Global response to the financial crisis
Collective action and financial crisis

William
Okay so we have a set of problems to look at, we have got a boom and bust cycle in the financial sector leading to one of several financial crises that we have seen over the years but perhaps one of the worst ones we have seen in many decades, a set of responses among governments and central banks in trying to stave off a complete collapse and deep worldwide recession and an ongoing relationship, a kind of shifting context for this of relations between regulatory authorities and the private sector financial institutions. What I would like us to do now then is to take these different aspects of this issue and explore how and in what ways they might be analysed using some of the tools developed in the course so far, in particular to ask in what different ways the crisis might be seen as a collective action problem. Hedley if we look at the causes of crisis, can we say this arises from collective action problem?

Hedley
Yes in some ways, I mean as Chapter 13 in Making the International explains, some choices can't be made by an individual or by an individual government and indeed some choices perhaps shouldn't be made by an individual or an individual government and really in the lead up to this crisis choices were being made by banks, by financial institutions which appeared to be in their best interests at the time, but the cumulative and collective effect of which was certainly not in the end in anyone's interests. So this – in that sense is very much a – a collective action problem, it's a problem where collective action is needed and it can be very difficult to see how to – to put that into practice. Once the crisis has arisen there is of course a collective action problem of - of trying to put things right, for example take bank lending which has almost come to a halt, banks are not going to be willing to lend unless they think the other banks in the system are going to be willing to lend as well, they don't want the – the suckers pay off of lending and finding the loans that they make are being distributed among – other institutions which are not themselves lending. The banks very much depend on receiving money from loans made by other banks and you know the whole banking system is extremely interdependent, so an individual bank is going to be unwilling to be the first to lend because that might lead it to a sucker's payoff.

William
But you would also argue there is a collective action problem among governments?

Hedley
Certainly and er there is some recognition of that in fact by – by governments themselves and if we consider the fairly recent G20 summit in April 2009 looking at the communiqué that was issued at the end of that, there was a good deal of er recognition and certainly a good deal of hand waving towards the idea that there were collective action problems that needed very much cooperative solutions. The second clause in the communiqué – a global crisis requires a global solution, and later on we will conduct all our economic policies cooperatively and responsibly with regard to the impact on other countries and will refrain from competitive devaluation of our currencies. So there is very much a sense that countries are at least paying lip service to the idea that collective action is going to be needed to solve financial and economic problems.

William
Simon a Prisoners' Dilemma amongst states facing us?

Simon
– yes I think so to some extent and I think its also interesting to ask what forms of cooperation are we talking about here because I think we probably need to distinguish as it were forms of cooperation that respond to the crisis by doing no more damage which is fairly limited really,

its states recognizing that there is an underlying degree of cooperation around for example, currency stability, around openness to international trade and investment, around some minimal sense of not competing against one another to deregulate further financial markets and I think there is a recognition, we will see how well honoured – honoured it is in practice that states are in a collective action problem that they could make things considerably worse unless they act carefully. And in one sense you could model that as a Prisoners' Dilemma. There is another sense then which you can ask whether states are acting cooperatively in a stronger sense to reconstruct financial regulation or to rebalance demand globally for example through coordinated policies demand stimulus and there I think its much less obvious that we are seeing any significant cooperation. So I think the position there is states again are in a collective action problem, but they are actually finding it very difficult to come out with um collective global solutions so that in a sense collective action problems are really of two kinds, there is kind of not making things worse and I think we have seen quite a lot of effort to not make things worse, there is then – can we actually then act coherently, collectively to kind of get out of it – construct something new and there I think the picture is much less certain that much has happened.

William
And do you think it would be reasonable to characterize that looking forward that kind of medium to longer term discussions around future regulation to characterize that as a prisoner's dilemma; can you put it in those sort of terms?

Simon
I think you probably can, I think you need to be careful about that in that to characterize it as a prisoner's dilemma we would need a fairly clear sense of the particular interdependencies in strategies open to – to the major players that we are talking about in this case, lets say the states of the G20. We would need some sense of the way in which they rank their pay offs and so to characterize it strictly as a prisoner's dilemma, we would need to kind of have the answers to those and know whether really kind of what's best for some is worse for others and I am not entirely sure that we do know enough about that, but I certainly think there are elements of it that have prisoner's dilemma character, yes.

William
Like the fear of getting the sucker's pay off to use the term Hedley used earlier?

Simon
Or the fear of – of being the state that regulates its financial institutions and others don't and so the financial institutions leave and go somewhere else where….

William
Through a lot of competitiveness?

Simon
Yes – yeah.

William
Yeah – okay. Grahame does that sound like a – a – an accurate representation?

Grahame
Oh very much so I think, there has been a minimal amount of – of limited cooperation I think as Simon sort of outlined, but I think its limited. I mean to be honest most of the responses to the crisis have been just that responses, not by a collective kind of sense of – of developing policies, but um you know at the national level, each of the particular countries that were badly affected, responded through trying to er reorganize their own financial systems and it was very much at the level I think of particular countries trying out particular policies that suited the particular circumstances of their own financial system, certainly in the first – instance. I mean the US went for this massive fiscal stimulus as Simon has alluded to and tried to bale out of its banks, but it didn't, but other countries I don't think have gone for such a significant fiscal stimulus and that went down very well in the US amongst the parties, particularly the manufacturers because they saw this kind of maintaining aggregate demand

and bolstering their own position. But in the UK for instance we – we have not gone for a fiscal stimulus I don't think, there have been certain fiscal measures and – giving sort of advantages on VAT and so on, but broadly speaking its been to try and bale out the banks. Other countries have gone done different routes, I mean some countries in Europe have had very conservative lending policies by their banks and have regulated this – Spain was a case in point where a lot of the assets – the toxic assets that Hedley was speaking about, were not allowed to be formally entered into the system, they didn't have this kind of hangover of the problems that Hedley was kind of mentioning about. So their response, they hadn't had a problem about baling out their banks because they didn't have all these – the toxic assets in their system. So I think there has been a minimal amount of cooperation er but broadly speaking the bulk of the response has been by particular countries to their particular sets of problems.

William
And you would situate that kind of limited cooperation as well as individual national efforts within that broader pattern of a cycle between regulation and financial crisis that you alluded to earlier?

Grahame
Yeah I think we could you know just kind of go over that a little bit and just – just sort of try and draw out some implications of it because I think its very characteristic this cyclical moves that have been going on. I mean lets start with financial innovation because that was the – the problem that, that has been raised by um Hedley and er and er Simon. Well when financial innovation happens and– the private sector is incredibly innovative in the financial system, so its always looking for new opportunities to make money, that's basically it and there are warnings then raised about those because they look as though they could kind of disrupt the regulatory kind of framework. Well those warnings and risks I think er – are never really properly heeded at the time because these innovations are getting going and people are enthusiastic about them…

William
And people are making money so ………..

Grahame
Making money so there is massive incentive just to keep – keep going along the same lines. The problems with innovations come a little bit later when er kind of crisis hits the system, I think largely because of the enthusiasm in – trying to deploy these new innovative financial instruments and so this leads to er – when the crisis hits er – er a sort of fire fighting response, lets try and put the fire out, try to gain control of the crisis, prevent it spreading and so on and then we go into a prudential phase of more prudential responses by the authorities beginning to put in place a discussion about the measures needed to prevent another crisis of this type. That's where we get into the obvious collective action problems that Simon was just kind of mentioning before then, to get a political agreement about the responses to this. Usually we come up with some consensus, some consensus is reached, however, often it's a very limited consensus, a minimal set of regulatory responses because getting agreement is difficult and meanwhile of course the system has moved on and it looks like when the policy responses are implemented it looks like they are addressing yesterday's issues, the horse has bolted from the door again with a new set of financial innovation. So we get another round of this sort of cycle developing I think and I think that's been a kind of enduring pattern really in these matters. And so I think the issue, that if this is the case, um you know what does – what does one say about the way in which the financial system kind of works under this – what is the problem of regulation, should we actually sort of go for another top down set of regulatory moves by either the – the IMF, the Bank of International Settlements or the G10 or should we think of something – some other way of addressing the – the – the issue of er a regulatory response?

William
Okay we will come back to that again in a bit but if I understand you rightly, what you are saying is not only do we have the problems of collective action about regulation that Simon explained, but that sits within such a shifting context that even if the minimal kind of

cooperation that you have talked about has been achieved, that may be speaking to yesterday’s problem.