

OVERVIEW

Institutions, Macroeconomics, and the Global Economy

Introduction

All managers face a business environment where international and macroeconomic phenomena matter. Understanding the genesis of financial and currency crises, stock market booms and busts, and social and labor unrest is a crucial aspect in making informed managerial decisions. Adverse macroeconomic phenomena can have a catastrophic impact on firm performance: witness the strong companies destroyed by the Mexican tequila crisis. Yet at the same time, such episodes also create business opportunities—and not just for the hedge funds and speculators that profit from them. Managers that have and use a coherent framework for analyzing these phenomena will enjoy a competitive advantage.

This book presents a series of case studies taught in the Harvard Business School course “Institutions, Macroeconomics, and the Global Economy.” The course addresses the opportunities created by the emergence of a global economy and proposes strategies for managing the risks that globalization entails.

Objectives

The cases in *Institutions, Macroeconomics, and the Global Economy* have three objectives. First, they expose readers to important macroeconomic events that have shaped the way professional international macroeconomists think about their subject. Most of these events in the international economy are quite recent, such as the financial crises in Mexico, East Asia, and Argentina and the evolution of the New Economy in the United States. The case studies emphasize the role of confidence, expectations, and crowd psychology in creating aggregate macroeconomic behavior that is distinct from the sum of individual behavior. In so doing, the material bridges a gap between firm and household level behavior—which is typically well understood by a managerial audience—and aggregate phenomena—which are often not well understood by this audience.

Second, the material in the book explores the often vague question of what are the important institutions from the point of view of macroeconomic performance and how good institutions are built. In doing so it presents examples of how institutions can be developed that focus the uncoordinated actions of individual households and firms on good, rather than bad, overall outcomes. In some countries, legal, political, economic, and social institutions are able to coordinate private decisions on stable and productive paths. Where institutional development is weak—as seems to be the case in much of the developing world—private actions are poorly coordinated and the result is greater macroeconomic volatility and slower growth. Understanding what constitute good institutions and how they can be designed to influence economic and business behavior in desirable directions is therefore crucial.

Finally, the cases presented in the book are designed to teach simple macroeconomics. The basic framework is one where rational expectations play a key role and where there is the possibility of market failure in the form of disorganization of individual players and coordination failures. The simple framework is developed linking institutional design and macroeconomic performance. The framework can be used to evaluate a number of standard macroeconomic events, ranging from a simple recession in a closed economy to a speculative attack in a market for foreign exchange, including more broadly how globalization is likely to change the performance of specific markets.

Outline

The book is divided into four modules. The first module, “**Introduction and Conceptual Framework**,” uses the experiences of two famous economic policy makers (Alan Greenspan and John Maynard Keynes) and two countries that suffered through tremendous economic dislocation in the 1980s and 1990s (Uganda and Mexico) to identify themes of communication, confidence, coordination, and institutional development that play a central role in the remaining cases.

The second module, “**Institutions: The Latin American Experience**,” uses frameworks developed in the introductory cases to address macroeconomic and financial dynamics in Latin America. It emphasizes the view that macroeconomic problems typically have deeply rooted institutional causes. Hence, rather than blaming the macroeconomic instability that has plagued Latin America during the 20th century on poor policies, a more complete understanding requires an explanation of why policies have been so poorly designed and thus exploration of the institutional structure of Latin American countries.

The third module, “**Macroeconomics: The Dynamics of European Union**,” uses the European experience to illustrate how different countries have developed institutions that permit coordination of individual business decisions on good aggregate economic outcomes. It introduces the idea—familiar from the literature on comparative international political economy—that labor market institutions (such as the structure of trade unions and employer associations, the legal framework for wage bargaining, etc.) will have important effects on inflation and employment dynamics. Moreover, it demonstrates how changes in the environment can render previously successful institutional structures outmoded, thereby creating both opportunities and risks for firms and households. A key insight is that alternative institutional structures exist to the Anglo-Saxon model of “free markets” and “weak unions” that can be successful over time and may, in the face of certain types of macroeconomic shock, even dominate the benchmark American framework. Ultimately, the module asks whether scope exists for a “third way” between the market-oriented approach characteristic of contemporary Anglo-Saxon economies and the social market economic model more prevalent in continental Europe.

The final module, “**The Global Economy: Globalization Meets National Institutions**,” discusses how the increasing integration of global capital markets can affect the economic performance of previously successful nations by acting to undermine the internal coherence of the institutional structures on which their economic performance rested. It addresses the question of whether convergence on a single “American-style” form of capitalism is likely in an increasingly integrated world, and what the positive and negative implications of such a convergence would be.