



ICRIER, InWEnt &
DIE Conference
Presentation,
Mumbai
Time: 20 Minutes
Slides: 14

Financial Crisis and the Political Economy of International Policy Coordination



Keywords: Financial Crisis; Monetary Policy; Fiscal Policy;
Exit Strategy; International Policy Coordination.

Mumbai; 28 October, 2010; Thursday; 9-00 am to 11-00 pm.



Plan of the Presentation

- Part I: Introduction
- Part II: The “best” policies to deal with financial crisis
- Part III: Major players in the global arena and their incentives
- Part IV: Incentives for cooperation while in crisis
 - Incentives for cooperation in fiscal policy
 - Incentives for cooperation in monetary policy
- Part V: Incentives for cooperation in crisis prevention
- Part VI: Conclusion



Part I: Introduction & Motivation

Financial Crisis in History

"Plus ça change, plus c'est la même chose" - Jean-Baptiste Alphonse Karr.
("The more things change, the more they remain the same!")

OR

One thing that we learn from history is that we do not learn from history!

- ❑ From early examples (e.g., Tulipmania, South Sea Bubble, Mississippi Bubble etc.) to more modern examples (e.g., crises in South-East Asia, Brazil, Russia etc.) , history repeats itself.
- ❑ The same story of human greed, irrational exuberance and Ponzi-type games is manifested in countries after countries and periods after periods.



Is the current financial crisis any different?

- ❑ Geographical spread: Suddenly all economies in the world are susceptible!
- ❑ Crisis has occurred in developed economies that supposedly had sounder regulatory framework. Suddenly, they look more vulnerable.



Part II: The best policies to deal with financial crisis

The Common Policies

- ☐ Tactical Action
 - Commitment of Liquidity (When the crisis is primarily fed by expectations)
 - Supply of Actual Liquidity.
 - ☐ Too-big-to-fail policy
 - ☐ Successful Examples of Tactical Action:
 - The Black Monday of 1987
 - Terrorist Destruction of the World Trade Centre (September 11, 2001)
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- ☐ Strategic Action
 - Temporary deficit financing to come out of depression
 - Depositor protection as part of institutional mechanism



Part III: Major players in the global arena and their incentives

Emergence of Transnational Companies

- Is the traditional North-South type dichotomy relevant in today's world?
- Globalization and emergence of transnational companies
- Increasing stake of transnational corporations in emerging markets and its implications
 - Emergence of WTO
 - Expansion of G7 / G8



Part IV: Incentives for cooperation while in crisis

Incentives for Policy Coordination: Theories

- Focus on incentives
- Specification in terms of interactions between North and South in different external environments.
 - Wilett (1988)
 - Webb (1994)
- What is needed: Game theoretic specifications with three major players – North, South and Transnational corporations.



Incentives for Coordination: Fiscal Policy

- Fiscal Coordination: The Standard Framework
- Determinants of Fiscal Coordination
 - Macroeconomic environment: stock of debt to GDP ratio is tolerable
 - Political environment: election is near
 - Institutional constraints on budget deficit
 - Presence of an influential third party who benefits significantly from coordination and who is in a position to punish non-coordination.



Incentives for Coordination: Monetary Policy

- So far as financial crisis is concerned, every country as well as transnational corporations have a stake in it.
- Implications:
 - The policy coordination game is like a battle of the sexes game.
 - During the last two decades, central banks have become more independent.
 - Due to long and variable lags with which monetary policy affects the real sector, domestic political pressure is less in case of monetary policy.
- Result:
 - Central banks of the world routinely cooperate to mitigate expectational factors and to provide liquidity to their respective economies in times of crises.



International Coordination of Monetary Policy: Beyond the Short-Term

- Beyond this short term maneuvering, the role of monetary policy coordination starts to become dubious.
- Example: Plaza Accord and Louvre Accord and their impacts on reserves of emerging market economies.
- Implication of coordination in more recent times



Part V: Incentives for cooperation in crisis prevention

Procedural Reforms and Politics

- International Coordination
 - Standards and Codes (Example: Basel I and Basel II)
 - Institutional Reforms in IMF, World Bank etc.
- Limitations of procedural reforms
- Acceptability to dominant pressure groups is a necessity for success.
 - Example of Coordination Failure: Tobin Tax (Compared to Loch Ness Monster).
- Importance of local politics in the current context



Blinder Principles

- ❑ For National Economies
 - Don't fix your exchange rate.
 - Borrow less in foreign currency.
 - Don't rush to open capital markets.
 - Follow sound macroeconomic and financial policies.

- ❑ For the "Fire-and-Rescue Squad"
 - Austerity is NOT always the right medicine. (My emphasis)
 - Devote more resources to protecting innocent bystanders.
 - Agree on some procedures for orderly debt settlement.
 - Prevention is better than cure.

- ❑ Comments on some of the principles



Blinder Principles and the History of Economic Reforms

- ❑ The success of gradualism over shock therapy.
- ❑ Gradualism is a safe strategy, if not the best strategy.
- ❑ Implications on gradualism being accepted as a principle:
Blinder principles revisited



Part VI: Conclusion

An Implication of Coase Theorem ...

- If trading in externalities is possible, then, in the absence of transaction cost, bargaining will lead to the most efficient solution irrespective of the initial allocation of resources.
 - Implication: Reduction of transaction cost is necessary ...
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Thank You!