Subject: Simplistic/Very Macro Overview of the Global Economy...
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[redacted] attached is a document that my Harvard researchers and I put together for the seminar I'll lead at Macaulay Honors College of CUNY. It is intended to be a survey of the global economy to set the stage for the course. By necessity, therefore, it is relatively simplistic. Nonetheless, it will have considerable value, I think, for the undergrads in the seminar.

I share it with you to see if you and/or your team might have a chance to read and comment on it as I get ready to put it into the syllabus readings...

If you're interested, I'll share similar pieces on each of the revolutions (energy, manufacturing, life sciences, and information technology) in the weeks/months ahead. We're getting them into final form, too.

Thanks/All best -- Dave Petraeus

5/22 attachmen

GLOBAL ECONOMY – BACKGROUND

The global economy is in a slow recovery from the 2009 recession brought on by the financial crisis. The crisis was precipitated by the conflation of incorrect assumptions about the housing market, indecipherable new financial instruments, and weak federal regulation of the financial sector.

US banks had long assumed that housing prices would continually rise. For most individuals, the value of their home is their largest financial asset. Believing that housing prices would continuously rise, banks pushed families, many with poor (subprime) credit, to take out greater loans against the value of their homes in the form of mortgages. At the same time, banks devised extraordinarily complex new financial instruments that sliced up individual mortgages and combined them with others to supposedly reduce their risk. Even prominent credit rating agencies bought into this belief and granted the bundles a perfect 'AAA' rating. Consequently, these bundles were sold to a range of financial firms such that they permeated the entire sector. This belief also led banks to take out multiple new loans against the value of these bundles such that the entire sector became highly dependent on the value of these bundles.

When housing prices began to decline as early as 2007 and many households proved unable to meet their mortgage payments, these new bundles became worthless assets to these firms. The lost capital from these deteriorating mortgage bundles meant that banks also lacked the means to repay other loans they had taken out against these bundles. This precipitated a massive crisis of indebtedness such that America's leading banks lacked the means to repay their obligations and faced collapse.

When banks lacks capital, they cannot make loans to either businesses or individuals, which in turn keeps them from spending on new employees, investment, or other immediate expenses. Also, these businesses and individuals begin to question the safety of their bank deposits and often move to withdraw them. When these withdrawals happen across the economy, the banks are unable to provide them all, which increases panic among depositors, and reduces the available capital for loans. This produces a negative feedback cycle that can cripple the economy.

This began to occur in the fall of 2008, when fears of bank collapse led the stock market fell 50 percent from its 2007 high. While the US government intervened to save these banks by effectively buying out their toxic mortgage bundles and using the government's credit to cover the financial sector's unmet loans, it broke this negative cycle. However, these tumultuous events crippled the confidence of households and businesses in the economy, as it was unclear whether the worst of the crisis had passed. As a result, all were less likely to spend money in the economy in the form of new purchases, investments or hires. Because businesses rely on these to cover their expenses, including payroll, and to grow, this weak demand has meant that the economy has limped along since 2009 as confidence and demand have haltingly returned. This explains the persistently high but slowly decreasing levels of unemployment in the US because businesses only spend money on new employees when their products or services experience greater demand.

Though the financial crisis began in the US, it immediately affected the entire global economy. That is not only because America's troubled banks are global firms, but also because the US economy is the largest in the world. Thus, when demand increases or decreases in the US, it has a disproportionate effect on the world economy. The collapse in American demand thus devastated the economies of many of our key trading partners, pushing the Japan, Europe, Canada and many others into recession while depressing GDP growth rates in China and India.

GLOBAL ECONOMY – KEY FACTS, TRENDS & IMPLICATIONS

World

- *The global economy is predicted to grow this year between 2.6 and 3.5 percent.* This is in line with the growth rate in 2012 of 3.2 percent, but is 1 percent lower than the potential growth rate of the global economy, which is thought to be between 4 and 4.5 percent.
- *Risks to the global economy from 2012 have carried over into 2012 but are less acute*: disintegration and recession in the European Union; excessive spending cuts in the short-term or credit default in the US; and tension during the leadership transition in China.
- *Reasons for concern*: spike in oil prices from Iran-Israel-US confrontation; disruption in Asian trade due to increased provocations by North Korea. Risk of new bubble in the US because of extended period of historically low interest rates, which have promoted higher-risk investments.
- *Reasons for optimism*: US tax hikes and spending cuts agreed to in the January 2013 fiscal deal had milder than anticipated effect on the economy; European markets more stable than in 2012; flow of investment capital to, and demand within, developing country markets remains strong; increased oil production means supply is not constraining growth; inflation mostly stable.[i]
- *Growth uneven by region:* advanced economies like the Eurozone and Japan will either mildly contract or grow around 0.2 percent in either direction due to demand-suppressing budget cuts and heightened uncertainty about the global economy; the US will demonstrate mild but stable growth between 1 and 2 percent; developing economies like China and India will post larger gains (8 percent), driven by increased domestic consumption.[ii]
- *Increase in number of trade deals between emerging markets signals their increased economic activity and clout.* This along with the increased frequency of regional organizations in driving intra-regional trade and development.[iii]
- *Global economic growth in the near-term will be driven increasingly by developing economies, but of the advanced economies, the US is in the strongest position to contribute based on the strength of its private sector, rebounding consumption and investment levels, and in spite of considerable drag on demand, stability and confidence due to lower spending, higher taxes and continued uncertainty about the nation's fiscal path.*

United States

- *Expect mild but stable growth in 2013:* the economy is on track to grow between 1 to 2 percent for the year.[iv] The pace of recovery, however, has not accelerated as hoped.
- *No return to full employment until 2020* unless you assume the most optimistic scenario of continuous increases in consumer demand, US competitiveness and alignment of skilled workers with available jobs. US needs to create 21 million new jobs this decade to employ the current jobless plus new entrants to the labor force.[v] The economy now creates an average of 175,000 new jobs each month, but this pace is volatile with highs and lows.[vi]
- *Positive influences on US growth*: increased consumer spending, business investment, stability in the financial sector, political stability post-2012 election; milder than expected impact of higher taxes on consumption; historically strong stock market along with corporate profits, cash reserves and competitiveness.[vii]
- *New housing demand and recovering home prices will help drive 2013 growth*: the rate at which new households, which are the basis for consumer demand, has grown. So has the rate of homebuilding, which is expected to double in next three years. This boosts job creation because every single-family household supports five jobs in one year. Growth in housing prices also means more wealth for households to borrow against for other spending and investments.[viii]

- *Negative influences on growth*: reduced demand from higher taxes and lower government spending; uncertainty over nation's finances also leading businesses to postpone hiring and investment decisions; higher taxes in 2013 from expiration of many Bush-era levels combined with the new taxes and fees associated with the Affordable Care Act; lower federal spending.[ix]
- *These government policies may cost up to 1.5 percent of potential economic growth this year*: $85 billion reduction in federal federal this year from 'sequester' will shave off 0.5 percentage points from GDP growth this year, reduce employment by 500,000 jobs and lift unemployment by up to 0.25 percentage points. The debt ceiling deal raises $200 billion in taxes this year and will cut a further 0.8 percentage points of economic growth.[x]

European Union

- *European economy expected to mildly contract or grow around 0.2 percent in either direction.*[xi]
- *The European Central Bank's actions have delayed a deeper crisis but also reduced the pressure to address systemic risks.* ECB Chief Mario Draghi pledged to "do whatever it takes" by using the Bank's power to purchase toxic assets from struggling European economies to shore up their balance sheets. This pledge alone increased market confidence but also deflated necessary political pressure for reform.[xii]
- *Germany entered the crisis in a stronger position than any European economy and was relied upon to help weaker ones. But, it misused this leadership opportunity by tightening the conditions associated with its bailout of struggling Eurozone countries instead of stimulating continent-wide growth.* German terms required sharper budget cuts in recipient countries, further reducing Eurozone demand and poisoning the collaborative spirit moving forward.
- *2008 crisis exacerbated longer-term problems in the Eurozone, but still cause for hope.herited Euro-wide problems dampening growth, but silver lining.* The public sector began in excessive debt, and has had to sharply reduce government payrolls, spending and investments in sources of future growth like infrastructure and research. The private sector was also over-indebted. The silver lining is that needed adjustments taking place, and short-term prospects for lower debt and higher competitiveness, especially in the Southern and Eastern European economies.[xiii]
- *Persisting country-level problems undermining investor confidence*: Italian political dysfunction remains despite selection of President Napolitano and Prime Minister Letta; France's budget deficit remains much higher than others in Eurozone and won't balance for at least five years, the country has paradoxically become less competitive after European integration, reforms insufficient to change required;[xiv] a Portuguese constitutional court struck down some of the government's austerity measures, threatening their access to bailout funds needed for them to repay existing debts; Greece and Spain still reeling with more than a quarter of their workforce unemployed.[xv]
- *Eurozone challenges ahead include sustaining momentum for economic reform, maintaining market confidence, and advancing the fiscal and monetary union.*

China

- *Rate of economic growth has been volatile in recent years, but likely to stabilize in 2013 around 8 percent*: Chinese GDP was in double-digits pre-recession, but went down to 7-8 percent in 2009 before shooting back up in 2010, and coming down again in 2011. This volatility has complicated macroeconomic planning and investment, and may provoke domestic tensions. But, a relatively more stable global environment will support more stable growth this year.[xvi] Despite volatility, China's economy has expanded 50 percent since crisis.[xvii]
- *Robust, government-issued economic data suspicious to some credible analysts* who are skeptical of their statistics for exports, income inequality, and GDP growth rates.[xviii]

- *Growing urbanization is an opportunity for growth.* An urban worker's per capita income is three times as large as their rural counterparts, so China's promotion of urban centers bodes well for potential growth in domestic consumption.[xix]
- *Risk of housing bubble a growing concern, but government acting to address it.* Rapid growth and low interest rates have exploded housing demand, raising the risk of a US-style housing bubble. To prevent this, the Chinese government has increased taxes on residential property sales and increase required down payments for buyers of second homes. Single individuals can now only buy one purchase in the city and can no longer buy two homes. This is a response to the rapid growth of real estate prices, which rose in 62 of 70 Chinese cities this February.[xx]
- *China has made insufficient economic and structural reforms in the last 3-5 years.* Reforms needed to improve infrastructure and environmental standards; increase competitive market pressures for large, inefficient sectors like utilities, airlines and fuel; reduce inequality which threatens social stability; and create a social safety net to reduce savings, improve domestic consumption and improve political stability.[xxi]
- *Once in a decade leadership change raises hopes for structural and economic reforms as China enters a complex socioeconomic transition:* Escalations with US over cyber-security may hinder economic cooperation; new leadership has shown early signs of real commitment to reduce corruption, alter the role of government in the economy, and deal with big social issues.[xxii]
- *Robust, sustained Chinese growth dependent on following five reforms*: (1) *Pricing deregulation* – many prices controlled by government, more should be lifted to allow for better resource allocation through market-based competition; (2) *Energy saving and environmental protection* – high growth fueled by resource depletion and high pollution, which requires higher emission standards, closer supervision, introduction of environmental taxes to change industrial practice; (3) *Social safety net and healthcare* – essential for reducing wealth disparity; could include pension and healthcare reforms, subsidized housing, social security, unemployment benefits; (4) *Financial sector deregulation and financial sector innovation* – China's government should improve regulation of the country's young financial sector to bolster the availability of capital to businesses and develop financial instruments like bonds needed to finance new public sector investment. (5) *Railway restructuring* – outdated ministry needs to be weaned from government ownership and become a commercially viable and sustainable entity.[xxiii]

Brazil

- *Brazil is fifth in population and geography, sixth in total GDP.* The last decade saw truly remarkable Brazilian growth owing both to luck and disciplined policies. Brazil was lucky in that the last decades produced continuous growth in total foreign investment and the prices for its main exports. Combined with good economic management, this led to huge economic boost.[xxiv]
- *Economic outlook for 2013 is favorable*: Brazil's economy continues to expand, though its government policies should focus on lowering inflation and preparingt for less friendly external environment in he years ahead.
- *Country remains heavily dependent on the prices of its chief exports for GDP growth.* To achieve higher growth, Brazil must address structural deficiencies that limit its economic potential. This means reducing taxes; reforming social security to increase domestic savings; and investing in infrastructure, which equals 18% of GDP in Brazil compared to 30% in Asia.[xxv]
- *Brazil's challenge is improving the business climate.* It ranks 128 of 185 economies for ease of doing business and has lost ground since 2011. The drivers of this decline are the difficulties businesses face paying taxes, resolving bankruptcy and securing construction permits.[xxvi]

Russia

- *Russia's economy was one of the fastest growing until 2008 crisis.* After Russian crisis in 1998, its economy has almost grown by factor of 10. This was largely due to rising oil prices for Russia is the world's second biggest oil producer.
- *Its population grew in 2012 for first time since fall of USSR, but stability of trend unclear.* Russia's population fell by 4 percent in 1990s but grew by 200K last year. Migration accounts for much of this, as does the higher birth rates of the adults born in the 1980s decade of liberal reforms.[xxvii]
- *Russia's energy sector highly inefficient.* It has more to gain from energy efficiency than almost any other country. If their energy use was in line with comparable advanced economies, they could bring down energy consumption by nearly 30%.[xxviii]
- *Russia has several upsides*: it has an extremely well educated populace at the top, natural resources, and an emerging tech industry. The middle and upper-middle classes, along with the business community, is asking for constructive reforms going forward. Youngest generation lacks memory of economic trauma and is less afraid of socioeconomic reforms.[xxix]
- *Projected increases in energy exports to Asia-Pacific will boost GDP.* China is becoming Russia's top market as European energy demand declines. Today, around 15% of Russian oil exports head east enabled by new pipelines. China also in talks to with Russian state-owned Gazprom to dramatically increase natural gas imports.[xxx]

India

- *Economy grew at about 8 percent over the last decade*, driven by rising investment, consumer demand and growth in business productivity.
- *India has favorable demographics.* Its large and growing population is young, with half under 25. As they enter the workforce, save, and consume it will produce a virtuous economic cycle.
- *Growing Indian consumer demand will shape its interaction with the global economy.* India already imports a significant portion of its GDP to satisfy this demand for foreign goods.
- *Country's manufacturing base is quite low.* It is in no position to match China, but is still expected to grow in medium-term.
- *India needs significant structural reforms to continue its high growth path*: (1) Infrastructure – roads, airports, ports; (2) increase tax base; (3) administrative reform so that brightest can attain areas of responsibilities in the public sector.[xxxi]
- *Political paralysis hampering growth by undermining investor and business confidence.* Momentum for continued economic and government reform has stalled. Unlike in early 1990s, India can no longer rely on a powerful external pressure from institutions like the IMF to push it through painful but vital reforms.
- *Political decentralization may alleviate paralysis and encourage innovation.* Though a radical suggestion for the increasingly nationalist country, this idea deserves merit given India's sheer size and diversity.[xxxii]
- *India's medium-term challenges include inflation and a large current account deficit*, with the latter driven mostly by growing energy imports.[xxxiii]

PROPOSED POLICIES, PROGRAMS, PRACTICES, LAWS & REGULATIONS

- *The US is the best positioned of all advanced economies to support the global recovery.* American advantages include a leaner, more competitive private sector anchored by well-positioned multinational corporations; gradual growth in consumer spending; steady rebound in housing construction; greater flexibility for investment and labor; active, pro-growth Federal Reserve policies; growing domestic energy production.

- *The true potential of America's contribution, however, is far greater than will be realized under existing policies.* Growth limited by uncertainty over the nation's future regulations and finances; gap between existing labor force skills and private sector needs; uncoordinated, under-resourced policies to support innovation and research; and loss of highly-skilled human capital to developing economies due to a needlessly burdensome immigration system.

- *US can strengthen its international position and contribution to the global recovery by acting to:* (1) reduce the fiscal drag on growth; (2) reform immigration to satisfy demands for high- and low-skilled labor; (3) accelerate domestic energy production consistent with environmental concerns; (4) and encourage innovation with an emphasis on the new revolutions in advanced manufacturing, life sciences and information technology.

(1) *Reduce fiscal drag on growth with grand bargain on debt, tax reform.*

a. Use President Obama's 2013 budget as a baseline for its balance of new investments in infrastructure, R&D and education and needed changes to entitlement programs.
b. Budget agreement should reduce national debt to 75 percent of GDP in medium-term and replace cuts from the 'sequester', which were haphazard and nonstrategic.
c. Social Security benefits should be readjusted to better align with today's longer life expectancies and rate of inflation while protecting lowest income and most aged beneficiaries.[xxxiv]
d. Expenditures in tax code on industry breaks, state and local taxes, high-income charitable giving, and healthcare benefits could be closed and used to lower rates while increasing their progressivity and simplicity.[xxxv]
e. Pass 'McConnell compromise' to grant president authority to raise the debt ceiling unless a two-thirds majority in Congress opposes him.[xxxvi]

(2) *Reform immigration to satisfy private sector demands for high- and low-skilled labor.*

a. Pass 'Gang of Eight' Senate compromise bill.[xxxvii]
b. Remove barriers to older workers staying in the workforce longer
c. Increase H1b visa quotas and expedite green cards for applicants with expertise in science, technology, engineering and math (STEM), venture capitalists, and those with credible business ventures.[xxxviii]

(3) *Accelerate domestic energy production consistent with environmental concerns.*

a. Authorize Keystone XL project given State Department's favorable report;
b. Require disclosure of fracking contents while expediting their patents;
c. Require embedded environmentalists at each phase for shale gas production;

d. Harmonize standards for renewable across states to increase demand for renewables[xxxix];
e. Offer grants in voluntary state competition to improve conservation;
f. Maintain and increase fuel efficiency standards for automotive fleet;
g. Use government revenue from the license fees and royalties taken from dirtiest fuels like oil and coal to finance tax credits for natural gas, renewables and energy R&D.
h. Invest in carbon capture and storage demonstration projects.

(4) *Encourage innovation with emphasis on new revolutions in advanced manufacturing, life sciences, and information technology.*
a. Extend and expand research and development tax breaks;
b. Provide low-interest loans and facilitate public-private partnerships for establishing tech-friendly infrastructure like public broadband and smart grids;
c. Create "Plug and play" enterprise zones. These would have zoning and environmental permits preapproved to slash the time needed to bring a new plant online[xl];
d. Use government's influence as major purchaser of equipment to help accelerate the development of new technologies and industries;
e. Cut backlog in US Patent Office as it can take up to three years to get approval[xli];
f. Establish "Race to the Shop" competition where states become eligible to receive generous federal grants if they establish innovation partnerships between the public, private and academic sectors to encourage cross-pollination and resource pooling.
g. Increase R&D funding in top cross-cutting technologies[1]

[i] http://www.goldmansachs.com/our-thinking/focus-on/outlook/hatzius-2013/
[ii] http://www.ihs.com/info/ecc/a/economic-predictions-2013.aspx
[iii] http://forumblog.org/2013/03/putting-hope-in-the-brics-nations/
[iv] World Economic Forum, 2013
[v] Manyika et al.
[vi] Dynan, 2013
[vii] Zandi, 2013
[viii] Zandi, 2013
[ix] Wells Fargo, 2012
[x] Wells Fargo, 2012
[xi] World Economic Forum, 2012
[xii] http://www.goldmansachs.com/our-thinking/view-from/a-view-from-europe/index.html
[xiii] McKinsey, 2013 Global Outlook
[xiv] http://www.brookings.edu/research/opinions/2013/01/08-french-economy-lombardi
[xv] http://www.economy.com/dismal/article_free.asp?cid=238915&src=mark-zandi
[xvi] McKinsey, 2012
[xvii] http://forumblog.org/2013/03/putting-hope-in-the-brics-nations/

[1] Advanced sensing, measurement and process control; advanced materials design, synthesis and processing; visualization, informatics, and digital manufacturing; sustainable manufacturing; nonmanufacturing.

[xviii] http://www.moneynews.com/Economy/Goldman-Sachs-UBS-China/2013/01/13/id/471207
[xix] Roach, 2013
[xx] http://www.forbes.com/sites/kenrapoza/2013/03/30/china-takes-another-stab-at-housing-bubble/
[xxi] http://www.goldmansachs.com/our-thinking/view-from/a-view-from-china/index.html
[xxii] http://www.cfr.org/economics/prospects-global-economy-2013/p29737
[xxiii] http://www.goldmansachs.com/our-thinking/view-from/a-view-from-china/index.html
[xxiv] http://www.goldmansachs.com/our-thinking/view-from/a-view-from-brazil/index.html
[xxv] BCG, 2012
[xxvi] http://www.doingbusiness.org/data/exploreeconomies/brazil/
[xxvii] http://www.ft.com/intl/cms/s/0/1dcce460-4ab6-11e2-9650-00144feab49a.html#axzz2RQQpyRt8
[xxviii] http://www.iea.org/countries/non-membercountries/russianfederation/
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[xxx] http://rt.com/business/china-become-russia-biggest-oil-client-667/ 0
[xxxi] http://www.goldmansachs.com/our-thinking/view-from/a-view-from-india/index.html
[xxxii] http://www.project-syndicate.org/commentary/india-s-economic-slowdown-by-kenneth-rogoff
[xxxiii] http://www.brookings.edu/research/opinions/2013/04/14-global-economy-prasad
[xxxiv] www.fixthedebt.org
[xxxv] Rivlin, 2013
[xxxvi] http://www.cnn.com/2012/12/07/politics/fiscal-cliff-senate-maneuvering
[xxxvii] http://abcnews.go.com/Politics/gang-introduces-immigration-reform-bill/story?id=18992123#.UXitzr88igE
[xxxviii] Manyika et al. 2011.
[xxxix] Manyika et al. 2011.
[xl] Manyika et al. 2011.
[xli] http://www.mckinsey.com/insights/americas/growth_and_renewal_in_the_us