of 2001 persuaded the Fed to keep interest rates extremely low for a sustained period. Second, the Fed actively encouraged the financial markets to believe it would follow an asymmetric policy: it would not act against a potential unsustainable rise in asset prices, but it would remain ready to pick up the pieces if a bubble burst.¹¹⁸

The markets arrived at that conclusion after Alan Greenspan, the now infamous President of the Federal Reserve from 1987 to 2006, during a speech in 2002, argued that although the Federal Reserve could not recognize or prevent an asset-price boom, it could “mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion”. In other worlds, the Fed

¹¹⁶ Cfr. THE FEDERAL RESERVE BANK OF MINNEAPOLIS, *Born of a panic: Forming the Federal Reserve System*, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3816, Access: October 3rd 2011, 10:21.

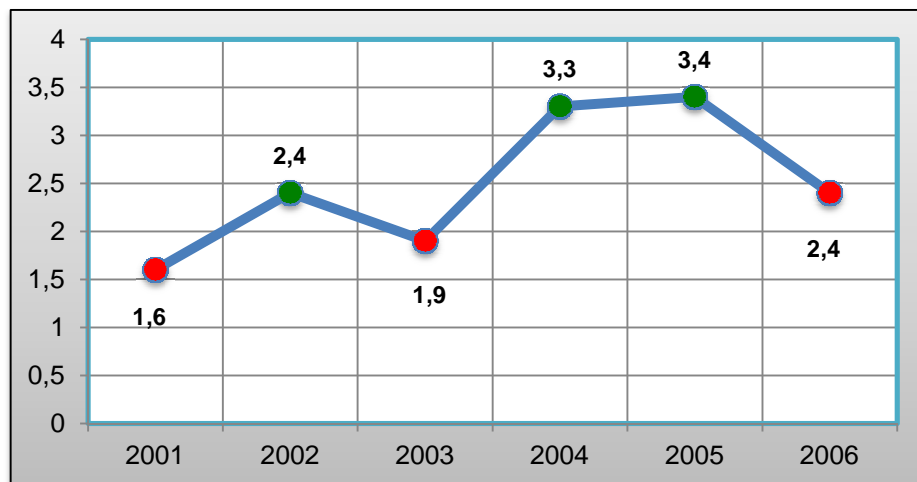
¹¹⁷ Cfr. THE FEDERAL RESERVE, *FRB: Mission*, <http://www.federalreserve.gov/aboutthefed/mission.htm>, Access: October 4th 2011, 12:11.

¹¹⁸ Cfr. RAJAN Raghuram, *Fault Lines*, op. cit, 233

won't intervene when it thought asset prices were too high but it could recognize a bust when it happened and would pick up the pieces. The implied promises of the two actions did considerable damage, because in attempting to stimulate sluggish job creation, they set off an "orgy" of financial risk taking.¹¹⁹

In the years before the crisis, central bankers and academia converged on targeting inflation as their primary objective. Of course, they also had to consider the objective of financial stability. According to conventional wisdom, central bankers had only one instrument with which to carry out monetary policy, the short-term interest rate, and they could not target more than one objective with it. Concerns about financial stability would complicate setting monetary policy. Financial stability was left to be addressed through "prudential" measures like capital requirements, and relegated to the less glamorous supervisory and regulatory arms of central banks.¹²⁰

FIGURE 15
INFLATION IN THE U.S. DURING LAST DECADE'S GREENSPAN YEARS



Source: U.S. Bureau of Labor Statistics
Made by: Germán Guerra Silva.

The main circumstances that encouraged Greenspan to have very low interest rates were the fact that the past decade's economic recoveries turned out to be jobless, output went back to pre-crisis levels relatively fast, but the same was not true for jobs. Also, it is important to remember the dot-com bubble crash in the early 2000s, which made the Fed believe that it needed to

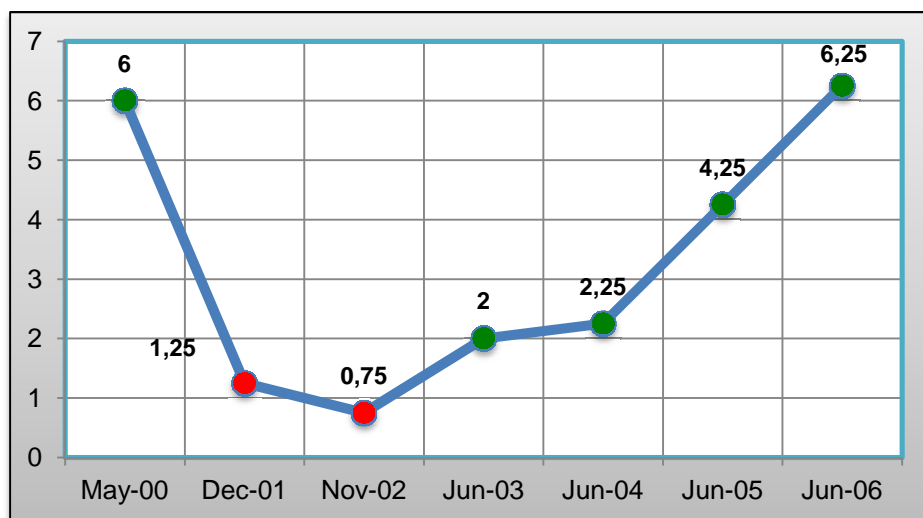
¹¹⁹ Cfr. THE FEDERAL RESERVE BOARD, *Alan Greenspan, "Opening Remarks"*, <http://www.federalreserve.gov/boarddocs/speeches/2004/20040827/default.htm>, Access: October 3rd 2011, 14:54.

¹²⁰ Cfr. RAJAN Raghuram, *Fault Lines*, op. cit, 234.

encourage the economic recovery in order to avoid a deflationary¹²¹ scenario. It was also under pressure from politicians to keep rates down in order to create as many jobs as possible.

In fact, a detailed study published in the Federal Reserve Bank of St. Louis Review in 2008 presents evidence that “monetary policy has significant effects on housing investment and house prices. The easy monetary policy designed to face the perceived risks of deflation in 2002–2004 has contributed to a boom in the housing market in 2004 and 2005.”¹²²

FIGURE 16
INTEREST RATES IN THE U.S. DURING LAST
DECADE’S GREENSPANS YEARS



Source: U.S. Federal Reserve.
Made by: Germán Guerra Silva.

So, after the dot-com bubble bust the Fed seemed to be influenced by the recent experience of Japan, which had faced prolonged price deflation and slow growth in the 1990s as a result of the collapse of its real estate bubble. But this concern was misplaced: unlike Japan, the United States in 2001 had not experienced a debt crisis, only a meltdown of the overvalued tech stocks. A debt crisis could have caused a downward spiral of bankruptcies, job losses, and fire sales that might have triggered a deflation.¹²³

¹²¹ NB. Deflation means prices going down

¹²² Cfr. JAROCINSKI Marek, SMETS Frank, *House Prices and the Stance of Monetary Policy*, <http://research.stlouisfed.org/publications/review/08/07/Jarocinski.pdf>, p. 362, Access: October 4th 2011, 11:03.

¹²³ Cfr. RAJAN Raghuram, *Fault Lines*, op. cit, 242

By mid-2003, almost every measure of economic activity other than inflation and employment was picking up strongly. With the Fed' low interest rates, it was adding stimulus to a world economy that was growing strongly, with jobs being created elsewhere but not in the United States. If the Federal Reserve, the world's central banker in all but name, had been focused on sustainable world growth, it should have been tightening monetary policy by raising interest rates. But its mandate covered only the United States.¹²⁴

The Federal Reserve had become, in the opinion of some, the fourth branch of government, nearly equal in power to the executive, legislative, and judicial branches, though still subject to their constitutional authority if they chose to assert it. So, for those who believe the Federal Reserve is too independent, the notion that it is subject to political pressure may seem unthinkable. Yet, as Fed governors¹²⁵ admit in private, pressure is applied all the time by Congress. Powerful politicians, in off-the-record conversations with Fed governors, frequently make disguised and not-so-disguised threats to scrutinize Federal Reserve activities and reduce its independence unless the Fed complies with their wishes. Ironically, the Federal Reserve's desire to remain independent is the tool with which Congress makes it compliant.¹²⁶

So, by 2006, Alan Greenspan was gone and the man to take over the Federal Reserve was a Princeton University professor who spent his entire economic career studying the causes of the Great Depression and the mistakes made by policy makers in handling it. About a year and a half after getting the job of "Central Banker of the World" he would have to face what almost becomes a Second Great Depression. At the beginning of October 2008, after some of the toughest weeks of the Great Panic, the lines in Ben Bernanke's face and the circles under his eyes offered evidence of more than a year of seven-day weeks and conference calls that stretched past midnight.¹²⁷

The subprime mortgage mess was *made* in America, and that meant the U.S. government was forced to lead the cleanup. Ben Bernanke had more immediate power to do that than any other individual. The president of the United States can respond instantly to a missile attack with real bullets but he

¹²⁴ Cfr. Ibid. 243

¹²⁵ NB. They are the heads of the 12 regional Federal Reserve Banks located across the U.S.

¹²⁶ Cfr. WESSEL David, *In Fed We Trust: Ben Bernanke's War on the Great Panic*, Crown Business, New York, 2009, p.10.

¹²⁷ Cfr. Ibid. 15.

cannot respond instantly to financial panic with real money without the prior approval of Congress. But Bernanke could and did. The Federal Reserve was the first responder to the financial crisis. It acted as quickly and forcefully as its leaders could manage in order to prevent the U.S. and the global economy from plunging into the abyss.¹²⁸

As the crisis worsened, central bankers around the globe cut interest rates, and by late 2008 and 2009 the Federal Reserve, the Bank of England, the Bank of Japan, the Swiss National Bank, the Bank of Israel, the Bank of Canada, and even the European Central Bank had pushed interest rates close to zero. In the case of the U.S it has remained in around 0.25% for 3 years. Compared to previous financial crises, this exercise of monetary policy was remarkably swift and partially coordinated. But the collective cuts did little to stimulate loans, much less consumption, investment, or capital expenditures, as market rates remained very high given the fear and uncertainty in banks, households, and firms. Nor did these cuts arrest the slide toward deflation. Conventional monetary policy ceased to have a great impact over the markets.¹²⁹

The Fed could inject plenty of liquidity into the banks, but it could not make banks lend it out. If they did anything with their excess reserves, they put them into the closest thing to cash: risk-free government debt. So while the Fed was willing to lend money at low rates, the actual market rates at which banks lent to one another—the LIBOR¹³⁰—remained very high. Worse, because the rates of many other kinds of short-term loans and of variable-rate mortgages are pegged in part to the LIBOR, borrowing remained very high for private firms and individuals.¹³¹

When the crisis hit, Bernanke instituted a series of measures, aimed at cutting the spreads between the short-term—and subsequently, the long-term—rates set by the market and the short-term rates set by policy makers. To accomplish this, the Fed set up a series of new “liquidity” facilities that made low-cost loans available to anyone who needed them. In effect, the government jumped directly into the market, reaching far beyond the usual mechanisms of

¹²⁸ Id.

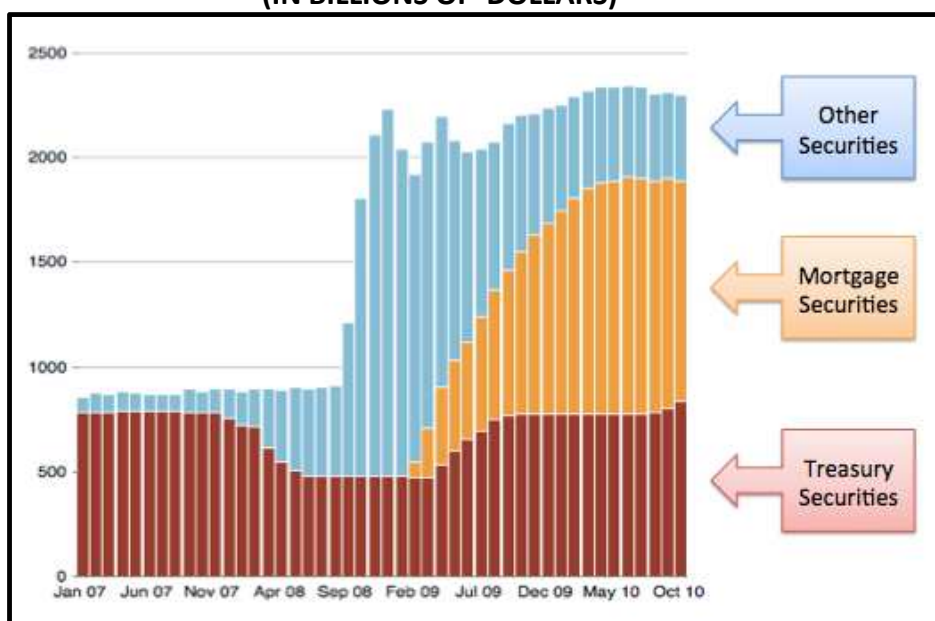
¹²⁹ Cfr. ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit. 163.

¹³⁰ NB. It is an acronym for London Interbank Offered Rate. It is the average interest rate that leading banks in London charge when lending to other Banks and serves as reference for the financial system.

¹³¹ Cfr. ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit. 164.

injecting liquidity and made loans directly to ailing financial institutions. The Federal Reserve and other central banks that instituted comparable programs had become not only the quintessential lender of “last resort” but first, last, and only resort and even adopted a new role: as investor of last resort. These interventions had little or no precedent in the history of central banking. They amounted to a massive expansion of government support of the financial system.¹³²

FIGURE 17
FEDERAL RESERVE BALANCE SHEET COMPOSITION
(IN BILLIONS OF DOLLARS)



Source: Financial Times Market Data
 Made by: Germán Guerra Silva.

One of the more remarkable weapons that the Fed and other central banks brought to bear on the crisis was “quantitative easing”. The basic idea is to have the central bank intervene in markets for long-term debt in the same way that it does in markets for short-term debt. They used it because the measures adopted so far hadn’t worked their magic. Thanks to cuts in the overnight Federal funds rate and the different new liquidity facilities banks had access to plenty of cash. Yet for all that largesse, banks continued to refuse to make longer-term loans to the many firms and businesses that needed credit to stay alive.¹³³

¹³² Cfr. Ibid 167.

¹³³ Cfr. HARDING Robin et al., *Quantitative easing explained*, <http://www.ft.com/intl/cms/s/0/69e8c92c-e758-11df-880d-00144feab49a.html#axzz1aKiXSxr2>, Access: October 4th 2011, 16:12.

Using quantitative easing, the Federal Reserve would attack this problem on multiple fronts. It would wade into the financial system and start buying up long-term government debt: ten-year and thirty-year Treasury bonds. That would immediately inject massive amounts of liquidity into the market because the Fed would pay for those bonds by creating money out of thin air.

This would also make less attractive for financial institutions to have their money invested in long-term government bonds, which were paying around 3 and 4% for 10 and 30-year bonds. Since the Fed was creating great additional demand for this kind of bonds, the prices would go up and the yields paid by these bonds would go down (because bond prices and yields go in opposite directions) making less attractive this type of investment and therefore banks would lend money to those starving for credit.¹³⁴

The policy of quantitative easing, adopted by the Fed and other central banks, provoked a profound transformation. In 2007, for example, the Federal Reserve held approximately \$900 billion worth of assets, consisting almost entirely of its stock in trade: the debt of the U.S. government. By October 2010, the Fed's balance sheet had expanded to approximately \$2.3 trillion, the overwhelming majority of which consisted of assets accumulated during the crisis, such as home mortgages, credit card debt, and auto loans. But after QE1¹³⁵ effects started to fade and the economy was once again in a slow path, the Fed decided to implement a second round of quantitative easing, QE2.¹³⁶

But since the U.S. economy seemed to dangerously close to a double-dip recession, the Fed had to step up once more to stimulate the economy. On September 21, the Federal Reserve announced its intention to purchase \$400bn of long-dated Treasuries and sell an equivalent amount of short-term securities. It said the program "should put downward pressure on longer-term interest rates". The name of this action was "Operation Twist". With this action the Fed makes evident its deep concerns about the weakness of the economy. It wants also to communicate that it has options to stimulate the economy.¹³⁷

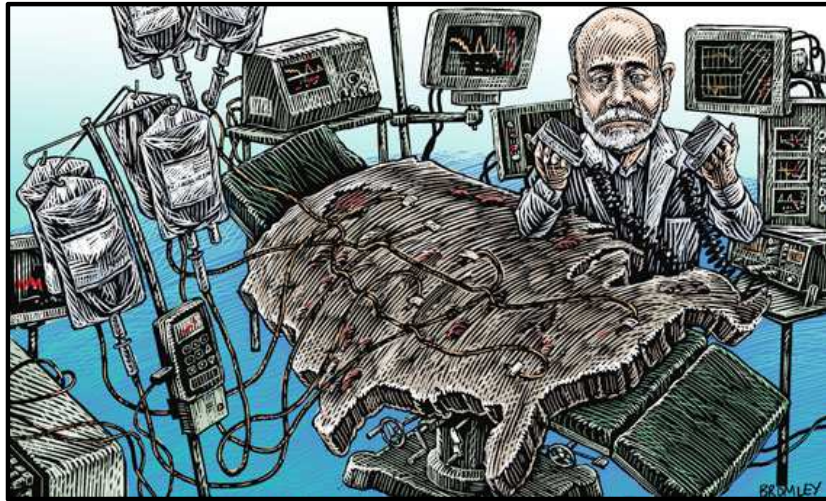
¹³⁴ Cfr. FINANCIAL TIMES, *The rise of quantitative easing*, http://www.ft.com/intl/cms/s/3/f74b0fee-e1d3-11df-b71e-00144feabdc0,dwp_uuid=9d04b7e0-e671-11df-95f9-00144feab49a.html#axzz1aKiXSxr2, Access: October 5th 2011, 09:48.

¹³⁵ NB. an acronym for the first round of quantitative easing.

¹³⁶ Cfr. *Id.*

¹³⁷ Cfr. HEANEY Vince, *Fed's Operation Twist signals deep concern*, <http://www.ft.com/intl/cms/s/0/d591d6ae-e9f6-11e0-b997-00144feab49a.html#axzz1aKiXSxr2>, Access: October 5th 2011, 22:43.

IMAGE 5
BEN BERNANKE TRYING TO REVIVE THE U.S' ECONOMY



Source: Financial Times.
Made by: Bromley

Unfortunately, a radical remedy administered in a crisis is bound to have unintended consequences. For starters there is fear of inflation going out of control sometime in the future. Also, the Fed has sent a clear message to the financial markets that it will do almost anything and everything to prevent a financial crisis from spinning out of control. And in such a context the risk of moral hazard is very much present and puts the whole economic system in a compromising position because as the saying¹³⁸ says “Capitalism without bankruptcy is like Christianity without hell”.¹³⁹

2.1.2. The Debt ceiling debate and political gridlock.

The first version of the US debt ceiling was created in the Second Liberty Bond Act of 1917, which helped finance the US entry into the First World War. Before then, the Treasury had to obtain Congressional approval every time it wanted to borrow money. The 1917 ceiling was set at \$11.5bn, a far cry from the \$14,300bn level where it stands today (October 2011).¹⁴⁰

U.S. Federal law requires Congress to authorize the government to borrow any money that is needed to pay for the programs that Congress has passed. As the national debt has grown, the Treasury has periodically bumped against this debt limit or debt ceiling. Votes to raise it are among the least

¹³⁸ NB. Said by Frank Borman an American astronaut

¹³⁹ Cfr. ROUBINI Nouriel, *Crisis Economics: A Crash Course in the Future of Finance*, op. cit.176.

¹⁴⁰ Cfr. MCGREGOR Richard et al., *US debt crunch: A nation taken to the limit*, <http://www.ft.com/intl/cms/s/0/be3ff8b8-ae51-11e0-844e-00144feabdc0.html#axzz1bLoBs1Op>, Access: October 12th 2011, 17:36.

popular things Congress does. The current aggregate debt limit was set up in 1939 and has been lifted nearly 100 times since then generally with little fanfare. But in 2011, the debt ceiling became the central battleground for conflict between the Republicans who took control of the House in the 2010 elections, and President Obama and the Democrats who still control the Senate.¹⁴¹

In May 2011, the Treasury Department announced that the debt limit of \$14.29 trillion had been reached, but said it could keep the government functioning normally by "extraordinary measures" that would run their course by Aug. 2. By the end of July, increasingly bitter talks still continued, as an event that had once seemed unthinkable — a default by the federal government — loomed only days away. Late on the night of July 31, President Obama and Congressional leaders of both parties announced an agreement that would raise the debt ceiling by up to \$2.4 trillion in two stages, enough to keep borrowing into 2013. The pact called for at least \$2.4 trillion in spending cuts over 10 years, with \$900 billion in across the board cuts to be enacted immediately.¹⁴²

The debt-ceiling agreement doesn't involve major spending cuts for 2011 or 2012. Of the nine hundred billion dollars in cuts already agreed upon, just twenty-five billion, less than one per cent of the federal budget, are scheduled for fiscal 2012. The cuts get steeper in later years. If there is no agreement on where cuts will be made or on revenue increases, a series of automatic cuts in military spending, education, transportation and Medicare payments to health care providers will go into effect in 2013.¹⁴³

Large portions of both parties were unhappy with the plan — Democrats opposed it because it cuts spending deeply without raising revenues, while many in the Tea Party wing of the House Republican were against any increase in the debt limit. Many economists complained that cutting spending in a time of economic weakness would slow down any recovery. Nevertheless, the House approved the agreement on Aug. 1st 2011, by a 269 to 161 vote. The Senate

¹⁴¹ Cfr. THE NEW YORK TIMES, *Federal Debt Ceiling*, http://topics.nytimes.com/topics/reference/timestopics/subjects/n/national_debt_us/index.html?scp=1-spot&sq=debt%20ceiling%20&st=cse, Access: October 12th 2011, 18:08.

¹⁴² Cfr. Id.

¹⁴³ JOHN Cassidy, *How bad is it?*, The New Yorker, New York, August 15th 2011, The Talk of the Town, p. 29.

passed the measure the following day, hours before the deadline set by the Treasury. It was signed shortly thereafter by Mr. Obama.¹⁴⁴

The agreement means there will not be another fight over the debt limit until 2013. But despite Mr. Obama's call to set the matter apart from partisan budget fights, Senator Mitch McConnell of Kentucky, the Republican leader, saw things differently. "Never again will any president, from either party, be allowed to raise the debt ceiling without being held accountable for it by the American people and without having to engage in the kind of debate we've just come through," he said in a speech on the Senate floor.¹⁴⁵

In a similar way, the U.S. public opinion states that democracy triumphed when the legislation to raise the debt ceiling was approved. But that "victory" had a very different meaning in Beijing. There, it is hard to imagine something better to vindicate the Chinese Communist Party idea that western democracy is some sort of institutionalized chaos that any sane Asian has to avoid than the debt ceiling debate. This kind of political gridlock and the huge debt the U.S. has are typical characteristics of a declining global power. So, with the approval of the legislation not only resounded proud American applause but also ran Chinese tiers of compassion.¹⁴⁶

An interesting fact is that besides the U.S. there is just one other country that has a debt ceiling. That's Denmark and its debt ceiling is deliberately kept very high so that it will never need to be raised. Why does no one else have a debt ceiling? Because when a legislature votes to authorize spending at a certain level but authorizes tax revenues at a lower level, it is assumed that the government will have to borrow the difference.¹⁴⁷

The vote to have higher expenditures than tax revenues is, in effect, a vote to borrow money to cover the difference. And in the United States, Congress, including Republicans, voted for a budget in which expenditures exceeded tax revenues. The logical consequence of that budget, again, passed

¹⁴⁴ Cfr. THE NEW YORK TIMES, *Federal Debt Ceiling*, op. cit.

¹⁴⁵ Cfr. Id.

¹⁴⁶ Cfr. NIALL Ferguson, *Washington proves the Communist were right*, Newsweek en español, Mexico D.F., August 14th 2011, Columns, p. 5.

¹⁴⁷ Cfr. ZAKARIA Fareed, *Fareed's Take: The damage is already done*,

<http://globalpublicsquare.blogs.cnn.com/2011/07/28/the-damage-is-already-done/>, Access: October 13th 2011, 10:15.

by Republicans and Democrats, is that the government has to make up the difference by borrowing.¹⁴⁸

To start a debate after the budget has been passed is like getting your Visa bill and calling up the company to say, "Actually we don't want to buy all that stuff we bought." That's not how it works. First you pay the bill, and then you can change your spending habits. Politicians have created a circumstance in which the world doubts the credibility of the U.S., and the dollar's role as the world's reserve currency could be jeopardized.¹⁴⁹

The US, home to Hollywood and the inventor of televised politics, produced a cliffhanger of a show around the debt-ceiling debate. The prospect of default and tense and problematic deficit negotiations captivated the nation like a TV drama – and was, like most TV dramas, an escapist distraction from things that matter more. Chief among these things is the jobless recovery the US is in right now. For more than two years, the unemployment rate has been close to or above nine per cent (that is the official rate; if the government counted people who have given up looking for work or who have been forced to work part time, the rate would be 16%).¹⁵⁰

IMAGE 6
THE DEBT CEILING “DEBATE”



Source: Financial Times.
Made by: Ingram Pinn.

A consequence of the “prime-time drama” on Capitol Hill, or the circus the politicians created was an unprecedented step by Standard & Poor’s of

¹⁴⁸ Cfr. Id.

¹⁴⁹ Cfr. Id.

¹⁵⁰ Cfr. SANDBU Martin, *Washington’s battle is a diversion*, <http://www.ft.com/intl/cms/s/0/d10e277a-bd39-11e0-9d5d-00144feabdc0.html#axzz1TGhq3vbz>, Access: October 13th 2011, 14:49.

downgrading the U.S. bond rating from the treasured AAA status to a AA+. In a statement, the ratings agency said:

The fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics (...) America's governance and policymaking is becoming less stable, less effective, and less predictable than what we previously believed (...) Despite this year's wide-ranging debate, in our view, the differences between political parties have proven to be extraordinary difficult to bridge¹⁵¹

If the US is to be solvent ten or twenty years from now, there will need to be reasonable limits on entitlement spending and a substantial increase in federal tax revenues, which are currently at fifteen per cent of GDP, the lowest level in sixty years. Yet neither entitlement reform nor revenue increases are dealt with in the agreement.¹⁵²

Across the political spectrum, pressure is building for a taxation overhaul that could boost the economy and win back the confidence of investors. But there is fierce disagreement on the details. Tax policy remains one of the most divisive issues in American politics, a critical battleground between Republicans and Democrats arguing over the size and role of the government – which makes it harder for either side to make concessions in the run-up to the 2012 election, with both parties basically unable to agree on anything.¹⁵³

But it is important to understand that none of the problems associated to the debt ceiling debate are happening because the United States is running deficits. There was no indication, by any metric, that the United States was having difficulty borrowing money one month before the debate started. In fact, the world has been lending money to the United States more cheaply than ever before. This country has a large deficit and debt that it needs to get under control. But that is not an excuse to endanger the good standing of the United States.¹⁵⁴

From now on, every time the debt ceiling needs to be raised, the world will wonder: *Will the U.S. stand by its promises or will it break them?* Something

¹⁵¹ THE WALL STREET JOURNAL, *S&P Strips U.S. of Top Credit Rating*, <http://online.wsj.com/article/SB10001424053111903366504576490841235575386.html>, Access: October 13th 2011, 23:01.

¹⁵² Cfr. JOHN Cassidy, *How bad is it?*, op. cit. 30.

¹⁵³ Cfr. POLITI James, *US tax system: A return to reform*, <http://www.ft.com/intl/cms/s/0/092efe64-ee67-11e0-a2ed-00144feab49a.html#axzz1aKiXSxr2>, Access: October 14th 2011, 22:07

¹⁵⁴ Cfr. ZAKARIA Fareed, *Fareed's Take: The damage is already done*, op. cit.

that was taken for granted, the credibility of the United States, is now surrounded by uncertainty. The IMF Managing Director Christine Lagarde says that "Global markets have always had a positive bias towards the United States but that is now eroded somewhat."¹⁵⁵

In pushing the government to the brink of default, the House Republicans adopted outrageous tactics; that basically could be called blackmail. Those tactics worked politically, but at a great cost to the country. For this erosion, the U.S. has only itself to blame.¹⁵⁶

2.1.3. Debt and public finances in the United States.

The idea that one of the main developed countries would default on its debt was, until recently, a ridiculous claim. But now, the governments of the rich countries are borrowing so heavily that it is plausible that someday, the two assumptions on which the growing borrowing is based (that the lenders will keep making them loans and that the governments will keep honoring their debt) could collapse. These rising debt levels combined with intensified concerns about fiscal solvency now constitute a major threat to global financial stability.¹⁵⁷

One of the main impacts of financial crisis are declining revenues and higher expenditures, due to a combination of bailout costs, higher transfer payments and debt servicing costs, leading to a rapid and marked worsening in the fiscal balance. It was not just the private sector that had been living in a dream world sustained by housing and stock bubbles. Governments had been indirectly sharing in that dream, as they received some of the "phantom income" of the bubbles in the form of tax revenues.¹⁵⁸

In the concrete case of the U.S., its budget situation was not so precarious just 13 years ago. The appearance of a federal budget surplus took place for the first time in 1998. It arrived after five years during which the federal deficit had been constantly reducing from its highest level of nearly 300 billion during the 1992 fiscal year. This surplus came from 2 factors: fiscal

¹⁵⁵ Cfr. Id.

¹⁵⁶ Cfr. SANDBU Martin, *Washington's battle is a diversion*, op. cit.

¹⁵⁷ Cfr. ROBERT Samuelson, *Against a Wall of Debt*, , Newsweek, Mexico D.F., November 8th 2009, Essays, p. 20.

¹⁵⁸ Cfr. REINHART Carmen, ROGOFF Kenneth, *This Time is Different: Eight Centuries of Financial Folly*, op. cit. 231

conservatism with higher taxes and strong economic growth. The year 2000 saw the biggest surplus in relation to the PIB since 1948. During the last years of the 1990s the economy grew more than 4% a year. This happened thanks to the technology boom. This made the American business culture the envy of the world. The American information technology swept the global market and helped to improve the U.S. national psyche and change the vision of this country's place in the world.¹⁵⁹

By the end of the U.S. Bush Administration it was once again running a deficit. One of the main reasons for this deficit was the tax cuts implemented by Bush, also the impact of the two wars the U.S. engaged in after 9/11.¹⁶⁰

The first one was the war in Afghanistan, a natural response by the U.S. since the Taliban government in this country was a supporter of Al-Qaeda. It was in Afghanistan where the attacks had been planned and put underway. And then there was the war in Iraq, a war of choice that turned out to be unnecessary. There were no weapons of mass destruction and even Alan Greenspan in his autobiography said that the true motive was oil.

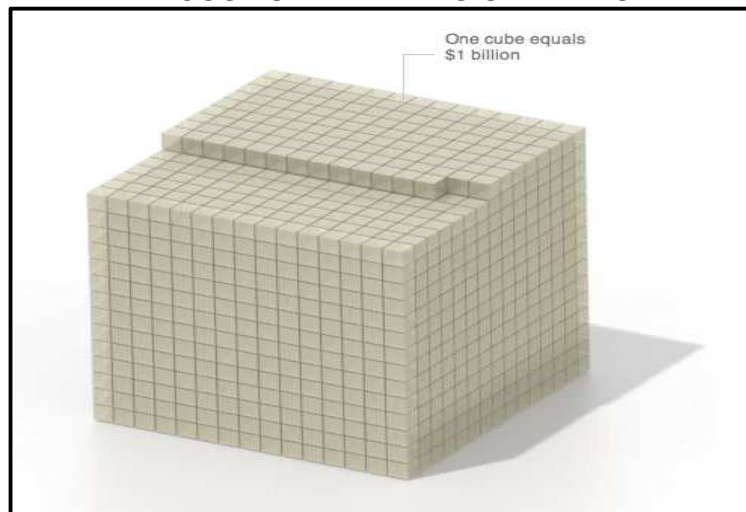
The cost of the two wars is around \$3.3 trillion dollars. One billion spent in Afghanistan and the rest on the war in Iraq that has cost thousands of lives and endless resources with the outcome of an unstable country with a government that is far from being a friend of the U.S. In other words, for every dollar Al Qaeda spent to pull off the Sept. 11 attacks, the cost to the United States was an astonishing \$6.6 million. The total cost of both wars, with some expenses still to come, equals one-fifth of the current national debt.¹⁶¹

¹⁵⁹ Cfr. GREENSPAN Alan, *The Age of Turbulence*, The Penguin Press, New York, First Edition, 2007, pp. 207-208

¹⁶⁰ *Id.*

¹⁶¹ Cfr. THE NEW YORK TIMES, One 9/11 Tally, <http://www.nytimes.com/interactive/2011/09/08/us/sept-11-reckoning/cost-graphic.html>, Access: October 16th 2011, 16:12.

IMAGE 7
THE COST OF THE WARS ON TERROR



Source: The New York Times.
Made by: Shan Carter.

The deficit for the fiscal year 2009 was more than \$1.4 trillion, about 10.8% of GDP, according to the Congressional Budget Office (CBO). That's a bigger deficit than any seen in the past 60 years, only slightly larger in relative terms than the deficit in 1942. The U.S. seems to be having the fiscal policy of a world war, without the war.¹⁶²

And yes, the United States is at war in Afghanistan and still has a significant contingent of troops in Iraq (U.S. troops will be totally cut by the end of 2011 as conditioned by the Status of Forces Agreement with the country, fulfilling a long-held campaign promise by President Barack Obama) but these are trivial conflicts compared with the World Wars.¹⁶³

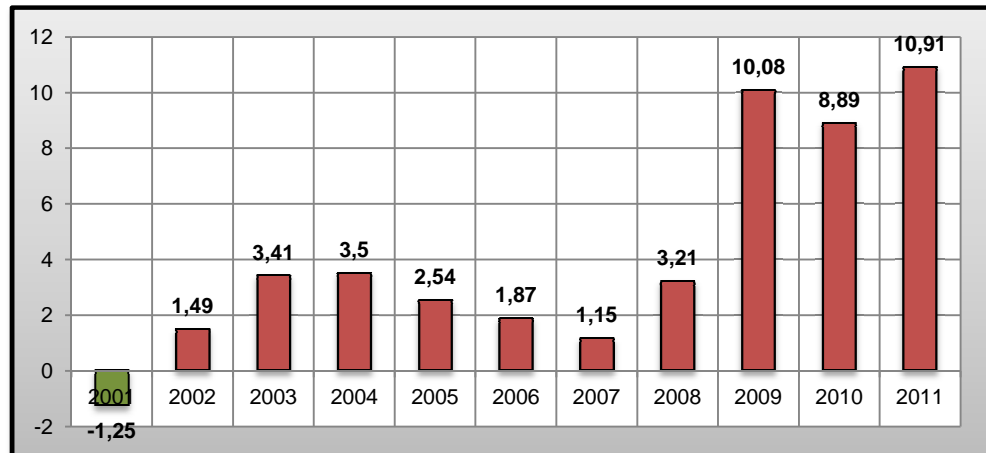
After the debt ceiling was lifted, it rose \$238 billion, the U.S. debt surpassed 100 percent of gross domestic product according to Treasury figures. The last time the debt topped the size of its annual economy was in 1945 during World War II. But the deficit at the time was driven by war spending; a degree of spending that declined once the war ended.¹⁶⁴

¹⁶² Cfr. FERGUSO Niall, *An Empire at Risk*, <http://www.thedailybeast.com/newsweek/2009/11/27/an-empire-at-risk.html>, Access: October 16th 2011, 18:14.

¹⁶³ Cfr. Id.

¹⁶⁴ FOX NEWS, *U.S. Debt Reaches 100 Percent of Country's GDP*, <http://www.foxnews.com/politics/2011/08/04/us-debt-reaches-100-percent-countrys-gdp/#ixzz1bThp6NGS>, Access: October 16th 2011, 19:57.

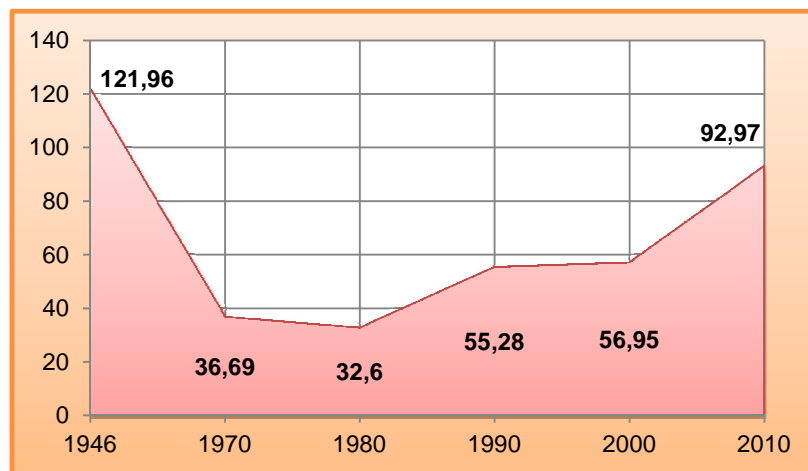
FIGURE 18
U.S. PUBLIC DEFICIT (%)



Source: Financial Times Market Data
Made by: Germán Guerra Silva.

The U.S. current deficits are driven in large part by entitlement programs that will not shrink without fundamental changes to their structure officials point, as well to lost revenue from the recession, tax breaks and increased domestic spending as contributors to the current deficit hole and gross debt. In other words, there is no end in sight to the borrowing binge. Unless entitlements are cut or taxes are raised, there will never be another balanced budget.¹⁶⁵

FIGURE 19
FEDERAL PUBLIC DEBT AS % OF GDP



Source: U.S. Government Spending.com
Made by: Germán Guerra Silva.

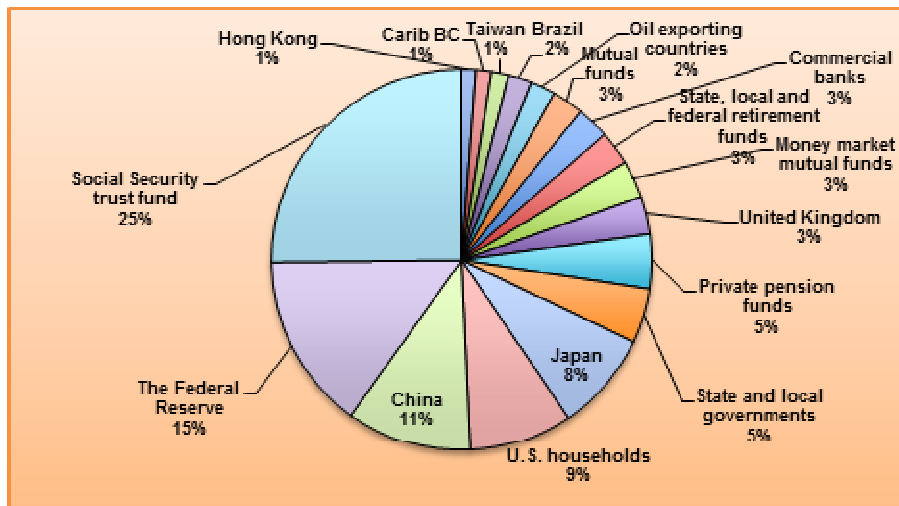
But what percentage of the federal debt is in fact debt of the actual government? Truth is elusive but it's a good thing we have math. Many

¹⁶⁵ Cfr. Id.

people — politicians and pundits alike — say that China and, to a lesser extent Japan, own most of America’s \$14.3 trillion in government debt.¹⁶⁶

But there’s one little problem with that conventional wisdom: it’s just not true. While the Chinese, Japanese and plenty of other foreigners own substantial amounts, it’s really Americans who hold most of America’s debt. So the U.S. government voted, after the debt ceiling fiasco, not to default on the debt that the government has with itself and with the American people.¹⁶⁷ Here’s a quick and fascinating breakdown by total amount held and percentage of total U.S. debt, according to Business Insider:¹⁶⁸

**FIGURE 20
BREAKDOWN BY PERCENTAGE OF THE TOTAL U.S. DEBT**



Source: Business Insider.
Made by: Germán Guerra Silva.

So, America owes foreigners about 29% of the total federal debt, or \$4.147 trillion. But the U.S. owes the U.S \$10.153 trillion or 71% of the total federal debt.¹⁶⁹

As it can be seen in the figure, China is the biggest foreign creditor of the U.S. with \$1.16 trillion dollars. In Beijing’s view the U.S. has become insolvent. Many Chinese observers merely see the debt agreement as a temporary solution. In words of the Xinhua News Agency, the last minute deal

¹⁶⁶ Cfr. MUCHA Tom, *Who owns America? Hint: It's not China*, <http://globalpublicsquare.blogs.cnn.com/2011/07/21/who-owns-america-hint-its-not-china/>, Access: October 15th 2011, 22:41

¹⁶⁷ Cfr. Id.

¹⁶⁸ BUSINESS INSIDER, *Who owns the U.S. Debt*, <http://www.businessinsider.com/who-owns-us-debt-2011-7#in-all-the-treasury-owes-foreigners-and-foreign-governments-4514-trillion-dollars-18>, Access: October 15th 2011, 24:12

¹⁶⁹ Cfr. Id.

“fail to permanently deactivate the Washington indebtedness bomb; the only thing that was achieved was to postpone the explosion, by lengthening the wick”¹⁷⁰

2.2. Bust: Greece, the Euro and the World Economy

The future of Europe seems uncertain. In spite of the important advances and efforts to consolidate a reasonable uniform union of countries that do not speak the same language, do not have common ethnic roots and have fought each other in many wars, Europe is facing today huge challenges that come from the lack of homogeneity in economic circumstances. The crisis that the continent is facing is the biggest one since the Second World War.

It is becoming clear that the 2008-2009 financial crisis is not over. It was simply being smothered by the full faith and credit of rich Western governments. Investors, scholars and some politicians are no longer talking about the collapse of a few bonds. They are talking about the collapse of entire countries.

It appears that the subprime mortgage crisis was more a symptom than cause. The financial crisis of 2008-09 was suspended only because investors believed that governments could borrow whatever they needed to rescue their banks. What happens when the governments themselves ceased to be credible? If we consider that situation is already starting to happen, another, bigger financial crisis is waiting to happen.

This subchapter will try to summarize the story of an international economic crisis in which a small country played a crucial role. At the time of this writing, it is not clear whether the impact will be cataclysmic, representing the beginning of the end of the good way of life for Europeans, or whether it will force a mere adjustment to the living standards of the Old Continent. The reasons are micro and macro, national and global. Not a single constituency emerges well from this story; Greek politicians, Greek society, trade unions, leaders of the European Union, the IMF, the world's investment banks, each and every one has scarcely put a foot right in a collective display of hubris,

¹⁷⁰ Cfr. NIALL Ferguson, *Washington proofs the Communist were right*, op. cit.

miscalculation, over ambition, deception, mis-selling, folly and, in some cases, sheer greed in a saga that has continued for decades.¹⁷¹

2.2.1. The Greek Tragedy.

Over the last decade, Greece went on a debt spree that came crashing to an end in late 2009, provoking an economic crisis that threatened Europe's recovery, the future of the euro and the world economy.

In 2001, an unreformed Greek economy was accepted into the European single currency. The reasons for this were overwhelmingly political, as the EU's leaders emphasized establishing as wide an area as possible for monetary union as part of the European movement's drive for full integration. Greece swapped the drachma for the euro, and acquired for its debt an implicit European (an euphemism for German) guarantee. Greeks could now borrow long-term funds at roughly the same rate as Germans, not 18 percent but 5 percent. To remain in the euro zone, they were meant, in theory, to maintain budget deficits below 3 percent of GDP; in practice, all they did was to alter its books to show that they were hitting the targets.¹⁷²

That same year entered Goldman Sachs, which engaged in a series of apparently legal but nonetheless hideous deals designed to hide the Greek government's true level of indebtedness. For these trades Goldman Sachs, which, in effect, handed Greece a \$1 billion loan, gained a reported \$300 million in fees. The machine that enabled Greece to borrow and spend at will was similar to the machine created to launder the credit of the American subprime borrower, and the role of the American investment banker in the machine was the same. The investment bankers also taught the Greek government officials how to securitize future receipts from the national lottery, highway tolls, airport landing fees, and even funds granted to the country by the European Union. Any future stream of income that could be identified was sold for cash up front and spent.¹⁷³

¹⁷¹ Cfr. MANOLOPOULOS Jason, *Greece's "Odious" Debt*, Anthem Press, New York, First Edition, 2011, p. 7

¹⁷² Cfr. *Ibid* 25

¹⁷³ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, W.W. Norton&Company, New York, First Edition, 2011, p. 64.

All this cheap money was put in all the wrong places. The public sector was overextended with wages that far exceeded those of the private sector. Just to give an example the Greek national railroad has annual revenues of 100 million euros against an annual wage bill of 400 million, plus 300 million euros in other expenses. The average state railroad employee earns 65,000 euros a year. Twenty years ago a successful businessman turned Minister of Finance named Stefanos Manos pointed out that it would be cheaper to put all Greece's rail passengers into taxicabs: that is still true.¹⁷⁴

The Greek public-school system is the site of breathtaking inefficiency: one of the lowest-ranked systems in Europe, it nonetheless employs four times as many teachers per pupil as the highest-ranked, Finland's. There are three government-owned defense companies: together they have billions of euros in debts, and mounting losses. The retirement age for Greek jobs classified as "arduous", is as early as fifty-five for men and fifty for women. More than six hundred Greek professions somehow managed to get themselves classified as arduous: hairdressers, radio announcers, waiters, musicians, and on and on and on.¹⁷⁵

Government ministers who have spent their lives in public service emerge from office able to afford multimillion-dollar mansions and two or three country homes. There is also a terrible culture of evading taxes. From individuals to big companies they learned the "art" of not paying their share of taxes to the government. Tax collectors are bribed, no service receipts are given and when someone is rarely caught evading taxes, at the end they are not prosecuted since no one bothers to start a legal process that on average lasts 6 to 7 years.¹⁷⁶

But, as anyone with a bit of common sense would have known, the Greeks would be able to disguise their true financial state for only as long as (a) lenders assumed that a loan to Greece was guaranteed by the European Union (aka Germany), and (b) no one outside of Greece paid very much attention.¹⁷⁷

¹⁷⁴ Cfr. *Ibid.*, 66

¹⁷⁵ Cfr. *Ibid.*, 67

¹⁷⁶ Cfr. MANOLOPOULOS Jason, *Greece's "Odious" Debt*, op. cit., 45.

¹⁷⁷ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 73.

That changed on October 4, 2009, when the Greek government turned over. A scandal demolished the government of Prime Minister Kostas Karamanlis and sent him packing. What's surprising about this was the nature of the scandal. In late 2008, news broke that Vatopaidi Monastery had somehow acquired a fairly worthless lake and swapped it for far more valuable government-owned land.¹⁷⁸

How the monks did this was unclear at the time (it turned out that they had swapped the lake for land with the Ministry of Agriculture, with the monks having to offer forgiveness apart from the lake)— they paid some enormous bribe to some government official, it was assumed. No bribe could be found, however. It didn't matter: the furor that followed drove Greek politics for the next year. Without Vatopaidi, Karamanlis would still be the Prime Minister, and everything would still be going on as it was before.¹⁷⁹

So as the global recession began in 2008, the Greek economy featured high levels of public debt, a large trade deficit, undiversified industries, an overextended public sector, militant trade unions, widespread corruption, uneven payment of taxes, an overvalued currency, consumers expecting rising living standards and euro membership based on inaccurate data.¹⁸⁰

When the new government arrived to power with George A. Papandreou as Prime Minister, in October 2009, the former Greek government had estimated its 2009 budget deficit at 3.7 percent. Two weeks later that number was revised upward, to 12.5 percent, and actually turned out to be nearly 14 percent. Once the new government started to go over the budget they discovered that the deficit of roughly 7 billion euros was actually more than 30 billion. How is this possible? Well, until that moment, no one had bothered to count it all up. The country had no independent statistical service. The party in power simply uses whatever numbers it likes, for its own purposes.¹⁸¹

In addition to its roughly \$400 billion (and growing) of outstanding government debt, the new Greek government had just figured out that it owed

¹⁷⁸ Cfr. *Ibid.*, 79.

¹⁷⁹ Cfr. *Ibid.*, 80.

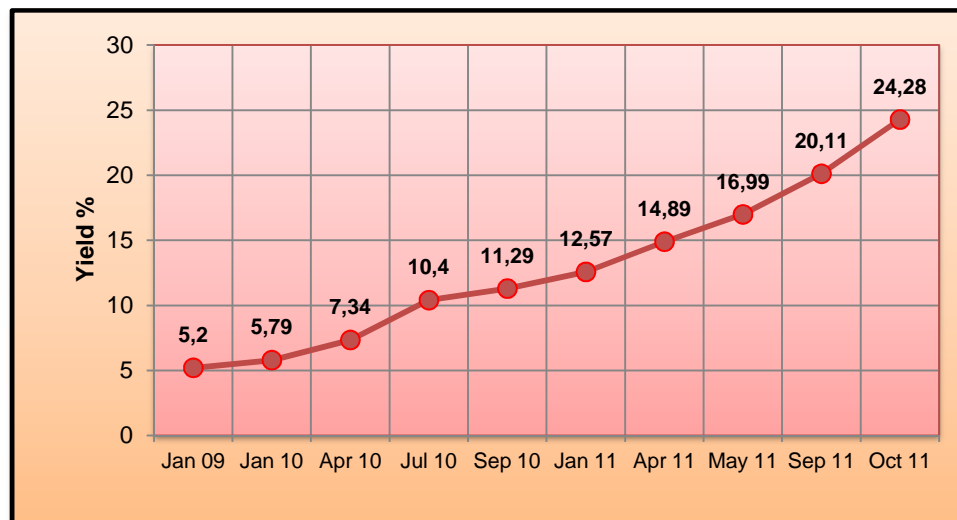
¹⁸⁰ Cfr. MANOLOPOULOS Jason, *Greece's "Odious" Debt*, op. cit., 7

¹⁸¹ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 84.

another \$800 billion or more in pensions. Add it all up and you got about \$1.2 trillion, or more than a quarter-million dollars for every working Greek.¹⁸²

When Mr. Papandreou announced that Greece's budget deficits had been badly understated, and that it was going to take some time to nail down the numbers, on November 2009, pension funds and global bond funds and other sorts who buy Greek bonds knowing the fragile state of a lot of European banks, panicked. The new, higher interest rates Greece was forced to pay left the country, which needed to borrow vast sums to fund its operations, more or less bankrupt. This continued until the interest rate on a 10-year Greek bond was over 6%, which forced the country out the financial markets.¹⁸³

FIGURE 21
YIELD ON A 10 YEAR GREEK BOND



Source: Financial Times Market Data.
Made by: Germán Guerra Silva.

Then came the rating agencies. From December 2009 Greece's credit rating was downgraded to the lowest level in the Eurozone as fears mount over its deteriorating public finances. By April 2010, Greece's credit rating was lowered to the level that turned all Greek government bonds into junk—and so no longer eligible to be owned by many of the investors who owned them.¹⁸⁴

¹⁸² Cfr. FINANCIAL TIMES, *Greece: a problem deferred*, <http://www.ft.com/intl/cms/s/3/467972d0-e2ce-11e0-93d9-00144feabdc0.html#axzz1befD9SGO>, Access: October 20th 2011, 21:09.

¹⁸³ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 93.

¹⁸⁴ Cfr. CADMAN Emily et al., *Interactive timeline: Greek debt crisis*, <http://www.ft.com/intl/cms/s/0/003cbb92-4e2d-11df-b48d-00144feab49a.html#axzz1befD9SGO>, Access: October 20th 2011, 22:12.

Then came the IMF to examine the Greek books more closely. At that moment it went out whatever tiny bit of credibility the Greeks had left. One senior IMF official said:

*Our people went in and couldn't believe what they found. The way they were keeping track of their finances—they knew how much they had agreed to spend, but no one was keeping track of what he had actually spent. It wasn't even what you would call an emerging economy. It was a third world country.*¹⁸⁵

Greece's experience in 2010, as it was attacked by financial markets, was similar to that of many developing countries. What was a surprise was that it occurred in an advanced industrial country. Oddly enough, the financiers in Greece remain more or less beyond reproach. They never ceased to be anything but sleepy old commercial bankers. Virtually alone among Europe's bankers, they did not buy U.S. subprime-backed bonds, or leverage themselves to the limit, or pay themselves huge sums of money. The biggest problem the banks had was that they had lent roughly 30 billion euros to the Greek government—where it was stolen or misspent. In Greece the banks didn't sink the country. The country sank the banks.¹⁸⁶

Since then, Greece has relied on a package of 110 billion euros, or \$152.6 billion, agreed to by its richer European neighbors and the IMF in May 2010. The price was a series of austerity measures meant to cut its large deficit and restore investor confidence. It cut the pay of its public workers — a quarter of the work force, by 10 percent but continued to miss deficit targets as its economy sank. Investors continued to demand ever higher interest rates for Greek borrowing as the market appeared to conclude that some sort of default was inevitable.¹⁸⁷

Greece barely avoided bankruptcy in June 2011, as European leaders threatened to withhold a 12 billion euro installment of the bailout funds until another austerity package of cuts, tax increases and sales of public companies was adopted. Mr. Papandreou managed to force the bill through Parliament in the face of days of massive street protests. People declared that the austerity measures were unfair. The interesting thing is exactly what a Greek finds

¹⁸⁵ Cfr. Id.

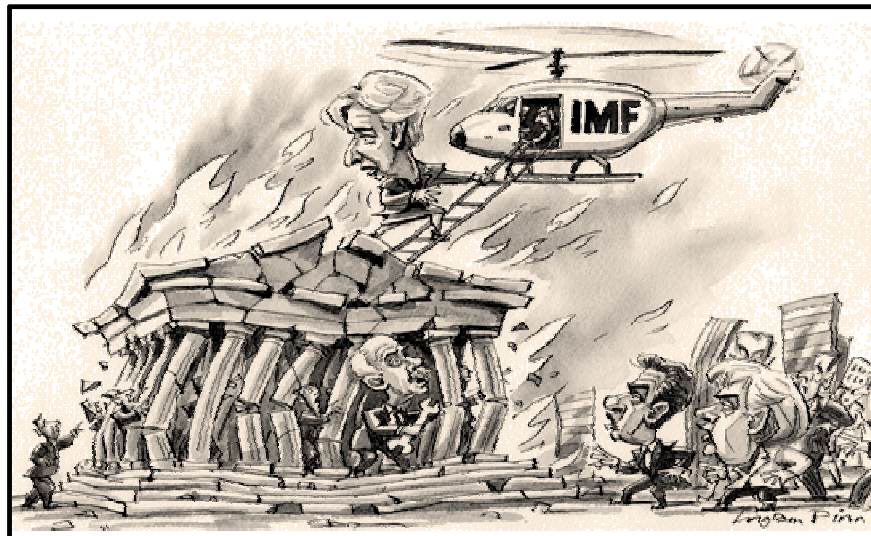
¹⁸⁶ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 132.

¹⁸⁷ Cfr. THE NEW YORK TIMES, *Greece News*, <http://topics.nytimes.com/top/news/international/countriesandterritories/greece/index.html?scp=1&sq=greece%20debt&st=cse>, Access: October 21st 2011, 09:17.

unfair. It's clearly not the corruption of their political system. It's not cheating on their taxes, or taking small bribes in their service to the state. No: what bothers them is when some outside party—someone clearly different from themselves, with motives apart from narrow and easily understood self-interest—comes in and exploits the corruption of their system.¹⁸⁸

Prime Minister Papandreou presented this bill, as he has presented everything since he discovered the hole in the books, not as his own idea but as a nonnegotiable demand of the IMF's. The general idea seems to be that while the Greek people will never listen to any internal call for sacrifice they might listen to calls from outside.¹⁸⁹

IMAGE 8
IMF AND EU LEADERS TO THE RESCUE



Source: The Financial Times.
Made by: Ingram Pinn.

In late July, European leaders agreed on a \$157 billion second bailout that proposed that investors swap some of their Greek bonds for loans with longer maturities and European guarantees. The deal would represent a loss of about 20 percent for banks — far less than the 60 percent discount Greek bonds were trading at.¹⁹⁰

In September 2011, European officials angrily stormed out of meetings in Athens, saying that Greece was failing to live up to austerity promises it had made for the first package. On Sept. 27, Greece's Parliament voted to back a

¹⁸⁸ Id.

¹⁸⁹ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 104

¹⁹⁰ Cfr. THE NEW YORK TIMES, *Greece News*, op. cit.

hugely unpopular new property tax, leading officials from the “troika” — the European Union, the European Central Bank and the International Monetary Fund — to clear the way the next installment of \$11 billion in international funding, avoiding a looming default. On Oct. 20, Parliament approved a new austerity measures, including additional wage and pension cuts, public sector layoffs and changes to collective bargaining rules, as violent demonstrations raged outside. Tens of thousands marched through Athens on the second day of a general strike.¹⁹¹

Meanwhile, the Greek economy continued to fall deeper into recession, with the recession projected to shrink by 6 percent in 2011, instead of 3 percent as previously forecast. That gloomy news led European leaders to consider pushing banks to take a far bigger “haircut” on their Greek loans than the 20 percent that had been agreed upon in July — perhaps as much as the 60 percent discount already reflected in the market price for Greek bonds.¹⁹²

The global financial system is consumed with the question of whether the Greeks will default on their debts. At times it seems as if it is the only question that matters, for if Greece walks away from \$400 billion in debt, then the European banks that lent the money will go down, and other countries now flirting with bankruptcy (Spain, Portugal) might easily follow. But this question of whether Greece will repay its debts is really a question of whether Greece will change its culture, and that will happen only if Greeks want to change.¹⁹³

2.2.2. The PIIGS and a Sovereign Debt Crisis.

The financial sector, after realizing the problems Greece was in, started to attack other peripheral countries that had high levels of debt, ultimately forcing them out of the private financial sector.¹⁹⁴

Greece’s debt troubles are not unique. Fourteen of the 27 European Union countries face debts equal to more than 60% of their gross domestic, the limit set by the European Commission. And that group includes some of the region’s biggest economies such as Britain and France. A large majority of this

¹⁹¹ Id.

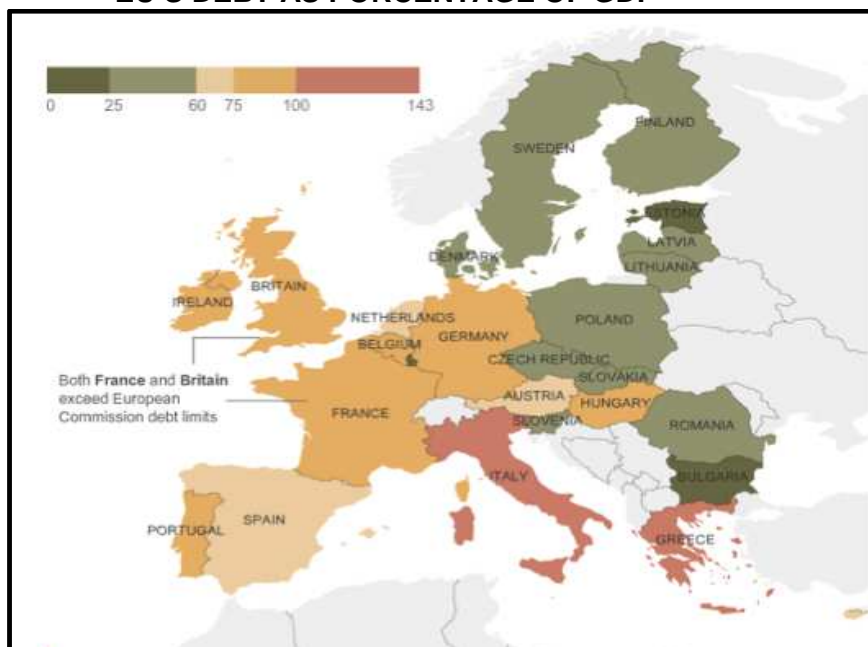
¹⁹² CADMAN Emily et al., *Interactive timeline: Greek debt crisis*, op. cit.

¹⁹³ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 108.

¹⁹⁴ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 132.

debt is issued on the international capital markets and is hence marketable, making it subject to fears and expectations of investors.¹⁹⁵

IMAGE 9
EU'S DEBT AS PORCENTAGE OF GDP



Source: The New York Times.
Made by: Kevin Quealy and Karl Russell

In the United States and a lot of Western countries, there is anger at the banks for now lecturing governments about the debt that has grown so much because of the bank's bad behavior. Seeing the huge deficits and the countries' need for funds, some in the financial sector saw a new opportunity for profits. Recognizing that when Greece came to the market to roll over its debt, or to finance its deficits, it might have trouble raising the funds without paying a high interest rate, the banks sold existing bonds short, betting that the bonds would fall in price. They used the new weapons of financial mass destruction, credit default swaps, to mount their attack.¹⁹⁶

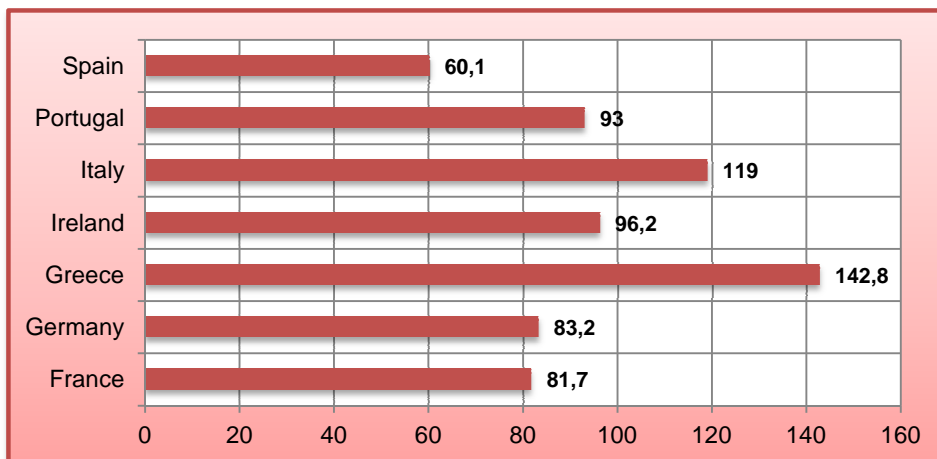
A credit default swap enabled investors to bet against the price of any given bond, to "short" it. It was an insurance policy, but with a twist: the buyer didn't need to own the insured asset. No insurance company can legally sell you fire protection on another person's house, but the financial markets can and

¹⁹⁵ Cfr. THE NEW YORK TIMES, *Debt Rising in Europe*, <http://www.nytimes.com/interactive/2010/04/06/business/global/european-debt-map.html?ref=global-home>, Access: October 28th 2011, 10:22.

¹⁹⁶ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 132.

will sell you default insurance on another person's investment. That is how the PIIGS countries put at risk the very existence of the euro.¹⁹⁷

FIGURE 22
DEBT AS PERCENTAGE OF GDP



Source: The New York Times.
Made by: Germán Guerra Silva.

PIIGS is a not-very-favorable term used by bond analysts, academics, and the media to refer to certain countries of Europe. Portugal, Italy, Ireland, Greece, and Spain make up the letters. All are part of the European Union and the Eurozone. The use of the acronym goes back to 1979 and describes countries in the EU considered to have troubled economies.¹⁹⁸

Originally, it was just PIGS, without Ireland. That changed in 2008, with Ireland's financial crisis and the country falling into recession. This was after Ireland had several years of economic growth, but two "economic bubbles", in credit and housing, pushed Irish banks and the economy into huge debt. The countries that make up the PIIGS are considered to have large risks of being unable to pay their national debts, and each country has faced some sort of severe economic crisis, either massive debt as in the case of Greece and Ireland, or slow growth and debt, in the case of Portugal and Spain.¹⁹⁹

Italy, too, has faced debt issues and has promised to cut debt and institute a liberalization of its economy to allow more 'free enterprise' and have less government control. The worry is that these five countries could bring down

¹⁹⁷ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 7.

¹⁹⁸ Cfr. KOBA Mark, *PIIGS: CNBC Explains*,

http://www.cnbc.com/id/44058478/PIIGS_CNBC_Explains, Access: October 28th 2011, 12:12.

¹⁹⁹ Id.

the European Union, as other European countries offer some kind of financial aid to these five nations, with tough restrictions, to avert a financial meltdown in the Eurozone.²⁰⁰

Many of the factors that helped to create the U.S. housing bubble were repeated outside this country. Countries like the U.K., Ireland and Spain had similar kinds of influences. In the case of the first, the situation was similar to that in the U.S. in the sophistication of the local financial markets as in the size of the economy. In the last two, the formation of the housing bubble was accelerated because the size of the investment and development of the housing industry as proportion of the total size of the economy accelerated growth and created an important wealth effect. In other words, as housing prices and other assets increased, the society inclination to consume increased, creating a fiction environment of plenty and prosperity.²⁰¹

If we had to summarize what happened, we could say that the adoption of the Euro allowed countries like Spain, Ireland, Portugal and Greece to have access to credit in conditions, interest payment and deadlines, they never dreamed of. Far from taking advantage of this condition to modernize their economies, invest in technology, modern machinery and equipment to make themselves more competitive internationally, they invested in bricks, creating ridiculous amounts of houses and apartments to satisfy the demand of local buyers, speculators and even buyers of northern Europe.²⁰²

Robert Samuelson, columnist of the Washington Post, says that the root of the crisis (concretely in the case of Ireland) comes from two essential political projects: first, the creation of a democratic welfare system capable of produce social justice through the creation of large social protection safety nets, second, the adoption of the euro as the main element of the European Union. It is important to notice that another important part of this crisis is the structural limitations to European growth with real rates of 2.5% between 1981 and 1993, of 2% from 1993 to 2003, but from then on only 1% while the obligations of the welfare European states grow exponentially as the population gets older.²⁰³

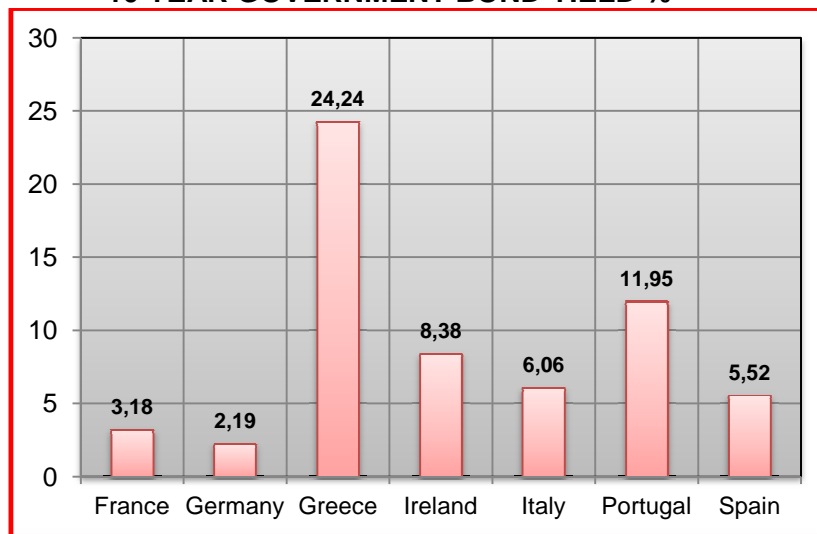
²⁰⁰ Id.

²⁰¹ Cfr. SUAREZ Jorge, *La Próxima Gran Caída de la Economía Mundial*, Debate, New York, First Edition, 2011, p. 91.

²⁰² Cfr. RACHMAN Gideon, *The single currency's true fatal flaw*, <http://www.ft.com/intl/cms/s/0/62a127a6-e2aa-11e0-897a-00144feabdc0.html#axzz1YtvyPdVs>, Access: October 29th 2011, 20:36.

²⁰³ Ibid., 94.

FIGURE 23
10 YEAR GOVERNMENT BOND YIELD %



Source: Thomson Reuters.
Made by: Germán Guerra Silva.

It is important to summarize what happened in each of the countries that are under attacks by the financial markets:

Ireland, unlike Greece, had a balanced budget before the crisis hit. However, it also had a huge real estate bubble even larger than the one in the United States. Before the crisis, 25 percent of its economy was involved in home construction compared with less than 10 percent in normal economies. Ireland is a good example of government arrogance, since when the financial crisis hit in September 2008, the bubble burst and the government announced it would cover all banks' losses, in an attempt to calm the markets. It guaranteed in an unlimited way for two years all bank deposits guaranteeing the big banks: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life & Permanent, Irish Nationwide Building Society and Educational Building Society.²⁰⁴

The promise turned out to be disastrous, as the banking sector continued to implode. Politicians believed that this kind of announcement ensures that the market will get scared and any speculation against them will run away scared. Nothing farther from the truth. Not only Ireland ended up being the safe haven of huge deposits looking for government guarantees, but

²⁰⁴ MATTHEWS Dylan, *Everything you need to know about the European debt crisis in one post*, http://www.washingtonpost.com/blogs/ezra-klein/post/everything-you-need-to-know-about-the-european-debt-crisis-in-one-post/2011/08/05/gIQAg69Qwl_blog.html, Access: October 29th 2011, 13:02.

the rescue ended up reaching more than one third of the Irish GDP because the banking system was superior to the size of the economy.²⁰⁵

In January 2009, Ireland nationalized one of its major banks, and in October 2010 conducted a bailout of some others. At this point, its budget deficit had grown to 32 percent of GDP. The following month, the E.U. and IMF launched a \$90 billion bailout of Ireland. In March 2011, the government was swept out of power, and the new government pledged to reduce the interest payments required under the E.U./IMF bailout, a promise they made good on in July 2011. On July 12, Moody's downgraded Irish debt to junk.²⁰⁶

In the case of **Portugal**, unlike Ireland and Greece, it had one of the best recovery records during the first part of the economic crisis. However, panic due to the Greek debt crisis hit the country in late 2009 and early 2010, due largely to concerns that the country could not grow over the long term, as well as higher deficit forecasts. It has below-average productivity, a legal structure some condemn as outdated, and strict labor market regulations that some say damages growth.²⁰⁷

By November 2010, the market had pushed interest rates to a point where the country was under pressure to ask for a bailout. Concern increased when the parliament failed to pass budget cuts in March 2011, and European leaders met to discuss the possibility of a rescue package. Finally, the Portuguese government requested an E.U. bailout in April 2011. It was approved in May and totaled \$116 billion. Portugal's center-right party came to power in elections in June and remains committed to the bailout. On July 2011, Moody's downgraded Portugal to junk status, saying there was a high risk of a second bailout.²⁰⁸

As for **Spain** like Ireland, it experienced a real estate bubble leading up to the crisis, which hurt its growth despite the country's unusually safe financial sector. Facing higher than expected deficits, Spain adopted austerity measures in May 2010. Fitch responded by downgrading its debt a notch from

²⁰⁵ Cfr. LEWIS Michael, *Boomerang: Travels in the New Third World*, op. cit., 109.

²⁰⁶ MATTHEWS Dylan, *Everything you need to know about the European debt crisis in one post*, op. cit.

²⁰⁷ Id.

²⁰⁸ Cfr. BBC NEWS, *Portugal's debt is downgraded to junk status by Moody's*, <http://www.bbc.co.uk/news/business-14038529>, Access: October 30th 2011, 21:01.

AAA, out of fear these measures would hurt growth. Moody's followed suit in September. In March, Spain announced it had met its deficit reduction target for the previous year. Moody's downgraded again, citing concern over slow growth. As fears of Greek default have increased, borrowing costs for Spain have spiked, spurring fears that it may require a bailout that other European governments cannot afford. Spanish leaders say they are considering more austerity, and Moody's has put Spanish debt on warning for another downgrade.²⁰⁹

In the case of **Italy**, due to its huge debt load and slow growth, fears that it would develop a debt crisis have circulated for months, but they grew more pronounced after S&P downgraded its outlook on Italian debt in May. In June, Moody's also threatened a downgrade, citing rising borrowing costs and the possibility that Italian Prime Minister Silvio Berlusconi, who is currently on trial for paying an underage girl for sex, might be forced out.²¹⁰

In August 2011, Berlusconi pushed through an austerity package intended to stave off a crisis as investors started selling off bonds. In October 2011, interest rates went up amid fears that a Greek default would cause a domino effect, causing Spain and Italy to fall as well. Europe probably has enough funds to support Spain for a short time, but Italy, the euro zone's third largest economy, would be incredibly expensive and perhaps impossible to bail out.²¹¹

**CHART 4
STANDARD & POOR'S CREDIT RATINGS**

France	AAA
Germany	AAA
Greece	CC
Ireland	BBB+
Italy	A
Portugal	BBB-
Spain	AA

Source: The New York Times.
Made by: Germán Guerra Silva.

At the time of writing, one more country is under scrutiny by the financial markets: France. Although not so strongly as the PIIGS but still questioned not

²⁰⁹ MATTHEWS Dylan, *Everything you need to know about the European debt crisis in one post*, op. cit.

²¹⁰ Id.

²¹¹ Id.

so much for its level of debt but for the strength of its banking system that is considerable exposed to sovereign debt of the troubled countries. This country along with Germany is the core of the E.U. and the Eurozone. This is the kind of country “too big to fail”.

In November 2011, President Nicolas Sarkozy cut France's growth forecast for 2012 and said he would offer new spending cuts. In Greece Prime Minister George Papandreou urged Greeks to support the new rescue plan. In Ireland, its government won't seek debt discounts, but might pursue other relief given to Greece, including cheaper interest payments on aid and longer to repay it, although the country remains committed to paying its debts in full.²¹²

Since Europe's problems no longer are a topic of concern only to that continent but rather is an issue that puts at stake the global economy because it could be hit really hard if the Eurozone were to collapse.²¹³ Leaders of the G-20 group of nations met in Cannes trying to help with the implementation of a plan the Eurozone leaders agreed on Thursdays, October 27th 2011, that could finally put an end to this economic drama of almost two years. But of course the general idea sounds promising but, as always, the “devil” is in the details.²¹⁴

2.2.3. The Euro Fatal Flaw and Possible Future Scenarios.

When the euro was created as a common currency in Europe, there were serious concerns by many experts. Countries that share a currency have a fixed exchange rate with each other and thereby give up an important tool of adjustment. If Greece and Spain had been allowed to decrease the value of their currency, their economies would have been strengthened by increasing exports.²¹⁵

Moreover, in switching their currencies to the euro, the two countries gave up another instrument for reacting to downturns: monetary policy. Instead, the hands of the countries of the Eurozone were tied. So long as there were no shocks, the euro would do fine. The test would come when one or more of the

²¹² Cfr. THE NEW YORK TIMES, *Tracking Europe's Debt Crisis*, <http://www.nytimes.com/interactive/business/global/european-debt-crisis-tracker.html?ref=europeansovereigndebtcrisis>, Access: October 30th 23:19.

²¹³ Cfr. Id.

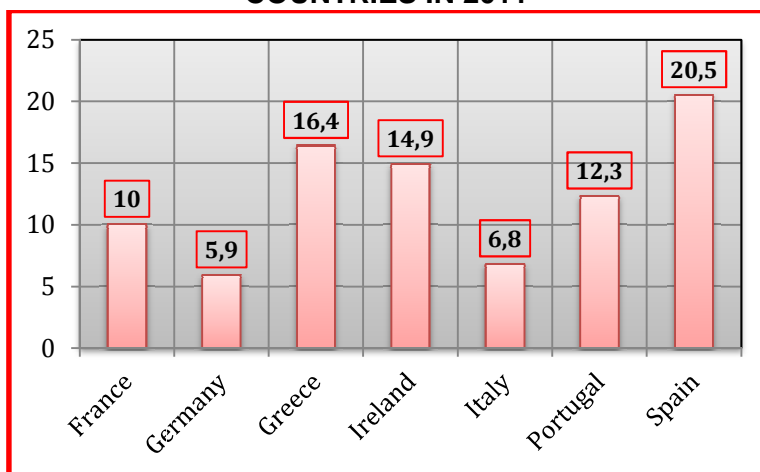
²¹⁴ Cfr. Id.

²¹⁵ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 135.

countries faced a downturn. The recession of 2008 provided that test and, as the moment of writing, it appears that Europe may be failing the test.²¹⁶

To make up for the losses of these vital tools for adjustment, the Eurozone should have created a fund to help those facing adverse problems. Europe has no way of helping countries facing severe problems. Spain has an unemployment rate of more than 20%, with 40 to 50 percent of young people unemployed. But under the rules of the game, Spain must now cut its spending, which will almost surely increase its unemployment rate still further.²¹⁷

FIGURE 24
UNEMPLOYMENT RATE IN SOME EUROPEAN COUNTRIES IN 2011



Source: The New York Times.
Made by: Germán Guerra Silva.

The euro-skeptics probably had the best arguments. They were right to note that there are no examples of lasting currency unions that are not ultimately backed by a political union. Some Europhiles, particularly in Britain, denied that a political union was necessary to support a single currency. Other Europhiles, particularly in Brussels, argued that economic union would, in due course, lead to a political union. The skeptics argued that, on the contrary, in an economic crisis, European political identity would be too weak to support the common currency. Events seem to be vindicating them.²¹⁸

There are big risks, including the future of the euro. Some in Germany (and headliners elsewhere) have responded: nothing was wrong with the euro's

²¹⁶ Cfr. Id.

²¹⁷ Cfr. Id.

²¹⁸ RACHMAN Gideon, *The single currency's true fatal flaw*, <http://www.ft.com/intl/cms/s/0/62a127a6-e2aa-11e0-897a-00144feabdc0.html#axzz1YtyvPdVs>, Access: October 30th 2011, 12:20

original framework. The only problem was laxity in enforcing the rules concerning fiscal discipline. If only Europe had been tougher, countries would have been forced to cut their deficits and debt. But the fact that Germany is a surplus country means that the majority of the rest of Europe is in deficit.²¹⁹

Therefore, the fact that countries other than Germany are importing more than they are exporting contributes to their weak economies. Germany views its high savings and its export prowess as virtues, not vices. But for every country with a surplus, there are others with a deficit, and countries with a trade deficit often must run fiscal deficits to maintain aggregate demand. Without the fiscal deficits, they will have high unemployment.²²⁰

But if one wants to understand why the euro is in such trouble we have to forget, for a moment, debt and sovereign bonds, and take a look at the bank notes. The images on euro notes are of imaginary buildings. While national currencies typically feature real people and places, George Washington on the dollar bill, the Bolshoi theatre on the Russian rouble, European identity is too fragile for that. Selecting a place or a hero associated with one country would have been too controversial. So the European authorities chose vague images that represented everywhere and nowhere.²²¹

Now, a decade after euro notes first emerged from cash machines across the continent, this lack of a common identity is the fatal flaw that may sink the common currency. Political leaders of the world have displayed palpable impatience with what they see as a lack of political leadership in Europe. But the problem that is damaging the currency ultimately has not to do with leadership, it is more fundamental than that. The fact that national loyalties are much stronger than any common European loyalty means leaders are constrained in the solutions they can feasibly consider.²²²

In most European Union countries, including Germany, the euro was introduced without securing the direct assent of voters. It was assumed that voters would learn to love their new currency, when they saw that it led to a more prosperous and powerful Europe. But now that the single currency is

²¹⁹ Cfr. Id.

²²⁰ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 136.

²²¹ Cfr. RACHMAN Gideon, *The single currency's true fatal flaw*, op. cit.

²²² Cfr. Id.

instead associated with pain, austerity and debt, the limits to European solidarity are clear.²²³

IMAGE 10
THE EURO TRUE FATAL FLAW



Source: The Financial Times
Made by: Ingram Pinn.

A series of half-offers and vague promises intended to calm the markets failed. After two years of crisis plans were in the making for broad ranging response that leaders hope would ensure the euro's long-term stability. Financial market pressures on Eurozone leaders have created responses that can be summarized in "too little almost too late".²²⁴

Since the Maastricht Treaty prohibits that one member state of the EU could rescue another in problems and the German constitution prohibits the government to provide such help, the European leaders created an SPV (special purpose vehicle) in order to triangulate help provided by States so it wasn't given in a direct way.²²⁵

With that in mind, after hesitating initially, Eurozone leaders in May 2010 scrambled to put together a €750bn emergency rescue package, with the European Union accounting for €500bn and the International Monetary Fund the rest: the European financial stability facility (EFSF) was constituted with 440bn euros. The EFSF is backed mainly by Germany (28.4%), France (21.3%) and Italy (18.7%). This program expires in 2013. The European Financial

²²³ Cfr. Id.

²²⁴ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 136.

²²⁵ Cfr. SUAREZ Jorge, *La Próxima Gran Caída de la Economía Mundial*, op. cit. 97.

Stabilization Mechanism provided 60 billion euros, and the IMF committed 250 billion euros of its resources to help the countries in problems.²²⁶

It was a “shock and awe” program: by announcing such a large program, members of the Eurozone hoped to convince the markets that Europe would come to the rescue of any country that needed help. But the market wasn’t please: interest rates for some of the “problematic” governments came down from the stratospheric levels to which they had risen, but they remained high, suggesting that the markets had not been fully convinced.²²⁷

The battle plans could go much further, to introduce strengthened fiscal rules, increased economic co-operation and co-ordination, and steps to improve competitiveness and the policing of government policies. But agreement on the future arsenal remains uncertain given sharpening differences between north and south, and even within the German government.²²⁸

However, the talk among investors and some European politicians now has been of a Greek default. It is becoming more and more evident that the money given to help Greece will only buy them time. The question is not whether Greece will default but when. The effects of any default would not be limited to Greece, however, since the investors would then question who was next. In a bid to avoid large losses, euros would flow from countries deemed at risk to those deemed safe.²²⁹

The sums are potentially huge, and the flows would reduce the value of sovereign debt of “at risk” nations. Plunging bond prices would further undermine the fate of many European banks and the confidence in Eurozone economies. A further slowdown would amplify this contagion. While the ECB has the firepower to fund Eurozone banks so long as they are solvent, any economic dislocation caused by contagion could become so severe that other countries would have to borrow more and on ever more unreasonable terms. More countries could decide to default.²³⁰

²²⁶ Cfr. ATKINS Ralph SPIEGE Peter, *Once more unto the breach*, <http://www.ft.com/intl/cms/s/0/52ccddf2-2fcc-11e0-91f8-00144feabdc0.html#axzz1cszRxp7P>, Access: October 29th 2011, 10:12.

²²⁷ Cfr. STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, op. cit., 137.

²²⁸ Cfr. Id.

²²⁹ Cfr. ATKINS Ralph SPIEGE Peter, *Once more unto the breach*, op. cit.

²³⁰ Cfr. Id.

The alternative would be to restore Greece's ability to create money to pay its bills – and that would require exit from the euro, to re-establish the central bank's ability to create money. If one country were to leave the euro, the fear would rise that others would follow, creating exchange rate risk across the zone, smart euros would fly out of, say, Tuscany and into Bavaria in case Italy also left the euro. Even so, the ECB could act as a circuit breaker, offering to buy unlimited sovereign bonds of countries under pressure, but that would require agreement across the zone that such purchases were acceptable.²³¹

If such unity were lacking, as it has been to date, other countries could find themselves with little option but to follow Greece out of the single currency, which could then break apart. None of these events is inevitable. But such are the vicious feedback loops in the system that everyone should be aware of the considerable risks. Should Athens default, the risks are real that both the euro and Europe would fail.²³²

Greece's debt has to be brought to a sustainable level. That can only be done by lowering the interest rate that Greece pays, lowering its indebtedness, and/or increasing gross domestic product. There are several ways this can be accomplished. But the institutional details are less important than an understanding of what will, and what will not, work. The strategy of the past 18 months of dealing with Greece's debt difficulties, the minimal response necessary to deal with the moment, has (predictably) not worked.²³³

Nor will more of the same. Official lending (from the International Monetary Fund and the European Union) has seniority over the private sector. The riskiness of new private sector lending is thereby increased, with obvious implications for interest rates. Meanwhile, as official lending replaces private sector lending, the risks associated with past lending are shifted to the public.²³⁴

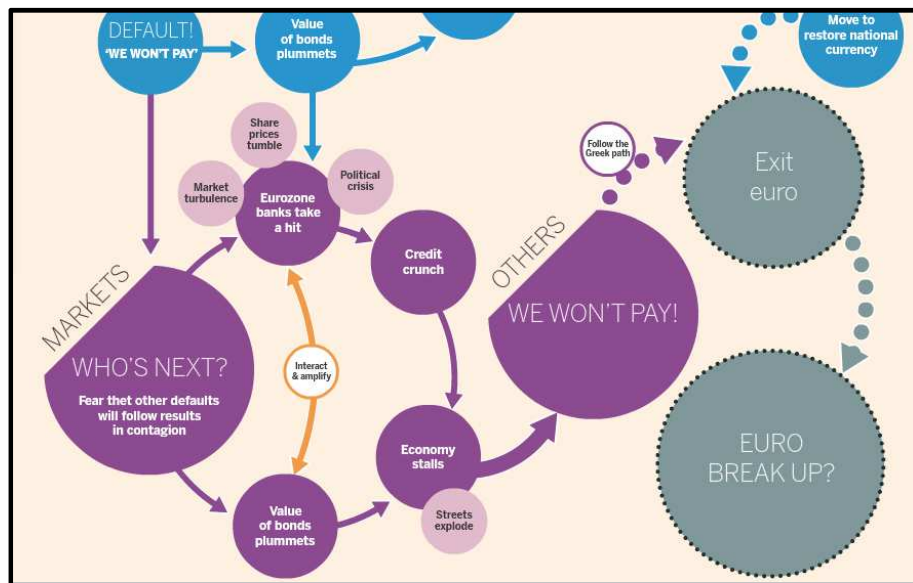
²³¹ Cfr. Id.

²³² Cfr. ATKINS Ralph SPIEGE Peter, *Once more unto the breach*, <http://www.ft.com/intl/cms/s/0/52ccddf2-2fcc-11e0-91f8-00144feabdc0.html#axzz1cszRxp7P>, Access: October 29th 2011, 10:12.

²³³ Cfr. Id.

²³⁴ Cfr. STIGLITZ Joseph, *Eurozone's problems are political, not economic*, <http://blogs.ft.com/the-a-list/2011/07/20/eurozones-problems-are-political-not-economic/#axzz1SascaW3V>, Access: October 29th 2011, 12:55.

IMAGE 11
CHAIN REACTION



Source: The Financial Times.
Made by: Germán Guerra Silva.

Of this we can be certain: Europe's response so far has amplified uncertainty concerning the future of the euro. "Contagion" has now spread from the periphery to the center, namely Spain and Italy.

An inverse crisis is hitting Europe. The first one in 2008-09 was a banking crisis that was absorbed by governments. Now governments are sinking the banks due to their exposure to sovereign bonds. A banking stress test was conducted in Europe to see how banks will react to a negative scenario. Only seven of 91 European banks failed a long-awaited stress test.²³⁵

But the problem is that this test lacked seriousness since it never consider a scenario of default by any country. Calls are now rising for a new stress test in order to determine the true likely impact of a crisis. Only then banks would be able to be adequately capitalized to strengthen the financial sector will it be better prepared to face a possible Greek or some other country's default.²³⁶

²³⁵ Cfr. Id.

²³⁶ Cfr. Id.

IMAGE 12
SOVEREIGNS SINKING THE BANKS



Source: The Financial Times.
Made by: Germán Guerra Silva.

On October 27th 2011 an agreement was reached that was hoped will put an end to the crisis. Leaders of the Euro area reached an agreement on a deal to save Greece and shore up banks exposed to losses on worthless Greek bonds. A €1 trillion rescue package will be put together along with forcing losses of 50% on bondholders of Greek debt and increasing to 9% the capital ratio for banks. However, the plan has been under pressure and European leaders are scrambling to implement extra measures and clarify the details of the bailout. For example there is no clear strategy to face the main problem of the countries in trouble, which is the lack of growth. Also it is unclear how the €1 trillion rescue package will be financed although the main idea is to have China and the emerging economies involved in the rescue. But while EU leaders managed to avoid immediate disaster, many experts question whether they have the political will and the economic firepower to resolve the long-term crisis.²³⁷

If much deeper European unity, through Eurobonds or the centralization of taxation and spending, is off the table, we are left with two options. Either the current program of austerity, mixed with emergency loans, will eventually “work”. Or some European countries will default and probably leave the single currency.²³⁸

As Nouriel Roubini the famous economist argued, a departure from the euro might ultimately be in Greece’s long-term interests. But the short-term economic and political consequences could be very grim, and not just in Greece. Europe could well see bank failures, much deeper austerity, higher

²³⁷ Cfr. NPR, *EU Pulls Greek Economy Back From Brink. Now What?*, <http://www.npr.org/2011/10/27/141767728/eu-pulls-greek-economy-back-from-brink-now-what>, Access: October 30th 16:40.

²³⁸ Cfr. RACHMAN Gideon, *The single currency's true fatal flaw*, op. cit.

unemployment, social unrest, political radicalization, heightened tension between nations and a threat to the EU itself. Under those circumstances, the economic crisis that started in 2008 will be very, very far from being finally over.²³⁹

2.3. The Decline of the West.

Relative decline is unavoidable. The rise of the rest (topic of the final chapter), though, is not a problem if the West grows at a half-decent pace. To the contrary, a buoyant global economy is a positive sum game. The danger arises when strong growth elsewhere is accompanied by immobility in the West, when a spasm turns into a spiral.

The pessimistic case starts with the financial crash of 2008. This was the event that crystallized the new geopolitical order. Previously such events had belonged to developing nations, to Latin America or to Asia. This one was made in the U.S.

The sacred text of liberal capitalism known as the Washington consensus was shredded. As the US and Europe fell into recession, it was left to the likes of China, India and Brazil to avert a collapse. The psychological impact has been profound. The West has lost its audience in the rising nations as the banking crisis has become a sovereign debt crisis. For outsiders looking in, this is about more than economics. They see a failure of liberal democracy.²⁴⁰

The moral authority of the West to lecture developing and emerging countries on the importance of good public finances and stable democratic systems is gone. Globalization imposes fast change and simultaneously weakens the ability of governments to adapt. Politicians find it easier to argue about taxing the rich or cutting entitlement and about central bank bond purchases versus default than to confront the consequences for western societies of the profound upheaval in the global economy.²⁴¹

²³⁹ Cfr. Id.

²⁴⁰ Cfr. STEPHENS Philip, *Spasm or spiral? The west's choice*, <http://www.ft.com/intl/cms/s/0/52ca17f6-b3cb-11e0-855b-00144feabdc0.html#axzz1SasgeYV7>, Access: November 2nd 2011, 10:12.

²⁴¹ Cfr. Id.

IMAGE 13
THE RISING OF A NEW GLOBAL POLITICAL
AND ECONOMIC ORDER



Source: The Financial Times.
Made by: Matt Kenyon.

So it is tempting to say that the West started a faster process of decline versus the “Rest”, that a political and economic model built on western primacy is cracking under the strain of the shifting balance of international advantage. The American dream and European welfare state are bending to the competitive winds of globalization.

The US faces an unsustainable debt burden alongside sustained political paralysis. Strategic decision-making is held hostage to ideological polarization. Democrats and Republicans may well have escaped a calamitous default. But that will not bridge the rancorous divide over tax and spending that piles deficit on deficit.

In Europe, the stakes have been higher still. The European Union’s core project, the single currency, has been collapsing under the weight of sovereign debt and political discord. Solidarity has been lost to resurgent nationalisms. Germany’s Angela Merkel says that 60 years of European integration is under threat. Yet the leader of Europe’s most powerful nation has seemed frozen in indecision.²⁴²

So here is the question: do these twin crises represent one of those damaging but short-lived spasms that have periodically disturbed the advance of the wealthy economies? A return of the 1970s? Or are the shocks of an

²⁴² Cfr. Id.

entirely different order – an omen of accelerating decline as the West surrenders two centuries of global hegemony?

2.3.1. The End of U.S' Hegemony.

Civilizations don't rise, fall, and then gently decline, as inevitably and predictably as the four seasons. History isn't one smooth, parabolic curve after another. Its shape is more like an exponentially steepening hill that quite suddenly drops off like a cliff. When you look back on the history of past civilizations, a striking feature is the speed with which most of them collapsed, regardless of the cause.²⁴³

The Roman Empire didn't decline and fall slowly, as historians used to claim. It collapsed within a few decades in the early fifth century, put over the edge of chaos by barbarian invaders and internal divisions. In the space of a generation, the vast imperial metropolis of Rome fell into disrepair, the aqueducts broken, the splendid marketplaces deserted. The Ming dynasty's rule in China also fell apart with extraordinary speed in the mid-17th century, succumbing to internal conflict and external invasion. Again, the transition from equilibrium to anarchy took little more than a decade.²⁴⁴

What all these collapsed powers have in common is that the complex social systems that supported them suddenly ceased to function. One minute rulers had legitimacy in the eyes of their people; the next they didn't. In the realm of power, as in the domain of the bond vigilantes, you're fine until you aren't, and when you're not fine, you're suddenly in a terrifying death spiral.²⁴⁵

In the U.S., every four years the National Intelligence Council (NIC) – which oversees its collection of intelligence agencies – releases a global trends report, which is given to the new president. The one given to President Obama on November 20th 2008, made headlines around the world since it established 2025 as the year when the U.S. dominance of the world will come to an end. As the NIC frankly notes, "the most dramatic difference" between the new report and the one issued before is that it now foresees "a world in which the US plays

²⁴³ Cfr. FERGUSON Niall, *America's 'Oh Sh*t!' Moment*, <http://www.thedailybeast.com/newsweek/2011/10/30/niall-ferguson-how-american-civilization-can-avoid-collapse.html>, Access: November 2nd 2011, 14:11.

²⁴⁴ Cfr. Id.

²⁴⁵ Cfr. Id.

a prominent role in global events, but the US is seen as one among many global actors". The report issued four years before, the one given to President Bush, projected "continuing US dominance".²⁴⁶

The NIC report has made people sit up because it comes from the heart of the US security establishment. But it is part of a broader intellectual trend in the US: a "new Declinism". This mood marks a complete break with the aggressive confidence of the Bush years and the "unipolar moment". Its starting assumption is that America, while still the most powerful country in the world, is in relative decline.²⁴⁷

Three developments have fed the new Declinism. First, the wars in Iraq and Afghanistan have underlined that US military supremacy does not automatically translate into political victory. Second, the rise of China and India suggest that America's days as the world's largest economy are numbered. Third, the financial crisis has fed the notion that the US is living beyond its means and that something is badly wrong with the American model.²⁴⁸

Americans have been concerned about the health of their country for much of its existence. In the 1950s and '60s, they worried about the Soviet Union and its march toward modernization. In the 1980s, they worried about Japan. This did them no harm; on the contrary, all these fears helped them make changes that allowed them to revive their strength and forge ahead. Dwight Eisenhower took advantage of the fears about the Soviet Union to build the interstate-highway system. Jack Kennedy used the Soviet challenge in space to set the U.S. on a path toward the goal of getting to the moon.²⁴⁹ So Americans can be forgiven if they greet talk of a new challenge from China as just another case of the boy who cried wolf. But a frequently overlooked fact about that fable is that the boy was eventually proved right. The wolf did arrive, and China is the wolf.²⁵⁰

The moment at which China becomes the world's largest economy is coming into view, the end of the decade seems a likely passing point. Of course,

²⁴⁶ Cfr. RACHMAN Gideon, *Is America's new declinism for real?*, <http://www.ft.com/intl/cms/s/0/ddbc80d0-ba43-11dd-92c9-0000779fd18c.html#axzz1cszRxp7P>, Access: October 30th 2011, 23:34.

²⁴⁷ Cfr. Id.

²⁴⁸ Cfr. Id.

²⁴⁹ Cfr. ZAKARIA Fareed, *Are America's Best Days Behind Us?*,

<http://www.time.com/time/magazine/article/0,9171,2056723,00.html#ixzz1dGpBrTqz>, Access: November 3rd 2011, 17:27.

²⁵⁰ Cfr. GIDEON Rachman, *Think Again: American Decline*, Foreign Policy, New York, January 2011, p.59.

it is true that China has its own grave political and economic problems. But they are the problems of a rising power. America's problems are plainly those of a power in decline.²⁵¹ Yet the fact that there are roughly four times as many Chinese as Americans means that, even allowing for a sharp slowdown in Chinese growth, at some point, China will become "number one". Moreover, Goldman Sachs predicts that China will become the first global economy measured in purchasing power parity by 2016.²⁵²

Moreover, the 9/11 attacks had a profound impact in the foreign policy of the U.S. The "war on terror" became the core of its policy towards the rest of the world. This may have distracted the U.S. from the true biggest geopolitical change of the last century: the rise of China and the emerging markets. The developing world is becoming a driver of the global economy. From the consumption of cement to eggs, China leads the world; it has also just overtaken US to become the world's largest market for cars.²⁵³

IMAGE 14
THE DECLINE OF THE U.S



Source: Newsweek Online.
Made by: Edel Rodriguez

China's voracious appetite for commodities is creating new trade routes, especially with emerging powerhouses such as Brazil. Last year, China surpassed the US as Brazil's biggest trading partner. Latin America, a region once best known for instability, has emerged through the crisis virtually untouched. Poverty is falling, the middle classes are expanding and asset

²⁵¹ Cfr. FERGUSON Niall, *Debt Debate: China's View*, <http://www.thedailybeast.com/newsweek/2011/08/07/china-s-view-of-the-debt-debate-america-in-decline.html>, Access: November 3rd 2011, 19:44.

²⁵² Cfr. RACHMAN Gideon, *America must manage its decline*, <http://www.ft.com/intl/cms/s/0/0c73f10e-f8aa-11e0-ad8f-00144feab49a.html#axzz1cszRxp7P>, Access: November 3rd 2011, 22:39.

²⁵³ Cfr. Id.

markets are bubbling. As for the legacy of 9/11, Gerard Lyons, chief economist of Standard Chartered Bank, says the three most important words in the past decade were not “war on terror” but “made in China”. On present trends, he adds, the three most important words of this decade will be “owned by China”.²⁵⁴

Several decades ago, economist Mancur Olson wrote a book called *The Rise and Decline of Nations*. He was driven by what he thought was a strange paradox after World War II. Britain, having won the war, slipped into deep stagnation, while Germany, the loser, grew powerfully year after year. Olson concluded that, paradoxically, it was success that hurt Britain, while failure helped Germany. The former embraced complacency, the latter hard work.²⁵⁵

Too much power is not good for a person, or for a nation. It leads to hubris, to the childish illusion of omnipotence, and, even when driven by good intentions, to abuse. In the case of the U.S., the illusion of being exceptional, the idea that the “Greatest Nation in the History of the World” can do anything, the illusion of omnipotence, rather than lengthening the days of *Pax America*, have speeded up its eventual demise.²⁵⁶

Another aspect that is accelerating the U.S’ decline is the increasing and alarming level of inequality. America is the original meritocracy. The American promise is that people are not prisoners of the circumstances of their birth. Who your parents are or where you were born should not determine your destiny. From the beginning, this has always been one of its self-evident truths. And for many decades, the U.S. had greater social mobility than other developed countries. But that is no longer true. The U.S. now ranks behind France and Finland in terms of the ability of people to move up the economic ladder.²⁵⁷

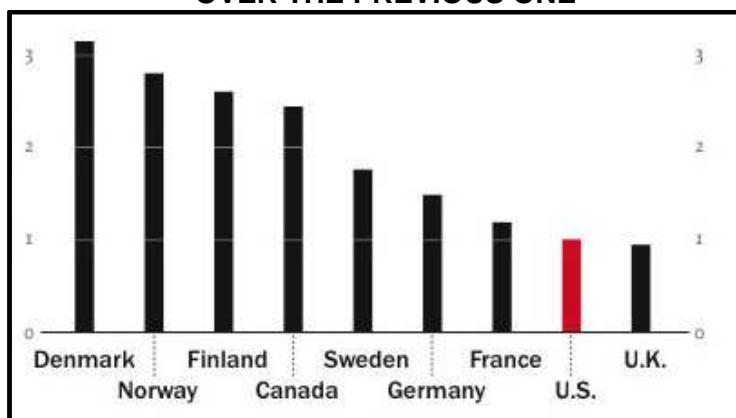
²⁵⁴ Cfr. BARBER Lionel, *The end of US hegemony: Legacy of 9/11*, <http://www.ft.com/intl/cms/s/0/f6acf1a6-d54d-11e0-bd7e-00144feab49a.html#axzz1cszRxp7P>, Access: November 4th 2011, 09:18.

²⁵⁵ Cfr. ZAKARIA Fareed, *Are America's Best Days Behind Us?*, op. cit.

²⁵⁶ Cfr. IAN Buruma, *Imperial Hubris*, Foreign Policy, New York, November 2011, The America Issue, p. 65.

²⁵⁷ Cfr. STENGEL Richard, *The Land of Opportunity*, <http://www.time.com/time/subscriber/article/0,33009,2098586,00.html>, Access: November 2nd 2011, 16:51.

FIGURE 25
RELATIVE INCOME MOBILITY OF A GENERATION
OVER THE PREVIOUS ONE



Source: TIME Online.
 Made by: TIME Online

The U.S story, its national mythology, is built on the idea of being an opportunity society. Americans care much more about being able to move up the socioeconomic ladder than where they stand on it. One may be poor today, but as long as there's a chance that he or she can be rich tomorrow, things are O.K.²⁵⁸

But does the US still work like that? The suspicion that the answer is *NO*, inspires not only the Occupy Wall Street (OWS) protests that have spread across the nation but also a movement as seemingly divergent as the Tea Party. While OWS may focus its anger on rapacious bankers and the Tea Party on spendthrift politicians, both would probably agree that there's a cabal of entitled elites on Wall Street and in Washington who have somehow alter the system and made it impossible for average people to get ahead.²⁵⁹

Some argue that this inequality was an unavoidable result of deeper shifts: global competition, cheap goods made in China, technological changes. Although those factors played a part, they have not been decisive. In Europe, where the same changes took place, inequality has remained much lower than in the United States.²⁶⁰

²⁵⁸ Cfr. Id.

²⁵⁹ Cfr. FOROOHAR Rana, *What Ever Happened To Upward Mobility?*, <http://www.time.com/time/magazine/article/0,9171,2098584,00.html>, Access: November 4th 2011, 13:01.

²⁶⁰ Cfr. PACKER George, *The Broken Contract inequality and American Decline*, <http://www.foreignaffairs.com/articles/136402/george-packer/the-broken-contract>, Access: November 4th 2011, 18:17.

The decisive factor has been politics and public policy: tax rates, spending choices, labor laws, regulations, campaign finance rules. Book after book by economists and other scholars over the past few years have presented a sound case: over the past three decades, the government has consistently favored the rich. This is the source of the problem: leaders and institutions.²⁶¹

The mythology of the American Dream has made it difficult to start a serious conversation about how to create more opportunity in their society, since many of them still believe that mobility is the result of hard work and nothing more. But there is a growing truth, seen in the numbers and in the protests that are spreading across that nation, that this isn't so. One can no longer blame the individual and, instead, should acknowledge that climbing the ladder often means getting some support and a boost.²⁶²

Inequality corrodes trust among fellow citizens, making it seem as if the game is arranged. It provokes a generalized anger that finds targets where it can -- immigrants, foreign countries, American elites, government in all forms -- and it rewards demagogues while discrediting reformers.²⁶³ Inequality diminishes the will to conceive of ambitious solutions to large collective problems, because those problems no longer seem very collective. Inequality undermines democracy.²⁶⁴

Democracy means rule by the people but everywhere, the people feel as if someone else is now ruling them, and see no way to regain control. They feel that the world is shifting deeply and inexorably beyond Americans ability to control it through their democratic institutions. That feeling laid the foundation of "Occupy Wall Street",²⁶⁵ a diffuse group of activists who say they stand against corporate greed, social inequality and the corrosive power of major banks and multinational corporations over the democratic process.²⁶⁶

On Sept. 17, 2011, the group began a loosely organized protest in New York's financial district, encamping in Zuccotti Park, a privately owned park

²⁶¹ Cfr. Id.

²⁶² Cfr. FOROOHAR Rana, *What Ever Happened To Upward Mobility?*, op. cit.

²⁶³ Cfr. PACKER George, *The Broken Contract inequality and American Decline*, op. cit.

²⁶⁴ Cfr. Id.

²⁶⁵ SULLIVAN ANDREW, *You Say You Want a Revolution*, <http://www.thedailybeast.com/newsweek/2011/10/23/how-i-learned-to-love-the-goddamned-hippies.html>, Access: November 4th 2011, 23:46.

²⁶⁶ THE NEW YORK TIMES, *Occupy Wall Street*, http://topics.nytimes.com/top/reference/timestopics/organizations/o/occupy_wall_street/index.html?scp=1-spot&sq=occupy%20wall%20street&st=cse, Access: November 3rd 2011, 15:29.

open to the public in Lower Manhattan. The idea, according to some organizers, was to camp out for weeks or even months to replicate the kind, if not the scale, of protests that had erupted earlier in 2011 in places as varied as Egypt, Spain and Israel during the year of “Global Indignation”.²⁶⁷

IMAGE 15
OCCUPIERS AGAINST THE FINANCIAL SECTOR



Source: The Financial Times.
Made by: Matt Kenyon.

The global public, more aware than ever of what is going on in the world, and more able than ever before to share ideas, facts, experiences, and testimonies, is highly sensitive to the established interests of the powerful who stand in the way of their dreams. Initially OWS was called a group of hippies who had no better things to do. But this movement gained legitimacy after other types of people started to join, like college graduates who can't find a job, and various unions and even several politicians that backed the movement.²⁶⁸

Occupiers consider that there is an “accountability deficit.” The financial sector and its deregulated leverage spree in the Clinton and Bush years greatly benefited the top 1 percent. Much of this, we now know, was based on obscure mathematical formulas no one fully understood at best or direct scams against their own customers at worst. What was Wall Street's response? A furious attempt to resist any new regulation, a refusal to take full responsibility for the mess, and eager participation in a bailout paid for in part by their victims. Who ended up paying the price? Not the elites. Largely the young, the poor, and the increasingly desperate middle class.²⁶⁹

²⁶⁷ Cfr. Id.

²⁶⁸ Cfr. HENDRIK Hertzberg, *A Walk in the Park*, The New Yorker, New York, October 17th 2011, The Talk of the Town, p. 25.

²⁶⁹ SULLIVAN ANDREW, *You Say You Want a Revolution*, op. cit.

Some on the peripheries seem skeptical of capitalism as a whole, but most seem to believe that what we currently have is not real capitalism, but a mixture of debt, cronyism, and corruption. The collapse of faith in big government is hard to distinguish from the collapse of support for big business, especially when the tax code reads like a conspiracy between them against the rest of society. And once the public loses trust in the core fairness of the economic and political system, we're in deeper trouble than we realize.²⁷⁰

What we're seeing today is a natural swing back against the excesses of the last 30 years of roller-coaster, globalizing capitalism. It's not so much a matter of left or right, but of balance. For the same reason, Occupy Wall Street is strikingly relevant today. Tax revenues, haven't been so low in half a century. The only way to achieve serious cuts in entitlements, the other half of the equation for fiscal balance, is if people believe that everyone is sacrificing something. That includes the rich. That isn't ideology. It's common sense.²⁷¹

In essence, even after the US has ceded its economic dominance, the US military, diplomatic, cultural and technological prowess will ensure that it remains the world's dominant political power, for a while at least. But although economic and political power are not the same thing, they are surely closely related. As China and other powers rise economically, they will inevitably constrain the U.S' ability to get its way in the world, since it is headed to be *primus inter pares*, first among equals.²⁷²

Finally, the U.S. is dangerously recreating the sequence of how empires decline: it begins with a debt explosion. It ends with an inexorable reduction in the resources available for the Army, Navy, and Air Force. After all, the lesson of history is clear. Voters and politicians alike dare not postpone the "big reboot". Decline is not so gradual that the biggest problems can simply be left to the next administration, or the one after that. If what the U.S. is risking is not decline but

²⁷⁰ Cfr. HENDRIK Hertzberg, *A Walk in the Park*

²⁷¹ SULLIVAN ANDREW, *You Say You Want a Revolution*, op. cit.

²⁷² PARENT Joseph MACDONALD Paul, *The Wisdom of Retrenchment*, <http://www.foreignaffairs.com/articles/136510/joseph-m-parent-and-paul-k-macdonald/the-wisdom-of-retrenchment>, Access: November 4th 2011, 17:10.

total collapse, then the time frame may be even tighter than one election cycle.²⁷³

2.3.2. The Possible End of the Euro.

The global financial crisis exposed the euro's weaknesses. When it first became apparent that Greece was in serious trouble, in 2009, the EU set itself two tasks. The first was to resolve the Greek crisis. The second was to convince the markets that Greece is an isolated case that bears no resemblance to the rest of the Eurozone. They have failed comprehensively in both tasks.²⁷⁴

The EU is institutionally blocked, insular, and incapable of effective crisis management. Low growth Europe is in decline in relation to the rising powers of China, India, Brazil and other emerging market economies. In short, Europe looks politically and structurally incapable of adapting to the challenges of today, let alone tomorrow.²⁷⁵ It has been known since the beginning of the financial crisis and subsequent economic downturn that the world order was changing in profound ways. But politicians have tried to dismiss it all with talk of temporary problems and cyclical recessions. They've come up with every possible excuse, from tsunamis to a lack of market certainty, to explain why rich-country economies aren't rebounding.²⁷⁶

But economic data tells otherwise: the West, and most immediately Europe, is in serious trouble. This is no other economic crisis but a crisis of the old order, a phrase once used by historian Arthur Schlesinger Jr. to describe the failures of capitalism in the 1920s. It is a crisis that is shaking not only markets, jobs and national growth prospects but also an entire way of thinking about how the world works, in this case, the assumption that life gets better and opportunities richer for each successive generation in the West.²⁷⁷

²⁷³ Cfr. FERGUSON Niall, *An Empire at Risk*, <http://www.thedailybeast.com/newsweek/2009/11/27/an-empire-at-risk.html>, Access: November 4th 2011, 23:57.

²⁷⁴ Cfr. RACHMAN Gideon, *Saving the euro is the wrong goal*, <http://www.ft.com/intl/cms/s/0/9542474a-0937-11e1-a20c-00144feabdc0.html#axzz1ddfnUOPI>, Access: November 6th 2011, 17:47.

²⁷⁵ Cfr. BARBER Liones, *Can the Euro survive?*, http://www.ft.com/intl/cms/s/2/26ded90a-e35c-11df-97db-00144feabdc0.dwp_uuid=79cadde4-5c1b-11df-95f9-00144feab49a.html#axzz1ddfnUOPI, Access: November 6th 2011, 10:15.

²⁷⁶ Cfr. FOROOHAR Rana, *The End of Europe*, <http://www.time.com/time/magazine/article/0,9171,2088040,00.html>, Access: November 6th 2011, 20:12.

²⁷⁷ Cfr. Id.

As bad as things might seem in the U.S., the burning center of the crisis is Europe. Volatile continental markets and angry demonstrations from Athens to Madrid are manifestations of the desperate struggle by European politicians to contain the euro-zone debt crisis that threatens to destroy the single currency and destabilize the region. The European Union and the euro zone were supposed to bring economic stability and remove traditional barriers to growth, such as tariffs and regulations. A monetary union had geopolitical appeal, too. In the wake of German reunification, the French worried that Europe was heading for a new kind of domination by its biggest member state. Getting the Germans to pool monetary sovereignty would increase the power of the other members over a potential Fourth Reich. And, best of all, it would create an alternative reserve currency to challenge the mighty U.S. dollar.²⁷⁸

Instead it's become a selfish union in which weakening economies feed rising nationalism, angst over immigration and provoking distrust between rich and less affluent countries.²⁷⁹ At each stage in the development of modern Europe, from the creation of the European Union to the introduction of the euro, it has always been difficult to get nations to agree to deeper political integration, which is hardly surprising given what a heterogeneous place Europe is. Now, Europe is at the center of the global financial problems. Those problems have been exacerbated by the inability, or the unwillingness, of policymakers to address the debt issues.²⁸⁰

IMAGE 16
THE COLLAPSE OF EUROPE



Source: The Financial Times.
Made by: Ingram Pinn.

²⁷⁸ Cfr. FERGUSON Niall, *The End of the Euro*, <http://www.thedailybeast.com/newsweek/2010/05/07/the-end-of-the-euro.html>, Access: November 5th 2011, 09:59.

²⁷⁹ Cfr. FERGUSON Niall, *Murder on the EU Express*, <http://www.thedailybeast.com/newsweek/2011/04/03/murder-on-the-eu-express.html>, Access: November 5th 2011, 15:18.

²⁸⁰ Cfr. FOROOHAR Rana, *The End of Europe*, op. cit.

Will the Eurozone survive? The leaders of France and Germany have now raised this question, for the case of Greece. The taboo that the euro might break-up was erased when these two leaders seriously started to question the Eurozone survival. If policymakers had understood two decades ago what they know now, they would never have launched the single currency. Only fear of the consequences of a break-up is now keeping it together.²⁸¹

Moreover, for reasons of pride, fear, ideology and personal survival, it is extremely hard for European leaders to accept that the euro is a large part of the problem. Instead they search for other explanations for the economic crisis. Countries have failed to stick to the rules. They have lied. Europe needs new political structures. The “bazooka”²⁸² is not big enough. The markets are irrational. The people are revolting. There are elements of truth in all these explanations. But they fail to get to the root of the problem. After roughly a decade we are discovering that a single currency area, uniting different countries with different levels of economic development – and very different political cultures – is inherently flawed.²⁸³

The euro has helped both to create and sustain the crisis in Europe. First, it caused interest rates to plunge in southern Europe, encouraging countries such as Italy and Greece to go on a borrowing spree. Now the single currency rules out the options that postwar Italy and others traditionally used to cope with high levels of debt: inflation and devaluation of the currency. Neither policy was cost free, but they provided an alternative to the “internal devaluation” (otherwise known as wage cuts and mass unemployment) that is currently being urged on Italy, Greece and much of southern Europe.²⁸⁴

Riots of the kind seen in London and Athens are just one side effect of the new age of austerity. Populist politics is another. Just as the economic downturn in the U.S. helped fuel the Tea Party, Europe's debt crisis is fueling a resurgence of polarizing, right wing politics. Xenophobia and anti-immigrant sentiment, especially against Muslims, are common, a fact most dramatically illustrated by the mass shootings at a Norwegian youth camp in July 2011. Even in mainstream politics, there's a sense that unity is impossible. Within the past

²⁸¹ Cfr. WOLF Martin, *Thinking through the unthinkable*, <http://www.ft.com/intl/cms/s/0/1299d48c-0a01-11e1-85ca-00144feabdc0.html#axzz1ddfnUOPI>, Access: November 7th 2011, 10:47.

²⁸² NB: “Bazooka” meaning a large enough rescue fund able to calm the markets.

²⁸³ Cfr. RACHMAN Gideon, *Saving the euro is the wrong goal*, op.cit.

²⁸⁴ Cfr. Id.

few months, Sarkozy, Merkel and British Prime Minister David Cameron have all spoken about the end of the European dream of multiculturalism.²⁸⁵

All the populist parties are deeply skeptical of the EU, which they see as promoting most of the things they hate: multiculturalism, international capitalism, the erosion of national borders and the erasure of national currencies. Far right politicians in France campaigns to withdraw France from the euro, impose tariff barriers and roll back the Schengen agreement on free movement of people across the EU. Polls show that a majority of the Dutch population now regret joining the European single currency.²⁸⁶

All this is happening in an economic situation that is bad – but not yet catastrophic. Imagine, however, what the European political landscape would look like if banks started to collapse, people lost their savings and their jobs, and there was another deep recession. At that point voters would be desperate and disillusioned enough to turn to the extremist parties in much larger numbers.²⁸⁷

To make things worse, Italy is in the financial storm now. With interest rates on its sovereign debt surging well above seven per cent on November 2011, there is a rising risk that Italy may lose market access. Given that it is “too-big-to-fail” but also “too-big-to-save”, this could lead to a forced restructuring of its public debt of €1,900bn. That would partially address its liquidity problem of large and unsustainable debt but it would not resolve its core problem: a large current account deficit, lack of external competitiveness and a worsening plunge in gross domestic product and economic activity.²⁸⁸

In November 2011, technocratic governments have taken office in Italy and Greece with Mario Monti and Lucas Papademos as respective Prime Ministers. They are perfectly at home in the world of yield curves and collateralized debt obligations. They understand foreign countries, as well as the markets. Since they are assumed not to want a long-term career in politics,

²⁸⁵ Cfr. FOROOHAR Rana, *The End of Europe*, op. cit.

²⁸⁶ Cfr. RACHMAN Gideon, *Look behind you, Lucas and Mario*, <http://www.ft.com/intl/cms/s/0/6913807e-0ebb-11e1-b83c-00144feabdc0.html#axzz1ddfnUOPI>, November 14th 2011, 11:36.

²⁸⁷ Cfr. Id.

²⁸⁸ Cfr. ROUBINI Nouriel, *Why Italy's days in the eurozone may be numbered*, <http://blogs.ft.com/the-a-list/2011/11/10/why-italys-days-in-the-eurozone-may-be-numbered/#axzz1diruQkTX>, Access: November 8th 2011, 12:41.

they may be able to take difficult decisions. Their qualifications will please the markets.²⁸⁹

So a great deal is riding on the ability of the technocrats to stabilize their national economies, calm the bond markets and prevent another financial crisis and a disorderly break-up of the euro. The trouble is that, while Mr. Monti, Papademos and Draghi are very able men, they are not miracle-workers. The danger is that the situation in Europe may now be too far gone for even the most steely and brilliant of technocrats to turn things around.²⁹⁰

IMAGE 17
BYE BYE BERLUSCONI



Source: The Financial Times.
Made by: Ingram Pinn.

But the financial problems for Europe and the euro do not end there. Spain may be the next victim of investors in the Eurozone bond markets because of its difficulty in meeting deficit reduction targets, weak economy and struggling banks, according to economists and analysts. Although Spain's stock of public debt is relatively small, below Germany's as a share of GDP, let alone Italy's, the country is nowhere near running a primary budget surplus and its private sector debt is burdensome. That affects the banks, and the potential losses on bank assets are "a massive contingent liability of the State".²⁹¹

Spain's National Statistics Institute said economic growth in the third quarter of 2011 was zero compared with the previous quarter. The economy

²⁸⁹ Cfr. ROUBINI Nouriel, *Why Italy's days in the eurozone may be numbered*, op. cit.

²⁹⁰ Cfr. Id.

²⁹¹ Cfr. MALLET Victor, *Spain seen as next eurozone victim by analysts*, <http://www.ft.com/intl/cms/s/0/9d5d69a8-0c63-11e1-8ac6-00144feabdc0.html#axzz1ddfnUOPI>, Access: November 10th 2011, 18:07.

expanded 0.8 per cent compared with the same period of 2010, but Spain is now unlikely to come close to the 1.3 per cent growth for this year forecast by the government and could fall into recession early 2012.²⁹²

It is alarming to see that not even France can escape the storm in the financial markets. France has not balanced its budget since the 1970s and is worrying about its triple A rating since Standards and Poor's "mistakenly" sent an email to investors informing that agency was about to downgrade the AAA rating of France. Hours later, the agency said that they were not planning to downgrade France although the doubt was already unleashed in the markets.²⁹³

Since the countries in trouble cannot devalue, or grow, or deflate to a real depreciation, the only option left will end up being to give up on the euro and to go back to the lira and other national currencies.²⁹⁴ It is true that breaking up the euro would be extremely difficult and dangerous. Capital flight and debt default in countries quitting the euro could cause banks to collapse. Economic and political chaos might follow, at least for a time.²⁹⁵

The Eurozone is caught in a gloomy downward spiral. Fears about whether the governments in Greece, Portugal, Ireland, Spain and, most alarmingly, Italy will honor their €3 trillion (\$4.2 trillion) are destroying European banks, which own their debt. Struggling banks undermine confidence and credit. Coming on top of fiscal austerity, this is bringing on recession, deepening fears that governments will be unable to pay back their debts, which further weakens the banks. And so the vice turns, down towards disaster. A euro-zone central banker confesses that he has lately been thinking about historical catastrophes such as the First World War and wondering how the world blundered into them. "From the middle of a crisis", he says ominously, "you can see how easy it is to make mistakes."²⁹⁶

The Eurozone can survive with the debt restructuring and exit of a small country such as Greece or Portugal. But if Italy and/or Spain were to restructure

²⁹² Cfr. Id.

²⁹³ Cfr. THE WALL STREET JOURNAL, *S&P 'Oops' on Rating of France Is Probed*, <http://online.wsj.com/article/SB10001424052970204224604577030083804142906.html>, Access: November 11th 2011, 14:19.

²⁹⁴ Cfr. ROUBINI Nouriel, *Why Italy's days in the eurozone may be numbered*, op. cit.

²⁹⁵ Cfr. RACHMAN Gideon, *Saving the euro is the wrong goal*, op. cit.

²⁹⁶ Cfr. THE ECONOMIST, *Starting into the abyss*, <http://www.economist.com/node/21536872>, Access: November 12th 2011, 18:18.

and exit this would effectively be a break-up of the currency union. Unfortunately this slow-motion train crash is now increasingly likely.²⁹⁷

The decision that Europe now faces is much bigger than whether to bail out Greece or other countries in problems. The real choice is between becoming a fully-fledged United States of Europe, or remaining little more than a modern-day Holy Roman Empire, a heterogeneous mixture of “variable geometry” that will sooner or later fall apart. The problem is that such a solution will take decades to implement, for a crisis that is escalating by the week.²⁹⁸

There is no doubt that the future of Europe lies in the hands of Germany. But the mood of the German voter can be summed up as follows: “No More *Herr Nice Guy*. So the tax-dodging Greeks, the “incompetent” Irish, and the bone-idle Portuguese expect the prudent German worker to write them yet another check?” For five decades after World War II, a penitent Germany paid up. The Federal Republic was the single biggest net contributor to the process of European integration. But the era of war guilt is now over. No matter how tough Chancellor Angela Merkel seems to the hard-pressed Greeks, to her own people she seems way too soft.²⁹⁹

For years the train of European integration ran on German subsidies. Not anymore. As the process of disintegration accelerates this year, as the economies of the periphery languish and their governments collapse, the demise of Europe is becoming everybody’s problem. If it results in a breakup of the Eurozone or even a growth reduction due to a series of bail-outs, it will reverberate from Beijing to Quito to New York and back. Let’s hope for the best but it will be smart to start preparing for the worst. The financial tsunami might soon cross the Atlantic.³⁰⁰

2.3.3. The Japanization of the West and a Double Dip Contraction.

If there is a poem for this moment, it is surely W.B. Yeats' dark classic "The Second Coming." Written in 1919, it evokes the darkness and uncertainty of Europe in the aftermath of a horrific war: "Things fall apart; the center cannot

²⁹⁷ Cfr. ROUBINI Nouriel, *The eurozone heads for break up*, <http://blogs.ft.com/the-a-list/2011/06/13/the-eurozone-heads-for-break-up/#axzz1diruQKtX>, Access: November 8th 2011, 09:47.

²⁹⁸ Cfr. FERGUSON Niall, *The End of the Euro*, op. cit.

²⁹⁹ Cfr. Id.

³⁰⁰ Cfr. RACHMAN Gideon, *Saving the euro is the wrong goal*, op. cit.

hold. Mere anarchy is loosed upon the world. The best lack all conviction, while the worst are full of passionate intensity." It's hard to imagine a more eloquent description of the current conflicted age.³⁰¹

The West, it seems, is out of ammunition, ideas and leadership. In his 20 years of attending IMF meetings, President Obama's former chief economic adviser Larry Summers said he had not been at one in which "matters have had more gravity." As a result, according to the new president of the European Central Bank, Mario Draghi, a "double dip" recession in Europe is now all but inevitable. Retail sales across the continent are plunging, and GDP growth, negligible the third quarter, will probably contract by year-end. Even Germany, the strongest nation in Europe, is affected. Industrial production in Europe's export powerhouse is falling as its neighbors and major trading partners fall back in financial and economic troubles.³⁰² That, of course are awful news for U.S. exporters and emerging markets targeting the EU market.³⁰³

But what is a double dip recession. Well, a "double dip" recession is two recessions in quick succession. If it were to happen, the DD recession will produce only 2 years after the first one ended in 2009. Historically speaking, this kind of recession has only occurred in the U.S. upon Fed monetary tightening: Whenever in post-war US history expansions have died young, the catalyst has been monetary policy tightening. Put differently: double-dips have occurred only when induced by the Fed.³⁰⁴

But the Fed has said that interest rates will remain very low till 2013. The U.S. economy during the last quarter of 2011 showed some modest growth and economic indicators are improving a bit but the country is unusually vulnerable to shocks. In addition to monetary tightening, the future US fiscal tightening is a worry. Moreover, given the weakness of sentiment in the US, a serious deterioration of the European crisis could just be sufficient to cause a double-dip.³⁰⁵

³⁰¹ FOROOHAR Rana, *A new Era Of Volatility*, <http://www.time.com/time/subscriber/article/0,33009,2095556,00.html>, Access: November 14th 2011, 10:51.

³⁰² Cfr. FOROOHAR Rana, *Berlusconi's Last Act*, <http://www.time.com/time/subscriber/article/0,33009,2099143-3,00.html>, Access: November 15th 2011, 12:39.

³⁰³ Cfr. FERGUSON Niall, *Europe's Disaster Is Headed Our Way*, <http://www.thedailybeast.com/newsweek/2011/11/13/europe-s-financial-crisis-is-headed-to-america.html>, Access: November 14th 2011, 17:19.

³⁰⁴ Cfr. MACKENZIE Kate, *The pre-conditions for a double-dip*, <http://ftalphaville.ft.com/blog/2011/09/16/677896/the-pre-conditions-for-a-double-dip/>, Access: November 13th 2011, 10:38.

³⁰⁵ Cfr. Id.

IMAGE 18
A DOUBLE-DIP WORLD ECONOMY



Source: The Financial Times.
Made by: Ingram Pinn.

Will Europe cause a double dip recession in the U.S.? As ever, it all depends on the banks. The trade links between the U.S. and Europe alone won't have a decisive impact. The U.S. sends just 13% of its exports to the euro zone and much less to the economies in the most trouble. But if Italy defaults, it would likely set off another global financial crisis that could sink the world economy.³⁰⁶

It is also important to notice that if one looks at unemployment (still above 8%) and housing in the U.S. "it's clear that for all practical purposes, it still has to fully get out of recession," says Harvard economist Ken Rogoff.³⁰⁷ In the U.S., the 2% economy is now a foregone conclusion. The main result of this disappointing apparent new normal rate of growth for the U.S has been the persistently high number of unemployed. The rate of GDP growth is insufficient to reduce the huge pool of long-term unemployed.³⁰⁸ It used to take roughly six months for the U.S. to get back to a normal employment picture after a recession; the McKinsey Global Institute estimates it will take five years this time around.³⁰⁹

³⁰⁶ Cfr. FOROOHAR Rana, *Berlusconi's Last Act*, op. cit.

³⁰⁷ Cfr. FOROOHAR Rana, *What U.S. Economic Recovery? Five Destructive Myths*, <http://www.time.com/time/nation/article/0,8599,2076568,00.html>, Access: November 13th 2011, 16:13.

³⁰⁸ Cfr. GOLDMAN SACHS, *The Outlook for the US Economy*, http://www2.goldmansachs.com/gsam/docs/fundsgeneral/general_education/economic_and_market_perspectives/wp_economic_outlook.pdf, Access: November 15th 2011, 20:15.

³⁰⁹ Cfr. FOROOHAR Rana, *What U.S. Economic Recovery? Five Destructive Myths*, op. cit.

What will this new “normal” rate of growth mean for the West? The only recent point of comparison is Japan, a country that has suffered 20 years of stagnation, its stock market down 60% from its highs two decades ago. Japan has endured not one but two lost decades without political or social chaos. Still, as well-known hedge-fund investor Barton Biggs recently argued in a note to investors, “Americans and Europeans are much less likely to be either patient or tolerant of a declining economy, wealth destruction, and political futility. After all the Great Depression produced guys named Hitler and Stalin, National Socialism, and Communism.”³¹⁰

The big question for many investors these days is one that could hardly have been thought about a few years ago: is the West turning into Japan? The response to that will determine the future direction of western economies as well as of shares and bonds. Many argue that despite the economic misery and political paralysis in the West it could be worse, the West could become Japan.³¹¹

Japan has been experiencing the West's current troubles for the past 20 years, ever since an asset bubble burst in the early 1990s. There is no end in sight. China usurped Japan's No. 2 ranking in the world economy last year. The situation of this country is so dire that *Japan* is now a dirty word in economics, a synonym for never ending malaise and decay. Eight characteristics contributed to Japan's inexorable decline: stock market and property crashes; zombie banks; deflation; zero interest rates; political stalemate; poor demographics; and a high debt-to-GDP ratio.³¹²

Believers of the west-is-turning-into-Japan argument point to several similarities between the West and Japan. In both cases, large debt burdens mean slow growth after a stock market crash. Meanwhile, the political response to the troubles is confused and does little to alleviate the pain.³¹³

³¹⁰ FOROOHAR Rana, *A new Era Of Volatility*, op. cit.

³¹¹ Cfr. MILNE Richard, West shows worrying signs of 'Japanisation', <http://www.ft.com/intl/cms/s/0/c86470b2-ca7b-11e0-94d0-00144feabdc0.html#axzz1ddfnUOPI>, Access: November 14th 2011, 21:41.

³¹² Cfr. SCHUMAN Michael, *The Japan Syndrome*, <http://www.time.com/time/magazine/article/0,9171,2097371,00.html>, Access: November 14th 22:38.

³¹³ Cfr. Id.

In the case of banks, there are an unknown number of European banks that are effectively insolvent if their holdings of government bonds are “marked to market”. These are zombie banks indeed.³¹⁴

Europe has been in denial about the weakness of its banking sector. That was also a major mistake committed by Japan after its 1990s financial crisis; by the time the banks were fixed, the damage was done. Indeed, the most important lesson from Japan is the perils of procrastination.³¹⁵

As Japan's politicians surrender opportunity after opportunity to change the country's course, its problems have gotten worse while the options for policymakers to solve them narrow. The political gridlock gripping the U.S. and Europe could also delay the tough decisions that must be made, making the cost of reform more painful. What Japan teaches us is the importance of political will. Without it, the West might turn Japanese.³¹⁶

Another risk of the profound economic and political shifts the West is experiencing is that these would lead countries to turn increasingly inward, exacerbating a downward spiral. Amazingly, that didn't happen right after the financial crisis and Great Recession. But that doesn't mean it won't happen now. The signs of polarization and insularity are growing.³¹⁷

German Chancellor Angela Merkel is battling anti-E.U. sentiment at home as she tries to save the euro. Obama and French President Nicolas Sarkozy are shifting their focus from global problem solving to their own re-election campaigns. Self-described free-market presidential candidate Mitt Romney is calling for tariffs on China. Currency wars are becoming stronger as nations try to drive down their exchange rates and boost their exports to stimulate growth.³¹⁸

³¹⁴ NB: In other words, holdings of government bonds valued at their current rock-bottom market prices.

³¹⁵ Cfr. FERGUSON Niall, *Europe's Disaster Is Headed Our Way*, op. cit.

³¹⁶ Cfr. SCHUMAN Michael, *The Japan Syndrome*, op. cit.

³¹⁷ Cfr. Id.

³¹⁸ FOROOHAR Rana, *A new Era Of Volatility*, op. cit.

IMAGE 19
CURRENCY WARS



Source: The Financial Times.
Made by: Ferguson

Indeed, there is a rising danger of a drift into protectionism and “currency wars”. Brazil took action in September 2011, as the government imposed “anti-dumping” duties on imports of steel tubes from China. President Dilma Rousseff’s statement was a text-book example of how an economic crisis can lead to protectionism: “In the case of the current international crisis,” she announced, “our principal weapon is to expand and defend our internal market.”³¹⁹

It was the Brazilian finance minister, Guido Mantega, who gave the world the expression “currency wars” to describe the process of competitive devaluation, as struggling economies seek to promote their exports. Also Switzerland decided that it could no longer allow the markets to drive the Swiss franc up to unprecedented levels. If protectionism rises then we should not worry about a double dip recession but a global depression.³²⁰

No wonder the rest of the world is so worried about the future of the West. Moreover, other regions won't be able to help it out, as happened in 2008. Europe is in the middle of its own debt crisis. And emerging markets like China, which helped sustain American companies by buying everything from heavy machinery to luxury goods during the recession, are now pushing on the growth

³¹⁹ Cfr. RACHMAN Gideon, *The long slide into protectionism*, <http://www.ft.com/intl/cms/s/0/9152417e-cfd2-11e0-a1de-00144feabdc0.html#axzz1XkvDLDsg>, Access: November 15th 2011, 14:49.

³²⁰ Cfr. Id.

brakes. Why? They're worried about inflation, which is partly a result of the Fed's policy of increasing the money supply.³²¹

The West and the rest of the world are entering what can only be called a new era of volatility. The cycles of boom and bust will most likely shorten as countries, companies and consumers adjust to a more uncertain world. This is the world people lived in from 1919 to '45, although without the technology that can move markets in seconds. It was a world in which recessions happened on average every three years instead of every six and people who struggled with large global changes saved more for a rainy day.³²²

No wonder why leaders around the world are struggling to move the global economy toward the next era of growth. An era that will be led by what the West once called.... the "Rest".

³²¹ Cfr. FOROOHAR Rana, *What U.S. Economic Recovery? Five Destructive Myths*, op. cit.

³²² FOROOHAR Rana, *A new Era Of Volatility*, op. cit.

CHAPTER III THE RISE OF THE REST

*The obvious thing is the only thing a president has to do,
inventing is for scientists
- Luiz Inácio Lula da Silva*

There is a great transformation taking place around the world, a transformation that, though often discussed, remains poorly understood. Changes, even monumental changes, take place gradually. Although we are witnessing the dawn of a new era, the world seems to be the one with which we are familiar. But in fact, it is very different.

There have been three tectonic power shifts over the last five hundred years. Fundamental changes in the distribution of power that have reshaped international life, its politics, economics, and culture. The first was the rise of the Western world, a process that began in the fifteenth century. It produced modernity as we know it: science and technology, commerce and capitalism, the agricultural and industrial revolutions. It also produced the prolonged political dominance of the nations of the West.³²³

The second shift, which took place in the closing years of the nineteenth century, was the rise of the United States. Soon after its industrialization, the United States became the most powerful nation since Imperial Rome, and the only one that was stronger than any likely combination of other nations. For most of the last century, the U.S. has dominated global economics, politics, science and culture. For the last twenty years, that dominance has been unrivaled, a phenomenon unprecedented in modern history.³²⁴

We are now living through the third great power shift of the modern era. It could be called “the Rise of the Rest”³²⁵. Over the past few decades, countries all over the world have been experiencing rates of economic growth that were once unthinkable. While they have had booms and busts, the overall trend has been unambiguously upward. This growth has been most visible in Asia but is no longer confined to it. That is why to call this shift “the rise of Asia” does not describe it accurately. In 2006 and 2007, 124 countries grew at a rate of 4% or more. That includes more than 30 countries in Africa, two-thirds of that

³²³ Cfr. ZAKARIA Fareed, *The Post-American World*, W.W. Norton & Company, New York, First Edition, 2008, p. 2.

³²⁴ *Ibid.*, 3.

³²⁵ NB. Rest: All those countries and regions of the world that were not part of the West.

continent. Antoine van Agtmael, the fund manager who coined the term “emerging markets”, has identified the 25 companies most likely to be the world’s next great multinationals. His list includes four companies each from Brazil, Mexico, South Korea, and Taiwan; three from India, two from China; and one each from Argentina, Chile, Malaysia, and South Africa.³²⁶

One only needs to look around. The tallest building in the world is now in Dubai. The world’s richest man is Mexican, the largest publicly traded corporation is Chinese. The leading refinery in the world is under construction in India, the largest factories are all in China. The United Arab Emirates are home to the most richest investment fund. The biggest movie industry, in terms of both movies made and tickets sold, is Bollywood, not Hollywood. Even shopping has gone global. Of the top ten malls in the world, only one is in the U.S.; the world’s biggest is in Beijing. And those are just a few examples of the fast changes taking place in the global order.³²⁷

It might seem strange to focus on growing prosperity when there are still hundreds of millions of people living in desperate poverty. But in fact, the share of people living on a dollar a day or less fell from 40% in 1981 to 18% in 2004, and it is estimated to fall to 12% by 2015. China’s growth alone has taken out of poverty more than 400 million people. Poverty is falling in countries housing 80 percent of the world’s population. In places like China, India, Brazil, Russia, Indonesia, Turkey, Kenya, and South Africa, the poor are slowly being absorbed into productive and growing economies.³²⁸

Neill Ferguson a professor at Harvard University and a famous scholar, recently published a book where he tries to explain why the West ruled the world for the past 500 and now is being surpassed by the Rest. To use the language of today’s computerized, synchronized world, these were six “killer applications”, the killer apps, a series of institutional innovations that allowed a minority of mankind originating on the western edge of Eurasia to dominate the world for the better part of 500 years.

1. Competition – a decentralization of both political and economic life, which created the launch-pad for both nation-states and capitalism. Five hundred

³²⁶ Cfr. Id.

³²⁷ Cfr. FERGUSON Niall, *Civilization: The West and the Rest*, Penguin Group, New York, First Edition, 2011, p. 68.

³²⁸ Cfr. ZAKARIA Fareed, *The Post-American World*, op. cit. 5.

years ago Europe was politically fragmented into multiple monarchies and republics, which were in turn internally divided into competing corporate entities, among them the ancestors of modern business corporations.

2. **Science** – a way of studying, understanding and ultimately changing the natural world, which gave the West (among other things) a major military advantage over the Rest. All the major 17th-century breakthroughs in mathematics, astronomy, physics, chemistry, and biology happened in Western Europe.

3. **Property rights** – An optimal system of social and political order emerged in the English-speaking world based on the rule of law as a means of protecting private owners and peacefully resolving disputes between them, which formed the basis for the most stable form of representative government.

4. **Medicine** – Nearly all the major 19th- and 20th-century breakthroughs in health care were made by Western Europeans and North Americans, which allowed a major improvement in health and life expectancy.

5. **The consumer society** – a mode of material living in which the production and purchase of clothing and other consumer goods play a central economic role, and without which the Industrial Revolution would have been unsustainable.

6. **The work ethic** – a moral framework and mode of activity derivable from (among other sources) Protestant Christianity, that allowed westerners to be the first people in the world to combine more extensive and intensive labor with higher savings rates, permitting sustained capital accumulation.³²⁹

For hundreds of years, these ‘killer apps’ were essentially monopolized by Europeans and their cousins who settled in North America and Australasia³³⁰. They are the best explanation for what economic historians call “the great divergence”: the astonishing gap that arose between Western standards of living and those in the rest of the world. But now, the non-Western societies are adopting these killer apps while the Western countries are eliminating them.³³¹

In this final chapter I will explore the main new powers in the world. The famous BRIC: Brazil, Russia, India and China. I won’t address Russia because I think it is a country that is going backwards on every significant aspect other than oil and gas exploitation. The other countries of the group have sound fundamentals and their relative power keeps increasing. For the first time ever, we are witnessing genuinely global growth. This is creating an international

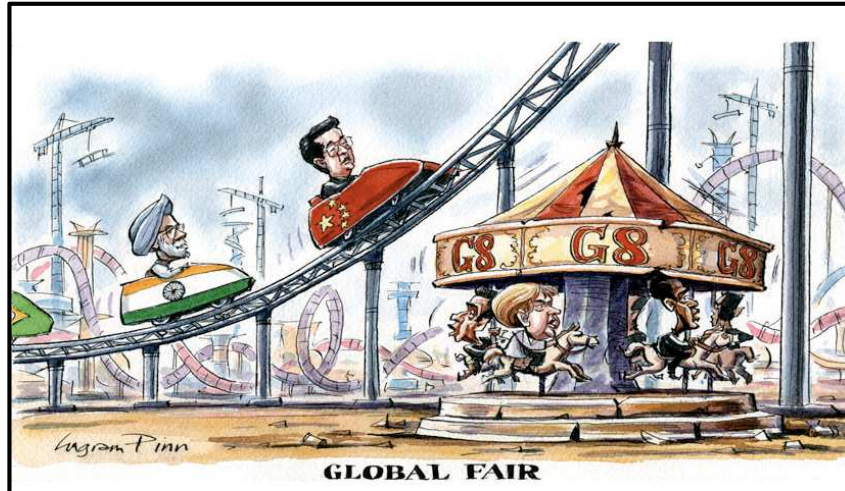
³²⁹ Cfr. FERGUSON Niall, *Civilization: The West and the Rest*, op. cit. 66

³³⁰ NB. Australasia is a region of Oceania comprising Australia, New Zealand, the island of New Guinea, and neighbouring islands in the Pacific Ocean. The term was coined by Charles de Brosses in *Histoire des navigations aux terres australes* (1756).

³³¹ Cfr. FERGUSON Niall, *America's 'Oh Sh*t!' Moment*, op. cit.

system in which countries in all parts of the world are no longer objects or observers but players in their own right. It is the birth of a truly global order.

IMAGE 20
GLOBAL FAIR



Source: The Financial Times.
Made by: Ingram Pinn.

3.1. China: The Rising Dragon

3.1.1. The Power of Central Planning

Four decades ago, Richard Nixon understood sooner than most the huge potential of China. “Well,” he said, “you can just stop and think of what could happen if anybody with a decent system of government got control of that mainland. Good God ... There’d be no power in the world that could even, I mean, you put 800 million Chinese to work under a decent system ... and they will be the leaders of the world.” That prophecy is being fulfilled in our time.³³²

The journey towards the market of China started in 1978 under Deng Xiaoping, the successor of Mao when, due to a severe drought, authorities were forced to loose the strong administrative controls that for a long time ruled the crops of individual farmers. The new rules allowed them to keep a significant part of their products for consumption or sale. The results were incredible. The agricultural production grew exponentially, which in turn allowed more deregulation and the development of agricultural markets. After decades of stagnation the agricultural production flourished.³³³

³³² Cfr. FERGUSON Niall, *Dr. K's Rx for China*, <http://www.thedailybeast.com/articles/2011/05/17/dr-k-s-rx-for-china.html>, Access: December 1st 2011, 10:41.

³³³ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 332

The success in the farms encouraged reform extension to the industry. Once more, a modest looseness of the regulations produced beyond expected growth, which gave momentum to the reformers that wished to move faster towards a competitive market. No civil servant ever dared to call “capitalism” to the new model. They used euphemisms like “market socialism” or according to Deng “socialism with Chinese features” .³³⁴

The Chinese authorities were too clever not to see the contradictions and limitations of the socialist economy and the evidence of the success of capitalism. Indeed, what other reason could there be for such an ambitious reform that was against the traditions of the Communist Party? As China was entering inexorably the capitalist path, the economic progress became so evident that the ideological debate of past years was history.³³⁵

IMAGE 21
CHINA OVERVIEW



Source: CEIC China Database
Made by: The Economist

Back in the present, it is fair to say that one of the great ironies revealed by the global recession that began in 2008 is that the Communist Party ruling

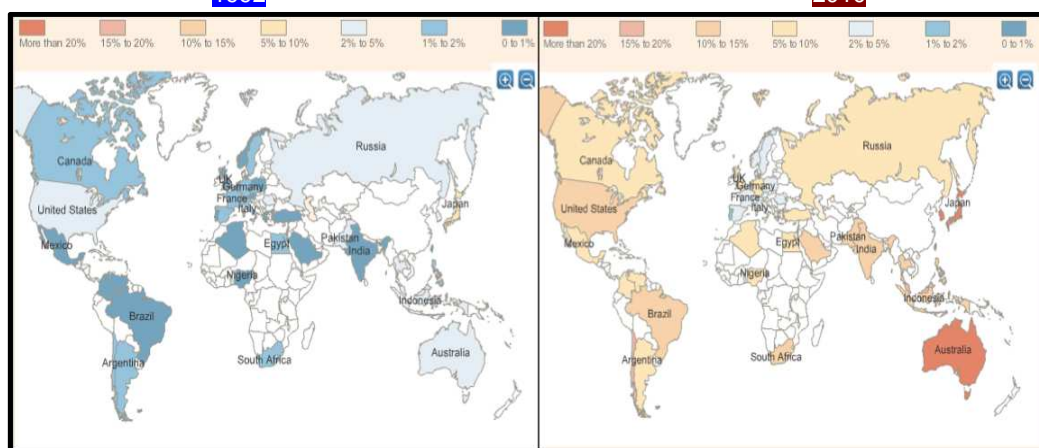
³³⁴ Cfr. BLOOMBERG BUSINESSWEEK, *China Is a Private-Sector Economy*, http://www.businessweek.com/magazine/content/05_34/b3948478.htm, Access: December 1st 2011, 14:17.

³³⁵ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 333

China may be doing a better job managing capitalism's crisis than the democratically elected U.S. government. Beijing's stimulus spending was larger, infinitely more effective at overcoming the slowdown and directed at laying the infrastructural tracks for further economic expansion.³³⁶

As Western democracies try to move breathlessly forward, China's economy roars, having lifted some half a billion people out of poverty over the past three decades and having rapidly created the world's largest middle class to provide an engine for long-term domestic consumer demand. Sure, there's massive social inequality, but there always is in a capitalist system. (Income inequality rates in the U.S. are some of the worst in the industrialized world, and more Americans are falling into poverty than are being raised out of it. The number of Americans officially designated as living in poverty in 2009, 43 million, was the highest in the 51 years that records have been kept.)³³⁷

IMAGE 22
CHINA'S INCREASING SHARE OF GLOBAL TRADE
 1992 2010



Source: CEIC China Database
 Made by: The Economist

China's rapid recovery from the global financial crisis, and the West's continuing malaise, has had a profound psychological impact on many Chinese. Emotions ranging from pride to nationalism fill official rhetoric. Diplomats treat their Western counterparts with a bit of disdain. What is great about socialism, said the Prime Minister, Wen Jiabao, in March 2010, is that it enables China "to make decisions efficiently, organize effectively and concentrate resources to

³³⁶ Cfr. KARON Tony, *Why China Does Capitalism Better than the U.S.*, <http://www.time.com/time/world/article/0,8599,2043235,00.html>, Access: December 2nd 2011, 21:12.

³³⁷ Cfr. Id.

accomplish large undertakings". In the eyes of some Chinese, and even some foreigners, authoritarianism has gained a new legitimacy.³³⁸

China is now the world's second largest economy after the U.S., having grown nearly 10% per year through the first decade of this century. Income growth per capita in 2010 rose 9%. Manufacturing productivity is expanding 10% a year. The country continues to run a huge current account surplus and will be having only a slight budget deficit in 2011. It also has close to \$3 trillion (and counting) worth of foreign-exchange reserves and, in a world in which the developed nations are engaged in currency devaluations, a steadily strengthening renminbi.³³⁹

Over the past 3 decades China was able to grow thanks to its investments in infrastructure that allowed it to be a relatively low-wage economy with a first-world infrastructure. This in turn, helped boost the exports sectors that combined with its low-wage labor made of this Asian country the "manufacturer of the world".

It is interesting to consider the cosmic irony: weak Western economies are depending on the Chinese Communist Party to save their capitalist system. Likewise, the Chinese government's big plan to rebalance its economy centers on Western-style materialism. By substantially boosting wages, it wants to create a new generation of spenders, including not just urban sophisticates but a much broader part of China's 1.3 billion people. "Shop till you drop" is probably not what Mao had in mind for China.³⁴⁰

It might be difficult to create this generation of spenders but if the Communist Party can successfully navigate the risky rebalancing road laid out in its new five-year plan, millions of nonfarm workers will soon get what American workers haven't had in a decade: a raise. A really big one. The government is targeting minimum-wage increases of 13% to 15% over the next five years, essentially doubling the income of many citizens.³⁴¹

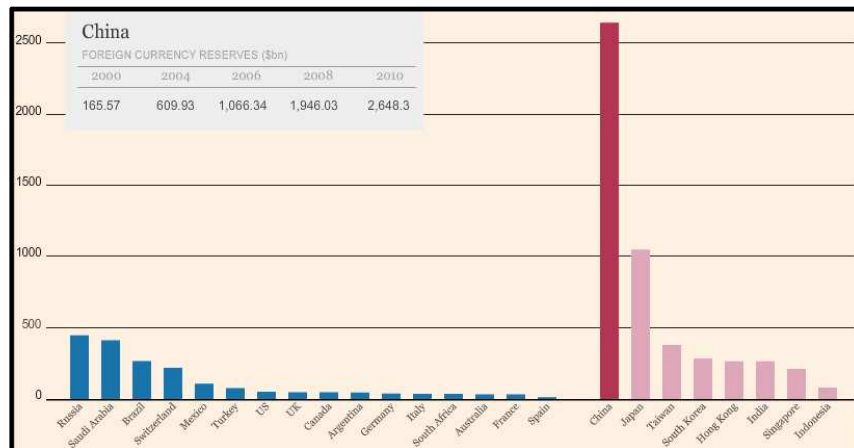
³³⁸ Cfr. THE ECONOMIST, *Rising power, anxious state*, <http://www.economist.com/node/18829149>, Access: December 2nd 2011, 15:38.

³³⁹ Cfr. SAPORITO Bill, *A Great Leap Forward*, <http://www.time.com/time/magazine/article/0,9171,2097400,00.html>, Access: December 3rd 2011, 09:20.

³⁴⁰ Cfr. *Id.*

³⁴¹ Cfr. ULRICH Jing, *China's challenge: drive growth without inflation*, <http://www.ft.com/intl/cms/s/0/18b26a92-c41e-11e0-b302-00144feabdc0.html#axzz1ffQjJoi9>, Access: December 3rd 2011, 20:22.

FIGURE 26
CHINA'S FOREIGN CURRENCY RESERVES IN 2010



Source: The Financial Times Database
Made by: The Financial Times

Wage and spending growth is one way to close the still vast gap between China's poorest workers and its advancing middle class, which will comprise 70% of China's population by 2020. If successful, the shift to consumer spending will take a good chunk of the weight of the global economy off the shoulders of American consumers and make China a “gotta-be-there” market for everything from video games to surgical tools to potato chips.³⁴² Many pro-consumption initiatives have been introduced, including an undertaking to increase the availability of affordable housing, healthcare reforms to make basic services and drugs more accessible, and an increase in the personal income tax threshold. These and other initiatives will liberate a greater portion of disposable income.³⁴³

The issue of the Chinese government's significant role in the country's growth invariably gets enclosed into politics. The Communist Party has created the conditions so that the private sector can flourish. The Chinese education system is producing ever larger numbers of graduates who, while limited in skills to conduct advanced original research, are perfectly suited — and probably better suited than their foreign counterparts — to excel in other stages of innovation. Intel was one company that transferred much of its manufacturing base to China. "Nobody put a gun to our head and said move here," says Bruce

³⁴² Cfr. SAPORITO Bill, *A Great Leap Forward*, op. cit.

³⁴³ Cfr. ULRICH Jing, *China's challenge: drive growth without inflation*, op. cit.

Aitken, Intel's financial controller for the Chengdu China site. "We're here because we wanted to be here once we saw what was taking shape."³⁴⁴

China private sector is vibrant. For 17 months till the moment of writing, private-sector investment growth has been running significantly faster than that of the public sector. That's especially significant because private companies in China, and in particular small and medium enterprises (SMEs), barely have access to capital from state banks. For the most part, they are investing their own money. The only rational conclusion to be drawn is that the state of the private sector here is very strong.³⁴⁵

It's going to get stronger. China is in the process, slowly but surely, of liberalizing its capital markets. The renminbi will eventually be fully convertible. Sectors like e-commerce and biotechnology, already red hot, will get more access to domestic capital. Less glamorous but no less important industries are also expanding rapidly, and taking advantage of China's well-educated workforce. In 2008, General Electric moved its research center for producing clean, affordable energy out of coal to the nation that consumes the most coal in the world. Guess where? Yes, China.³⁴⁶

China has all but caught up with the US as an economic power. Its economy is about as large, in purchasing power, while its exports and overseas assets are much larger. If one were to draw an historical analogy, the potential eclipse of the dollar might be just a decade away. Chinese economic strength creates the conditions for the rise of its currency. China's policymakers seek to exit from the mercantilist status quo. Without a doubt China still has to undertake major policy reforms and has many challenges ahead but the latter are common in the road ahead of a rising super power that might be coming to stay.³⁴⁷

³⁴⁴ Cfr. POWELL Bill, *The Case for China: The Power of Planning*, http://www.time.com/time/specials/packages/article/0,28804,2099180_2099179_2099175,00.html, Access: December 3rd 2011, 21:12.

³⁴⁵ Cfr. Id.

³⁴⁶ Cfr. Id.

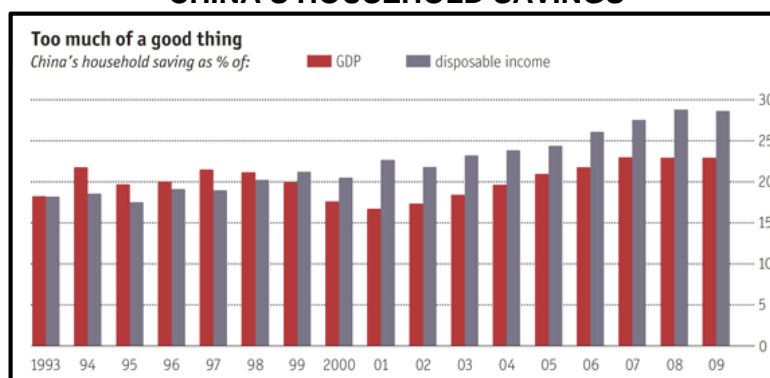
³⁴⁷ Cfr. SUBRAMANIAN Arvind, *Coming soon: when the renminbi rules the world*, <http://www.ft.com/intl/cms/s/0/098adcf6-daea-11e0-a58b-00144feabdc0.html#axzz1ffQjJoi9>, Access: December 2nd 2011, 22:51.

3.1.2. The Big Chinese Bubble.

What's the most important economic question in the world today? One contender is whether the euro will collapse. Another is whether the U.S. will plunge into a double-dip recession. But a third, and possibly the most important over the long term, is whether China can save the world, or whether the entire country is a \$6 trillion bubble that's ready to pop.³⁴⁸

In order to understand the potential consequence from a China bubble, it's important to understand how the bubble began. The popular narrative is that China's rise from nowhere in 1978 to its position today has been fueled mainly by an inexpensive and massive labor force. That's part of it, but equally important have been low-cost capital and land. Most Chinese, who are huge savers, have little choice but to put their money in bank accounts that pay interest rates lower than inflation; in a country with a relatively undeveloped financial sector, there are few other options. These funds are then channeled into state-owned enterprises whose capital expenditures create the factories and skyscrapers on which the Chinese miracle has been built.³⁴⁹

FIGURE 27
CHINA'S HOUSEHOLD SAVINGS



Source: CEIC China Database
Made by: The Economist

Back in early 2009 Beijing encouraged a local government borrowing spree to finance infrastructure spending in order to stimulate the economy that was at risk due to the financial crisis unleashed in the US. China's communist rulers ordered the country's banks to lend, lend, lend. China's 4 trillion yuan stimulus program (about \$620 billion at current exchange rates), launched in

³⁴⁸ MILLER Ken, *Be Very Afraid of The China Bubble*, <http://www.time.com/time/magazine/article/0,9171,2097399,00.html>, Access: December 4th 2011, 11:51.

³⁴⁹ Cfr. Id.

November 2008, allowed banks to lend almost at will raising the prospect of a flood of new bad debt. The biggest borrowers were state-owned enterprises, property developers and local governments.³⁵⁰

Then it tried to keep interest rates as low as possible, partly to reduce the service charges on local government debt, officially estimated in 2010 at RMB10,717bn (\$1,681bn). But as bank deposit rates languished far below inflation, savers withdrew their money and deposited it with high-yielding shadow financial institutions. This means that Beijing, which has exercised financial control as a key tool of Communist party power, now finds itself largely at the mercy of an unregulated collection of trust companies, private banks, and loan sharks.³⁵¹

Plenty of smart people are worried that a big housing and banking bubble has been created. There are big questions about China's future despite its incredible economic power. The Chinese miracle model built on cheap labor, cheap land and cheap capital, which worked for the past 30 years, is starting to break down. China's banks, which have made too many bad loans, are perhaps as troubled as those in the West. China's own Premier, Wen Jiabao, calls his nation's economy "unbalanced, uncoordinated and unsustainable."³⁵²

Nouriel Roubini of New York University, a chronic pessimist, argued in a recent article that the brick wall would most likely be hit between 2013 and 2015. He noted that China was spared a recession in the wake of the financial crisis because investment in fixed assets, such as transport, infrastructure and factories, increased from an already very high 42% of GDP in 2008 to nearly 50% in 2010. No country, he says, could be productive enough to invest 50% of GDP in new fixed assets without eventually facing "immense overcapacity and a staggering non-performing loan problem".³⁵³

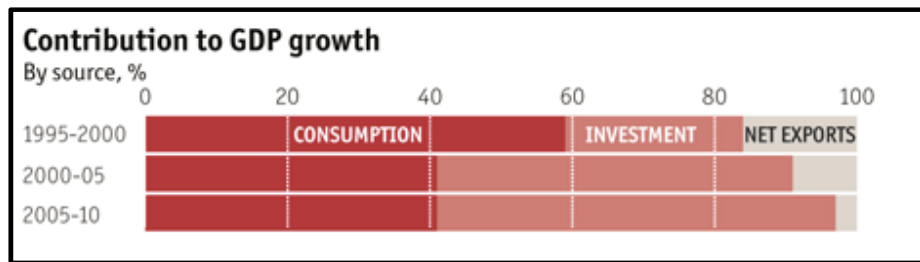
³⁵⁰ Cfr. FERGUSON Niall, *Gloating China, Hidden Problems*, <http://www.thedailybeast.com/newsweek/2011/08/14/china-faces-its-own-fiscal-problems.html>, Access: December 4th 2011, 14:59.

³⁵¹ Cfr. KYNGE JAMES, *Cracks in Beijing's financial edifice*, <http://www.ft.com/intl/cms/s/0/a83e5cf4-f02c-11e0-977b-00144feab49a.html#axzz1ffQjJoi9>, Access: December 2nd 2011, 23:12.

³⁵² Cfr. MILLER Ken, *Be Very Afraid of The China Bubble*, op. cit.

³⁵³ Cfr. THE ECONOMIST, *China's roaring growth cannot last indefinitely*, <http://www.economist.com/node/18832106>, Access: December 3rd 2011, 21:07.

**FIGURE 28
CONTRIBUTION TO GDP GROWTH BY SOURCE**



Source: CEIC China Database
Made by: The Economist

Nowhere are the problems more evident than in the real estate sector, which has been at the core of the country's growth and development. Real estate prices all over China keep increasing. Many Chinese families get into more debt in order to buy a second home, which they see as a good and safe investment since "property prices never fall". This very belief is causing the bubble to keep inflating like a hot potato. Similar to Republicans in the U.S. who try to "starve the beast" by cutting government spending, the Chinese Communist Party has been attempting to put an obstacle on the nation's debt-fueled real estate boom.³⁵⁴

This is part of a deliberate attempt to reorder the economy into one that relies more on domestic consumer spending and less on manufacturing and exports. To ensure its future growth, China must move from being the world's factory to being one of its largest consumers. If, however, the party's efforts to take the country in that direction result in a precipitous drop in real estate values, the entire economy could crash. Multinational corporations whose revenue and earnings growth are tied to China could be hit hard. And the U.S. could be thrown back into recession.³⁵⁵

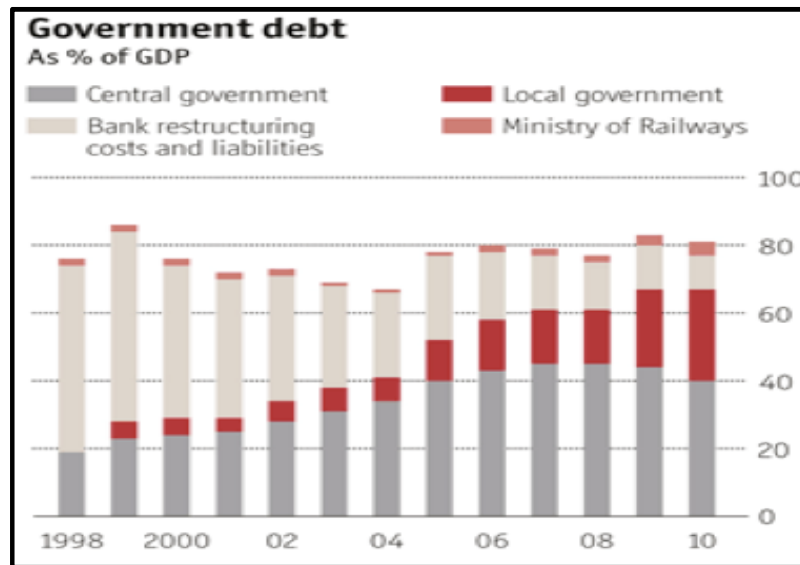
The question is whether the bubble, not only in housing but in commercial property as well, is about to pop. Everywhere you go in China, you see new airports and high-speed-train lines under construction; glass-fronted apartment buildings whose empty units loom unilluminated in the night; underutilized roads, bridges and tunnels; and entire towns waiting for occupants. The government wants the high-speed railway network, already the world's longest at 8,300km, to quintuple in length by 2015. Beijing, having completed

³⁵⁴ Cfr. MILLER Ken, *Be Very Afraid of The China Bubble*, op. cit.

³⁵⁵ Cfr. Id.

one of the world's largest airport terminal buildings in 2008, will get a whole new airport. So will 54 other cities, increasing the total airports number by nearly one-third. These investments, officials hope, will help to boost urban growth, and with it consumption. Infrastructure targets are usually met in China because governments have little trouble with “not-in-my-backyard” protests.³⁵⁶

FIGURE 29
GOVERNMENT DEBT AS % OF GDP



Source: CEIC China Database
Made by: The Economist

Why does China keep building? Because building creates jobs and wealth for those who are associated with all that development. Of course, nothing is ever a bubble until it bursts. Even an empty city is not a convincing warning to those who remember that it took Shanghai many years to build its now booming Pudong business district. Although some of those pristine new bridges, roads, tunnels and buildings may be underused today, they might prove to be just the catalyst needed to keep the economy driving forward when demand catches up.³⁵⁷

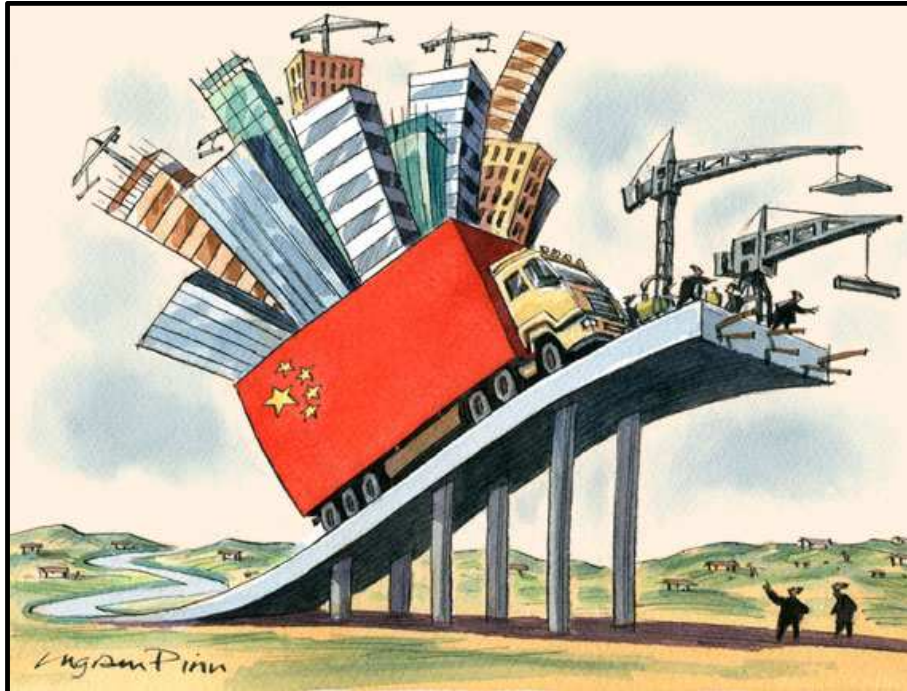
While very few economists doubt that China's growth is going to slow eventually, it's a question of how much and how soon. Will the landing be hard or soft? The signs are mixed. GDP growth has moderated slowly in the past few quarters rather than falling off a cliff (though it's worth noting that Chinese economic figures, as released by the government, can be questionable). Yet in

³⁵⁶ Cfr. THE ECONOMIST, *China's roaring growth cannot last indefinitely*, op. cit.

³⁵⁷ Cfr. FERGUSON Niall, *Gloating China, Hidden Problems*, op. cit.

many parts of the economy, the bubble continues to expand. Local-government debt grew about 30% in 2010 from the previous year. In the first six months of 2011, Chinese investment in real estate was up 33% from the same period in 2010.³⁵⁸

IMAGE 23
CHINA'S INFRAESTRUCTURE GROWTH ABOUT TO COLLAPSE



Source: The Financial Times.
Made by: Ingram Pinn.

If the party's attempt to stop the easy money running to state-owned enterprises, results in a dramatic decline in property values, the outcome could be an earthquake in the Chinese financial system that would be felt in the U.S. and thus the world. In the past, loans made by state banks to big government-related businesses created a significant amount of bad debt that had to be written off.³⁵⁹

In 1998 and 2004-05, loans totaling about \$500 billion were classified as nonperforming, and state officials transferred them to special investment vehicles in an attempt to create the appearance of containing the problem. But because the state, which owns the biggest banks, and thus the people's savings, ultimately pays the price of any write-off, households bear the cost of

³⁵⁸ Cfr. MILLER Ken, *Be Very Afraid of The China Bubble*, op. cit.

³⁵⁹ Cfr. KYNGE JAMES, *Cracks in Beijing's financial edifice*, op. cit.

the cleanup. Chinese banks are the original “too-big-to-fail” financial institutions.³⁶⁰

If the bubble pops, the consequences will be very serious to the world. But if China succeeds in moving away from its model of cheap land and cheap capital and makes a smooth transition to an economy based more on domestic demand, hallelujah. But if Chinese land prices plummet, there will be less demand for raw materials and a sharp decline in world commodity markets and global trade in general, which will cause a negative and event dramatic impact to all.³⁶¹

3.1.3. China’s Main Challenges and its International Role.

In spite of all the amazing economic data, China’s leaders appear more nervous now than at any time for over a decade. They have massively increased spending on domestic security, which in the 2011 budget has overtaken that on defense for the first time. The government has been reviving a Maoist system of neighborhood surveillance by civilian volunteers. Also during 2011, the police have launched an all-out assault on civil society, arresting dozens of lawyers, NGO activists, bloggers and even artists. The Arab revolutions have spooked the leadership. From its perspective, the system looks vulnerable.³⁶²

The “growth-at-all-costs” model followed in the past three decades, has had enormous costs on Chinese society. Yet despite undrinkable water and unbreathable air in many parts of the country, the Communist Party continues to enjoy widespread support; its P.R. (Personal Relations) machine emphasizes its efforts to redress China's humiliation at the hands of the West in the 19th and 20th centuries.³⁶³

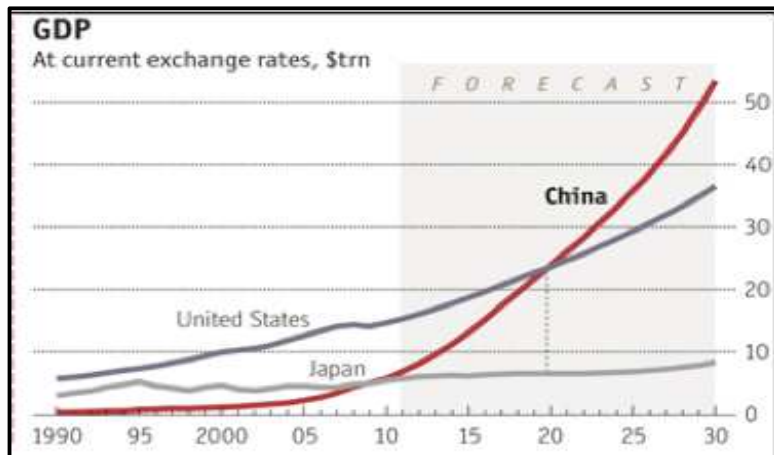
³⁶⁰ Cfr. Id.

³⁶¹ Cfr. MILLER Ken, *Be Very Afraid of The China Bubble*, op. cit.

³⁶² Cfr. THE ECONOMIST, *Rising power, anxious state*, op. cit.

³⁶³ Cfr. MILLER Ken, *Be Very Afraid of The China Bubble*, op. cit.

FIGURE 30
CHINA'S GDP AT CURRENT EXCHANGE RATES



Source: Economist Intelligence Unit
Made by: The Economist

Even intellectuals who protest about personal-freedom and civil rights issues seem to do that through a sort of sincere patriotism. Unfortunately, the damages caused by enormous growth are starting to show up everywhere. Mass protests of party abuses, often the taking of land without fair compensation, have been multiplying so steadily that the government, departing from past protocol, did not publish the number of them in 2010. At government facilities in many regions of the country, there have been explosions set off by citizens so disaffected that they didn't care about the consequences.³⁶⁴

Despite the government's calls for more evenly shared prosperity, the gap between rich and poor and between cities and countryside has continued to widen. Since the current administration took office in 2003, absolute poverty has dropped markedly.³⁶⁵

But the number of people in relative poverty (with 50% or less of the median income) grew from 12.2% of the population to 14.6% between 2002 and 2007, according to research by Terry Sicular of the University of Western Ontario and Li Shi and Luo Chuliang of Beijing Normal University.³⁶⁶ By the end of the plan period the goal of establishing a "harmonious socialist society", a favorite slogan of the current government, appears even more remote than at

³⁶⁴ Cfr. Id.

³⁶⁵ Cfr. THE ECONOMIST, *Rising power, anxious state*, op. cit.

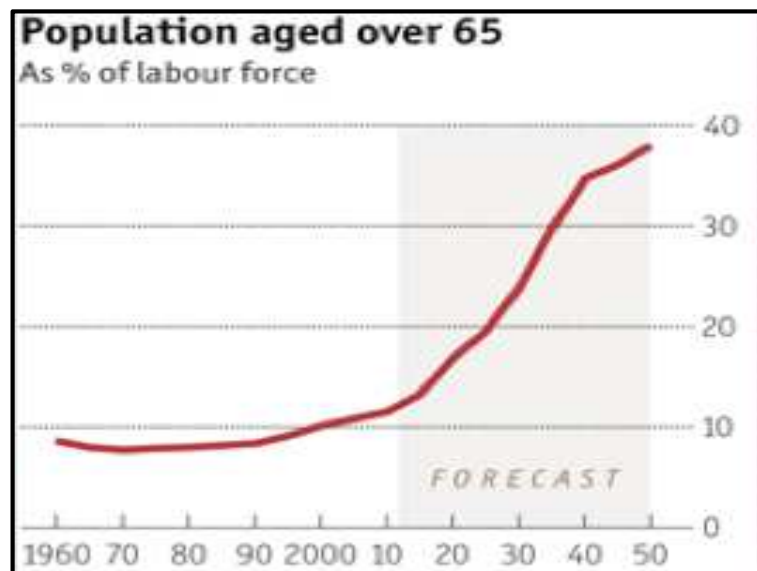
³⁶⁶ NB. Most recent data on this topic.

the beginning. Protests over local injustices, already running at tens of thousands a year, are becoming more frequent.³⁶⁷

On the other hand, China's demographic advantage, an abundant supply of labor in the countryside, is beginning to decline. In a few years the working-age population will peak. It will become increasingly difficult to maintain the rapid rate of urbanization that has been one of the main drivers of growth without huge and politically risky policy changes. Looking towards the 2020s, many Chinese economists worry about falling into a "middle-income trap": losing competitiveness in labor-intensive industries but failing to gain new sources of growth from innovation.³⁶⁸

In other words, some worry that China could be approaching a Japanese-style crisis: a boom in exports and investment along with bubbly property markets, followed by many years of stagnation. In China's case the added problem would be that it has not yet got rich. Officials and experts debate endlessly whether the country is slowly heading towards this "middle-income trap".³⁶⁹

FIGURE 31
CHINA'S POPULATION AGED OVER 65 AS A %
OF LABOR FORCE



Source: Economist Intelligence Unit
Made by: The Economist

³⁶⁷ Cfr. THE ECONOMIST, *Rising power, anxious state*, op. cit.

³⁶⁸ Cfr. Id.

³⁶⁹ Cfr. THE ECONOMIST, *Beware the middle-income trap*, <http://www.economist.com/node/18832106>, Access: December 20th 2011, 17:19.

Another big worry for the Communist Party is the increase of inflation figures. Indeed, Chinese leaders are permanently worrying about inflation, not least because of its role in fuelling the discontent that led to the Tiananmen Square protests of 1989. As China's banks unleashed a flood of credit to stimulate the economy, an 87 per cent expansion in M2³⁷⁰ money supply since January 2008 has given rise to stubborn inflation, which has been exacerbated by food supply disruptions and rising commodity prices.³⁷¹

But even though inflation rose to 5.5% in May 2011, considerably above the government's 4% target for the year, it shows little sign of returning to previous highs of about 20% in 1988 and more than 25% in 1994. It also has a useful political side-effect, easing some of China's tension with the U.S. over the value of its currency. The U.S Treasury says that because of the higher inflation rate in China, the yuan is in effect appreciating against the dollar by more than 10% a year.³⁷²

Chinese leaders have been debating whether to push interest rates higher, although Chinese policymakers have become more tolerant of medium rates of inflation.³⁷³ Chinese Officials have indicated that they might use a form of "targeted easing" in case of a downturn in 2012, meaning monetary policy could remain prudent but preferential credit terms would be available to projects relating to affordable housing, rural development and small businesses.³⁷⁴

As for China's foreign policy, it is understandably that China deserves a big say in what goes on in its neighborhood. But what most people haven't noticed yet is that Beijing also wants to write, or, at least, help write, new rules of the road for the world. "China now wants a seat at the head of the table," says Cheng Li, director of research at the John L. Thornton China Center at the Brookings Institution. "Its leaders expect to be among the key architects of global institutions."³⁷⁵

³⁷⁰ NB. Economists use M2 when looking to quantify the amount of money in circulation and trying to explain different economic monetary conditions.

³⁷¹ Cfr. ULRICH Jing, *Chinas Challenge: drive growth without inflation*, <http://www.ft.com/intl/cms/s/0/18b26a92-c41e-11e0-b302-00144feabdc0.html#axzz1hgLbpu47>, Access: December 21st 2011, 10_17.

³⁷² Cfr. Id.

³⁷³ Cfr. THE ECONOMIST, *Rising power, anxious state*, op. cit.

³⁷⁴ Cfr. ULRICH Jing, *Chinas Challenge: drive growth without inflation*, op. cit.

³⁷⁵ Cfr. FOROZHAR Rana, *It's China's World We're Just Living in It*, <http://www.thedailybeast.com/newsweek/2010/03/11/it-s-china-s-world-we-re-just-living-in-it.html>, Access: December 21st 2011, 17:10.

Now China has more worldwide influence, and public opinion at home has taken on a combative tone. So with one eye on China's national interests and the other on domestic critics accusing the regime of "indulging" the West, Beijing has begun to push harder to reshape international systems to make them more China-friendly.³⁷⁶

Ironically, U.S. officials often complain that Beijing isn't more involved in running the world, declining to help security efforts in Afghanistan, for instance. But in most such cases, China is being asked to take part in a system it didn't set up, one it views as inherently biased in favor of the West. The Chinese are far more eager to participate in groups they've had a hand in building, like the Shanghai Cooperation Organization, a sort of Central Asian NATO in which China (as might be guessed from the name) plays the leading role. While that alliance started out as something of a joke in 1996, it's grown into a pillar of regional security.³⁷⁷

Chinese have now an odd mix of confidence, pride, and insecurity. On the one hand, China knows its technological capabilities are dramatically improving and sees a chance to move beyond the West in certain fields. "There's always been this feeling in China and a number of other developing nations that the West was the place to be, but now suddenly it's not," says Ruchir Sharma, head of emerging markets for Morgan Stanley Investment Management. Chinese scientists and researchers are going back home to conduct original research at well-funded labs.³⁷⁸

On the other hand, the Chinese worry that if they're not involved in writing the new standards, those could be manipulated by their enemies. The regime has tried to bar government computers from running Microsoft software, for example, largely because it's assumed that such software might include a "back door" that would allow the U.S. government to launch cyberattacks against China.³⁷⁹

Indeed, while China isn't necessarily looking to take over the world, its actions put Chinese interests foremost. Beijing's space programs are highly

³⁷⁶ Cfr. Id.

³⁷⁷ Cfr. THE ECONOMIST, *Rising power, anxious state*, op. cit.

³⁷⁸ Cfr. Id.

³⁷⁹ Cfr. Id.

secret, but they've been accelerated in recent years with the first successful test of an antisatellite weapon in 2007, followed in 2010 by the launch of an exo-atmospheric surface-to-air missile (which some Western security experts think may actually be a new satellite-killer weapon). That same year China conducted its second unmanned lunar exploration. In 2011 it launched a space module for the country's first docking exercise, all leading up to a 2013 moon landing. With NASA's budgetary rollback, China is now the only country making major investments in space exploration.³⁸⁰

The idea that as China got rich it would simply become more like the U.S, or at least more sympathetic to the U.S. agenda, is turning out to be wrong. China has never been transformed from without, and it's unlikely to be now. Among ordinary Chinese, pride in their nation's prospects is matched by a feeling that it's all still too new and precarious.³⁸¹

The dizzying pace of change is having a particularly dramatic effect on younger Chinese, turning them inward and making them more nationalistic—a trend that experts like Hudson Institute fellow John Lee believe to be a factor in China's new and more aggressive policies on security, trade, and foreign affairs. That aggressiveness is only likely to increase between now and 2012, when the top leadership of the Communist Party will be changed.³⁸²

Equally important is how China is regarded internationally. Americans aren't the only ones concerned about China's rise. Across Asia, China's every move is now watched with great attention. In 2010, as China asserted its sovereignty over disputed waters and islands in the South China Sea, it upset neighbors from Japan to South Korea to Vietnam. In 2011, Beijing has been more diplomatic, but tensions persist. At the Asia-Pacific Economic Cooperation (APEC) summit on Nov. 12-13 2011, many leaders echoed Singapore's Prime Minister when he said the U.S. was welcomed in the region and that its presence would "do good." The U.S. announced on Nov. 16th 2011 that it would for the first time establish a formal military presence in Australia, a base in all but name.³⁸³

³⁸⁰ Cfr. ZAKARIA Fareed , *How to Be a Real Superpower*, <http://www.time.com/time/magazine/article/0,9171,2099706,00.html>, Access: December 20th 2011, 22:50.

³⁸¹ Cfr. FOROZHAR Rana, *It's China's World We're Just Living in It*, op. cit.

³⁸² Cfr. ZAKARIA Fareed , *How to Be a Real Superpower*, op. cit.

³⁸³ Cfr. Id.

The Obama Administration is now quietly re-engaging in Asia, reversing the troop cutbacks of the Bush Administration, which was more focused on Iraq and the Middle East. Asian diplomats had often complained that U.S. participation at regional summits was too low-level. Obama's attendance at the APEC summit in November 2011 marks a shift in that approach.³⁸⁴

China might well view this as the start of a containment policy. But the Chinese authorities should reflect on the changing attitudes toward their country, from businessmen in the U.S. to peasants in Africa to diplomats in Australia. People are waking up to China's enormous impact on the world, and that leads to very close scrutiny of everything China does, and does not do. Beijing is being held to a higher standard, a superpower standard. This is the way the world has looked at the U.S. for decades. Welcome to the club.³⁸⁵

What's worrisome is that China seems content to act narrowly and exclusively in its own interests, unconcerned about helping maintain global rules. It is happy to consume peace, stability and free trade while doing little to produce any of these public goods. When it does try to project values, its actions seem even more worrying. Consider the awarding of the Confucius Peace Prize, China's version of the Nobel Peace Prize, to Vladimir Putin in Nov. 13th 2011. Does Beijing seriously think this will help its image?³⁸⁶

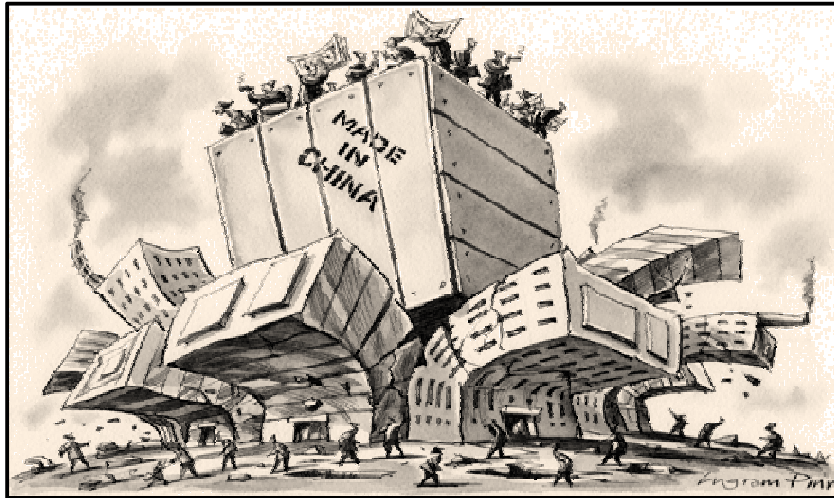
China is clearly still working out its identity: is it a rich nation or a poor one, a major power that should lead on global issues or a developing one that should simply look out for itself? The answer to these questions will determine the future of the international system. We will have to wait and see.

³⁸⁴ Cfr. Id.

³⁸⁵ Cfr. Id.

³⁸⁶ Cfr. FOROOHAR Rana, *It's China's World We're Just Living in It*, op. cit.

IMAGE 24
“MADE IN CHINA” CRASHES THE WORLD



Source: The Financial Times.
Made by: Ingram Pinn.

3.2. India: The Rising Elephant.

3.2.1. The Next Super Power.

When Great Britain declared India's independence in 1947, it withdrew all aspects related to the British government, but it left behind a concept that captivated the Indian elite: Fabian socialism³⁸⁷. Jawaharlal Nehru, disciple of Mahatma Gandhi and India's Prime Minister for sixteen years after independence, felt a strong interest for the ideas of the Fabians and perceived market competition as economically destructive. Because of him, socialism kept a strong influence over Indian economic policy long after the British abandoned it. Nehru was fascinated by central planning, considering it a natural extension of gathered human activity capable of producing material well-being for many instead of for just a few.³⁸⁸

Therefore, India followed socialist-inspired policies for most of its independent history, including state-ownership of many sectors; extensive regulation and red tape (excessive bureaucratic regulation) known as "Licence Raj"; and isolation from the world economy. India's per capita income increased at only around 1% annualized rate and GDP grew at what was known as the

³⁸⁷ NB. **Fabian Socialism** is a British socialist movement, whose purpose is to advance the principles of democratic socialism via gradualist and reformist, rather than revolutionary, means

³⁸⁸ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 355

“Hindu 3%” in the three decades after Independence. Since the mid-1980s, India has slowly opened up its markets through economic liberalization.³⁸⁹

In 1991, after India faced a balance of payments crisis, it had to ask for assistance to the International Monetary Fund. The IMF required India to undertake a series of structural economic reforms. As a result of this requirement, the government of Narasimha Rao and his finance minister Manmohan Singh (the current Prime Minister of India) started breakthrough reforms.³⁹⁰ The new neo-liberal policies included opening for international trade and investment, deregulation, initiation of privatization, tax reforms, and inflation-controlling measures. The overall direction of liberalization has since remained the same, regardless of the ruling party, although no party has yet tried to confront powerful lobbies such as the trade unions and farmers, or controversial issues such as reforming labor laws and reducing agricultural subsidies. The main objective of the government was to transform the economic system from socialism to capitalism so as to achieve high economic growth and industrialize the nation for the wellbeing of Indian citizens.³⁹¹

As of 2010, about 300 million people, equivalent to the entire population of the United States, had escaped extreme poverty. The fruits of liberalization reached their peak in 2010, when India recorded its highest GDP growth rate of 10%. With this, India became the second fastest growing major economy in the world, next only to China.³⁹² In the past two decades, the size of the middle class has quadrupled (to almost 250 million people), and 1 percent of the country's poor have crossed the poverty line every year. At the same time, population growth has slowed from the historic rate of 2.2 percent a year to 1.7 percent today, meaning that growth has brought large per capita income gains, from \$1,178 to \$3,051 (in terms of purchasing-power parity) since 1980. India is now the world's fourth-largest economy in purchasing power parity. Soon it will surpass Japan to become the third-largest.³⁹³

³⁸⁹ Cfr. OECD, *Economic Survey of India*, <http://www.oecd.org/dataoecd/17/52/39452196.pdf>, Access: December 23rd 2011, 20:03.

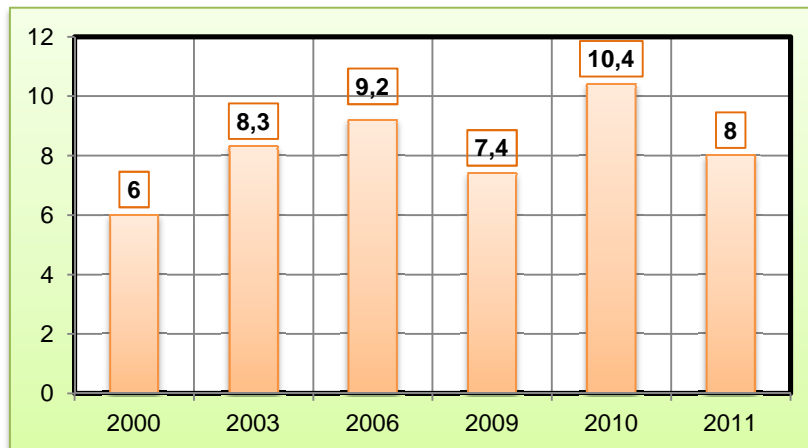
³⁹⁰ Cfr. THE ECONOMIST, *Ruled by Lakshmi*, http://www.economist.com/node/12749719?story_id=12749719&fsrc=rss, Access: December 23rd 2011, 22:39.

³⁹¹ WORLD BANK, *India Outlook*, <http://siteresources.worldbank.org/INDIAEXTN/Resources/Reports-Publications/IndiaEconomicUpdate-September2011.pdf>, Access: December 23rd 2011, 20:41.

³⁹² IndexMundi, *India Information*, <http://www.indexmundi.com/g/g.aspx?c=in&v=66>, Access: December 23rd 2011, 23:42.

³⁹³ Cfr. Foreign Affairs, *The India Model*, <http://www.foreignaffairs.com/articles/61728/gurcharan-das/the-india-model>, Access: December 24th 2011, 10:12.

FIGURE 32
INDIA'S GDP REAL GROWTH RATE (%)



Source: IndexMundi
Made by: Germán Guerra Silva.

The notable thing about India's rise is not that it is new, but that its path has been unique. Rather than adopting the classic Asian strategy of exporting labor-intensive, low-priced manufactured goods to the West, India has relied on its domestic market more than exports, consumption more than investment, services more than industry, and high-tech more than low-skilled manufacturing. This approach has meant that the Indian economy has been mostly insulated from global downturns, showing a degree of stability that is as impressive as the rate of its expansion. That isolation became obvious during the Great Recession. India could deal very well with the downturn because the resilient Indian consumer pushed the economy forward. The consumption-driven model is also more people-friendly than other development strategies. Moreover, 30 to 40 percent of GDP growth is due to rising productivity, a true sign of an economy's health and progress, rather than to increases in the amount of capital or labor.³⁹⁴

Of course, India is famous for its IT (Information/Technology) outsourcing services. The economic liberalizations under Singh combined with the drop of the communications costs, the capacity of the educated Indians to speak English and low wages pushed India to the first place in the provision of services to outsourcing companies: telephone exchanges, software engineering, insurance claims processing, accounting, radiographs evaluations and so many

³⁹⁴ Cfr. Id.

other services based on the Internet. The Indian software engineers have helped the world to be up to the challenges of the XXI century.³⁹⁵

Indian firms like Infosys, Tata Consultancy Services and Wipro practically invented the entire offshore IT-services industry. At their ever-expanding campuses, these companies train and absorb thousands of new hires each year while extending their reach to every corner of the globe. They also tend to operate core manufacturing and service businesses in advanced economies. These companies have helped propel the Indian economy to higher growth rates and create almost half of the new urban jobs during the past decade.³⁹⁶

Domestic consumption in an awakening market of 1.2bn people, strikes many as a sure bet for the next 40 years, with opportunities in infrastructure, retail and education. Its leading companies, particularly in the IT outsourcing, automotive and pharmaceutical sectors, continue to expand their global footprint. One of the most often quoted figures to illustrate the promise of a domestic market of 1.2bn people is the number of new mobile telephone users who sign up each month. This raised skeptical eyebrows when it was 5m a month. But now the figure has grown to nearer 15m a month. Mobile operators are driving growth by offering call rates for less than Rs (rupees) 1 a minute.³⁹⁷

The new India belongs to a visionary breed of business people who see greater possibility for their companies within India and beyond than at any other time in this country's history. Among them is Ratan Tata, chairman of Tata Group. Not only has his conglomerate launched the Nano, the world's cheapest car, it has set out on the most ambitious foreign expansion of an Indian company, buying foreign companies, including car companies like Land Rover and Jaguar and the Anglo-Dutch steel maker Corus.³⁹⁸

³⁹⁵ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 358

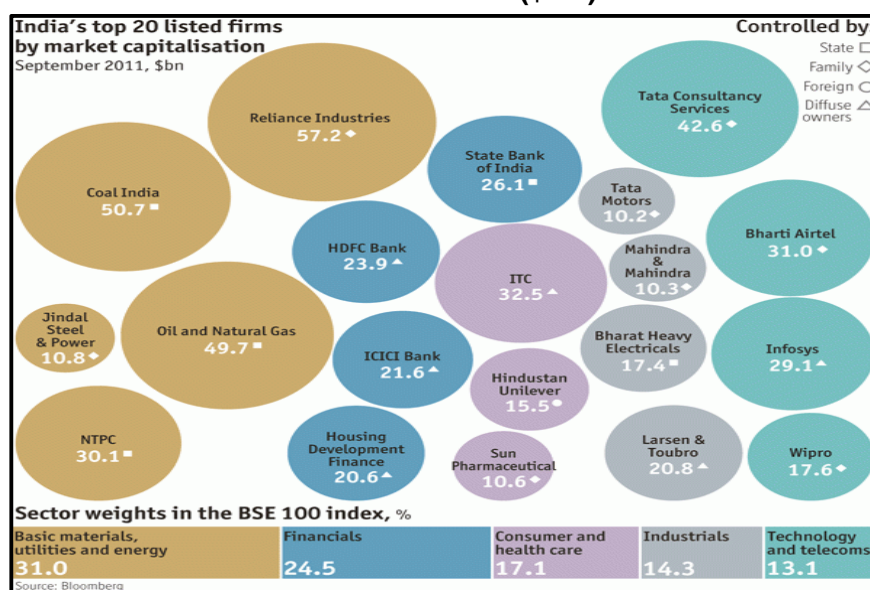
³⁹⁶ Cfr. SCHUMAN Michael *The case for India*,

http://www.time.com/time/specials/packages/article/0,28804,2099180_2099179_2099176,00.html, Access: December 20th 2011, 20:13.

³⁹⁷ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, <http://www.ft.com/intl/cms/s/0/415b0bd6-2827-11e0-8abc-00144feab49a.html#axzz1hgLbpu47>, Access: December 21st 2011, 14:29.

³⁹⁸ Cfr. LAMONT James, *Land of opportunity*, http://www.ft.com/intl/cms/s/0/3d2a921a-4ac1-11de-87c2-00144feabdc0,dwp_uuid=edca7290-4abf-11de-87c2-00144feabdc0.html#axzz1hgLbpu47, Access: December 23rd 2011, 16:19.

IMAGE 25
INDIA'S TOP 20 LISTED FIRMS BY MARKET CAPITALISATION (\$BN)



Source: Bloomberg Market Data
 Made by: The Economist

In 2010, cross border mergers and acquisitions (M&A) saw a strong revival; deals in and out of India were five times the value of the previous year. More outbound acquisitions were made last year than inbound, reflecting the increasingly global nature of Indian companies. Overall M&A activity was estimated at about \$45bn by Grant Thornton, the auditing group, for the first 11 months of 2011.³⁹⁹

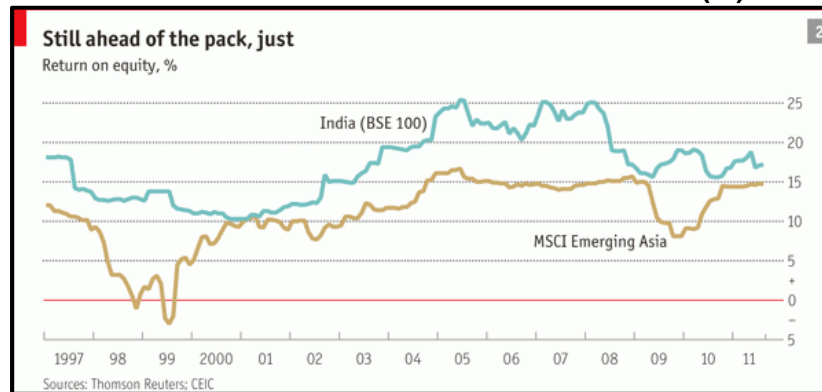
India is also one of the most promising destinations for foreign direct investment (FDI). Ministers talk ambitiously of attracting investment of \$1,000bn into infrastructure within five years. In the first 10 months of 2010, India attracted \$78bn in FDI. Another important business in India is the diamond industry. This is one of India's great business success stories from the past 30 years. One of the country's key export sectors, its polishers import rough diamonds, cut and then export them to the big jewelry markets of the US, the Gulf and Europe. In 2011, India had a 55 per cent market share of the world's diamond cutting and polishing business. Some 800,000 jobs were created in this sector by virtue of India's low-cost but technically skilled labor force. And the sector is at the forefront of the economy's integration into global markets.⁴⁰⁰

³⁹⁹ Cfr. Id.

⁴⁰⁰ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, op. cit.

The past half-century of Asian economic history tells us that sustained development ultimately depends on entrepreneurship, a strong private sector, rule of law and political openness. India possesses these crucial building blocks of economic progress. And that is why, in the opinion of many, India could overtake China as the world's premier emerging economy.⁴⁰¹

FIGURE 33
RETURN ON EQUITY IN INDIAN COMPANIES (%)



But not everything is shiny for the Indian economy; many reforms need to take place if the economy is not to grow by “default” but by design. But in the way of reform is an enormous and corrupt bureaucracy. Next, I address India’s problems.

3.2.2. The Problems of an Emerging Superpower.

Not only is India the world’s most populous democracy, it is also one of its messiest. It holds periodic elections, but nearly one fifth of the elected representatives it sends to Parliament have some criminal record. Its Constitution guarantees freedom of expression, but journalists in India often get physically attacked for what they write. Its laws permit peaceful demonstrations, but the police can impose restrictions and even prevent demonstrations from taking place if the demonstrators, in their opinion, are likely to affect peace.⁴⁰²

Political, bureaucratic, corporate and individual corruption in India are major concerns. A 2005 study conducted by Transparency International in India

⁴⁰¹ Cfr. SCHUMAN Michael *The case for India*, op. cit.

⁴⁰² Cfr. TRIPATHI Salil, *Hunger Strike Inflames India*, <http://www.thedailybeast.com/articles/2011/08/18/india-protests-anna-hazare-s-new-battle-against-corruption.html>, Access: December 25th 2011, 12:34.

found that more than 55% of Indians had first-hand experience of paying bribes or use influences to get jobs done in public offices successfully. Transparency International estimates that truckers pay US\$5 billion in bribes annually.⁴⁰³ In 2011 India was ranked 95th out of 178 countries in Transparency International's Corruption Perceptions Index.⁴⁰⁴

That said, the anger in India against corruption is justified. Doing business in India remains stuck in bureaucracy, and each delaying tactic creates rent-seeking opportunity for bureaucrats at many levels. The World Bank ranks India 134th out of 183 countries it surveyed for the ease of doing business. People are most angry about two major scandals, involving the issuing of licenses for the next generation of mobile telephones for \$39bn in 2008, and the way contracts were awarded for the Commonwealth Games in India in 2010.⁴⁰⁵

Several usually discreet eminent figures have warned of a widespread governance deficit that the country can ill afford if it wants to bring greater development. While the scandals are huge, several implicated politicians and businessmen are in custody facing charges of corruption, and if found guilty will spend a long time in jail. The system is slow in India, but apparently it works. (Or, as former U.S. Ambassador to India John Kenneth Galbraith put it, it is an anarchy, but it functions).⁴⁰⁶

There is another type of corruption, which corrodes the nation's strength, affecting the poor, police officers seeking bribes from vendors, officials refusing to register land titles or authenticate marriage documents, sales-tax officials shaking down small businesses. Common citizens of the country pay a bribe 21,068 rupees (\$410.60) while using one or more of the eleven public services in a year. As high as 62 percent of citizens think that the corruption is not a rumor, but they in fact had the firsthand experience of paying bribe or "using a contact" to get a job done in a public office.⁴⁰⁷

⁴⁰³ Cfr. BUSINESSWEEK, *India: Where Shipping Is Shaky*, http://www.businessweek.com/magazine/content/07_12/b4026010.htm, Access: December 25th 2011, 13:59.

⁴⁰⁴ Cfr. TRANSPARENCY INTERNATIONAL, *Corruption Index*, http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results, Access: December 25th 2011, 16:16.

⁴⁰⁵ Cfr. TRIPATHI Salil, *Hunger Strike Inflames India*, op. cit.

⁴⁰⁶ Cfr. Id.

⁴⁰⁷ Cfr. Id.

Many activists have threatened a hunger strike to force the government's hand. The government has responded by jailing its critics and making them heroes. It might seem that India is in a corruption downward spiral. But this is India; Indians love drama, and if the past is a predictor, soon there will be a photo opportunity, and everyone will declare a victory. Don't expect corruption to end anytime soon, though.⁴⁰⁸

IMAGE 26
DEMOCRACY PER SE DOES NOT
GUARANTEE STABILITY



Source: The Financial Times.
Made by: Ingram Pinn.

In the economic field, the general outlook does not look promising in 2012. India's growth has been hit by the fastest interest rate increases since 1935 and the rupee's decline to a record low, which fueled inflation and deterred foreign investment. The government is struggling to tame stubbornly high inflation that spent much of 2011 in double figures. The wholesale price index rose 8.4 per cent in December 2011, despite an earlier promise by the government to cut inflation to 6 per cent by the end of 2011.⁴⁰⁹

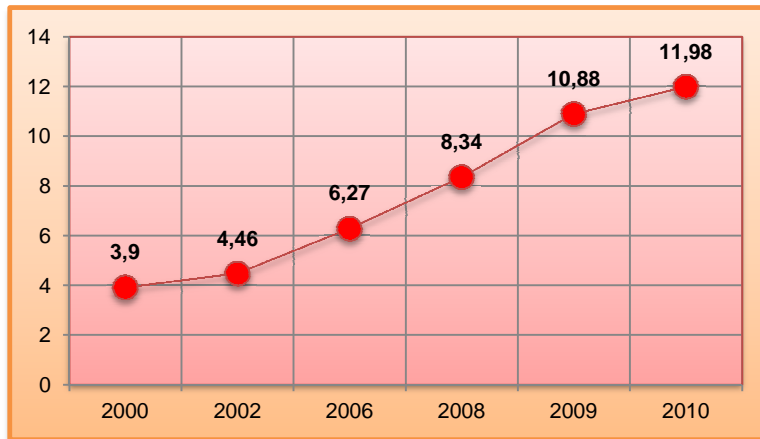
As previously said, the Reserve Bank of India (RBI) has been raising rates through 2011 to try to bring inflation, under control. At Mumbai "drink parties", after a scotch too many, industrialists can be reduced to tears on this subject. The central bank, they argue, has overreacted, killing growth to tame an inflation problem that is largely the result of structural factors such as poor food supply chains.⁴¹⁰

⁴⁰⁸ Cfr. Id.

⁴⁰⁹ Cfr. THE ECONOMIST, *Slip-sliding away*, <http://www.economist.com/blogs/freeexchange/2011/12/india-s-economy>, Access: December 26th 2011, 10:19.

⁴¹⁰ Cfr. Id

FIGURE 34
INDIA'S INFLATION RATE (%)



Source: IndexMundi
Made by: Germán Guerra Silva.

Expectations for India's economic growth rate have been falling inexorably. In the early spring of 2011 there was still strong talk about 9-10% being the new "natural" rate of expansion, a trajectory which if maintained would make the country an economic superpower in a couple of decades. Now things look different.⁴¹¹

The latest GDP growth figure slipped to 6.9% and industrial production numbers released on December 12th 2011 showed a decline of 5.1% compared with the previous period, a miserable state of affairs. The slump looks broadly based, from mining to capital goods, and in severity compares with that experienced at the height of the financial crisis, in February 2009, when a drop of 7.2% took place. Pretentiousness is turning to panic.⁴¹²

Another significant problem for India is inequality. Crucial to its future, and its global standing, is whether higher growth is changing the lives of the poor to reduce some of the domestic risks, such as insurgencies, surrounding inequality. Amartya Sen, the Nobel laureate and Harvard professor, and others are critical of an often singular focus on headline growth numbers, without giving greater consideration of the chronic undernourishment damaging the growth of half the country's children. "Until the number of malnourished children and illiterate women has been reduced by 90 per cent, there should be no horn

⁴¹¹ Cfr. Id.

⁴¹² Cfr. Id.

blowing,” says Jean-Pierre Lehmann, founder of the Evian Group, a think tank.⁴¹³

The country's ability to transform the lives of many of its 1.2bn people is uncertain. The poor are faced with rising food prices and undiminished worries about food and energy security. In coming years, wider distribution of India's growing prosperity and shared benefits of global integration are vital if good is to outweigh the bad.⁴¹⁴

The Indian economy hasn't been growing as quickly as China's, nor has its industry imprinted as deep a mark on the global economy. India has more than twice as many people trapped in desperate poverty, while its fractious democracy traps policymaking in long-winded debates and ideological battles unthinkable within China's autocratic government. Beijing and Shanghai are connected by high-speed trains; their streets are lined with modern office towers. In New Delhi and Mumbai, the dusty lanes remain lined with barefoot vagabonds and chaotic with motorized rickshaws.⁴¹⁵

The IT industry and other services isolated in the modern cities of Bangalore, Hyderabad, Ahmedabad, Mumbai and New Delhi skipped the XX century and jump directly to the XXI. But, as one government official complain on a BBC interview in 2007: “ If you leave the glamour of some of the cities you go back to the XIX century”. The overall infrastructure of India is decrepit unable even of offering reliable electricity supply.⁴¹⁶

Rural India is trapped in a level of poverty only surpassed by Sub-Saharan Africa. Is there that a big part of illiterates reside (two fifths of the adult population) and the majority of the 250 million Indians that live with less than a dollar a day. Half of Indian households do not have electricity.⁴¹⁷

India has some serious problems, many of which can be a result of years of reform procrastination. Years of government drift⁴¹⁸ have meant a loss of momentum on reform, from building infrastructure to controlling corruption.

⁴¹³ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, op. cit.

⁴¹⁴ Cfr. Id.

⁴¹⁵ Cfr. DEHEJIA Vivek, *Don't blame 'neoliberal' reforms for corruption*, <http://www.ft.com/intl/cms/s/0/e4660ef4-b68c-11e0-ae1f-00144feabdc0.html#axzz1T4jxUqkr>, Access: December 26th 2011, 12:48.

⁴¹⁶ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 360

⁴¹⁷ Cfr. Id.

⁴¹⁸ NB. Drift meaning a general underlying design or tendency <perceiving the *drift* of the government's policies>

That drift was symbolized by the ruling coalition's decision in November 2011 to allow foreign supermarkets into India (Wal-Mart for example), which it was forced to reverse two weeks later after widespread protests and objections from the smaller parties it relies on to stay in power. India's economy can be seen as a bicycle, it needs to keep moving fast to be stable. Once conviction in the destination falters, companies curb investment and hope turns to fear that the country's problems may be intractable. Much needs to be done.⁴¹⁹

3.2.3. India's International Role and its Need for Reform.

India has never looked so good, nor so bad. In the eyes of global leaders and investors, the country is "coming of age". A procession of statesmen has acclaimed India as a responsible, rising power, inviting it to take a seat at the top table of world affairs. Mr. Obama, for example, described the country as "emerged" rather than emerging and identified the relationship with New Delhi as one of the defining partnerships in the 21st century. The promise of access to US technology and an endorsement of a future permanent seat on a reformed United Nations Security Council gave substance to warm words.⁴²⁰

Similar praise was given by four other big powers that seek a closer partnership with India. Within six months during 2011, David Cameron, the UK prime minister, Nicolas Sarkozy, the French president, Dmitry Medvedev, the Russian prime minister and Wen Jiabao, China's president, landed in Delhi. Their visits redefined the country's global standing, and lent support for India to take a greater role in the world's multilateral institutions.⁴²¹

As is necessary for any nation, India's principal priority is ensuring conventional security for its country and its people. In recent years, India has built up a strong and capable Army, Navy and Air Force: the third, fourth and seventh largest in the world respectively. The sense of a rising super power deepened in 2008 when India signed a civil nuclear agreement with the US to bring the country's nuclear program out of international isolation. The restraint India showed after the devastating terror attacks on Mumbai, its financial capital,

⁴¹⁹ Cfr. THE ECONOMIST, *Slip-sliding away*, op. cit.

⁴²⁰ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, op. cit.

⁴²¹ Cfr. Id.

by Pakistani-militants was also a step forward in its transition from big power to great power.⁴²²

A big concern for India is the need to develop nuclear capability. India has two nuclear weapon powers on its borders, China and Pakistan and one would-be nuclear weapons power in its immediate location, Iran. As seen through historical facts, relations with these first two powers are unstable; India has fought wars with both in recent decades and tensions rise and fall over border disagreements. In this context, India continues to focus on its own nuclear resources, and is very sensitive to intimidation of control by any other power.⁴²³

India's main conventional threat is perceived to be Pakistan. These two nations had a military stand-off in late 2001 and early 2002 following an attack on the Indian Parliament. While India's military is vastly larger than Pakistan's, this numerical supremacy is somewhat mitigated by the topographic limitations of their western border, which restricts the number of troops that India could deploy against Pakistan at any one time.⁴²⁴

Moreover, India also has tense relations with another of its neighbors, China. The security establishment views neighboring China, with whom trade has boomed to \$60bn a year, as far more of a menace than a partner. In 1962, the two nations fought a war, lost quickly by India, a fact that has long stuck in the memories of many Indian military officers.⁴²⁵

As a consequence, India is looking more to the West, as it deepens its embrace of a free-market economy, and international markets. The high water mark in 2011 was undoubtedly the visit of Barack Obama, the US president. India's top diplomats gave Mr. Obama high praise for "getting the political messaging right" and taking forward a new relationship forged by his predecessor George W. Bush with the transformative recognition of India's nuclear program.⁴²⁶

⁴²² Cfr. LAMONT James, *Land of opportunity*, op. cit.

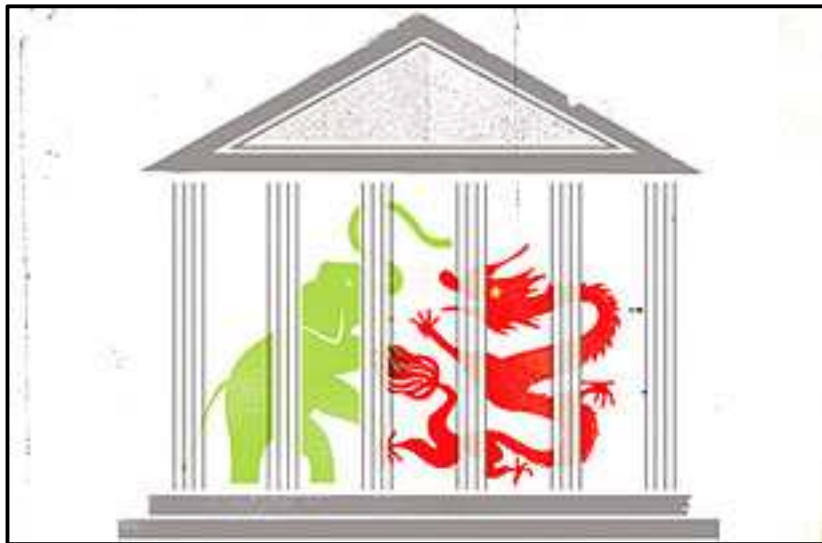
⁴²³ Cfr. Id.

⁴²⁴ Cfr. KHOSLA Tamanna, *India's Foreign Policy & Its Growing Role in the International Arena*, <http://www.darpanmagazine.com/2011/02/indias-foreign-policy-its-growing-role-in-the-international-arena/>, Access: December 27th 2011, 22:06.

⁴²⁵ Cfr. Id.

⁴²⁶ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, op. cit.

IMAGE 27
THE FIGHTING ELEPHANT AND DRAGON



Source: Time Magazine.
Made by: Time Magazine.

A further concern for India in order to sustain economic growth at around 10% is ensuring energy security. According to statistics, India currently imports 70% of its oil and 50% of its gas; by 2025 it is projected that India will import 80% of its energy needs. In an effort to ensure access to energy resources, India will continue to focus on the Middle East region.⁴²⁷

The final international priority for New Delhi's government is the need of India to take its "rightful" place on the global stage. In so doing, they will recognize the importance of building their strategic stature and leadership. Despite already being a leader of the developing world, India wants its status recognized in the developed world. Given South Asia's instability, there is much scope for India to focus its assets on helping to alleviate the conflicts in its neighborhood such as those in Nepal, Sri Lanka and Bangladesh. India's positive role in Afghanistan is also now recognized by the US, France and Britain. Given India's impressive military and soft-power capabilities, as India builds confidence and finds its voice, it will become more active in helping to create a regional security regime and in pushing stability outwards.⁴²⁸

But in order to become a global player India needs first to undertake some serious reforms in order to ensure stability and progress for its citizens. The Government is facing rising popular expectations to make administrative

⁴²⁷ Cfr. KHOSLA Tamanna, *India's Foreign Policy & Its Growing Role in the International Arena*, op. cit.

⁴²⁸ Cfr. Id.

reforms and deliver education and better quality jobs to one of the youngest nations in the world, with 70 per cent of the population under the age of 35.⁴²⁹

Manufacturing in India and even high technology services have been affected for decades by labor regulations that destroy jobs. Because of these expensive regulations applied to establishments with 10 or more employees, more than 40% of employment in the manufacturing sector takes place in centers that hire from 5 to 9 workers. The productivity of these Indian companies is 20% less than that of the larger firms, due to their inability to create economies of scale gain competitiveness and attract workers from the rural areas.⁴³⁰

IMAGE 28 INDIA'S DEVELOPMENT CONTRADICTIONS



Source: The Economist.
Made by: Jon Berkeley.

This is just one of the many sectors where reform is needed, some others, for example, are foreign direct investment, trade, tax, agricultural policy and market competition. The case for liberal economic reform has never been properly made in India. Reform, when it happens, comes under the weight of a crisis, as in 1991, or in furtiveness, as it did subsequently. This “original sin” of 1991 has contaminated all subsequent discussion of economic policy and there lie the roots of the country’s current difficulties.⁴³¹

⁴²⁹ Cfr. LAMONT James, *Strong growth yet to improve lives of the poor*, op. cit.

⁴³⁰ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 359

⁴³¹ Cfr. DEHEJIA Vivek, *Don't blame 'neoliberal' reforms for corruption*, op. cit.

Vitally needed regulatory reform has to be implemented in order to keep big business at arms' length⁴³² from politicians and bureaucrats, and, at the same time, have a rationalization of the regulatory regime to eliminate the incentive for corruption in the first place. In addition, as pointed out by scholars and some officials, India needs a thorough renovation of electoral finance to cut off the incentive for politicians to accumulate black money with which to fight elections.⁴³³

As economists are aware, there is both a supply and demand side to corruption, and both must be attacked if it is to be eliminated. That would take India a long way toward a truly liberal economic order, far from the unfinished task of today, which is being castigated by deep but misguided Indian critics who see the symptoms but have failed to diagnose the disease.⁴³⁴

The delay in the necessary reforms maybe lays in the little will of the country to fully adopt the forces of the market. This is something made obvious by the Indian response to economic problems, often only governmental. When there was a rising food inflation at the beginning of 2007, the answer was not to allow that rising prices permitted and increase of supply, but rather forbid all wheat exports for the rest of the year and stop the trading of futures to "stop speculation", the very market forces the Indian economy needs to break up the sinister rule of the bureaucracy.⁴³⁵

3.3. Brazil: The Rising Latin-American Titan

3.3.1. The Power of Commodities and Public Policies.

For decades, the joke about Brazil has been that it's the country of the future, and always will be. Despite enormous natural resources, it has long displayed a strange ability to waste its vast potential.⁴³⁶ Now it's beginning to look like Brazil may have the last laugh. Brazil, or the Federative Republic of Brazil, is the largest country in South America in area and population, with about 200 million people. Over the last decade it has also become one of the

⁴³² NB. The arm's length principle (ALP) is the condition or the fact that the parties to a transaction are independent and on an equal footing.

⁴³³ Cfr. DEHEJIA Vivek, *Don't blame 'neoliberal' reforms for corruption*, op. cit.

⁴³⁴ Cfr. Id.

⁴³⁵ Cfr. GREENSPAN Alan, *The Age of Turbulence*, op. cit. 362

⁴³⁶ Cfr. CBSNEWS, *Brazil: The World's Next Economic Superpower?*

<http://www.cbsnews.com/stories/2010/12/09/60minutes/main7134185.shtml>, Access: December 31st 2011, 10:11.

world's fastest-growing economic powerhouses.⁴³⁷ Brazil is a huge country, slightly larger than the continental U.S, with vast areas of arable farmland, an abundance of natural resources, and 14 percent of the world's fresh water. Eighty percent of its electricity comes from hydropower. It has the most sophisticated biofuels industry in the world, and, for its size, the world's greenest economy.⁴³⁸

While most of the world is consumed with debt and unemployment, Brazil is trying to figure out how to manage an economic boom. It was the last country to enter the Great Recession, the first to leave it, and is poised to become the world's fifth-largest economy.⁴³⁹

In December 2011, the latest figures from the Centre for Economic and Business Research's annual world economic league table from the UK, showed that Great Britain was now the seventh richest country in the world, and had fallen behind a South American nation for the first time: Brazil.⁴⁴⁰ In 2011, the size of Brazil's economy was \$2.52trn versus \$2.48trn of Britain.⁴⁴¹

Brazil's economy has yet again become an object of fascination and speculation for international investors, academics, pundits, and policymakers around the world. This is a country full of natural resources, endowed with a large internal market, and home to dynamic and increasingly global corporations. The confluence of strong global demand for the country's major products, global successes for its major corporations, and steady results from its economic policies have strengthened confidence and even revived dreams of *grandeza*, the greatness that has proven elusive in the past.⁴⁴²

Brazil's economic potential has been on display in the past. Between 1947 and 1962, the country grew at an average rate of 6 percent annually and was seen as one of the brightest starts in the world economy. During the so-

⁴³⁷ Cfr. THE NEW YORK TIMES, *Brazil*, <http://topics.nytimes.com/top/news/international/countriesandterritories/brazil/index.html>, Access: December 31st 2011, 12:30.

⁴³⁸ Cfr. CBSNEWS, *Brazil: The World's Next Economic Superpower?*, op. cit.

⁴³⁹ Cfr. Id.

⁴⁴⁰ Cfr. THE ECONOMIC TIMES, *Brazil overtakes UK as world's sixth largest economy*, http://articles.economictimes.indiatimes.com/2011-12-27/news/30561599_1_brazil-sixth-largest-economy-uk, Access: January 2nd 2012, 14:51.

⁴⁴¹ Cfr. INVESTMENT WEEK, *Brazil overtakes UK as world's sixth largest economy*, <http://www.investmentweek.co.uk/investment-week/news/2134781/brazil-overtakes-uk-worlds-sixth-largest-economy>, Access: January 2nd 2012, 17:12.

⁴⁴² Cfr. MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil's Changing Role in the Global Economy*, The Brookings Institution, Washington D.C., First Edition, 2009, p. 32.

called Brazilian miracle period (1968-73), the country enjoyed economic growth of more than 10% a year, among the highest in the world. Its industrial sector grew at almost 10% a year, and its agricultural exports almost doubled between 1962 and 1971. Yet the country's star faded with the debt crisis of 1982 and the "lost decade" of the 1980s. Years of macroeconomic instability and high inflation followed.⁴⁴³

In comparison with the Brazilian miracle of the 1970s, the country's bright prospects appear to rest on a more solid foundation this time around. The country is now a stable, vibrant democracy, not a military dictatorship. It has enjoyed a sustained period of low inflation and conservative macroeconomic management, in contrast to the external-debt-fueled 1970s.⁴⁴⁴

The 2002 election and the subsequent leadership of President Luis Inácio Lula da Silva have demonstrated that a left-wing candidate can win the presidency, navigate a sound macroeconomic course, and open the country's economy to global trade and investment. Today, Brazil is more deeply integrated with the global economy than at any time in the past forty years.⁴⁴⁵

The country's meteoric rise occurred under the quiet stewardship of the already named Luiz Inácio Lula da Silva, a former auto plant worker with a fourth-grade education, and a doctorate in charisma who served as Brazil's president from 2002 to 2010. Wildly popular, Mr. da Silva, known as Lula inside Brazil, presided over the country during a period of significant economic growth that solidified Brazil as the center of gravity in Latin America and an increasingly important player in the world. Mr. da Silva fostered this growth through a centrist combination of respect for financial markets and targeted social programs, which lifted millions out of poverty.⁴⁴⁶

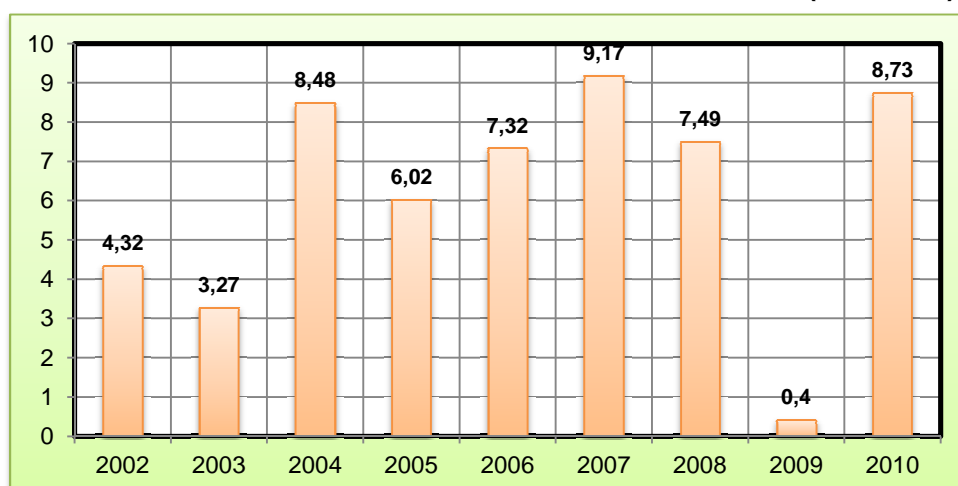
⁴⁴³ Cfr. *Ibid.*, 36.

⁴⁴⁴ Cfr. *Ibid.*, 38.

⁴⁴⁵ Cfr. *Id.*

⁴⁴⁶ Cfr. THE NEW YORK TIMES, *Brazil*, op. cit.

FIGURE 35
BRAZIL'S GDP GROWTH DURING THE LULA YEARS (% IN PPP)



S
 Source: IndexMundi
 Made by: Germán Guerra Silva

Lula is still admired as Brazil's most towering contemporary political leader. One thing obvious to him was the social and economic gap separating Brazil's rich and poor. He gave the poor families a monthly stipend of \$115, just for sending their children to school and taking them to doctors. The infusion of cash helped lift 21 million people out of poverty and into the lower middle class, creating an unexploited market for first-time buyers of refrigerators and cars. Lula said, "If there is something I am proud of, it is to have told my people that we are not second-class citizens, that we can get things done, we can believe in ourselves, and then people have started to believe."⁴⁴⁷ In January 2011, Mr. da Silva was succeeded by Dilma Rousseff, the country's first female president. Her election was seen as a call to continue the economic and social policies of her popular predecessor. Ms. Rousseff served as chief of staff for Mr. da Silva and was his hand-picked candidate.⁴⁴⁸

Brazil's status among the world's rising economic powers emanates from a favorable conjuncture of external forces and internal strengths. The entry of hundreds of millions of people into the middle class in China and India has boosted demand for many of Brazil's key agricultural and commodity exports, and Brazil's resource wealth appears destined to grow with new oil finds that were made in 2007 in Tupi. Overnight the country became a potential mega-

⁴⁴⁷ Cfr. Id.

⁴⁴⁸ Cfr. MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil's Changing Role in the Global Economy*, op. cit. 41

exporter of oil, with enough reserves for the next 50 years. "God is Brazilian" said Lula after these findings were announced.⁴⁴⁹

However, Brazil is not only benefiting from historically high commodity prices, which have proven to be temporal. It is also benefiting from its sustained commitment to sound macroeconomic policies; from the strength of its corporations, which are achieving global success across a variety of sectors; and from the legacies of its policies on alternative energy and agricultural self-sufficiency, which were put in place in the 1960s and 1970s but are now delivering unanticipated benefits.⁴⁵⁰

Brazil is currently the largest producer of iron ore in the world and the world's leading exporter of beef, chicken, orange juice, sugar, coffee and tobacco, much of it bound for China, which has replaced the U.S. as Brazil's leading trade partner. But it's not just commodities that are driving the Brazilian boom. The country has a substantial manufacturing base and a large auto industry. Aviation giant Embraer is the world's third-largest aircraft manufacturer, behind Boeing and Airbus and a main supplier of regional jets to the U.S. market.⁴⁵¹ A surge in deal-making and the resilience of Brazil's currency, the real, has attracted foreign investment bankers, hedge fund managers and venture capitalists. Well-educated Brazilians are returning from abroad. Compensation in some executive offices now rivals the pay on Wall Street.⁴⁵²

Yet, sustained growth and ascension to the ranks of the global economic powers has eluded many resource-rich countries. Why might Brazil succeed where others have failed? One possible answer is that the country is obtaining the benefits from its legacy of policies that were intended to advance its self-sufficiency and autonomy from international markets but are now paradoxically conferring important advantages for engaging with the world economy as its leadership seeks to seize opportunities in globalizing capital, product, and energy markets.⁴⁵³

⁴⁴⁹ Cfr. OPPENHEIMER Andrés, *Basta de Historias*, Vintage Español, New York, 2010, p. 253.

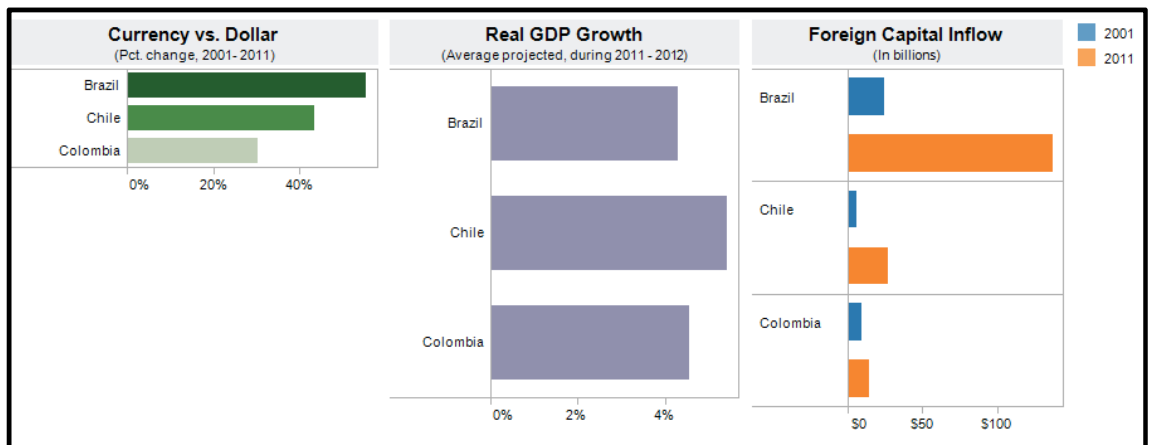
⁴⁵⁰ Cfr. THE BROOKINGS INSTITUTION, *Brazil: The "B" Belongs in the BRICs*, http://www.brookings.edu/~media/Files/Press/Books/2009/brazilasaneeconomicssuperpower/brazilasaneeconomicssuperpower_chapter.pdf, Access: January 2nd 2011, 20:18.

⁴⁵¹ Cfr. CBSNEWS, *Brazil: The World's Next Economic Superpower?*, op. cit.

⁴⁵² Cfr. THE NEW YORK TIMES, *Brazil*, op. cit.

⁴⁵³ Cfr. THE BROOKINGS INSTITUTION, *Brazil: The "B" Belongs in the BRICs*, op. cit.

FIGURE 36
SOME ECONOMIC INDICATORS OF 3 LATIN AMERICAN COUNTRIES



Source: The New York Times.
 Made by: The New York Times.

Also prominent was the state’s role as business manager and economic planner. As manager of state-owned businesses, the Brazilian state has a mostly typical record, but one punctuated by prominent successes, especially in aircraft manufacturing, biofuels, and petrochemicals. There was a notable involvement of the Brazilian state in technological development through investments in research centers and institutions.⁴⁵⁴

In sectors such as informatics, the state played the role of “midwife,” trying to assist in the emergence of new entrepreneurial groups or to induce existing groups to venture into more challenging kinds of production. This role was facilitated by a range of instruments, including protective tariffs, subsidies, targeted credit, and government help for local entrepreneurs negotiating with foreign investors.⁴⁵⁵

Policies put in place in the 1960s and 1970s helped to stimulate the agribusiness and biofuels sectors and to develop strengths in selected manufacturing areas. Through entrepreneurial vision, a number of Brazilian producers have been able to translate this policy legacy into competitive advantages in global markets now that the country’s policy orientation has turned outward and global demand has shifted favorably.⁴⁵⁶

⁴⁵⁴ Cfr. Id.

⁴⁵⁵ Cfr. MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil’s Changing Role in the Global Economy*, op. cit. 52.

⁴⁵⁶ Cfr. Ibid., 54

According to projections by Goldman Sachs, Brazil would have to grow by about 4 percent a year from 2005 through the middle of the century to become the world's fourth-largest economy. Whether these growth rates will come to pass will depend, among other things, on whether Brazilian firms are able to capitalize on new opportunities in the global economy and Brazilian policymakers pursue deeper global economic integration and well-designed public policies. As for now, as President Obama said: "Brazil is no longer the country of the future, but of the present"⁴⁵⁷

3.3.2. The Dark Side of Brazil's Rise.

Brazil is booming thanks to a tectonic shift in global investing toward the developing world that has lifted its stock market, strengthened its currency and provided financing for new ports and World Cup soccer stadiums. But while foreign investment is mostly a good thing, there are downsides. The abundance of cash has helped fund riskier bank loans and fueled a potential real-estate bubble. By some measures, the Brazilian real is now the world's most overvalued currency, and many local factories aren't competitive in global markets.⁴⁵⁸

Daily life has become so expensive that movies, taxis and even a can of Coke cost more in São Paulo than in New York. Rio de Janeiro apartment prices have doubled since 2008, and office space in São Paulo is suddenly more expensive than Manhattan. In many cases, investment banks must pay their Brazilian bankers and analysts more than they would get doing the same job in New York.⁴⁵⁹

Concern about the strong real is a key reason why Brazil's central bank cut its benchmark interest rate by half a percentage point to 12%, reversing course after a year of rate hikes. Even after cutting its interest rates Brazil has among the highest real interest rates. The move risks spurring inflation and generated a debate in Brazil on whether the central bank had succumbed to political pressure. But Brazilian officials say the country's high rates have attracted speculative foreign investments that increase the value of the Real

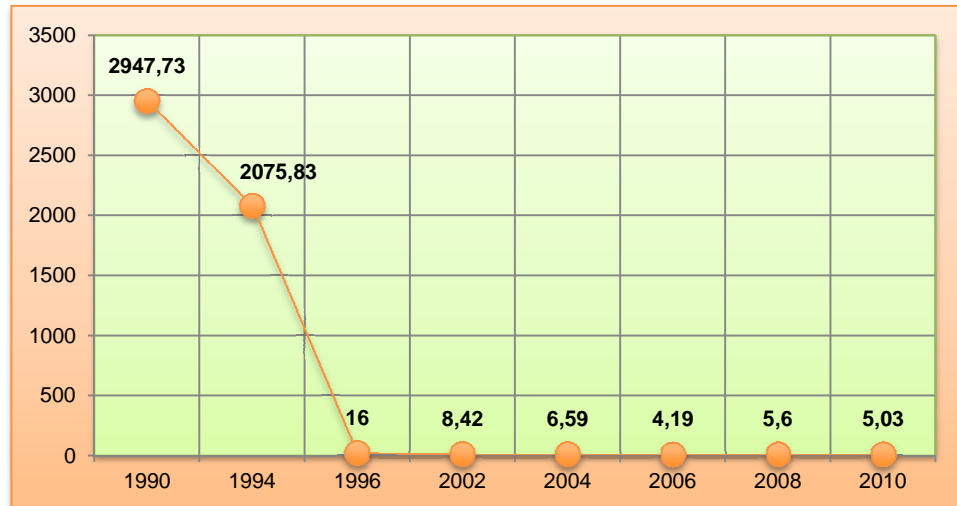
⁴⁵⁷ Cfr. Id.

⁴⁵⁸ Cfr. LEAHY Joe, *Brazil's economy: still two-speed*, <http://blogs.ft.com/beyond-brics/2011/11/23/brazils-economy-still-two-speed/#axzz1iVWZSH4u>, Access: January 3rd 2012, 11:16.

⁴⁵⁹ Cfr. Id.

and hurt the economy. Indeed, there are early indications that the Brazilian economy is beginning to slow.⁴⁶⁰

FIGURE 37
BRAZIL'S INFLATION RATE (%)



Source: IndexMundi
Made by: Germán Guerra Silva

Some executives in Brazil worry that the cost of doing business has risen so fast that their country may be unable to become the manufacturing power it has aspired to be for generations. "Ever since I was a little girl I always heard Brazil was the country of the future. Now that the future is here, I am starting to fear it will be brief," said Cynthia Benedetto, the Chief Financial Officer of Brazil's flagship manufacturing firm, Embraer SA, the world's No. 3 jet maker. Embraer, a major exporter, says it is investing in equipment to lower its labor costs at home and opening more plants abroad.⁴⁶¹

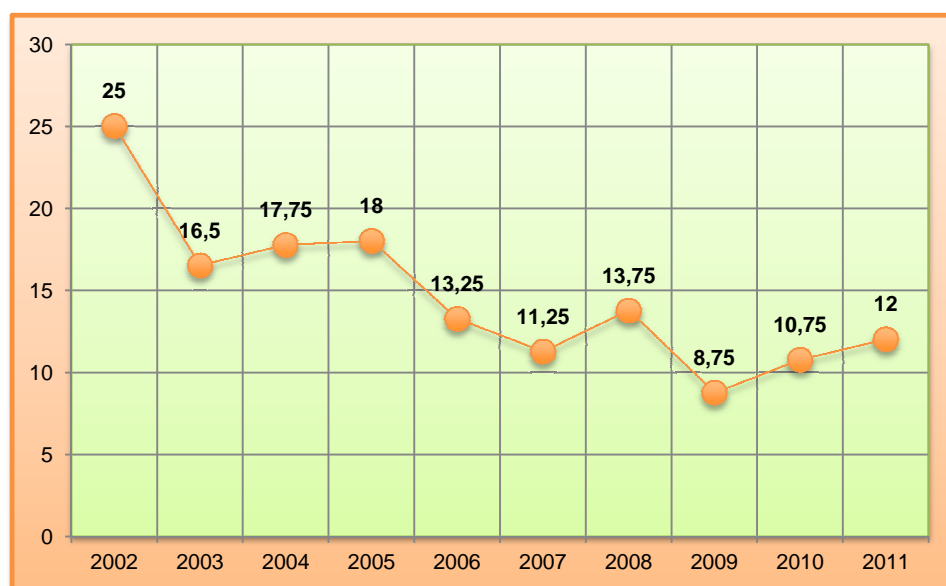
Brazilian industrial production fell 1.6% in June 2011 for the first time since the 2008 global financial crisis. Factories are losing their overseas markets and getting beat by cheap imports because Brazilian labor, parts and transport have first-world price tags, even though Brazil still has all its third-world disadvantages, like bad roads, poorly educated workers and high crime rates.⁴⁶²

⁴⁶⁰ Cfr. LYONS John, *Dark Side of Brazil's Rise*, <http://online.wsj.com/article/SB10001424053111904716604576544722103262938.html>, Access: January 3rd 2011, 13:00.

⁴⁶¹ Cfr. THE FINANCIAL TIMES, *Brazil: Things starting to get hairy?*, <http://blogs.ft.com/beyond-brics/2011/11/18/brazil-things-starting-to-get-hairy/#axzz1iVWZSH4u>, Access: January 3rd 2011, 15:41.

⁴⁶² Cfr. PEARSON Samantha, *Brazilian assets dumped despite robust economy*, <http://www.ft.com/intl/cms/s/0/962942a6-c27b-11e0-9ede-00144feabdc0.html#axzz1iLyYDQGp>, Access: January 4th 2011, 09:02.

FIGURE 38
BRAZIL'S REFERENCE INTEREST RATE (%)



Source: IndexMundi
 Made by: Germán Guerra Silva

Learning to manage abundance is an unusual situation for Brazil, which historically struggled to attract investment flows as it waded between currency crashes and economic crises. But efforts to stabilize the currency, control inflation and lower the debt load starting in the 1990s have resulted in \$350 billion in foreign reserves and investment-grade credit ratings. Indeed, Standard & Poor's became the third ratings agency in 2011 to upgrade Brazil's sovereign debt in a vote of confidence for the country that stands in contrast to the situation in Europe and the US.⁴⁶³

The plans have been laid. The economy is growing. Investors are lining up, confident that regulations can be trusted. "For the first time in the history of Brazil we have an excellent environment for investment," says Alexandre Chequer, partner at Mayer Brown, an international law firm, in São Paulo. Moody's, Fitch and S&P have raised their foreign and local currency credit ratings for Brazil to reflect the government's strong finances. The move, under which Brazil's foreign currency credit rating was raised one notch to "BBB" and its local currency rating to "A-", emphasizes the growing divergence between the fast-growing large emerging markets, led by China, Brazil and India, and the advanced economies.⁴⁶⁴

⁴⁶³ Cfr. LYONS John, *Dark Side of Brazil's Rise*, op. cit.

⁴⁶⁴ LEAHY Joe, *S&P upgrade Brazil's Credit Rating*, <http://www.ft.com/intl/cms/s/0/a1c1a890-116a-11e1-9d04-00144feabdc0.html#axzz1hgLbpu47>, Access: December 31st 2011, 15:10.

Money flows easily into Brazil because it has a free-floating currency and sophisticated stock, bond and derivative markets, unlike China. Indeed, many investors seeking exposure to China get it by investing in Brazil instead because it's a major seller of raw materials to the Chinese. Of course, capital that floods into a country can flood out of it. Leaders in emerging economies are concerned that a financial catastrophe in the developed world, such as sovereign defaults in Europe, could cause a sudden reversal of investment flows. That would prompt falls in currency, real estate and other prices that have soared in places like Brazil during the boom.⁴⁶⁵

IMAGE 29
BRAZIL'S FOREIGN CAPITAL FLOW



Source: IndexMundi.
Made by: Germán Guerra Silva.

Brazil's President Dilma Rousseff's has fought a difficult battle to keep the real from rising. Brazilian officials blame near-zero interest rates in the U.S. and Europe for making it possible for hedge funds to borrow cheaply in the rich world to place bets in Brazil. "We have to defend ourselves from this immense, fantastic, extraordinary sea of liquidity that finds its way to our economies in search of returns that it can't find in its own". Brazil has been announcing new measures almost monthly to reduce the flow, such as a tax on bond purchases, to offset its impacts, such as a multibillion dollar package of subsidies for

⁴⁶⁵ Cfr. LEAHY Joe, *Brazil: market plunge could provide breathing space on inflation*, <http://blogs.ft.com/beyond-brics/2011/08/10/brazil-market-plunge-could-provide-breathing-space-on-inflation/#axzz1iVWZSH4u>, Access: January 2nd 2011, 12:18.

manufacturers hit by the soaring real. Manufacturers say the currency is still too strong and the subsidies aren't enough.⁴⁶⁶

It turns out that international capital flows a lot like water. Close one hatch and it pours into another. Brazilian officials suspect that when the country moves to restrict speculative investments, the money is being disguised as direct investments in companies. The evidence is a 260% spike in foreign direct investment to \$38.5 billion in the first six months of 2011. Due to these investment flows, one of the hottest debates in Brazil these days is whether high prices of everything from cars to houses are a bubble that will pop.⁴⁶⁷

Indeed, The cash inflows have heated up the Brazilian real-estate market as well. A group of Brazilian homebuilders such as Gafisa SA and Cyrela SA raised hundreds of millions of dollars in share sales in recent years, mainly to U.S. investors. The money helps them build homes for Brazil's emerging middle class, a good thing. But cash-rich home builders have bid up the prices of available land in big cities, causing a spike in home prices, according to Sergio Freire, chief executive of real-estate brokerage Brazil Brokers. Credit bubbles are another concern.

Credit is rising rapidly in the big emerging-market countries—Brazil, Russia, India and China. In 2011, loan-default rates have ticked up in Brazil. The strong real is an even bigger problem for manufacturers. Humberto Barbato owns a company that makes parts for high-power transmission lines. Decades ago, he benefited from government policies that helped manufacturers set up export businesses. Now the currency is pricing him out of hard-won overseas markets.⁴⁶⁸

Smart measures need to be implemented by the government if it wants to control the capital inflows but not damage the FDI in the country. But what now is a problem could stop being that due to some terrible financial event, like a default in Europe, scares investors who flee the country and sink the currency and investment hitting hard Brazilian interest. For Brazil's own sake it is better to have problems derived from a country's success than those much worse caused by the lack of confidence.

⁴⁶⁶ Cfr. LYONS John, *Dark Side of Brazil's Rise*, op. cit.

⁴⁶⁷ Cfr. Id.

⁴⁶⁸ Cfr. THE FINANCIAL TIMES, *Brazil: Things starting to get hairy*, op. cit.

3.3.3. Brazil's Main Challenges and International Role.

Right in the middle of a wave of optimism in 2010, Brazil obtained the role of organizer of the Soccer World Cup of 2014 and defeated the U.S. over the seat of the 2016 Olympic Games. With these two big achievements, Brazil is about to make its grand entrance on the global stage.⁴⁶⁹

IMAGE 30
BRAZIL'S INTERNATIONAL EVENTS LOGOS



Source: CNN.

Made by: Brazilian International Committee.

More than a century ago, before it became a republic, Brazil was an empire with occasional designs on neighbors' territory, often serving as an arbiter in disputes in Latin America. Brazil now relies on sophisticated diplomatic corps, rising foreign aid payments and the deep pockets of its development bank, a financial giant that dwarfs the lending of the World Bank and has become a principal mean for Brazil to project its power across Latin America and beyond.⁴⁷⁰

As the U.S. dominance in the region diminishes and Brazil increasingly flexes its newfound political and economic might, it also began to experience the pitfalls of the role as well: a pushback against the hemisphere's rising power. Brazilian endeavors are being met with caution in several countries in Latin America. A proposal to build a road through Guyana's jungles to its coast has stalled because of fears that Brazil could overwhelm its small neighbor with migration and trade.⁴⁷¹ In Argentina, officials suspended a large project by a Brazilian mining company, accusing it of failing to hire enough locals. There are

⁴⁶⁹ Cfr. OPPENHEIMER Andrés, *Basta de Historias*, op. cit. 253

⁴⁷⁰ Cfr. THE NEW YORK TIMES, *Brazil*, op. cit.

⁴⁷¹ Cfr. Id.

tensions in our own country, Ecuador, over a hydroelectric plant that led to a bitter legal battle. Also, protests by Asháninka Indians in Peru's Amazon have put a Brazilian dam project in doubt.⁴⁷²

But perhaps no Brazilian project in the region has produced as much anger as the one in Bolivia. Financed by Brazil's national development bank, the plan was to build a road through a remote Bolivian indigenous territory. But it provoked a slow-burning revolt; hundreds of indigenous protesters undertook an arduous 523 km march from the Bolivian central lowlands to La Paz, the capital, denouncing their onetime champion, Bolivia's President Evo Morales, for supporting it. Mr. Morales, suddenly found himself at odds with an important part of his political base, defending a Brazilian project that could increase deforestation. He eventually yielded to the protesters' demands and ruled out the road. In spite of that, Brazil continues to nurture a group of plans in Bolivia, including several hydroelectric projects and an ambitious antidrug policy that involves deploying drones on the border and training and equipping Bolivian security forces.⁴⁷³

Despite these pitfalls, if Brazil becomes a superpower it would be one of a different kind. One that would rather make love, not war. It has no nuclear arsenal, and aside from contributing a small number of troops to the allied cause in 1944, Brazil hasn't fought a war since 1870. "Why fight?" said a government official "With all the pleasures, beach and sun. War? Forget it. Soccer? Let's watch a soccer game. Let's go to the beach. Let's drink a beer."⁴⁷⁴

Still, Brazil keeps working to expand its international role and power. In November 2011 the vessel⁴⁷⁵ that will come to define early 21st-century trade between Latin America and Asia arrived in Guanabara Bay, the picturesque harbor of Rio de Janeiro. The Vale Brazil, commissioned by Vale, the Brazilian miner and the world's largest exporter of iron ore, is the first of a new class of bulk carrier, known as the Chinamax. With a capacity of 400,000 tonnes and measuring 362m in length and 65m in width, this "goliath" can carry twice as

⁴⁷² Cfr. REUTERS, *Argentina suspends \$4.6 bln Vale potassium Project*, <http://www.reuters.com/article/2011/06/18/vale-argentina-idUSN1E75H04N20110618>, Access: January 5th 2012, 15:52.

⁴⁷³ BBC, *Brazil joins Bolivia anti-drug fight*, <http://www.bbc.co.uk/news/world-latin-america-12916154>, Access: January 5th 2012, 18:36.

⁴⁷⁴ Cfr. CBSNEWS, *Brazil: The World's Next Economic Superpower?*, op. cit.

⁴⁷⁵ NB. A huge carrier ship

much iron ore as most vessels now plying the route between Brazil and China. As these two leading emerging economies draw each other into an ever closer embrace, one of the first overseas trips by Brazil's new president Dilma Rousseff was to China, few doubt that the world is witnessing the birth of one of the great commercial relationships of the future.⁴⁷⁶

IMAGE 31
CHINAMAX VS. PANAMAX



Source: Commodity Trading
Made by: Commodity Trading

So, is Brazil going to be an economic superpower? If by “economic superpower” we mean a country that can use significant influence in the global economy, one that is a significant force as a rule maker, not just a rule taker, then Brazil is already well on its way. It already has the necessary material conditions to have economic influence globally, and it is a dominant player in many commodity markets and can exercise market power in some of them. Its role in energy markets, as a producer of ethanol and, eventually, oil and gas, is large and growing. Its vast rainforests and high utilization of renewables, such as sugarcane-based ethanol and hydropower, put it in a strong position to be a major player on climate change. And its leading companies are aggressively investing abroad, tapping new markets and acquiring assets and technologies. This phenomenon may accelerate as Brazilian companies venture abroad and acquire cheap, crisis-affected foreign assets and companies.⁴⁷⁷

Whether Brazil is able to exercise more influence in global economic governance will depend on whether it can leverage its growing economic weight

⁴⁷⁶ Cfr. LEAHY Joe, *Drawn into an ever closer embrace*, <http://www.ft.com/intl/cms/s/0/a202fd86-829a-11e0-8c49-00144feabdc0.html#axzz1iLyYDQGp>, Access: January 4th 2012, 21:03.

⁴⁷⁷ Cfr. MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil's Changing Role in the Global Economy*, op. cit. 71.

to set agendas and shape the debate in key international forums in collaboration with other emerging economies. But in areas ranging from climate change to trade, Brazil's ability to exercise leadership internationally will also depend centrally on whether its political leaders are able to build domestic support for outwardly oriented strategic policies. Brazil's future role in the global economy will in large measure depend on whether and how it chooses to integrate further into world markets. This choice, in turn, depends centrally on the country's domestic politics, which reflect its enormous ambivalence on the question of openness and contribute to a posture on trade that many agree is jeopardizing its economic potential.⁴⁷⁸

First, Brazil's emphasis on South-South trade agreements with countries like India and South Africa rather than on trade deals with major developed economies makes little sense from an economic standpoint. These South-South deals are of little economic consequence, whereas trade agreements with major developed economies would deliver far greater economic benefits to Brazil. Second, Brazil's leaders have tended to oversell the benefits of Mercosur while showing reluctance to address its major flaws, which are undermining its political support. Third, Brazil's high transportation and regulatory costs, along with its high tariff barriers, especially on capital goods, on average triple the level in rival emerging markets, harm the country's competitiveness.⁴⁷⁹

How can one make sense of these incoherent trade policies? One answer might be the resilience of deep-rooted groups in key sectors that were protected during the period of import-substitution industrialization. Successful lobbying by these groups may explain why islands of protectionism remain in Brazilian trade policy, even while the country overall has moved toward greater openness. The momentum of liberalization will be maintained only if powerful export interests emerge and mobilize in favor of greater openness. These "liberalizers" are most likely to appear in the dynamic agribusiness sector⁴⁸⁰.

But while many in Brazil's cities lust for first world status, the third world is never far away. For decades, Brazil ignored the decaying slums known as

⁴⁷⁸ Cfr THE BROOKINGS INSTITUTION, *Brazil: The "B" Belongs in the BRICs*, op. cit.

⁴⁷⁹ MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil's Changing Role in the Global Economy*, op. cit. 72.

⁴⁸⁰ Id.

favelas, which are located around Rio, overlooking some of the most valuable real estate in the city. They have been a central area for street crime against tourists, and safe havens for drug gangs so well armed that they brought down a police helicopter a few years ago with heavy machine gun fire. After years of looking the other way, the military police have begun to move in. However in recent months, some parts of Rio have been a battle zone with the drug traffickers burning buses near some of the sports venues. But so far, the police have pacified 13 of the most dangerous *favelas*. And there are 27 more to go.⁴⁸¹

There are also massive problems with infrastructure. If the road to Brazil's future is long and wide, it is also blocked with traffic and filled with potholes. Ninety percent of the roads in the country are still unpaved, and in the cities there is not much in the way of public transportation. And there are already major delays in the building and renovation of stadiums for the 2014 World Cup.⁴⁸²

Also worrisome at the time of writing is that the economic boom appears to have dissolved, at least for now. The country's economy slowed in the third quarter of 2011, officials said in early December 2011, ending a long stretch of growth due to the headwinds now facing Brazil and big economies in Asia, notably India and China. Fearing a deeper slowdown, Brazilian authorities introduced a fiscal stimulus package, including tax cuts on some appliances and food, intended to get consumers to spend again. Nevertheless, Brazil still shows indicators that suggest the economy is far from a crisis. Unemployment fell in October 2011 to 5.8 percent, a historic low, from 6 percent the previous month. The country also maintains \$352 billion in foreign currency reserves, compared with just \$54 billion at the end of 2005.⁴⁸³

There is no doubt that Brazil still has homework to do if it wants to be an "emerged economy" in the foreseeable future. Indeed, as Brazilians like to say: "Brazil is troubled, but it is on the right track".

⁴⁸¹ Cfr THE BROOKINGS INSTITUTION, *Brazil: The "B" Belongs in the BRICs*, op. cit.

⁴⁸² Cfr. CBSNEWS, *Brazil: The World's Next Economic Superpower?*, op. cit.

⁴⁸³ Cfr. THE NEW YORK TIMES, *Brazil*, op. cit

4. ANALYSIS

In the first chapter it could be seen how dangerous it can be when “good intentions” of politicians are mixed with a financial sector that only cares for profits. Nevertheless, I find unfair to say that the main reason of the subprime crisis was the greed of Wall Street. It is like saying that planes crash due to gravity. There was a lot more behind the bubble.

Foremost, the subprime crisis shows that there is a problem with the values of the American people from top to bottom. It is a problem of people taking away what they can just because they can, without thinking of the consequences. It is a problem of culture. People are willing to put at stake their future in order to get some instant gratification. Those who were the “victims” of Wall Street cannot be forgiven just because they didn’t know the problem they were getting into when they bought a suspicious mortgage. In general terms they knew that they couldn’t afford the house they were buying compared to what they were earning.

And in the same way, Wall Street is not free of gild either. In their desire to make profits they got involved in what were criminal activities when they lie and alter data in order to gain more money. The financial industry became a casino where risks were underestimated and where the role of finance was no longer allocate resources into productive use, but rather gain more and more money out of mere speculation.

It is also striking to see how financial innovation created products that very few people could understand like CDOs. This was the kind of innovation that is not welcomed because the premise behind it, of better allocating risk only made the whole financial system riskier. And when they are mixed with high levels of debt, a bomb is created. From average people to investment banks, there was an abuse of credit. People wanted to consume more and banks wanted to increase their profits using leverage. At the end, this credit bubble grew so out of proportion that the real economy was at huge risk.

For me, it is raveling to see how damaging human arrogance can be. It was becoming a paradigm to assume that the business cycle was over, that it was under control. They talked about the Great Moderation: according to them

the market was under control; how further from the truth. A quiet bubble was forming: the housing bubble. It is baffling to me how the US' Government saw housing as the best economic indicator of a good economy. It might create jobs while the houses are under construction but on the long run the maintenance of the fix asset becomes a liability rather than an asset.

The "Great Moderation" gave room to the "Great Recession" and this marked the beginning of the new normal: the "Great Turbulence": a period of rapid oscillations and little equilibrium. The US is years from having full employment, a normal consequence of a Contraction, when a large deleveraging process takes place putting a downward pressure on prices, employment and economic growth.

It is also fundamental to put special attention to global imbalances, which were behind the housing and credit bubble. China is saving too much and the US spending out of its limits. This process reduced interest rates and made credit cheaper. These imbalances are the macro factor behind the subprime crisis.

As for the response to the crisis, it is very important to notice that it was fast and avoided a Second Great Depression. The role of the Fed was crucial. Its chairman, Ben Bernanke, learned the lessons from the Great Depression and loosened monetary policy to stimulate the economy. I believe that much of the stock market increase and economic growth since 2008 was thanks to the Federal Reserve. Those that say it did too much should remember that in case of fire you first worry about extinguishing it and then about the wet furniture. There will be unpleasant consequences, that is inevitable with any given public policy, the important thing to remember is that a financial apocalypse was averted.

As for the bailouts, it is dangerous to send the message of a government ready to pick up the pieces. By erasing the fear of bankruptcy we make the capitalist system much more risky, and even worse, this notion goes against the fundamental human concept that actions have consequences. The financial sector is no exception, or it shouldn't be. It is outrageous that profits are private but losses are socialized. A return to the basics of capitalism is much needed.

The core element of my thesis was the financial and democratic crisis in the West, and nowhere that's more evident than in Europe. It is clear to me that the implementation of the euro in countries with very different economic situations was a huge mistake. I can't come to understand how European policymakers believed it was a good idea to put under the same currency a mediocre economy like Greece with the hypercompetitive Germany without a transfer union, without a coordinated fiscal policy. And even worse, to put together countries with very different cultures: the consume-crazy South versus the frugal North.

The Euro put in evidence this big cultural difference: when the South was able to borrow at the same interest rate as the North, their governments started to borrow heavily in order, not to re-modern their economies and make long term investments, but rather to make happy their constituents and gain more votes. Without the euro the debt level of Southern Europe would have never been so high as it is today.

Germany is pushing for big spending cuts and austerity measures all over Europe. In the German view the current sovereign crisis is a consequence of not respecting the fiscal rules. There is truth in that statement but it is also true that the country that has benefited the most from the common market and the undervalued Euro vs. strong Deutsche Mark is Germany. And it is also true that for every surplus country there is a deficit country. The surplus Germany benefited from the consumption of the South. So it needs to be careful when asking for austerity, because that might hurt its exporting economy. As the saying goes: "be careful of what you wish for because you might just get it".

Many say that the "ugly German is back" pushing for austerity and some degree of control over national budgets and expenses. For me, that is more than logical. If Germany is giving the bailout funds it has all the right to ask for some degree of control over how these resources are expended. If the problems of the periphery is indebtedness then putting deficits under control and public finances in order is more than welcome. Some say that doing this during a downturn is not a very good idea, but Germany needs to take advantage of the fear the crisis has created to make the south undertake the necessary austerity measures.

But as chapter two clearly showed, the true fatal flaw of the euro is that there was never popular support for its introduction. This was a political effort with no real involvement of the people. The lack of a common identity and solidarity is proving to be fatal when different countries are sharing the same currency. Politicians created the European Union without real Europeans to support it. It is obvious now that a big part of the current mess is the euro itself. The only thing that stops countries from leaving it is the fear of the consequences.

The positive impact that the euro was to have over Europe never fully materialized. Rather than bringing a new era of prosperity, the euro has doomed millions of Europeans to years of penury. And far from bringing together the people of Europe, it is on the verge of tearing them apart.

Another revealing aspect of the crisis is that the Western democratic system was weakened under the sovereign crisis. Europe is divided over how to deal with the crisis. And the democratic system has proven to be very inefficient when having to take fast and bold action. Politicians care more about being reelected rather than doing the right thing and taking unpopular but necessary measures in order to solve a crisis that is getting worst by the minute. I think that they should remember that maybe the current generation will hate them but future ones will thank them and they will be remembered in a positive way.

The democratic system has been proven to be so ineffective that elected officials were replaced by technocrats in Greece and Italy since they don't care about a career in politics and will be able to put under way the painful needed reforms. Germany went so far as to propose that the European Commission should appoint someone to control the taxing and spending policies of Greece, meaning the replacement of an elected government by a European institution. Germany might be right when saying that it should have some control over how the bailouts funds are expended if it is giving the majority of money. But this kind of statement goes against the principles of democracy that the West previously fiercely defended.

In the case of the US, before the crisis there were differences between the two political parties, Democrats and Republicans, but after the crisis,

ideology positions are the core of negotiations. Pragmatism has been put aside and ideology is all that matters. Under such a circumstance almost every piece of new legislation becomes a war field. And in a time when audacious political action is needed, the inability to pass legislation, and even used blackmail to get what a political party want, is really dangerous. During the summer of 2011, politicians of the US preferred to put at risk the credibility of the US rather than make concessions. The result: the US lost its precious triple A credit rating by Standard&Poor's.

Talking of levels of sovereign debt is even less encouraging. Public finances of developed countries are a mess. Of course, the increase of debt levels preceded the financial crisis but the latter made it obvious how unsustainable they were. Falling output and thus falling taxing revenue made things worse. Financial markets started to realize that during the subprime crisis the governments of the developed world were able to stop a financial Armageddon, but if they were the ones in trouble now, there was no one left to fix the situation. Therefore, investors started to question the capacity of several countries to pay back their debts. The US is not yet paying higher interest rates since the Treasury Bonds are considered safe investments, but that paradigm might start to break down, especially if the deficit is not put under control, and with the current political situation investors shouldn't have their hopes up.

The final part of my working hypothesis stated that the bad political and debt situation of the West would have had as consequence an inexorable change of the centers of political and economic power towards the emerging markets, specially China, thanks to the implementation of radical structural reforms that allowed high economic growth and healthy public accounts

After the facts presented in the third chapter, it is clear that the recession accelerated the Downfall of the West. Economic supremacy is certainly a key component of power. It is the foundation over all other kinds of power stand. China has had rates of GDP growth of 10% for the past decade. India had average rates of 8%. That is evidence that an Asia Century has already began. The economic engine of the world is no longer the West but the "Rest". Brazil's commodities and industry has produced rates of economic growth of around 8% which in turn has made the country an economic powerhouse and a key element of the world economy.

It is important to notice that economic power not always translates into political power. The current international institutions were designed to serve mainly the interest of the West and, thus, emerging powers are skeptical about their role. The emerging markets are not ready to take the lead in global affairs. They are more concerned about their domestic ones. Inflation is a problem in all 3 key emerging markets, they also face corruption, red tape, inequality, and some version of asset bubble problems that put significant pressure in their current and future development.

Structural reforms were, without a doubt, a key element of China, India and Brazil road to becoming economic powerhouses. From opening their economies to foreign capital to taming inflation, their economic success is evidence of the importance of the implementation of good public policies and at least a semblance of decent government. Having public finances in order is another key element of stability and progress. These countries learned their lessons from the previous financial crisis they had to endure in the past. Good financial health gave them the possibility to have resources to face downturns and room to maneuver when implementing contra-cyclical policies. Their rising middle classes provide them with strong internal markets that protect them from international shocks and make their future growth more sustainable.

Of course, nothing is inevitable and their path to economic and political superpowers is not free of pitfalls. More reforms are needed and changes to growth patterns will have to be implemented in the near future. But the challenges that lie ahead for these countries are those of rising powers not decaying ones, and that is a key fact in order to understand the new world order we are already living in.

In my opinion, in Chapter 2 it can be noticed a much closer relationship between all elements of this work. In that chapter we can see how the Great Recession, explained in Chapter 1, led to a sovereign debt crisis that is right now the epicenter of international financial turmoil. This in turn, will determine the future role of the West in International Affairs and their importance in decision making. In Chapter 2 can also be clearly seen how the Great Recession accelerated both the demise of the West and the rise of the “Rest”, the former due to huge debt levels and a dysfunctional political system. It also shows how the lack of reforms and bold political action can lead to chaos and

the formation of bubbles. The opposite is true in key emerging markets where much of its current success is based on reforms and fast political decision, exactly what the main Western countries lack right now. The essence of Declinism can clearly be seen in that particular chapter.

In this way, I can say that the general objective of analyzing the new international economic and financial reality after the Great Recession establishing its major impacts in the US, Europe and the three main emerging markets: China, India and Brazil, was reached. The reader should have a better understanding of the world around him. And this in turn, I hope will help him better understand how old paradigms are breaking down and new realities are creating a new international order that affects all and every region of the world.

5. CONCLUSIONS

Finally, it is essential to point out that the hypothesis proposed at the beginning of this work is true for the reasons below:

- The abuse of credit in order to alleviate inequality or to leverage financial bets, is behind the current economic malaise in the West. Easy credit and low interest rates produced huge debt levels compared to income, from households to countries, which in turn created a false sense of prosperity that encouraged reckless risk taking and the formation of asset bubbles. Therefore, the Great Recession was produced by a mixture of greed, global imbalances, excess credit and dangerous financial innovation.
- What the world is going through right now is a Second Great Contraction and not just a severe recession. The developed world is facing a painful process of deleveraging that brings output down, unemployment up and, in the worst case scenario, produces a deflationary process. The Great Depression and the Great Recession have this deleveraging process in common. Deflation and a new depression were averted during the financial crisis of 2008/09 thanks to the fast and effective action of the Federal Reserve. It loosened monetary policy and flooded with liquidity the financial system.
- The Great Recession made obvious the huge debt level compared to GDP of the majority of countries in Europe and the US. The costs of the bailouts that governments had to face were a part of the further deterioration of public finances. The main situation that damaged debt levels though, were the rapid decline of revenue due to the deep contraction of output and the burst of asset bubbles, especially the housing bubble. When investors realize that Western debt was no longer “risk free” a collapse of sovereign bond prices sent interest rates through the roof, forcing countries as Greece, Ireland and Portugal out of private debt markets and putting them under public help.
- The Great Recession damaged the democratic system since it made clear its weakness when dealing with a crisis that needs fast and bold

political action. The Euro-Crisis went out of control when politicians hesitated about the course of action that was needed and repeatedly did 'too little almost too late'. What two World Wars did not managed to give Germany, a financial crisis did. Europe is under German control right now but Germany does not want to lead or gift 'free money' to Southern Europe. A solution is far from being reached to put an end to the Euro-crisis. As for the US, ideology is the main driver behind political action. Every piece of legislation has to endure a ferociously divided Congress that does not want to make concessions. Under such circumstances, as Chinese policy makers say, "Democracy has become institutionalized chaos"

- World power is moving to the big emerging countries: China, India and Brazil. These countries are the new economic engines of the world due to their large populations, gains of productivity and capital investment. China is by far the biggest of them all, with an economy only second to that of the US, it has had rates of growth of around 10% for the last decade and its influence over the world keeps expanding. India is also an economic powerhouse with a strong domestic market and a sophisticated outsourcing service industry. As for Brazil, it is a country rich in commodities with a growing industry and a rising middle class. All these countries have in common a new found leading role in international affairs, mainly in their regions, although for the moment, they focus more on putting things in order within their own borders.
- The path of China, India and Brazil to superpower is not inevitable. Reforms were needed in order to release the hidden capacity of their economies. These countries learned from previous financial crisis that hit their economies the importance of having good public finances and controlled inflation. These countries also had good politicians who took bold political decisions in order to implement reforms that at the moment were considered painful but that now have paid out, making them the new stars of the world economy. Nevertheless, new reforms are needed to adapt to their changing economies and a changing global environment. Depending on a successful reforms implementation, the superpower status will be reachable.

6. RECOMMENDATIONS

- In order to correct the global imbalances that lead to the Great Recession it is important that the US becomes a country that produces more and not just consumes. A weaker dollar is welcomed to make US' exports more competitive. As for China, it has to consume more, but in order to do this; raising wages and a stronger Yuan are needed. Also and more complicated, Chinese policymakers need to create a strong social safety net in order to encourage people to spend more and not just save their income. As for the other big problem behind the Great Recession, financial innovation needs to be regulated, banks have to be forced to keep more of the debt they produce and not securitized all of it. Raising capital levels for banks is also important with the Fed ready to act against the formation of asset bubbles.
- Encourage people to get more credit is dangerous when precisely this was behind the big Crash of 2008. The deleveraging process needs to be controlled and facilitated with public intervention. The Government of the US needs to be actively involved in the process of correcting debt levels and absorb some of it because otherwise, if public and private sectors deleverage at the same time, a painful and long recession will follow. As for the Fed, it needs to be actively involved in the recovery process and ignore political pressure that wants it to back up. Monetary easing is helping the mild recovery of the US, and if more of it is needed the Fed should be ready to act.
- Deep austerity measures in European countries should not be implemented in the midst of recession and economic weakness. The main goal of European policymakers should be the implementation of reforms that make Southern Europe more competitive. It is also fundamental to modernize the entitlement programs that were designed for the 20th century but are obsolete in the 21st century. Also it is very important that the European Central Bank becomes more involved in the Euro-Crisis solution, it needs to be more active like the Fed in the US. If the ECB has the guts to engineer a sustained period of monetary ease, and manages to control or ignore German fears of inflation, it can deliver

an indirect debt relief and also improve competitiveness via a weaker euro. If the crisis is to be really over a fiscal union has to be implemented with a “super” finance ministry for the Eurozone, Eurobonds need to be introduced to the market if policymakers want to create such a big and liquid bond markets that smaller and less competitive countries can be protected from speculation and the rulings of rating agencies.

- Leaders of the US need to realize that what is at stake is the economic future of its nation and not just votes for the next election. Pragmatism needs to return in order to manage the worst financial and economic crisis since the Great Depression. In extraordinary times like now, ideology should be put behind and politicians should be Statesmen that care about the future of the US and not just the next election cycle. As for Europe, more coordinated action is needed. Europe has the economic and political resources to put an end to the Euro-Crisis, what they need is more determination and confidence in the Euro, otherwise by letting the crisis get worse and worse, it looks like not even European politicians have faith in the single currency. Germany should tolerate more inflation and be willing to accept smaller austerity measures; otherwise the crisis will get only worse.
- The big emerging countries China, India and Brazil need to be willing to lead more in their regions so they help the world governance process. They need to provide and not just consume public goods like peace, stability, free trade and environmental sustainability. They should be willing to lead more in international affairs and in the construction of a new multilateral international system. When the time of the ‘Only Superpower’ is coming to an end, with the US becoming first among equals, more international cooperation is needed in order to take important decisions that make the world more stable and prosperous. A multilateral world is welcomed, and for the first time in human history is becoming a reality, but it can be unstable if the big powers are not willing to think in the greater good, otherwise we will be back to mercantilism.
- New big reforms are needed in emerging markets if they want to keep having a successful growth pattern. Labor reforms, more openness, a

better industrialization policy, a better redistribution system among others reforms are needed. Corruption and red tape need to be fought and it is fundamental to keep inflation under control. In the case of China a new economic model is needed, one in which consumption is the driver and not investment. Its housing bubble needs to be put under control and the banking system needs to be modernized and opened. India needs to improve their poor infrastructure and increase its manufacturing capabilities. As for Brazil, it needs to implement a better industrialization policy and be careful of the 'curse of abundance' since its big stock of commodities can make the government complacent and economic development arrive to a standstill. These countries need to take advantage of this momentum in history and modernize their economies so that they are better prepared to the challenges and crisis of tomorrow, because there is always another crisis just waiting to happen.

BIBLIOGRAFÍA

Libros

BELLAMY John, MAGDOFF Fred, *The Great Financial Crisis: Causes and Consequences*, Monthly Review Press, First Edition, New York, 2009.

FERGUSON Niall, *Civilization: The West and the Rest*, Penguin Group, New York, First Edition, 2011.

GREENSPAN Alan, *The Age of Turbulence*, The Penguin Press, New York, First Edition, 2007.

KRUGMAN Paul, *De Vuelta a la Economía de la Gran Depresión y la Crisis del 2008*, Grupo Editorial Norma, First Edition, Bogota, 2009.

LEWIS Michael, *Boomerang: Travels in the New Third World*, W.W. Norton&Company, New York, First Edition, 2011.

MANOLOPOULOS Jason, *Greece's "Odious" Debt*, Anthem Press, New York, First Edition, 2011.

MARTINEZ Leonardo, BRAINARD Lael, *Brazil as an Economic Superpower?: Understanding Brazil's Changing Role in the Global Economy*, The Brookings Institution, Washington D.C., First Edition, 2009.

MCLEAN Bethany, NOCERA Joe, *All the Devils are Here: The Hidden History of the Financial Crisis*, Portfolio Penguini, First Edition, New York, 2010.

OPPENHEIMER Andrés, *Basta de Historias*, Vintage Español, New York, 2010.

PASTRÉ Olivier, SYLVESTRE Jean-Mark, *They lie to us: Truths and Myths about the Crisis*, Fayard, Paris, 2011.

RAJAN, Raghuram, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, Princeton, First edition, 2010.

REINHART Carmen, ROGOFF Kenneth, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, First Edition, 2008.

ROSS, Andrew, *Too Big to Fail*, Penguin, New York, First edition, 2009.

ROUBINI Nouriel, MIHM Stephen, *Crisis Economics: A Crash Course in the Future of Finance*, The Penguin Press, New York, First Edition, 2010.

STIGLITZ Joseph, *Freefall: America, Free Markets, and the Sinking of the World Economy*, W.W. Norton&Company, New York, First Edition, 2010.

SUAREZ Jorge, *La Próxima Gran Caída de la Economía Mundial*, Debate, New York, First Edition, 2011.

WESSEL David, *In Fed We Trust: Ben Bernake's War on the Great Panic*, Crown Business, New York, 2009.

ZAKARIA Fareed, *The Post-American World*, W.W. Norton & Company, New York, First Edition, 2008.

Artículos

NIALL Ferguson, *Washington proves the Communist were right*, Newsweek en español, Mexico D.F., August 14th 2011.

ROBERT Samuelson, *Against a Wall of Debt*, , Newsweek, Mexico D.F., November 8th 2009.

GIDEON Rachman, *Think Again: American Decline*, Foreign Policy, New York, January 2011.

IAN Buruma, *Imperial Hubris*, Foreign Policy, New York, November 2011.

HENDRIK Hertzberg, *A Walk in the Park*, The New Yorker, New York, October 17th 2011.

JOHN Cassidy, *How bad is it?*, The New Yorker, New York, August 15th 2011.

THE ECONOMIST, *Three-way split*, New York, December 11th 2010.

Web

ANDERSON J., *Wall Street Winners Get Billion-Dollar Paydays*, www.nytimes.com/2008/04/16/business/16wall.html

ATKINS Ralph SPIEGE Peter, *Once more unto the breach*, <http://www.ft.com/intl/cms/s/0/52ccddf2-2fcc-11e0-91f8-00144feabdc0.html#axzz1cszRxp7P>

BARBER Lionel, *The end of US hegemony: Legacy of 9/11*, <http://www.ft.com/intl/cms/s/0/f6acf1a6-d54d-11e0-bd7e-00144feab49a.html#axzz1cszRxp7P>

BARBER Liones, *Can the Euro survive?*, http://www.ft.com/intl/cms/s/2/26ded90a-e35c-11df-97db-00144feabdc0,dwp_uuid=79cadde4-5c1b-11df-95f9-00144feab49a.html#axzz1ddfUOPI

BBC , *Brazil joins Bolivia anti-drug fight*, <http://www.bbc.co.uk/news/world-latin-america-12916154>

BBC NEWS, *Portugal's debt is downgraded to junk status by Moody's*, <http://www.bbc.co.uk/news/business-14038529>

BBC, *Analysis of the Global Imbalances*, http://www.bbc.co.uk/iplayer/episode/p004jq1j/Analysis_Global_Economic_Imbalances/

BERNARD Steven et al., *Automotive industry bail-outs around the world*, <http://www.ft.com/intl/cms/s/0/28d25392-fcf2-11dd-a103-000077b07658.html#axzz1Wwj554gx>

BLOOMBERG BUSINESSWEEK, *China Is a Private-Sector Economy*, http://www.businessweek.com/magazine/content/05_34/b3948478.htm

BLOOMBERG BUSINESSWEEK, *IMF's Zhu Warns Global Imbalances May Worsen on Chinese Exports*, <http://www.businessweek.com/news/2011-01-27/imf-s-zhu-warns-global-imbalances-may-worsen-on-chinese-exports.html>

BLOOMBERG BUSINESSWEEK, *The Mortgage Mess Spreads*, http://www.businessweek.com/investor/content/mar2007/pi20070307_505304.htm?chan=rss_topStories_ssi_5

BRAITHWAITE Tom, VAN DUYN Aline, *Regulatory reform: A disappearing act?*, <http://www.ft.com/intl/cms/s/0/9c61755a-b2c0-11e0-bc28-00144feabdc0.html#axzz1Wwj554gx>

BRINK, Linsey, *Nostalgianomics: Economic Policies, Social Norms and Income Inequality*, <http://www.cato.org/pubs/wtpapers/Nostalgianomics.pdf>

BUSINESS INSIDER, *Who owns the U.S. Debt*, <http://www.businessinsider.com/who-owns-us-debt-2011-7#in-all-the-treasury-owes-foreigners-and-foreign-governments-4514-trillion-dollars-18>

BUSINESSWEEK, *India: Where Shipping Is Shaky*, http://www.businessweek.com/magazine/content/07_12/b4026010.htm

CADMAN Emily et al., *Interactive timeline: Greek debt crisis*, <http://www.ft.com/intl/cms/s/0/003cbb92-4e2d-11df-b48d-00144feab49a.html#axzz1befD9SGO>

CBSNEWS, *Brazil: The World's Next Economic Superpower?*, <http://www.cbsnews.com/stories/2010/12/09/60minutes/main7134185.shtml>

CNN MONEY, *Stocks crushed*, http://money.cnn.com/2008/09/29/markets/markets_newyork/index.htm

CNN MONEY, *The Great Recession*, http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/index.htm

CNN MONEY, *The last days of Bear Stearns*, http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/

CONNOR Kevin, *Wall Street and the Making of the Subprime Disaster*, http://showdowninamerica.org/files/wall_street_making_subprime_disaster

COUNCIL OF FOREIGN RELATIONS, *Timeline: Global Economy in Crisis*, <http://www.cfr.org/economics/timeline-global-economy-crisis/p18709>

DAVIES Gavyn, *What went wrong with the global recovery?*, <http://blogs.ft.com/gavyndavies/2011/08/18/what-went-wrong-with-the-global-recovery/>

DEHEJIA Vivek, *Don't blame 'neoliberal' reforms for corruption*, <http://www.ft.com/intl/cms/s/0/e4660ef4-b68c-11e0-ae1f-00144feabdc0.html#axzz1T4jxUqkr>

FERGUSON Niall, *An Empire at Risk*,
<http://www.thedailybeast.com/newsweek/2009/11/27/an-empire-at-risk.html>

FERGUSON Niall, *America's 'Oh Sh*t!' Moment*,
<http://www.thedailybeast.com/newsweek/2011/10/30/niall-ferguson-how-american-civilization-can-avoid-collapse.html>

FERGUSON Niall, *An Empire at Risk*,
<http://www.thedailybeast.com/newsweek/2009/11/27/an-empire-at-risk.html>

FERGUSON Niall, *Debt Debate: China's View*,
<http://www.thedailybeast.com/newsweek/2011/08/07/china-s-view-of-the-debt-debate-america-in-decline.html>

FERGUSON Niall, *Dr. K's Rx for China*,
<http://www.thedailybeast.com/articles/2011/05/17/dr-k-s-rx-for-china.html>

FERGUSON Niall, *Europe's Disaster Is Headed Our Way*,
<http://www.thedailybeast.com/newsweek/2011/11/13/europe-s-financial-crisis-is-headed-to-america.html>

FERGUSON Niall, *Gloating China, Hidden Problems*,
<http://www.thedailybeast.com/newsweek/2011/08/14/china-faces-its-own-fiscal-problems.html>

FERGUSON Niall, *Murder on the EU Express*,
<http://www.thedailybeast.com/newsweek/2011/04/03/murder-on-the-eu-express.html>

FERGUSON Niall, *The End of the Euro*,
<http://www.thedailybeast.com/newsweek/2010/05/07/the-end-of-the-euro.html>

FINANCIAL TIMES, *Government bail-outs*
<http://www.ft.com/intl/cms/s/0/251d855a-8ef7-11dd-946c-0000779fd18c.html#axzz1Wwj554gx>

FINANCIAL TIMES, *Greece: a problem deferred*,
<http://www.ft.com/intl/cms/s/3/467972d0-e2ce-11e0-93d9-00144feabdc0.html#axzz1befD9SGO>

FINANCIAL TIMES, *Reforming the Global Financial System*,
<http://www.ft.com/intl/cms/s/0/f58d854e-82db-11df-b7ad-00144feabdc0.html#axzz1Wwj554gx>

FINANCIAL TIMES, *The greenest bail-out?*,
<http://www.ft.com/intl/cms/s/0/cc207678-0738-11de-9294-000077b07658.html#axzz1Wwj554gx>

FINANCIAL TIMES, *The rise of quantitative easing*,
http://www.ft.com/intl/cms/s/3/f74b0fee-e1d3-11df-b71e-00144feabdc0,dwp_uuid=9d04b7e0-e671-11df-95f9-00144feab49a.html#axzz1aKiXSxr2

FORBES, *The Great Depression And The Great Recession*,
<http://www.forbes.com/2009/10/29/depression-recession-gdp-imf-milton-friedman-opinions-columnists-bruce-bartlett.html>

Foreign Affairs, *The India Model*,
<http://www.foreignaffairs.com/articles/61728/gurcharan-das/the-india-model>

FOROOHAR Rana, *A new Era Of Volatility*,
<http://www.time.com/time/subscriber/article/0,33009,2095556,00.html>

FOROOHAR Rana, *Berlusconi's Last Act*,
<http://www.time.com/time/subscriber/article/0,33009,2099143-3,00.html>

FOROOHAR Rana, *It's China's World We're Just Living in It*,
<http://www.thedailybeast.com/newsweek/2010/03/11/it-s-china-s-world-we-re-just-living-in-it.html>

FOROOHAR Rana, *The End of Europe*,
<http://www.time.com/time/magazine/article/0,9171,2088040,00.html>

FOROOHAR Rana, *What Ever Happened To Upward Mobility?,,*,
<http://www.time.com/time/magazine/article/0,9171,2098584,00.html>

FOROOHAR Rana, *What U.S. Economic Recovery? Five Destructive Myths*,
<http://www.time.com/time/nation/article/0,8599,2076568,00.html>

FOX NEWS, *U.S. Debt Reaches 100 Percent of Country's GDP*,
<http://www.foxnews.com/politics/2011/08/04/us-debt-reaches-100-percent-countrys-gdp/#ixzz1bThp6NGS>

FRANK Barney, *We are on course to stop a new financial crisis*,
<http://www.ft.com/intl/cms/s/0/52b9651e-b3cb-11e0-855b-00144feabdc0.html#axzz1Wwj554gx>

GOLDMAN SACHS, *The Outlook for the US Economy*,
http://www2.goldmansachs.com/gsam/docs/fundsgeneral/general_education/economic_and_market_perspectives/wp_economic_outlook.pdf

GOTTSCHALK, Peter, *The Growth of Earnings Instability in the US Labor Market*,
http://www.brookings.edu/~media/Files/Programs/ES/BPEA/1994_2_bpea_papers/1994b_bpea_gottschalk_moffitt_katz_dickens.pdf

HARDING Robin et al., *Quantitative easing explained*,
<http://www.ft.com/intl/cms/s/0/69e8c92c-e758-11df-880d-00144feab49a.html#axzz1aKiXSxr2>

HEANEY Vince, *Fed's Operation Twist signals deep concern*,
<http://www.ft.com/intl/cms/s/0/d591d6ae-e9f6-11e0-b997-00144feab49a.html#axzz1aKiXSxr2>

INDEXMUNDI, *India Information*,
<http://www.indexmundi.com/g/g.aspx?c=in&v=66>

INTERNATIONAL MONETARY FUND, *The Global Economic Outlook and Risks from Global Imbalances*,
<http://www.imf.org/external/np/speeches/2005/093005.htm>

INVESTMENT WEEK, *Brazil overtakes UK as world's sixth largest economy*,
<http://www.investmentweek.co.uk/investment-week/news/2134781/brazil-overtakes-uk-worlds-sixth-largest-economy>

JAROCINSKI Marek, SMETS Frank, *House Prices and the Stance of Monetary Policy*, <http://research.stlouisfed.org/publications/review/08/07/Jarocinski.pdf>

KARON Tony, *Why China Does Capitalism Better than the U.S.*,
<http://www.time.com/time/world/article/0,8599,2043235,00.html>

KEDROSKY Paul, *Infectious Greed: Finance and the Money Culture*,
<http://paul.kedrosky.com/>

KHOSLA Tamanna, *India's Foreign Policy & Its Growing Role in the International Arena*, <http://www.darpanmagazine.com/2011/02/indias-foreign-policy-its-growing-role-in-the-international-arena/>

KOBA Mark, *PIIGS: CNBC Explains*,
http://www.cnbc.com/id/44058478/PIIGS_CNBC_Explains

KYNGE JAMES, *Cracks in Beijing's financial edifice*,
<http://www.ft.com/intl/cms/s/0/a83e5cf4-f02c-11e0-977b-00144feab49a.html#axzz1ffQjJoi9>

LAMONT James, *Land of opportunity*, http://www.ft.com/intl/cms/s/0/3d2a921a-4ac1-11de-87c2-00144feabdc0,dwp_uuid=edca7290-4abf-11de-87c2-00144feabdc0.html#axzz1hgLbpu47

LAMONT James, *Strong growth yet to improve lives of the poor*,
<http://www.ft.com/intl/cms/s/0/415b0bd6-2827-11e0-8abc-00144feab49a.html#axzz1hgLbpu47>

LEAHY Joe, *Brazil: market plunge could provide breathing space on inflation*,
<http://blogs.ft.com/beyond-brics/2011/08/10/brazil-market-plunge-could-provide-breathing-space-on-inflation/#axzz1iVWZSH4u>

LEAHY Joe, *Brazil's economy: still two-speed*, <http://blogs.ft.com/beyond-brics/2011/11/23/brazils-economy-still-two-speed/#axzz1iVWZSH4u>

LEAHY Joe, *Drawn into an ever closer embrace*,
<http://www.ft.com/intl/cms/s/0/a202fd86-829a-11e0-8c49-00144feabdc0.html#axzz1iLyYDQGp>

LEAHY Joe, *S&P upgrade Brazil's Credit Rating*,
<http://www.ft.com/intl/cms/s/0/a1c1a890-116a-11e1-9d04-00144feabdc0.html#axzz1hgLbpu47>

LUCAS Douglas, *Collateralized Debt Obligations and Credit Risk Transfer*,
<http://www.usdrinc.com/downloads/Collateralized-Debt-Obligations.pdf>

LYONS John, *Dark Side of Brazil's Rise*,
<http://online.wsj.com/article/SB10001424053111904716604576544722103262938.html>

MACKENZIE Kate, *The pre-conditions for a double-dip*,
<http://ftalphaville.ft.com/blog/2011/09/16/677896/the-pre-conditions-for-a-double-dip/>

MARKETWATCH, *Lehman folds with record \$613 billion debt*,
<http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss>

MATTHEWS Dylan, *Everything you need to know about the European debt crisis in one post*, http://www.washingtonpost.com/blogs/ezra-klein/post/everything-you-need-to-know-about-the-european-debt-crisis-in-one-post/2011/08/05/gIQAg69Qwl_blog.html

MCGREGOR Richard et al., *US debt crunch: A nation taken to the limit*,
<http://www.ft.com/intl/cms/s/0/be3ff8b8-ae51-11e0-844e-00144feabdc0.html#axzz1bLoBs1Op>

MILLER Ken, *Be Very Afraid of The China Bubble*,
<http://www.time.com/time/magazine/article/0,9171,2097399,00.html>

MILNE Richard, *Each to their own*, http://www.ft.com/intl/cms/s/0/0705933c-f2f2-11dd-abe6-0000779fd2ac,dwp_uid=2f146ad2-f122-11dd-8790-0000779fd2ac.html#axzz1Wwj554gx

MILNE Richard, *West shows worrying signs of 'Japanisation'*,
<http://www.ft.com/intl/cms/s/0/c86470b2-ca7b-11e0-94d0-00144feabdc0.html#axzz1ddfnUOPI>

MUCHA Tom, *Who owns America? Hint: It's not China*,
<http://globalpublicsquare.blogs.cnn.com/2011/07/21/who-owns-america-hint-its-not-china/>

NATIONAL BUREAU OF ECONOMIC RESEARCH, *The Great Recession and The Great Depression*, http://www.nber.org/papers/w15645.pdf?new_window=1

NOMURA HOLDING, *Nomura to close acquisition of Lehman Brothers' Europe and Middle East investment banking and equities businesses on October 13*,
http://www.nomuraholdings.com/news/nr/europe/20081006/20081006_a.html

NPR, *EU Pulls Greek Economy Back From Brink. Now What?*,
<http://www.npr.org/2011/10/27/141767728/eu-pulls-greek-economy-back-from-brink-now-what>

OECD, *Economic Survey of India*,
<http://www.oecd.org/dataoecd/17/52/39452196.pdf>

PACKER George, *The Broken Contract inequality and American Decline*,
<http://www.foreignaffairs.com/articles/136402/george-packer/the-broken-contract>

PARENT Joseph MACDONALD Paul, *The Wisdom of Retrenchment*,
<http://www.foreignaffairs.com/articles/136510/joseph-m-parent-and-paul-k-macdonald/the-wisdom-of-retrenchment>

PEARSON Samantha, *Brazilian assets dumped despite robust economy*,
<http://www.ft.com/intl/cms/s/0/962942a6-c27b-11e0-9ede-00144feabdc0.html#axzz1iLyYDQGp>

POLITI James, *US tax system: A return to reform*,
<http://www.ft.com/intl/cms/s/0/092efe64-ee67-11e0-a2ed-00144feab49a.html#axzz1aKiXSxr2>

POUNDER Laurie, THOMAS Charles, *Foreign Exposure to Asset-Backed Securities of U.S. Origin*,
<http://www.federalreserve.gov/pubs/ifdp/2008/939/ifdp939.pdf>

POWELL Bill, *The Case for China: The Power of Planning*,
http://www.time.com/time/specials/packages/article/0,28804,2099180_2099179_2099175,00.html

PROJECT SYNDICATE, *The Second Great Contraction*,
<http://www.projectsyndicate.org/commentary/rogoff83/English>

RACHMAN Gideon, *America must manage its decline*,
<http://www.ft.com/intl/cms/s/0/0c73f10e-f8aa-11e0-ad8f-00144feab49a.html#axzz1cszRxp7P>

RACHMAN Gideon, *Is America's new declinism for real?*,
<http://www.ft.com/intl/cms/s/0/ddbc80d0-ba43-11dd-92c9-0000779fd18c.html#axzz1cszRxp7P>

RACHMAN Gideon, *Look behind you, Lucas and Mario*,
<http://www.ft.com/intl/cms/s/0/6913807e-0ebb-11e1-b83c-00144feabdc0.html#axzz1ddfUOPI>

RACHMAN Gideon, *Saving the euro is the wrong goal*,
<http://www.ft.com/intl/cms/s/0/9542474a-0937-11e1-a20c-00144feabdc0.html#axzz1ddfUOPI>

RACHMAN Gideon, *The long slide into protectionism*,
<http://www.ft.com/intl/cms/s/0/9152417e-cfd2-11e0-a1de-00144feabdc0.html#axzz1XkvDLDsg>

RACHMAN Gideon, *The single currency's true fatal flaw*,
<http://www.ft.com/intl/cms/s/0/62a127a6-e2aa-11e0-897a-00144feabdc0.html#axzz1YtvyPdVs>

RACHMAN Gideon, *The single currency's true fatal flaw*,
<http://www.ft.com/intl/cms/s/0/62a127a6-e2aa-11e0-897a-00144feabdc0.html#axzz1YtvyPdVs>

RAJAN Raghuram, *Has Financial Development Made the World Riskier?*,
<http://www.kc.frb.org/publicat/sympos/2005/pdf/rajan2005.pdf>

RATTNER Steven, *The 2012 rivals can be named: Hayek v Keynes*,
<http://www.ft.com/intl/cms/s/0/0cebaa1a-dd47-11e0-b4f2-00144feabdc0.html#axzz1XkvDLDsg>

REUTERS, *Argentina suspends \$4.6 bln Vale potassium Project*,
<http://www.reuters.com/article/2011/06/18/vale-argentina-idUSN1E75H04N20110618>

ROGOFF Kenneth, *The bullets yet to be fired to stop the crisis*,
<http://www.ft.com/intl/cms/s/0/1e0f0efe-c1a9-11e0-acb3-00144feabdc0.html#axzz1XkvDLDsg>

ROUBINI Nouriel, *The eurozone heads for break up*, <http://blogs.ft.com/the-a-list/2011/06/13/the-eurozone-heads-for-break-up/#axzz1diruQKtX>
ROUBINI Nouriel, *The White Swan*, <http://es.scribd.com/doc/36327721/Crisis-Economics>

ROUBINI Nouriel, *Why Italy's days in the eurozone may be numbered* ,
<http://blogs.ft.com/the-a-list/2011/11/10/why-italys-days-in-the-eurozone-may-be-numbered/#axzz1diruQKtX>

SAMUELSON, Robert, *Indifferent to Inequality?*,
<http://www.thedailybeast.com/newsweek/2001/05/06/indifferent-to-inequality.html>

SANDBU Martin, *Washington's battle is a diversion*,
<http://www.ft.com/intl/cms/s/0/d10e277a-bd39-11e0-9d5d-00144feabdc0.html#axzz1TGhq3vbz>

SAPORITO Bill, *A Great Leap Forward*,
<http://www.time.com/time/magazine/article/0,9171,2097400,00.html>

SCHUMAN Michael *The case for India*,
http://www.time.com/time/specials/packages/article/0,28804,2099180_2099179_2099176,00.html

SCHUMAN Michael, *The Japan Syndrome*,
<http://www.time.com/time/magazine/article/0,9171,2097371,00.html>

SENATE SUBCOMMITTEE ON INVESTIGATIONS, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*,
<http://es.scribd.com/doc/53174301/Anatomy-of-a-Financial-Collapse>,

STENGEL Richard, *The Land of Opportunity*,
<http://www.time.com/time/subscriber/article/0,33009,2098586,00.html>

STEPHENS Philip, *Spasm or spiral? The west's choice*,
<http://www.ft.com/intl/cms/s/0/52ca17f6-b3cb-11e0-855b-00144feabdc0.html#axzz1SasgeYV7>

STIGLITZ Joseph , *Eurozone's problems are political, not economic* ,
<http://blogs.ft.com/the-a-list/2011/07/20/eurozones-problems-are-political-not-economic/#axzz1SascaW3V>

STRADFOR GLOBAL INTELIGENCE, *Annual Forecast 2012*,
<http://www.stratfor.com/forecast/annual-forecast-2012>

SUBRAMANIAN Arvind, *Coming soon: when the renminbi rules the world*,
<http://www.ft.com/intl/cms/s/0/098adcf6-daea-11e0-a58b-00144feabdc0.html#axzz1ffQjJoi9>

SULLIVAN ANDREW, *You Say You Want a Revolution*,
<http://www.thedailybeast.com/newsweek/2011/10/23/how-i-learned-to-love-the-goddamned-hippies.html>

THE BROOKINGS INSTITUTION, *Brazil: The "B" Belongs in the BRICs*,
http://www.brookings.edu/~media/Files/Press/Books/2009/brazilasaneconomic-superpower/brazilasaneconomicssuperpower_chapter.pdf

THE ECONOMIC TIMES, *Brazil overtakes UK as world's sixth largest economy*,
http://articles.economictimes.indiatimes.com/2011-12-27/news/30561599_1_brazil-sixth-largest-economy-uk

THE ECONOMIST, *Beware the middle-income trap*,
<http://www.economist.com/node/18832106>

THE ECONOMIST, *China's roaring growth cannot last indefinitely*,
<http://www.economist.com/node/18832106>

THE ECONOMIST, *Rising power, anxious state*,
<http://www.economist.com/node/18829149>

THE ECONOMIST, *Ruled by Lakshmi*,
http://www.economist.com/node/12749719?story_id=12749719&fsrc=rss

THE ECONOMIST, *Slip-sliding away*,
<http://www.economist.com/blogs/freeexchange/2011/12/india's-economy>

THE ECONOMIST, *Starting into the abyss*,
<http://www.economist.com/node/21536872>

THE ECONOMIST, *When a flow becomes a flood*,
<http://www.economist.com/node/12972083>

THE FEDERAL RESERVE BANK OF MINNEAPOLIS, *Born of a panic: Forming the Federal Reserve System*,
http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3816

THE FEDERAL RESERVE BOARD, *Alan Greenspan, "Opening Remarks"*,
<http://www.federalreserve.gov/boarddocs/speeches/2004/20040827/default.htm>

THE FEDERAL RESERVE, *FRB: Mission*,
<http://www.federalreserve.gov/aboutthefed/mission.htm>

THE FINANCIAL TIMES, *Brazil: Things starting to get hairy?*,
<http://blogs.ft.com/beyond-brics/2011/11/18/brazil-things-starting-to-get-hairy/#axzz1iVWZSH4u>

THE FINANCIAL TIMES, *The end of Lehman Brothers*,
http://www.ft.com/intl/cms/s/0/2c0c5d82-8344-11dd-907e-000077b07658,dwp_uuid=5e34aac4-8ae9-11dd-b634-0000779fd18c.html#axzz1Vi5cdLZZ

THE FREEMAN, *Comparing the Great Depression to the Great Recession*,
<http://www.thefreemanonline.org/columns/our-economic-past/comparing-the-great-depression-to-the-great-recession/>

THE GUARDIAN, *Beware global economic imbalances, Mervyn King warns*,
<http://www.guardian.co.uk/business/2010/jan/20/mervyn-king-internationaltrade>
THE NEW YORK TIMES, *Brazil*,
<http://topics.nytimes.com/top/news/international/countriesandterritories/brazil/index.html>

THE NEW YORK TIMES, *Debt Rising in Europe*,
<http://www.nytimes.com/interactive/2010/04/06/business/global/european-debt-map.html?ref=global-home>

THE NEW YORK TIMES, *Federal Debt Ceiling*,
http://topics.nytimes.com/topics/reference/timestopics/subjects/n/national_debt_us/index.html?scp=1-spot&sq=debt%20ceiling%20&st=cse

THE NEW YORK TIMES, *Greece News*,
<http://topics.nytimes.com/top/news/international/countriesandterritories/greece/index.html?scp=1&sq=greece%20debt&st=cse>

THE NEW YORK TIMES, *Occupy Wall Street*,
http://topics.nytimes.com/top/reference/timestopics/organizations/o/occupy_wall_street/index.html?scp=1-spot&sq=occupy%20wall%20street&st=cse

THE NEW YORK TIMES, *One 9/11 Tally*,
<http://www.nytimes.com/interactive/2011/09/08/us/sept-11-reckoning/cost-graphic.html>

THE NEW YORK TIMES, *Tracking Europe's Debt Crisis*,
<http://www.nytimes.com/interactive/business/global/european-debt-crisis-tracker.html?ref=europeansovereigndebtcrisis>

THE WALL STREET JOURNAL, *S&P 'Oops' on Rating of France Is Probed*,
<http://online.wsj.com/article/SB10001424052970204224604577030083804142906.html>

THE WALL STREET JOURNAL, *S&P Strips U.S. of Top Credit Rating*,
<http://online.wsj.com/article/SB10001424053111903366504576490841235575386.html>

TRANSPARENCY INTERNATIONAL, *Corruption Index*,
http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results

TRIPATHI Salil, *Hunger Strike Inflames India*,
<http://www.thedailybeast.com/articles/2011/08/18/india-protests-anna-hazare-s-new-battle-against-corruption.html>

ULRICH Jing, *China's challenge: drive growth without inflation*,
<http://www.ft.com/intl/cms/s/0/18b26a92-c41e-11e0-b302-00144feabdc0.html#axzz1ffQjJoi9>

WOLF Martin, *Struggling with a great contraction*,
<http://www.ft.com/intl/cms/s/0/079ff1c6-d2f0-11e0-9aae-00144feab49a.html#axzz1XkvDLDsg>

WOLF Martin, *Thinking through the unthinkable*,
<http://www.ft.com/intl/cms/s/0/1299d48c-0a01-11e1-85ca-00144feabdc0.html#axzz1ddfUOPI>

WORLD BANK, *India Outlook*,
<http://siteresources.worldbank.org/INDIAEXTN/Resources/Reports-Publications/IndiaEconomicUpdate-September2011.pdf>

ZAKARIA Fareed , *How to Be a Real Superpower*,
<http://www.time.com/time/magazine/article/0,9171,2099706,00.html>

ZAKARIA Fareed, *Are America's Best Days Behind Us?*,
<http://www.time.com/time/magazine/article/0,9171,2056723,00.html#ixzz1dGpBrTqz>

ZAKARIA Fareed, *Fareed's Take: The damage is already done*,
<http://globalpublicsquare.blogs.cnn.com/2011/07/28/the-damage-is-already-done/>