The Global Recession of 2007-2009

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A Changing World: Globalization

• On or around 1972, the world changed:

1. Visit of Nixon to China.
2. Old Bretton Woods system collapsed.
3. Oil shocks.

• Bigger picture: globalization started to re-arrange the world.
Figure 3: China’s Share of World GDP. Source: IMF Data, World Economic Outlook Database
The Impact

Combined with new IT and lower transportation costs, dramatically changed size of world labor force.

Effects:

1. International trade.

2. Capital flows.
Figure 2.5: Current Accounts, billions of dollars
Figure 2: The ratios of China and US gross national savings (left scale) and nominal GDP (right scale). Source: Based on data from China National Bureau of Statistics and the BEA. National savings equals gross domestic investment plus the current-account balance.
Capital Flows from China

- China saved even more than it invested.

- This seems odd: basic intuition.

- However:
  1. Absence of a social insurance network.
  2. Inadequate financial markets and poor financial contract enforcement.

- This leads to over-savings.
Figure 5: The Ratio of Consumption to GDP in China. Source: Derived from China Statistical Yearbooks (1995-2008), Table 9-7/10-18.
Additional Force

- Chinese government kept Yuan from appreciating in the currency markets.

- Large accumulation of foreign reserves.

- Why?
  2. Instrument of national security.
  3. City-biased policy. CPC has read Marcuse.
Figure 7: Foreign exchange rate (Yuan/US$) as of January 1 each year Source: FRB St. Louis
Pressure on interest rates.

Flawed regulations in Basel II.

Financial institutions, particularly in U.S., started to invent new instruments to satisfy world demand for highly-rated yet high-yield securities.

Mortgage-Backed Securities (MBS).

Tranches.
Figure 15: Average US household residential leverage computed as total residential mortgage debt divided by residential home values (primary residence only). Source: FHFA, OFHEO
Figure 10: Current account balance and change in household indebtedness. All numbers are in US$ per household.

Source: Treasury
While housing prices in Western countries increased, everything seemed fine.

Of course, eventually housing prices started to fall.

Institutions most involved in the trading of MBS and related instruments collapsed.

We did not know how to properly handle huge capital inflows.

A first warning because...
Situation in China

- Communist Party of China (CPC) lacks legitimacy.
- Old memories from SWW and Civil War quickly fading out.
- Bottom line of party to the people: Après moi le déluge.
- Lieux de Mémoire (Pierre Nora):
  1. The Century of National Humiliation.
  2. Imperialist powers jumping over China.
  3. War lords.
- Extreme nationalism of urban middle class.
A Changing World: the Collapse of Bretton Woods

- Bretton Woods was one of the pillars of the reconstruction of the world economic order after the SWW.

- U.S. and U.K. were keenly aware that they could not repeat the mistakes of 1919-1939.

- System of governance of capital flows.

- System of financial regulation.
We still do not know how to regulate our international financial sector.

What is really the role of the IMF?

Are meetings such as G-20 effective?

Issues have become even more salient.
But Globalization is Still Leaving Many Countries Behind

- Two main areas:
  1. Most of the Islamic World.
  2. Africa.

- Tensions for the future.

- Role of Oil and other commodities.
Meanwhile, in the Western World

- Median incomes stagnated in many countries.

- Income inequality has grown.

- Educational systems losing their role as means of social mobility.

- Many privatizations processes only meant the substitution of a public monopoly for a private one.

- Scandals of corporate governance.

- Demographic change.

- Health costs.

- Large Immigration flows.
Figure 2.14: Hourly Earnings

- France
- Germany
- Spain
- UK
- US

Hourly Earnings over time from 1996 to 2008.
Income Distribution

- Big changes in relative wages.

- More true in Anglo-Saxon countries than in continental Europe (but perhaps no!).

- Possible reasons:
  1. International trade.
  2. Skill-biased technological change.
  3. Erosion of rents (decline of unions?).
FIGURE 1
The Top Decile Income Share in the United States, 1917-2007

Income is defined as market income including realized capital gains (excludes government transfers).
In 2007, top decile includes all families with annual income above $109,600.
FIGURE 2
Decomposing the Top Decile US Income Share into 3 Groups, 1913-2007

Income is defined as market income including capital gains (excludes all government transfers).
Top 1% denotes the top percentile (families with annual income above $398,900 in 2007).
Top 5-1% denotes the next 4% (families with annual income between $155,400 and $398,900 in 2007).
Top 10-5% denotes the next 5% (bottom half of the top decile, families with annual income between $109,600 and $155,400 in 2007).
FIGURE 3
The Top 0.1% Income Share and Composition, 1916-2007

The Figure displays the top 0.1% income share and its composition.
Income is defined as market income including capital gains (excludes all government transfers).
Salaries include wages and salaries, bonus, exercised stock-options, and pensions.
Business income includes profits from sole proprietorships, partnerships, and S-corporations.
Capital income includes interest income, dividends, rents, royalties, and fiduciary income.
Figure 7B. Top 1% Share: Middle Europe and Japan (L-shaped), 1900-2005
Figure 7C. Top 1% Share: Nordic and Southern Europe (U/L-shaped), 1900-2006
Figure XIII. Educational Attainment Decompositions, Males and Females 1900-1980 Birth Cohorts

Notes: 3-year moving averages based on CPS October, Census, CPS March and NCES data. HS graduates are those who obtained a regular public or private HS diploma (excluding GEDs) from the NCES. "Graduate HS" is the fraction of 8th grade enrollments for a given cohort who report a regular HS diploma. "Attend Given HS" is the fraction of recent HS graduates who report being enrolled the fall of the year following graduation. "Attend College" is college enrollments of recent HS graduates as a fraction of 18 year old cohort size. College graduates are those who report a BA or higher by age 25. "Graduate Given Attend" is those who obtained a four year degree as a fraction of the college enrollment total for that cohort. Two-year degrees are not included. "Graduate College" is the number of college graduates as a fraction of the 18 year old cohort size. Population estimates are from the Census P-20 reports. HS diplomas issued by sex are estimated from CPS October data after 1982.
Figure 2.11a
Percentage of students at each proficiency level on the science scale

Countries are ranked in descending order of percentage of 15-year-olds at Levels 2, 3, 4, 5 and 6.
Source: OECD PISA 2006 database, Table 2.1a.

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Challenges for the Future

- Manage arrival of new countries to world stage.
- Achieve international cooperation to handle collective action problems.
- In particular, financial and corporate governance.
- Convince middle classes that they have a “stake” on the right policies.
- A “pro-market agenda” is not a “pro-business agenda”
- Decline of Volkspartei.