Global Economy Short-Term Checklist

Revised: September 20, 2013

A checklist of indicators and tools for assessing the economic conditions of a country before entering a short-term business relationship.

1. Measures of short-term country performance

- ☐ Macroeconomic conditions: GDP growth; consumption, investment, and saving; employment and unemployment; inflation; short and long-term interest rates; government deficit and debt; real and nominal exchange rates.
- ☐ Business cycle indicators: housing starts, retail sales, new claims for unemployment insurance, stock prices, many others; details vary by country.
- ☐ Comment: All countries experience fluctuations in growth rates. In developed countries, near-term growth is somewhat predictable from a variety of economic indicators. In developing countries, volatility is greater and there is a greater chance of a complete change in long-term growth prospects, up or down.

2. Analytical tools

- ☐ Graphs: plot indicator (or its growth rate); draw lines for mean and mean +/− one standard deviation for comparison.
- ☐ Business-cycle scorecard: a table that summarizes the strengths of a number of business-cycle indicators.
- ☐ Cross-correlation function: graphical tool for identifying leads and lags in economic indicators.
- ☐ Aggregate supply and demand: the benchmark theoretical framework for thinking about short-term movements in GDP growth and inflation.
- ☐ Taylor rule: bond traders' guide to monetary policy; indicates how short-term interest rate is likely to respond to changes in economic growth and inflation; helps to identify "neutral" policy so that you can say whether current policy is unusual.

☐ Government debt dynamics: shows sources of year-to-year changes in the ratio of government debt to GDP. Critical inputs: interest on debt, GDP growth, primary deficit.

☐ Exchange rates: purchasing power parity, interest rate parity. Comment: short-term fluctuations in currency prices are large and mostly inexplicable.

3. Crisis indicators

☐ Government debt and deficits. Common rules of thumb: worry if government deficit is more than 5% of GDP or debt is more than 50% of GDP. Adjust upward for developed countries, downward for developing countries. But note: quantitative benchmarks are less important than the political environment. Default is more closely associated with weak institutions than high levels of debt.

Fine points: worry further if debt is short-term and/or denominated in foreign currency. Short-term debt subjects the government to refinancing risk: markets may demand better terms or refuse to refinance. Foreign-denominated debt subjects government to risk if currency falls in value, increasing the debt in local terms. Watch out for hidden liabilities: pensions, health care, bank bailouts, etc.

☐ Banking/financial system. A financial collapse hurts the economy and may leave the government with a large expense. Not a topic for this course, but analysts track leverage and nonperforming loans.

☐ Currency and capital controls. Does the central bank limit purchases and sales of local currency? Can you move money ("capital") in and out of the country? Under what conditions?

☐ Exchange rate and reserves. Fixed exchange rate regimes sometimes blow up. Rule of thumb: worry if the exchange rate is fixed, or close to it, and the currency is overvalued in PPP terms (Big Macs cost 30% more than in other currencies, real exchange rate has risen more than 30% in last 2-5 years). Worry more if foreign exchange reserves are low or have fallen significantly.

The trilemma. You can only have two of (i) fixed exchange rate, (ii) free international movement of capital, and (iii) independent monetary policy. If you try to have all three, something will give, probably the exchange rate.

☐ Politics and institutions. Especially in emerging markets, it's often more important to follow the politics than the economic numbers. Worry if the political situation is unstable, especially in a country with otherwise weak institutions.

4. Integration

The challenge is to put all these pieces together: to use our tools and economic data to come up with a coherent picture of current and near-term future economic conditions, and how these conditions are likely to affect any business opportunities you are considering. Remember, too, that bad current conditions can be wonderful opportunities if things improve.

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