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Exploring Policy Trade-offs in Domestic and Global Economies

The policymakers have been saying lately that rising inflation is not a domestic issue, but has become a global phenomenon. Hence, to tackle it we need global solutions as domestic solutions will not be enough. This issue is not limited to inflation alone but extends to other policy areas as well – fiscal, financial regulation, international monetary system and so on.

In this paper, we will discuss how the global environment has affected the local economies. It reviews how local policies should be responding to the problems whose sources are becoming global and whether global cooperation/coordination is needed. The paper will start discussing the issues of global coordination in economic policy in general and then look at a few fields of economics separately where these issues have come to light.

I. Global Policy Cooperation/Coordination: Great Depression vs. 2007 Crisis

One always falls back to analyzing Great Depression while discussing the 2007 crisis as there are no other parallels. Both the crises were huge and global in their impacts. The history of cooperation is very different in the two recessions. In Great Depression economies did not coordinate and cooperate as the crisis struck (thus deepening the crisis). There was limited historic knowledge on managing crisis, as the crisis struck economies retorted to making domestic policies at the cost of global economies. Economies abruptly left the gold standard and devalued their currencies. They also passed trade measures to protect their domestic industries leading to similar measures across the world. However, post Depression policymakers cooperated (Bretton Woods Agreement) which led to formation of international institutions like IMF and World Bank and formation of GATT which was a precursor to WTO.

The situation was opposite in the 2007 crisis. The lessons from Great Depression were well known to most and Federal Reserve was chaired by Ben Bernanke, a noted Great Depression historian. This led to strong cooperation amidst both central banks and fiscal policymakers and one saw stimulus passed at a global level. Central banks of leading countries even coordinated a policy rate cut on the same day. It was historic by all means as such global coordination of economic policy was never seen.

However, post-crisis policymakers have preferred to diverge and look at domestic interests ahead of global interests (Table 1).

	Fiscal Policy Stance	Monetary Policy	
		Policy Rates	Unconventional Policies
US	Remains Easy	Maintains Ultra- low rates	Continues with QE-II
Europe	Fiscal Austerity Plans Passed across Europe	ECB started to tighten rates from Apr-11	Has maintained liquidity
UK	Fiscal Austerity	BoE maintains low rates	Maintains Asset Purchase program at GBP 200 bn



Emerging Economies	Started to tighten fiscal policies	Started raising rates	Unwound liquidity programs
<i>Source: STCI PD Research</i>			

Jean Pisani-Ferry and Adam S. Posen in a research paper (From Convoy to Parting Ways? Post-crisis Divergence Between European and US Macroeconomic Policies, 2010) note how policies in EU and US converged as the crisis started and have diverged as crisis situation eased. The reasons for the divergence are different stages of recovery in US and EU. US historically had lower tolerance for high unemployment compared to EU and hence US adopts more stimulating policies till an extended period of time compared to EU.

One major reason for the divergence is different stage of recovery in each economy and hence different policies. But still this should not be at the expense of global economies.

II. Framework to Analyze Global and Domestic Policy Trade-Offs

IMF Chief Dominique Strauss-Kahn, MD of IMF in a speech (Macro and Growth Policies in the Wake of the Crisis, Mar-11) says there are three types of situations with respect to domestic and global policies. RBI Governor Dr. D. Subba Rao in a recent speech (Policy Discipline and Spillovers in an Inter-connected Global Economy, May-11) added a fourth situation as well. We can put these four situations in a nice framework that will help analyse the policy situations and trade-offs. :

	Global Good	Global Bad
Domestic Good	1 st Quadrant e.g. Trade Liberalization	2 nd Quadrant e.g. Undervalued currency
Domestic Bad	3 rd Quadrant e.g. Financial regulation in international finance centres	4 th quadrant e.g. Poor financial regulation

- 1st Quadrant: Policies help both domestic and global interests like trade liberalization. In this situation, international cooperation could help support the reformers, as they take on vested interests resisting the changes.
- 2nd Quadrant: Policies which help domestic but worsens global interests like maintaining undervalued exchange rates. This was seen during Great Depression as explained above. Other examples are when countries undertake competitive weakening of financial or environmental regulation to make them more attractive to foreign investors. This may lead other countries to follow and we end up with weaker domestic standards and greater financial or environmental risks making everyone worse off.
- 3rd Quadrant: Policies which makes domestic worse off but global better-off like stiff financial regulation will help the world but worsen prospects of international finance centres. Then the world as a whole would benefit from clean technology in a domestic economy but this might lead latter to suffer short-term costs associated with such structural change.



- 4th Quadrant: RBI Governor Dr. D. Subba Rao added another situation in a recent speech (Policy Discipline and Spillovers in an Inter-connected Global Economy, May 2011) where policies make both domestic and global worse off. The examples here would include poor financial regulation policies which hurt domestic and then international economies via the spillover effects.

Obviously the best option is the first one and we saw many such cooperation efforts post Great Depression. However, post 2007 crisis we are seeing policies either in the second or fourth options. Some have fallen in first option as well. Let us now look at the current policies in the above framework and see what could be done to push the policies in the first option.

III. Monetary Policy

Ideally, the 2007 food and oil crisis should have led to global discussions and reforms to improve the supply-side issues in food and fuel sectors. Also, it should have led to some reality check on emerging economies that they need to make demand adjustments or be prepared to pay higher prices for these items. Historically, price elasticity for these items is very low especially for fuel and it requires large rises in price for people to consumer lower fuel.

However, because of the global crisis nothing much happened. The focus of policies instead shifted dramatically to raising demand. In very quick time the debates had shifted from lowering domestic demand to increasing the same. This led to postponing of working on solutions to a major global problem which have resurfaced now.

The concerns over high inflation have resurfaced. Now whether the food price inflation is because of high demand (of emerging economies) or low supply leads to interesting policy choices:

- **High Demand:** In 2007, the problem was not as complicated as most economies were growing and one could ascribe the inflationary pressures to high demand. Even then central bankers debated extensively on whether they should be looking at headline or core inflation. Barring Federal Reserve, most central banks did raise rates in that period worried over headline inflation leading to higher core inflation as well.

In 2011, complexity rises as growth patterns are highly uneven and uncertain. Developed economies are growing at a slower pace whereas emerging economies have recovered faster from the crisis and are growing at the pre-crisis levels. Headline inflation is again higher than core leading to confusion over which is a better measure of inflation (see STCI PD paper for a review- **Which Measure of Inflation: Headline, Core or Trimmed?** (Apr-11)).

The central banks of developed economies like US and UK are still expected to maintain low interest rates to stimulate their economies. Within developed economies only ECB has raised rates which have been criticized given critical state of peripheral economies of EMU. The emerging economies have also blamed the central banks of developed economies especially Federal Reserve for keeping highly loose monetary policy which has pushed higher inflation.

The monetary policy decisions of developed economies central banks have both negative and positive spillovers on the global economy. For instance, Fed's QE-II policies has led to high global liquidity leading to higher commodity and fuel prices leading to higher global headline inflation. It has also led to high capital flows in EMEs leading to problems in monetary



management. However, overall QE-II has led to better US economy prospects which has led to better global and EME economic prospects.

Tight EME monetary policies also leads to both positive and negative spillovers. Tight monetary policy leads to lower inflation, lower growth and higher capital flows but also leads to lower demand which would eventually lower global inflation as well. The central bankers especially in emerging markets are often quoted saying inflation is not a domestic problem but a global problem and global coordination is needed to fight the inflation menace.

In terms of the quadrant framework, we can put policies of Advanced economies central banks in middle first and second quadrant. The polices of EMEs would fall in the middle of the first and third quadrant.

	Global Good	Global Bad
Domestic Good	Emerging Economies Monetary Policy	Advanced Economies Monetary Policy
Domestic Bad		

- Low Supply:** This is one area in which there is tremendous scope of global coordination and cooperation. FAO has shown how agriculture production and productivity has declined over the years. Economists like James Hamilton (an oil expert) have shown how global oil supplies have not increased despite surge in demand from EMEs. The reduced supplies coupled with rising demand is putting pressure on prices of these natural resources essential for growth.

The problem is going to be even more acute as Asian and African countries house nearly two thirds of the world's poor. As these economies grow, it will lead to more people demanding these stagnant natural resources intensifying price pressures further. The other option is that these economies slow which is clearly not acceptable as these economies have been mired in poverty for decades.

Hence, there is a need to augment the world's natural resources pool considering the long term demand for these resources. There is a need for more scientific innovation to reduce dependence on oil and develop either alternative modes or more efficient systems whose energy intensity is lower. This requires coordination and collaboration worldwide.

So far, the polices are falling in fourth quadrant but better cooperation could lead them to shift to first quadrant. Better supply-side policies will also lead to monetary policies working for both local and global interests. This does not mean supply side alone will lead to better monetary policy outcomes. Central Banks need to be vigilant to demand pressures as well.

	Global Good	Global Bad
Domestic Good	Future Agriculture/ Oil Policies	
Domestic Bad		Current Agriculture/Oil Policies



IV. Financial Sector Regulation

One of the major lessons from the crisis was the need to have a coordinated approach on financial regulation. Ironically, before this crisis there was maximum coordination in this field but it is this field in which the coordination was found highly inadequate. The regulators coordinated via multiple central bank/policymaker forums, Basel standards etc. But still the global scale of the financial system has left many gaps to fill. Some of these are:

- Global scale of financial firms:** FDIC in a recent research report recalls how Lehman failed despite Barclays agreeing to provide equity support. Barclays could not clearance from its UK regulators in due time leading to bankruptcy of Lehman leading to a global meltdown. The crisis pointed how regulators need to be very vigilant to the risks emerging from other international finance firms as the impact could be felt in their economies as well. The Too Big Too Fail (TBTF) problem is not a domestic but a global problem.
- Nature of foreign banks presence:** The crisis showed that foreign banks suffered in East Europe whereas not much impact was seen in Latin and Asian economies. Research showed that in East Europe foreign banks from West Europe followed a subsidiary model which relied on funding from parent bank. Parent banks in turn were highly dependent on wholesale/repo finance which dried up in the crisis leading to problems for their subsidiaries as well. Foreign banks in Latin America followed the branch model which relied on domestic deposits of host countries and hence there was minimum impact. As crisis did not really impact Latin American economies, there was no rush for deposits and foreign banks were safe. This case showed the importance of regulators domestic understanding the funding patterns of foreign banks in both domestic and international shores.
- Capital regulation levels:** Despite Basel norms and much discussions, it was found banks were following very low capital levels in advanced economies. The leverage ratios of banks and investment banks skyrocketed which implied a small decline in assets was enough to fail the whole entity. Basel norms were supposed to standardize these norms worldwide but both regulators and banks paid little attention to these low capital standards. Infact, as the crisis was shaping up, regulators believed their banks were highly capitalized and hence there would be minimal impact of the crisis. This was a belief which was totally shattered.

The above cases point to the critical role to be played by global coordination in financial regulation space. Unlike monetary policy where central banks are divided on whether global coordination is needed, there is much more agreement on the need in financial regulation. Both central banks and financial regulators are working on the new Basel-III norms and proposing changes in the way banks are regulated.

In terms of the quadrant framework, pre-crisis the domestic financial regulation policies of leading advanced economies were clearly in the 4th quadrant. The emerging economies were much more conservative and hence fitted in the first quadrant. The recent attempts are trying to shift the policies to the first quadrant.

	Global Good	Global Bad
Domestic Good	<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: auto;"> Emerging Economies Financial Regulation </div>	
Domestic Bad		<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: auto;"> Advanced Economies Financial Regulation </div>



V. International Monetary System and Capital Flows

This is another area which has come under close scrutiny in the area of policy cooperation. International monetary system (IMS) can be defined as a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between nation states. As the definition states, national economies agreeing to the IMS framework is critical for the global economy and trade to prosper. The international financial system works under this IMS code of conduct.

IMS has been fractured since Bretton Woods broke down in early 1970s. Bretton Woods system was based on fixed exchange rates with currencies pegged against the US Dollar. The system worked fine till early 1970s as persistent trade deficits undermined confidence in the dollar. Since then we have had countries pursuing their own sets of policies amidst some attempts to drive policy consensus which was accepted by some and ignored by others.

Now, we have countries having multiple exchange rate systems like floating (US, UK etc), fixed (EMU economies), floating but managed exchange rates (India) and others managing undervalued exchange rates (China). Given these multiple exchange rates, US Dollar remains the major currency for international transactions though Euro as an alternate currency has picked up over the years especially amidst European economies.

This lack of a proper IMS has led to development of global imbalances where some countries like China are generating high current account surplus via undervalued exchange rates. These surpluses are being flown to deficit economies like US, helping the US households finance their consumption drive. The global imbalances have grown over the years and are seen as one of the major reasons for the current crisis.

In other words, the fractured IMS is a case of second quadrant with economies giving priority to domestic interests ahead of global interests.

	Global Good	Global Bad
Domestic Good	?	← Current IMS
Domestic Bad		

There are lots of conferences and presentations discussing ways to improve IMS, but one does not see the strong will amidst policymakers seen post Great Depression. George Soros' Institute for New Economic Thinking assembled many economists/policymakers at the same Bretton Woods in Apr-11 but again it was just a discussion and nothing like the Bretton Woods event in 1945 where major decisions were taken. Part of the reason could be that 2007 crisis has not been as severe as Great Depression and hence there is limited willingness to reform the current system. Unlike Financial regulation where there is consensus on good financial regulation polices, similar consensus is not there with respect to IMS. Hence, unlike financial regulation we do not really see any efforts so far to move to first quadrant.



VI. Fiscal Policy

Role of Fiscal Policy has gained a new life in this crisis. Pre-crisis it was not considered as an important policy for business cycle management and its role was limited to collecting taxes and spending on public services. However, as the crisis struck and central banks hit zero policy rates, fiscal stimulus was seen as very useful for stimulating demand conditions.

The current state of the crisis has left fiscal policy in an interesting situation. The fiscal stimulus did prevent the second depression, but has led to fiscal crisis. The huge fiscal stimulus and low tax revenues have led to surge in fiscal deficits. In cases of advanced economies the situation is even more adverse as the future fiscal outlook looks as bleak on account of ageing populations and pensions. Hence, both current and future fiscal outlooks look bleak. Some economies like US have not still tightened fiscal policy where as others like Europe and UK have tightened their fiscal policies. Emerging economies have also started to tighten their fiscal belts. Economists are divided on whether the countries should be tightening their belts as countries have still not recovered fully.

High global fiscal deficits are undoubtedly a bad global policy. Again like monetary policy, the policies differ based on domestic situation. However, most policymakers are vigilant to the fiscal risks and are debating/implementing plans to cut the deficits. But given the scale of rise in deficits, we are many years away from the first quadrant.

	Global Good	Global Bad
Domestic Good	?	← Current Fiscal Policies
Domestic Bad		

VII. Conclusion

The above analysis is an attempt to provide a framework to analyse the domestic policies in a global world. The economies are increasingly getting inter-connected and domestic policies have an impact on the global world. This leads to interesting aspects on the trade-off between global and domestic policies. Ideally one should be making policies that benefits both domestic and global economies, but this is difficult given the different economic situations. The divergences have especially appeared after the crisis with many critical areas like International Monetary System needing some serious attention and reform. Similar framework could be applied to understand the issues in other areas like climate change, natural disasters etc.

Coordination and Cooperation between countries has become very important as seen during the crisis. Economic research has not actively looked at this area and has focused on either domestic or global economies and not really on the policy linkages and trade-offs. We clearly need more research and ideas to work on new institutional frameworks which can help deliver positive outcomes on both domestic and global front.



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