International Economic Policy | Lecture 4

1. Debt cancellation ('clean slate')

In ancient civilizations debt cancellation was a policy preventing the financial sector from ruining the whole economy: ancient policy-makers discovered that debt (which can accumulate exponentially) can quickly surpass the economy's ability to pay. Periodic debt cancellation was a standard measure of financial regulation in ancient societies.

- An example of this policy occurred around 1792 BC in Babylonia under King Hammurabi. At the time, barley was the basic foodstuff households consumed. Households runned up debts denominated in barley as liabilities for crop-sharing rents and water fees. These debts, owed to the temple-state public financial system, were forgiven, but not the debt denominated in silver (already 'the money of the world'), incurred by traders as commercial debt.

M Hudson; C Wunsch (2004): *Creating economic order: Accounting in the Ancient Near East*.

2. Inventions and innovations tend to occurs first in the public sector and are later transferred to (appropriated by) the private sector

Detailed public accounts survive from Bronze Age societies (Near Eastern societies), but not for later ones, such as Greece and Rome (Western societies). Economic decentralization progressed and private agents and organizations acquired and exercized more economic control. The knowledge of how to manage economic affairs initially developed by public institutions ('the temple' and 'the palace' created bureaucracy and accounting practices to measure and quantify economic activity and to more efficiently squeeze out economic surplus) was later appropriated by private hands in put in full use to create massive fortunes (in Rome, for instance). Mesopotamian history proves that public planning and distribution is not necessarily destabilizing, ineffective, inefficient or self-defeating.

3. Babylonians did better than us

The global financial liberalization unfolding since the 1980s coincided (in most developed economies) with financial policies stimulating credit expansion but without enough prudential measures. Banks exploited these opportunities for debt creation by engaging in securities trading (trying to manipulate asset prices), downplaying their traditional functions as deposit takers and credit providers. Public support to banks continued with bank bailouts and the real sector of the economy suffered the consequences (more unemployment, firms closing down, families losing their homes). These policies implicitly considered the lack of credit as the problem, when the real problem is excessive debt: governments helped the creditors (banks) instead of the debtors (families, firms). (When debt is built up, it creates the illusion of wealth.) The inverse of the clean slate policy is policy in support of creditors, which treats the symptom (the credit crisis) not the cause (debt overhead). Allowing creditors to pursue debtors makes economic recovery almost impossible: a debt workout should be preferable to a bank bailout.

Dirk J. Bezemer (2009): "This is not a credit crisis –it is a debt crisis," Economic Affairs

4. Hypocrisy or challenge of policy paradigm during the 2008 global financial crisis?

The IMF, and most economists, gave support during the 2008 global financial crisis to policy measures different from those (based on unfettered markets and uncontrolled capitalism) advocated during the 1997 Asian financial crisis: bank rescue plans (bank bailouts), bank nationalizations (government purchases of banks), strong expansionary policies (fiscal stimulus plans), near-zero interest rates, massive quantitative easing programmes (purchases of government bonds and other privately-issued financial assets), huge public deficits (two-digit deficit-to-GDP ratios), discussion of more strict financial regulation, consideration of the elimination of tax havens…

- The policy prescriptions by the most orthodox economists is reduced to close the central banking, dismantle regulations and keep the government budged balanced.
- "When things go really wrong, neoclassical theories are thrown out of the window, being replaced by more pragmatic and realistic theories. With public deficits, governments are hopeful that aggregate demand will be sustained and that corporate profits will recover."

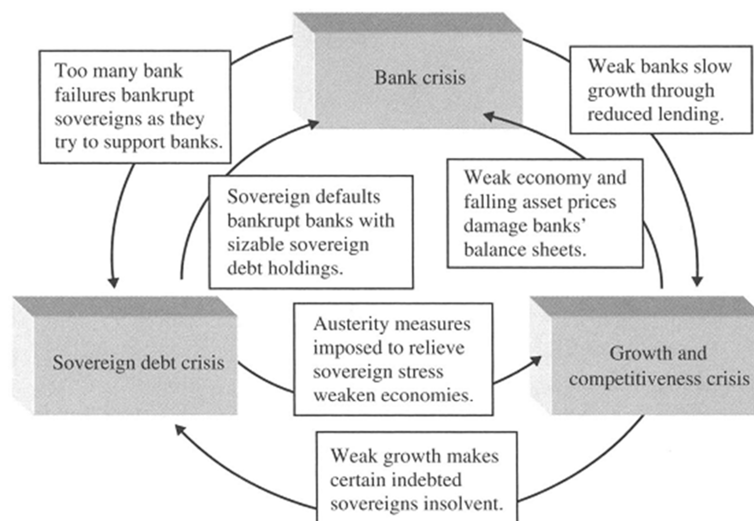
Lavoie, Marc (2011): "The global financial crisis: Methodological reflections from a heterodox perspective," Studies in Political Economy 88(1), 35-57.

Paradox	Description
Paradox of thrift (Keynes)	Higher saving rates lead to reduced output
Paradox of costs (Kalecki)	Higher real wages lead to higher profit rates
Paradox of public deficits (Kalecki)	Government deficits raise private profits
Paradox of debt (Steindl)	Efforts to de-leverage might lead to higher leverage ratios
Paradox of tranquillity (Minsky)	Stability is destabilizing
Paradox of liquidity (Nesvetailova)	New ways to create liquidity end up transforming liquid assets into illiquid ones
Paradox of risk (Wojnilower)	The availability of individual risk cover leads to more risk overall

Crisis-related macroeconomic paradoxes (Lavoie, 2011, p. 46)

5. The euro's three crises

In 2012 the eurozone faced three interdependent crises that challenged the euro's viability. (i) Banks had liquidity problems (banking crisis). (ii) Governments had funding problems, with yields on government bonds sky-rocketing (sovereign debt crisis). (iii) Economic activity slowed down (growth crisis). The euro implied that severe economic problems can no longer be contained within the countries initially experiencing the problems, as now these problems easily cross national borders.



Shambaugh, Jay C. (2012): "The euro's three crises," Brookings Papers on Economic Activity, Spring, 157-211

6. The dollar in the international monetary system

The international monetary system is currently characterized by a centre (developed countries) and periphery that uses as reserves assets from the centre. The viability of this system depends on its participants to obtain from it what they want or need. Jeanne (2012) identifies three necessary conditions for the viability:

- the centre must provide liquid and safe assets;
- in a sufficient amount to meet the international demand; and
- providing a satisfactory return (global stable store of value).

The US has been so far playing a central role in the international monetary system. Will it continue to do so and for long? The 2008 financial crisis questioned the safety and liquidity of US assets. It is not clear whether the US economy will be strong enough to meet a rising demand for international liquidity. And the decisions by the US authorities on the return on the dollar (the US interest rate) are solely based on domestic considerations and do not take into account whether the decisions ensure that the dollar remains an international stable store of value. Despite all this, it does not appear likely that, in the near future, the international monetary system will become more multipolar (with the central role of the dollar shared with other currencies, like the euro or the renminbi, or replaced by the IMF's Special Drawing Rights).

Jeanne, Olivier (2012): "The dollar and its discontents," Journal of International Money and Finance 31, 1976-1989

7. International coordinated policy responses to the Great Recession

The Great Recession has provided an opportunity for international policy coordination to play an important role. An unprecedented degree of policy activism occurred during this episode. Policy coordination involves joint decision on policies; policy cooperation, a series of non-binding decisions in which disagreements and uncertainties between policy-markers are resolved, with the effect that policies adopted simultaneously in the future become more effective for all cooperating countries. Two global coordinated policy responses stand out.

- A macroeconomic stabilization policy: the worldwide combined adoption of expansionary fiscal measures.
- A macroprudential policy: Basel III, a worldwide harmonized financial market regulation.

Jaromir Benes, Michael Kumhof, Douglas Laxton, Dirk Muir, Susanna Mursula (2013): "The benefits of international policy coordination revisited," IMF Working Paper WP/13/262

8. International coordination is episodic (a rare event)

International policy coordination has been most common and successful in the aftermath of crises. In normal circumstances, international coordination has been rare: there are just a few significant cases.

- 1978 Bonn Summit Conference (fiscal policy to lower worldwide unemployment)
- 1985 Plaza Acord (pro-growth agreement; currency intervention to depreciate the dollar)
- 1987 Louvre Accord (fiscal and monetary policies to appreciate the dollar)

1978: Andreotti, Fukuda, Carter, Schmidt, Giscard d'Estaing
http://www.g8.utoronto.ca/summit/1978bonn/communique.html

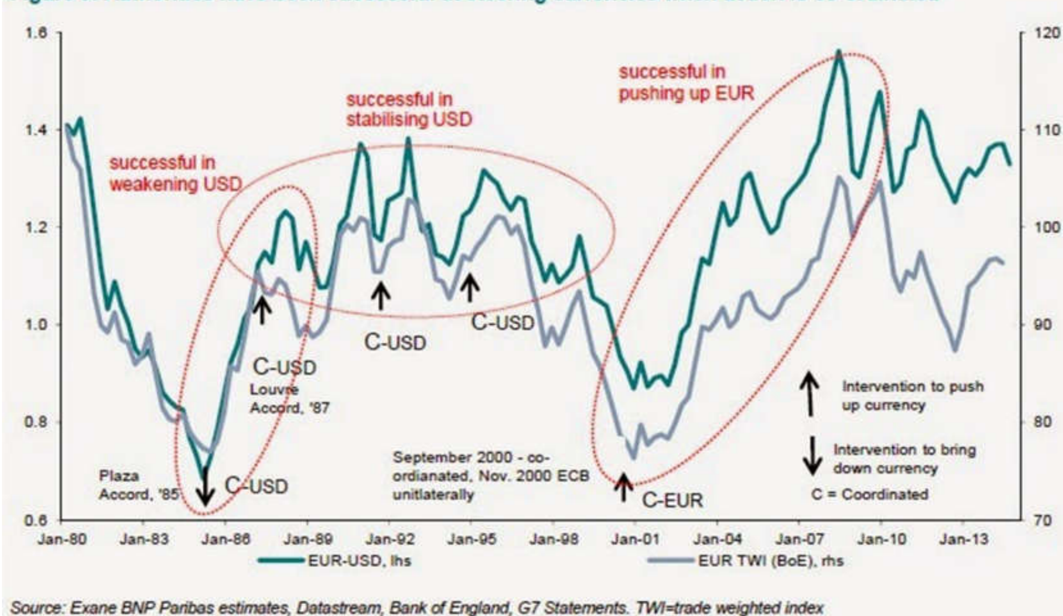
1985: Stoltenberg, Bérégovoy, Baker, Lawson, Takeshita
http://www.g8.utoronto.ca/finance/fm850922.htm

1987
http://www.g8.utoronto.ca/finance/fm870222.htm

9. Firsts in the Plaza Accord (or Plaza Agreement): globalization displaces sovereignty

- "First time central bankers agreed to intervene in the currency markets"
- "First time the world set target rates"
- "First time for globalization of economies"
- "First time each nation agreed to adjust its own economies (…) Germany agreed to tax cuts, the U.K. agreed to reduce its public expenditure and transfer monies to the private sector, while Japan agreed to open its markets to trade, liberalize its internal markets and manage its economy by a true yen exchange rate. All agreed to increase employment."

Brian Twomey: "The Plaza Accord: The world intervenes in currency markets"
https://www.investopedia.com/articles/forex/09/plaza-accord.asp



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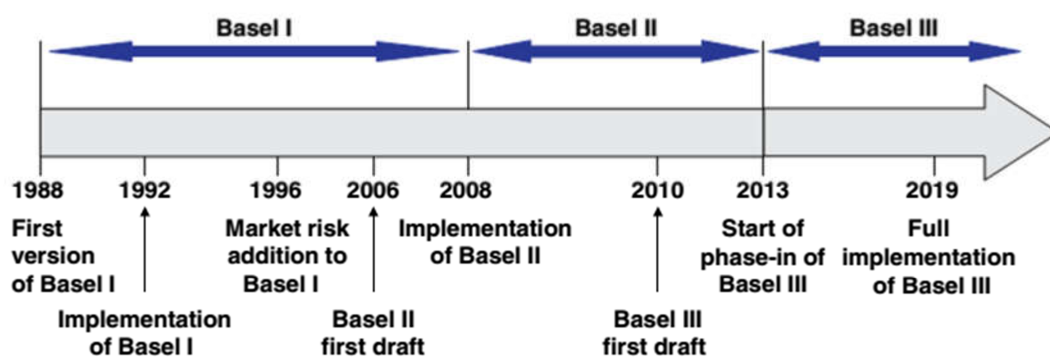
10. The Basel Accords

The Basel Accords are recommendations and advices, issued by the Basel Committee on Banking Supervision, for the national regulators and supervisors of financial institutions. The Basel Accords do not constitute regulations or laws directly applicable to financial institutions. In view of the experience of the 2008 global financial crisis, the aim of Basel III is to enhance the resilience of the banking sector by strengthening global capital and liquidity rules. Though the Basel III rules define a common framework for financial institutions, their specific implementation may differ across countries (for instance, CRD IV is the EU version of Basel III).

- Basel I proposes uniform definitions for capital and minimum capital adequacy levels depending on the riskiness of assets.
- Basel II was intended to promote the safey of the financial system focusing on internationally active banks.
- Basel III introduced changes in the prudential regulatory regime for banks: higher minimum capital ratios, redefinition of capital, alternative ways of calculating risk and new measures regarding leverage, liquidity and funding.

Ramirez, Juan (2017): *Handbook of Basel III capital: Enhancing bank capital in practice*, Wiley, Chichester, UK



The Basel Accords as global standards for bank capital (capital requirements to protect depositors from bank and systemic risks)

11. The 'old' international trade theory

International trade theory has been driven by the need to explain certain stylized facts. The 'old' trade theory based the explanations on the concept of comparative advantage. The sources of comparative advantage that have received more attention have been divergences in labour productivity, typically attributed to technological advances (Ricardian model), and in the endowments of natural resources (the Heckscher-Ohlin model). The 'old' trade theory states that (under ideal conditions of perfect competition and unrestricted trade) a country exports the commodities in whose production the country has a comparative advantage (can be produced at a smaller cost in relation to the cost of the rest of countries). As a result, the theory can explain the trade involving different commodities (inter-industry trade), as one country having a comparative advantage in the production of some commodity prevents other countries from having a comparative advantage in the production of the same commodity. Hence, difference in technology and resource endowments can explain why countries engage in trade.

Malabika Roy; Saikat Sinha Roy; eds. (2016): *International trade and international finance: Explorations of contemporary issues*, Springer India.

12. The 'new' international trade theory

The 'new' trade theory was motivated by the existence of intra-industry trade; that is, most trading activity between (advanced) countries involves the exchange of similar commodities. One explanation of intra-industry trade (the Krugman model) assumes that commodities exist in different varieties, that consumer have a preference for variety and that it is more profitable for firms to produce few varieties of the same commodity (due to increasing returns to scale). As a result, each firm will specialize in the production of a single variety, which could equally be sold at home and abroad.

13. The 'new-new' international trade theory

The 'new-new' trade theory attempts to explain the new stylized facts listed next (Melitz (2003) suggests a model consistent with these facts, where firms act also as regulators of trade flows).

- To sell commodities abroad is the exemption, not the norm. On the one hand, the stylized fact is that, in each industry, the proportion of firms that export is relatively small. On the other, the proportion of production that the exporting firms export is itself relatively small: most output of exporters is sold domestically. Hence, exporting is an uncommon activity.
- Exporting firms are 'superior' to non-exporting firms. Firms engaging in exporting activity are larger firms, more productive and pay higher wages than non-exporting firms.
- Given enough time, trade liberalization in an industry generates a rise in the average productivity of the industry.

Melitz, MJ (2003): "The impact of trade on intra-industry reallocations and aggregate industry productivity," Econometrica 71(6), 1695-1725

14. Unequal distribution of trade gains: impact of trade liberalization on the labour market

There appears to be a general, theoretical consensus that trade liberalization creates gains at the macroeconomic level at the expense of generating losses at the microeconomic level. Specifically, trade liberalization makes low-skilled workers worse off: trade liberalization tends to destroy jobs requiring low or no particular skill and also tends to reduce the wages of these occupations (and, thus, increase income inequality). The unequal distribution of trade gains provides a reason for the adoption of public policies that compensate the groups harmed by trade without losing the trade gains. There are two main policy instruments to redistribute the gains.

- Use wage subsidies for low-skilled workers to offset or attenuate the wage decrease. This policy tool is rarely used.
- Use unemployment benefits to compensate the income that the unemployed no longer obtain from a job they no longer have. The theoretical claim is that this measure raises the average wage in the economy, which reduces the aggregate demand for labour and, as a result, aggregate production; that is, trade gains are partially lost. The funding of unemployment benefits is also a relevant issue. Are they financed by means of: (i) a wage tax paid by workers; (ii) a payroll tax paid by firms; (iii) a profit tax paid by the exporting firms?

Marco de Pinto (2013): *International trade and unemployment: On the redistribution of trade gains when firms matter*, Physica-Verlag, Heidelberg, Germany.

Giancarlo Gandolfo (2014): *International Trade Theory and Policy*, Springer, Heidelberg, Germany, chapters 16 and 17.

15. Ideological support for the current global economic structures and rules

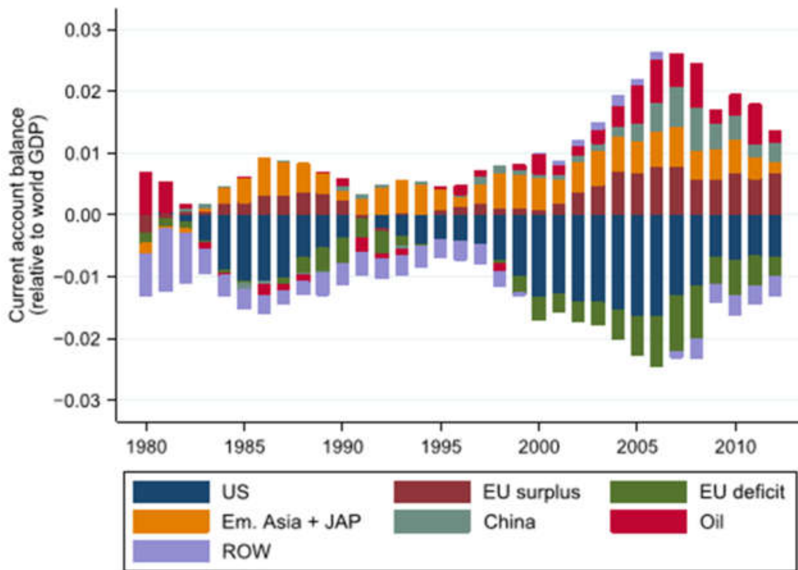
Two doctrines provide ideological support for the current global economic structures and rules: free markets (governments should not establish obstacles to domestic private economic activity) and free trade (governments should not establish obstacles to international private economic activity involving the circulation of goods). The doctrines endorse the presumption that there is a self-adjusting free trade equilibrium which also happens to maximize social welfare. Specifically, international trade is supposed to be manageable through exchange-rate adjustments, that occur spontaneously or are administered by countries individually and independently. Heterodox economists contend that these doctrines misinform global economic policy and contribute to perpetuate global imbalances that threaten global economic stability.

- Can 'markets' replace, at the international level and in a sufficiently satisfactory way, global governance and institutions for collective action?
- Can national democracy be extended at the global level and create a global democracy?
- Does the world need a global Marshall Plan to help developing countries to develop and reduce international inequality?

16. Stylized facts of current global trade and finance

- In the period 1985-2012, foreign direct investment (FDI) become more volatile and grew faster than exports (in the period 1975-1985, trade grew faster).
- Persistent global imbalances appear to contradict the free trade doctrine: in the post 1985 era, external deficits by (mostly) developed countries are matched by external surpluses by (mostly) developing countries. The US has accounted for a large share of global external deficits, whereas China has accounted for a large share of global external surpluses.
- The above facts have coincided with an extraordinary growth of transnational corporations. Intra-firm trade of transnational corporation seems to represent one third of global trade.
- Financial globalization dwarfs trade (and FDI) globalization. World GDP itself is many times smaller than the value of non-FDI financial capital flows, most of which is speculative capital.
- For certain internationally traded commodities, it is no longer true that developed countries employ the newest production technologies, plants or equipment. In some industries, developing countries enjoy a double advantage over developed countries: lower wages and more productive technologies.

Ron Baiman (2017): *The global free trade error: The infeasibility of Ricardo's comparative advantage theory*, Routledge, London and New York.



Andreas Steiner (2016): *Global imbalances, financial crises, and central bank policies*, Academic Press, London, pp. 6, 8.

17. Rise and fall of great powers

The rise and fall of great powers appears to be a stylized fact of international relations. It is a process in which the status quo represented by the dominance of some power is challenged by the emergence of a new power. Is it now the turn for the US to fall and for China to rise? Will be system become bipolar? Basic explanations for the fall are: (i) internal instability; (ii) external over-extension.

The basic explanation for the rise is emulation: the states lagging behind the leading powers learn from them how to catch up. In the process of developing and accumulating power, the lead states that first go through this process may attempt several strategies of which some may prove unsuccessful. The less developed or weaker states do not have to replicate failures, since they may just adopt the successful strategies. The laggards do not need to go through all the stages that the leaders initially followed and that allows the laggards to catch up faster and at smaller cost than the vanguard states.

John Glenn (2016): *China's challenge to US supremacy: Economic superpower versus rising star*

18. A paradox of dominance?

If the global contest for dominance is a zero-sum game, then the resources used by the rising powers are no longer available to the lead states to maintain or expand their dominance. In fact, the economic system created by the dominant powers is used by the challengers to rise: when the profit opportunities become scarce in the lead economies, it becomes an attractive option to invest abroad and that helps less developed economies to develop and close the gap with the richer economies. As it is cheaper to produce in poorer economies, these economies could develop easier and faster by selling their production in the leading economies. Hence, the initial leadership of some economies is accompanied by convergence of the rest of economies.

- "The paradox of power for the USA is therefore that the very economic system that has propelled it on to the world stage also contains within it the potential seeds of its own destruction." Glenn (2016, p. 2)