The Macroeconomic Impact of the Financial Crisis 2008-2009: A Capital Account Analysis of Germany, India and Japan

Report Launch in Delhi, India

10th of February 2011

Presentation of Major Findings

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A Quote....

- "Regaining (*national*) policy space from the stranglehold of (*global*) finance is a basic challenge in many middle-income developing countries"

  - Kozul-Wright and Paul Rayment (2007) in "The Resistible Rise of Market Fundamentalism", p.307

Outline

1. The Research Goals
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3. The Policy Responses
4. Measuring Global Financial Exposure
5. Capital Account Management: A Regular Policy Tool
6. Institutional Embeddedness: A Pre-requisite for Effective Capital Account Management
7. The Dabate about Emerging Economic Systems!
8. Conclusions

1. The Research Goals

- To survey the impact of the crisis on the national economies of Germany, Japan and India
- To review their policy response to the global crisis
- To explain the financial crisis exposure through the capital account channel
- To provide an analytical review of the capital account management experience of Germany, Japan and India

2. Impact of the Global Financial Crisis

- Spread of crisis in advanced economies (Germany and Japan) primarily through the money market channel
- In emerging economies (India), crisis spread initially through the export channel
- A subsequent slump in business confidence transmitted distress through the capital markets everywhere
- Some countries (including Germany) were highly exposed to the systemic risk, whereas others were affected by liquidity shortage (Japan) and sudden withdrawal of short-term capital flows (India)

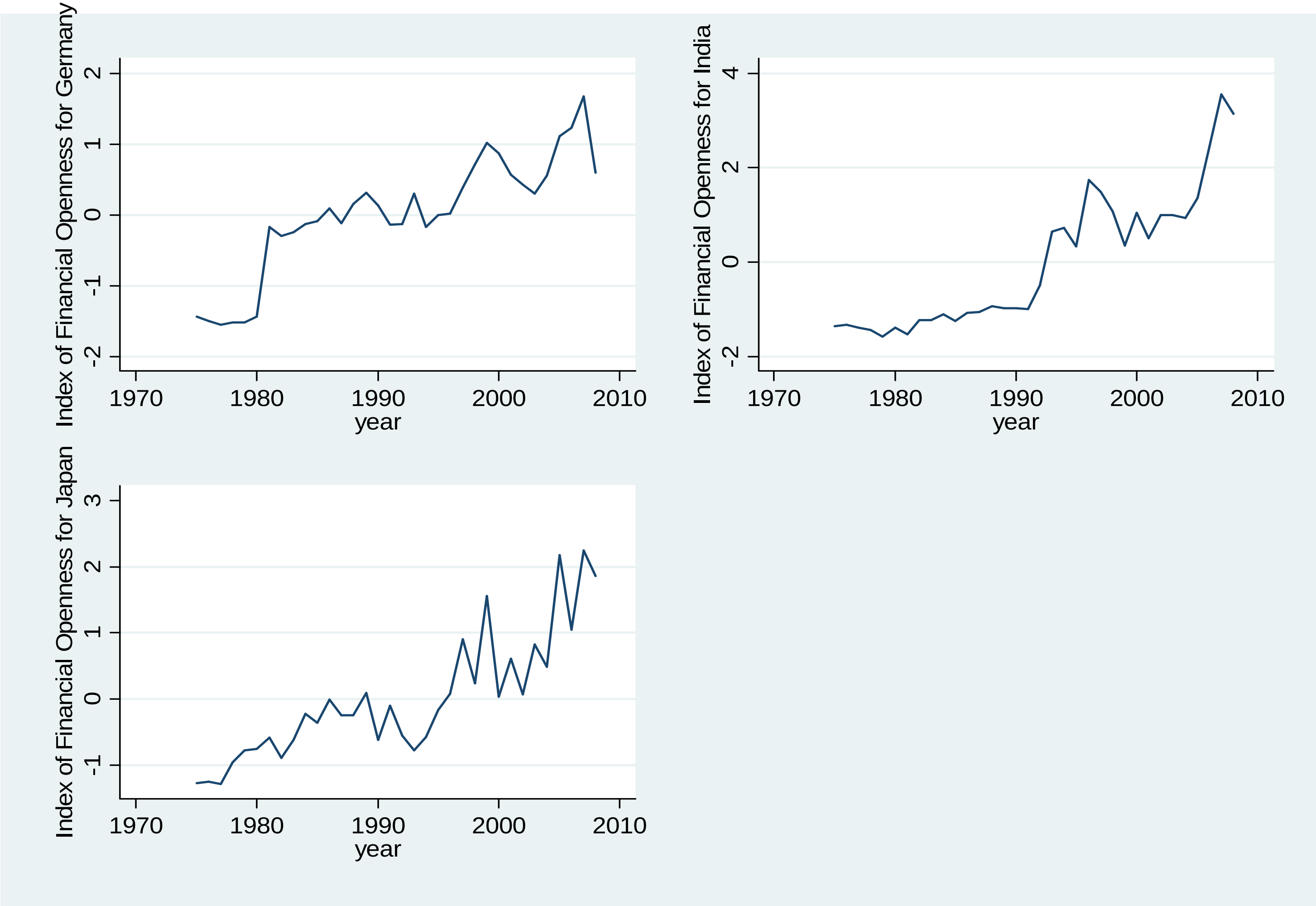
3. Policy Responses

- Monetary policy choices were used by Germany and India to ease liquidity conditions
- Japan had to primarily depend upon its fiscal policy
- Several types of stimulus packages were announced to combat the recessionary tendencies
- Germany had to rescue some of its financial institutions. New legislation were enacted to allow for eventual public takeover of banks

4. Measuring Global Financial Exposure

- Limitations of *de jure* measures and the indices based on these measures
- *De facto* measures, though better, do not capture the extent of intended controls
- Composite Index of Financial Openess:
  - Based on total FDI , total portfolio investment (scaled to GDP), and
  - Two *de jure* measures indicating the relative ease of borrowing abraod for demestic banks/corporates and ease of foreigners investing in the domestic stock markets

Measuring Global Financial Exposure II



5. Capital Account Management: A Regular Policy Tool

- Though Germany and Japan had liberalized their capital accounts in the 1960s and 1970s, they continued active capital account management in the 1980s
- The *de jure* liberalization did not eliminate the responsibility for its management
- Attempts to curb excessive capital inflows using capital controls were successful in maintaining monetary independence in the fixed exchange rate system
- In the 1970's, capital controls and floating exchange rate system had more or less solved the excessive short-term flows
- Capital controls to manage exchange rate were not successful

5. Capital Account Management: A Regular Policy Tool

- The Indian experience of capital account management has been guided by the goals to achieve desired volume and structure of capital flows
- Capital controls gave India's macroeconomic policies an extra degree of freedom
- Capital control insulated the Indian economy from the current global financial crisis
- However, controls on capital outflows have not been as effective as controls of capital inflows

6. Institutional Embeddedness: A Pre-requisite for Effective Capital Account Management

- What is institutional Embeddedness?
  - It refers to the nature of the national institutional system and its role in shaping economic policy and action
  - Four competing and mutually complementary forms of governance define the nature of institutional embeddedness:
    - governance by state control;
    - governance by the market;
    - governance by regulation; and
    - governance by supranational interdependence

6.1 Institutional Embeddedness and Sequencing

- Importance of carefully sequencing capital account liberalization with other policies associated with the larger process of institutional development.
- Kaminsky and Schmukler (2008,p.25) suggest that discussion about sequencing may be irrelevant if institutional changes are:
  - Not undertaken by the governments independently; or
  - Introduced only in response to certain shocks; or
  - Never predate liberalization; or
  - Happen mostly as a result of the existence of deregulated financial markets

6.2 Institutional Embeddedness for Effective Capital Account Management: Comparative Analysis

- Germany has had a preference for liberalization *with* institutionalization. Abdelal, 2007 believes that it appears to be a function of idealogy and not of power
  - The institutional significance and the role given to German Bundesbank until the creation of ECB!
- The problems in the Japanese experience of liberalization appear to be related to weaker institutional embeddedness.
  - the reluctant/delayed liberalization of the domestic financial system and protection of the domestic institutions
- In the Indian context, RBI and SEBI's position offers an interesting example of embeddedness
  - RBI is not only the custodian of the monetary policy but also supervises banks/other financial institutions, and is the primary regulator of the financial markets.
  - SEBI has the mandate of supervising and regulating the capital markets

7. The Debate about Emerging Economic Systems

- The literature on the varieties of capitalism has largely been driven by the experience of industrialized countries (Hall and Soskice 2001)
- Germany and Japan are known as parts of the Co-ordinated Market Economies (CMEs) group
  - Both of them thrived on the support of socially embedded economic insitutions, their long-term commitments and the mutual trust among economic agents
- Growing global influence of India (and also that of China) in indicative of the success of a **hybrid form of capitalism**
  - Various economic institutions in India operate within a liberal market economy environment
  - State involvement in the Indian economic system is undergoing a transformation

8. Conclusions

- The debate on capital controls is not over!!
- Usefulness of capital account management for advanced economies dimished gradually, particularly after the changeover to a floating exchange regime
- At the core of the link between crisis and financial liberalization is the lack of good corporate governance (and the existence of weak government policies and institutions)
- The credibility of any economic model depends on how far it is able to instill confidence in economic institutions and reduce uncertainties in decision making

One more Quote....

- "Research on (*policy*-) and institutional change must consider the evolving relationship between international market expansion and a social order that is still largely national"

  - Max Planck Institute, Germany (2010): "Research Agenda for the Study of Societies"

We thank you for your attention!