



MAURO GUILLEN'S TAKE ON THE PROLIFERATION OF INTERNATIONAL ECONOMIC CRISES

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The Euro Crisis has gone on for several years now and it shows no signs of going away. The combination of structural issues in the Euro-Zone and weak macroeconomic recovery have prevented lasting resolutions. How likely do you think a solution is in the near future?

It depends on whether the countries involved can shift their focus purely from public finances, deficits and the current state of bond markets to strategies for accelerating growth. I'm obviously not the first to say this; people like Joseph Stiglitz and Paul Krugman have been saying this for years without much reaction from these governments. More interestingly, the new head of the IMF Lagarde has started urging a focus on growth policies in the past few months as well. The thinking behind this shift is that when the economy grows you get more taxes, and you also spend less because you have to pay unemployment subsidies, which in Europe are quite generous, and of course the reverse when the economy shrinks. I think that Europe will get out to the extent that they balance the two objectives of growth and austerity, because right now they're focused on budgets and not so much an agenda for growth. If they only think about budgets, the likelihood of success is close to zero because it will take Greece or Portugal or Spain years to get out. As the focus shifts to growth, the probability rises to a point, because the debt remains important. **So the question isn't necessarily how to get a grand debt bargain, but on how to get Europe growing again. How much resolve is there in these countries to do that? We've seen measures in the UK, under David Cameron, and in Italy, under Mario Monti, have mixed results.**

There are two considerations here to balance. There is the immediate problem which is that the distressed countries don't have enough buyers for their bonds or pay too high interest rates, and then there's the 2-4 year concern which is to get the economy going again. But there's another thing in that we all agree that the markets have become very influential because they give very clear signals of what they see going on. And they're starting to give clear signals that they want European leaders to start thinking about growth; up to now they've been obsessed by debt, and thus so have European leaders. With Cameron people had a clearer commitment to "small government" concepts, but in Europe a reduction in public spending is going to lead to sharp drops in aggregate demand. With European and world credit markets still weak despite central bank interventions, it seems unlikely that private demand will step in to fill the gap in, especially with banks holding on to cash and preventing small and even large businesses from getting capital. But it'll be markets that put on the pressure as they raise their voices about where growth will come from and not just budgetary concerns. **What happens if these discussions don't succeed? There used to be concerns that the Euro would come apart, but now a "status quo" stagnation seems more likely.**

There are two schools of thought here. One is that if things continue to go down, with neither Greece nor Portugal figuring out their problems and Spain and Italy continuing to have their problems, someone will collapse and Germany will come to the rescue. Germany is being tougher with conditions, making money conditional and ruling out a straight bailout. But if push comes to shove and things start to collapse, Germany won't want to be at the center of chaos. With the Euro-

pean Union's 13 new members east of Germany, Germany is both the economic and geographic center of Europe. As an economy, country and society Germany cannot afford to have these countries around it breaking down around it. I think there's some element of truth to this. The other school of thought is that the Germans will continue to be tough, and the Europeans will say that the strong fiscal union needed here will take years to build and that markets won't have the patience for it. It might not happen at all, but if it does it won't happen tomorrow. You would see the Euro-zone contract from the current 17 members down to a smaller number without the worst offenders. I think that has a probability of happening, but it depends on how bad things get. If Europe has trouble at the same time as the emerging economies, who import European machinery and know-how, it gets much harder. Brazil is already have trouble; last year it grew at 7-8% and this year the new rate was 2.7%, which is a dramatic slowdown and nothing for an emerging economy. China has been coming down from 11% growth to 7-8% growth (depending on who you believe), and India is down too. If that continues, where will the Europeans sell? The more these problems coincide, the more likely that the Germans basically get together with the Austrians, Dutch, Swedes and 3 or 4 other countries and create their own new currency. But things do seem to be improving, so Italy and Spain just get rescued and people realize the future of Europe doesn't hinge on Greece; the Germans will subsidize their exit from the Euro, and it will be good for them since they can devalue and be competitive again. In the past, Greece would drop their currency by 30% and be competitive again. But the inflexibility of the Euro, combined with the fact that the past 12 years have seen flat productivity in the Mediterranean countries (while Germany's higher base productivity grew quickly, widening the productivity gap), makes monetary union very hard to keep up. **Greece actually announced a restructuring of its debt recently to positive reactions from markets. What does this resolution mean? Do speculative concerns shift elsewhere now?**

Speculators are going to keep a close eye on different indicators to see where countries like Portugal and Spain go from here. But psychologically, although the Greeks probably have high unemployment and don't grow for the next 10 years, the problem quiets down and everybody feels better. The best piece of news would be for Italy and Spain to start getting out, because then people will realize that the problem is 1 or 2 relatively small economies that won't sink the Euro. But if Italy and Spain continue to struggle, even with the boost from Greece not imploding, it might be enough since their economies are 11 and 8 times bigger. They're making reforms in Italy, but it takes time for those things to increase economic growth. These countries are likely to announce that they've entered into recession next quarter, confirming fears of a double-dip. **There were fears that Greek credit default swaps [bond insurance] would not be paid out, although they ultimately were. Why has that been such a concern?**

A disorderly Greek default would have had systemic risk in two areas. One is banks in France and Germany, and the other is through these derivatives. Though this is a Greek problem, many banks in those two countries have large Greek exposure, and stress on them would pres-

sure a lot of other countries, including United States banks who insured them. As for the derivatives, no one really knows how much exposure there is since a lot of it is OTC. There are estimates from 10 to 15 billion Euros, which would be relatively nothing, to 200 billion or more. **We've seen the consequences of what happens when big financial firms go under, and we wonder if firms like Societe Generale or Santander are on the bubble if things get worse.**

Those are two examples that are very different. Deutsche Bank, Soc Gen, these banks have one advantage over the Italian and especially the Spanish, Irish, and Greek banks and that is that they are not exposed to a real estate bubble. But they are exposed to Greek and Spanish debt, so for the French and German banks, I think it's mostly that they are exposed to sovereign debt. The most important problem for the Spanish banks right now is the exposure to the real estate bubble in Spain. They have all these mortgages with a default rate of six percent, which is already high. If the economy doesn't improve, it will keep on going through the roof. And moreover, these banks had real estate divisions, so they're also real estate developers and they have housing stock. On top of that they have bad loans to other commercial developers, so it does not belong to only households. It belongs to commercial developers, real estate developers, and also their own real estate operations. So it's a different problem. The German banks, for example, don't have a real estate problem, because there was no bubble in Germany. If you take a look at

housing prices in Germany, they have been flat for the last twenty years. In Spain, they were going up by twenty percent each year for twenty years, with one little interruption ten years ago. So the problems with those banks in Europe are very different depending on the country. And when you look at Spain, there is the system of Cajas, which are the smaller, community banks that were a big concern earlier on in the crisis. And those concerns remain for the same reasons; for the exposure to the real estate bubble and less capital strength than the private banks like Santander. The big advantage of Santander of course, is that right now it is getting more than two thirds of its profits from outside of Spain. It is getting forty percent of its profits from Brazil and twenty percent from the U.K., they have a presence in other Latin American countries. Let's say that 25 percent of the bank is exposed to Spain. It is not 100 percent. For savings banks like Cajas, it is 100 percent. But the savings banks have been having trouble in Germany also, but not because of real estate. WestLB, the largest savings bank in Germany, was just liquidated because they invested in derivatives, etcetera, and they went wrong.

And how about Spain's Iberian neighbor Portugal?

Well Portugal is smaller than Spain and has more problems with competitiveness. Spain has grown over the last ten years, and Portugal has not grown that much, so even before the crisis Portugal was not doing that well. They have more problems than Spain in the longer run, and of course the markets know that. That's why the spreads for Por-





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tuguese bonds have been higher than for Spanish bonds. At the end of the day, Spain and Italy have had to pay higher interest rates over the last few months, but they have been able to place their bonds; in fact, they've been oversubscribed. There are more investors willing to buy Spanish bonds at such high interest rates than the government needs to sell in order to fund its existing stock of debt. **Recently it has been under discussion that China might be asked to assist in the situation.**

China is already doing that. China is accumulating a lot of cash, obviously it has been for some time, and right now I think the figure is 3.4 trillion dollars in foreign reserves. All countries have reserves since they always need money on hand, so about 70% are held in dollars or dollar-denominated securities like treasury bills. 25 or 26% in Euros, and then the rest are Yen, Swiss franc, sterling, but it's mostly in dollars and Euros. Over the last ten years the dollar is shrinking and the Euro is going up. But if you go to China, the indications are that China is already more into Euros than any other country in the world. The Chinese understand that they need to diversify because the dollar is a relatively weak currency right now. Just think about it: the Euro is still trading at 1.36 to the dollar even with the whole mess in Europe. The Euro should have lost a lot of value relative to the dollar. In my opinion, the only reason that it has not lost value is because the dollar has its own weaknesses, the biggest being, of course, the current account deficit here, meaning that we import much more than we export, putting a lot of downward pressure on the dollar. And at the same time, you see countries moving away from the dollar, meaning that the dollar is becoming less of a reserve currency than it was, which also puts downward pressure on it. The dollar-Euro exchange rate has fluctuated, but it's more or less at the same level as it was four or five years ago, in spite of the mess in Europe, because both currencies are weak. So relative to each other, they stay more or less stable, plus or minus 7%, which is a lot, but not plus minus 30%. If the dollar were strong now, the Euro would have lost 30% of its value, which by the way, would have been good for the Euro. Then, they could export more into the United States. That's another trouble in Europe: they would prefer a slightly weaker Euro, but they can't have it, because the dollar is also weak. Remember, the Eurozone is more or less balanced in terms of trade, because Germany has a big surplus and then you have a

number of countries with a big deficit. But the U.S. has a huge deficit. I almost never read this in the newspapers but it's very important to keep in mind. **What would an actual Chinese "bail-out" look like? What kind of actions can they take?**

I don't think they would need to sign an agreement or anything of the sort, but here's the problem from a discussion back in November. The Chinese want something in exchange. They are taking advantage of the situation, and why shouldn't they? They know they have the cash and they know that others have a problem, so they could just go to the markets in Europe whenever there's an auction for big bonds or German bonds or Spanish bonds and buy. They do that, but they are to do more of that and want to do so because they want to hold more in Euros and less in dollars. The problem of course, is that they do not want to do it for free. Back in November, the rumor was that they imposed two conditions just to go bid, that would probably have resolved the problem in the short run. Number one was that Europe would support China being treated as a developed economy at the WTO, which means it would be much harder to accuse them of trade violations. The second condition was that although Chinese investors, companies, and government would buy bonds, they would also be allowed to buy equities in Europe, especially in France. That would be a problem and is when the whole thing collapsed. Especially if we are talking about infrastructure, this is not discriminating against the Chinese. All the European countries have privatized their infrastructure firms over the last twenty years. So now you are going to have a state-owned Chinese firm take over the firms that you privatized? It undermines the whole program of reform and privatization that Europe has been implementing for twenty years now. **What about the IMF?**

Well, the IMF wants to resolve the problem, and there's a European who understands the problem well at the head of the IMF, LaGarde. But the IMF can only go so far - it can be a broker. It has a lot of power when we're talking about a developing country that has no other options, but there are very powerful countries in Europe. Even Italy is under some kind of pressure; it's a big economy. We are not talking about rescuing Ghana, we are talking about rescuing Italy or even Greece. Not only that, you have even stronger economies like Germany, and the IMF cannot just go in and fix the problem like they do in Latin America or Africa.

Could China then insist on more representation in the IMF as a bailout condition?

Well let me tell you the story. China is showing up and saying “We would like to play a bigger role in the World Bank or the IMF.” And of course, then they have to write a bigger check. But what do they care? Then of course, the people running the IMF or the World Bank say that if you’re writing a check for \$100 billion, then you’ll have 25% voting power, because your contribution will be the same as that of the U.S., which the other countries do not want China to have. The problem here is that the world has changed. All of these things were set up at the end of World War II. There was the U.S., there was Europe, Japan did not really exist. And China literally did not exist. Latin America was tiny, Africa did not exist either. Fast-forward seventy years later, and we have a totally different situation in the global economy. Emerging economies already make up more than half of the world GDP. These institutions are totally outdated. But the problem of course is that China cannot play a constructive role in the situation because it does not have a convertible currency. China can only intervene via dollars or Euros, but not with its own currency. This is highly anomalous and I think we are in for a long period of instability until China manages to make reforms so they can convert

to understand how all this works. China thirty years ago was a closed country. They have changed a lot of things, but mostly in manufacturing, not in the financial sector. That is going to take them five, ten, fifteen years. For me, this is a fundamental problem; you cannot run the global economy in a situation in which the big elephant, the big dragon, does not have a currency that others can use. It is a serious mismatch.

Do they have to have a desire to go and fix it?

Of course, because now they rely on the dollar and Euro, and they would prefer to trade with others in Yuan. They are signing bilateral agreements in Yuan, but they are very small and only with ten or twelve countries, such as Singapore, Hong Kong, Argentina and others that import and export extensively with them. But these are very small transactions; as a percentage of Chinese trade, it’s nothing. **These limitations in having a convertible currency obviously imply a lot of problems. Many accuse China of purposefully under-pricing its currency to preserve export competitiveness and are putting pressure on it to stop that practice. How likely is China to respond to these appeals? What would be the consequences of it accepting?**

Rapid currency appreciation would of course put a lot more pressure on them. But at some point they need to stop competing on just purely cost.

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their currency, because we’ve never been in a situation where the largest economy and largest trading power in the world does not have a convertible currency. The UK was dominant for a long time, and the pound sterling was the global reserve currency. The U.S. becomes dominant, and the dollar replaces the pound. China is already the biggest trading power in the world, but it is as if it doesn’t have a currency. They use their money in China, but nobody else can use it for international transactions. In order for them to have a convertible currency, they need to reform their financial system. The system is obsolete and is not prepared for that. They need to open up and remove control. They need to have sophisticated financial regulation and liberalize capital flow. They need to make sure the banks are not going to collapse before they develop an internal accounting system. The banking managers themselves need

They know this and have been making adaptations; they’re investing very heavily in technology and education. They’re investing in all the right things so that they are prepared for the time when they are more like Germany. Eventually, they have to compete with sophisticated goods. China has done a very difficult thing over the last thirty years, which is to grow fast and raise people out of poverty. Now I think they have to make a transformation that is even harder. One part of that transformation is the financial market and banking system that we talked about, and the other one is to shift towards a higher value-added real economy. **China has this reputation now, for better or worse, that it’s not able to adjust its exchange rate and that, because of that, it’s having competitive advantages. So there’s a lot of desire in the United States and in other countries to undertake retaliatory action. It’s something that**

a lot of presidential candidates have talked about doing, and there's a lot of support within the United States. How likely would such efforts be in successfully helping the United States compete with China?

Well I think that they can be successful, but there's too much focus in the US on what other have got to do. The U.S., over the long run, has several problems to solve here. One is education at the primary and secondary level. We have an increasing problem with funding schools, school performance and kids dropping out. In standardized tests, American students do very poorly compared to those from other countries. The United States has to fix this to ensure that over the long run - 15, 20, 25 years - it remains competitive. We have the best universities but some of the worst primary schools. Another problem is the U.S. and its trouble meeting its energy needs. There's got to be a solution to the dependence on foreign oil. It has been an issue for the last 40 years. It is a very difficult issue, but we need to be more creative when it comes to new energy policy and considering more options. That would help us innovate and get rid of that dependence.

A big change that you're seeing with the Chinese now is the reversal of traditional capital flows. Money used to go into developing these emerging economies, but China actually exports capital now. They're buying assets in Africa, Latin American, even in developed markets like Europe and the United States. But people aren't necessarily comfortable seeing Chinese firms, often state-run, control things. How do we adjust to this new reality?

Everyone is adjusting. We talked about it a little bit earlier. The issue here is that China and other emerging economies like India and Brazil grow very quickly but only growing along one dimension, as producers of things. They need to become more consumption-oriented and lead growth there as opposed to export growth. They need to, as we were saying earlier, manage their financial transition. You also asked earlier about their role in multinational organizations like the IMF. They need to assume more responsibility and more voting power. There are so many things out of whack because that one dimension, the country's production, has grown so much while their consumption hasn't and their financial role still has to be defined. We have to deal with it because otherwise we have a very unbalanced global economy.

So does that mean that we should be more receptive to Chinese investments within these places?

Oh, sure! There's no other way around it. China has a surplus, we have a deficit. In the absence of interplanetary trade, let say between Earth and Mars, if there are countries in the world that have surpluses, that means there are countries that have deficits. So money must flow from one to the other to cover those gaps. That's the way it is, at the end of the year planet Earth is planet Earth. So China is a very important part of this picture. The U.S. has been the dominant force for 50 years. I don't think the U.S. is going to be displaced by China, but they're just going to have the U.S. and China be very important economies. And then geopolitics depends on whether they get their act together or not.

One of the topics that you talk a lot about is globalization. The past 20 years have seen some pretty tremendous gains in terms of opening up the world, bringing it closer, making it smaller. I wonder if the past 5 years have changed the trajectory in any way or even reversed it.

Well, I think that it is a constant flow of changes, some of them moving

in certain directions, others moving in just the opposite direction. It's two steps forward, one step back, one step sideways. Going back to my overall theme, I think what we have in the world's situation is a lot of moving parts, things out of whack, economically, financially, politically. We have a lot of unsettled political situations, especially in the Middle East and North Africa. China is politically interesting place right now because of the problems you have in Tibet and western China. Globalization is not something that takes us to a particular place, that makes changes that are coherent and unidirectional. It is a very complicated and very haphazard process. Human society and economies have become so interconnected in real time. I call the nature of the beast very complex and very uncertain. We cannot fully anticipate what going to happen next, and the last four years have been very good demonstration of that.

Do you think it's possible that that governments become more protectionist and, in that sense, reduce globalization?

There was a lot of talk about that in '09 and '10. My hope is that politicians remember that the Great Depression of the 1930s was made worse by protectionism. I hope that we can avoid such taxation now. There are many tensions like the Chinese currency issue. The U.S. has adopted some protections, as have the Europeans. So, the mood and condition is there, I just hope that there's no vision on the part of the world's political leaders of going down that path; it can be a disaster.

One of the most popular careers for Wharton students continues to be financial services, despite the change in character of global finance. As a member of the board of advisors to one of Europe's largest savings banks, La Caixa, we'd like to ask for your comments on how the financial industry is going to change for new Wharton School graduates.

Well, in many ways, and not only investment banking, which is a different landscape in terms of jobs. I think a trend is going to be, instead of having big employers come to campus to recruit, we're going to have more boutique investment banks. I think private equity is going to be more important as potential employers look for Wharton graduates. And let's not forget about the emerging economy. You go to the commercial or investment banks or private equity, and they're retreating in Europe and the United States, but not so in the emerging economies. There are lots of opportunities in China, the Pacific, in India, in the Middle East. A lot of grads are going to take jobs over there because there are going to be very nice opportunities that won't be available in Europe or the U.S. Both the segments and the geographies will change.

Should some students start seeing opportunities outside traditional financial centers, such as New York and London?

New York and London will remain as the dominant financial centers for a very long time. But at the same time, we're going to see Sao Paulo, Shanghai, Dubai, Mumbai emerging as more important centers. It's going to take more than a few years to become as important as New York or London since they are already so entrenched.

How should students prepare for these changes?

Psychologically, since many of the jobs might not be in the U.S., the U.K., or Europe, but in different economies. And also by becoming knowledgeable about those parts of the world you want to operate in. Obviously, we won't all work there, but that's where the world is going. iBR