

UNCONVENTIONALLY YOURS

Bailout Economics

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Post the Second World War, the economies of most European countries were shattered. Taking advantage of this situation, the Soviet Union of Russia began influencing them both ideologically and politically to accept communism as an economic system. To contain this spread, the US which viewed communism as the biggest threat to free world came up with the Marshall Plan. In accordance with this plan, it started doling out funds to the weak European countries to help them out of their precarious economic conditions and away from the grasp of Russia. Behind this apparent altruism lay the objective of obstructing the growing power and strength of Russia. During the four years that the plan was in operation, the US spent more than \$15 billion helping countries like Greece and Turkey among others.

However today, in the 21st century, the greatest threat a country might face is the threat of terrorism. It has almost become imperative for every country to allocate a fraction of its budget for funds required to counter this menace. While countries like the US, England and even India can afford to spend large amounts to combat terrorism, smaller countries like Pakistan, Bangladesh and others just cannot do so. It is in economically weak countries like these that the threat of terrorism is even higher.

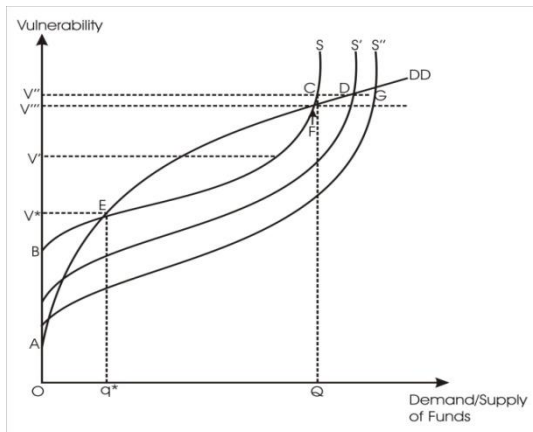
Since 9/11, American policymakers have significantly increased military as well as non-military assistance to Pakistan in an attempt to address their strategic concerns as well as to support their democracy. U.S. annual bilateral aid in totality went up from \$5.3 million in 2000 to \$798 million in 2002 to more than \$4.4 billion in 2010. More than two-thirds (68 percent) of the \$20.73 billion worth appropriated assistance over the past eight fiscal years has gone to security-related aid.

The above-cited examples clearly point to the fact that there exists a symbiotic relationship between a superior economy (in this case US) and the inferior economies. While the inferior economies need considerable aid for reviving themselves from a possible breakdown, the superior economy acts as their saviour and comes to their rescue, which is a means to address their strategic interests.

Now the questions that strike our mind at this instance are- 1) How much aid will the supreme country provide? 2) Will the inferior economy be able to improve its situation?

If not, then what happens to that economy? To answer these questions from an economic perspective a simple model is constructed to capture the behaviour of both economies.

It is assumed that the economic conditions in the superior country are more or less stable, instability in the inferior country has a considerable impact on the superior country and that the funds are efficiently used by the inferior economy for the assigned purpose. Consider the following diagram: -



Let X be the superior country and Y be the inferior country. On the vertical axis we plot the vulnerability of Y. Vulnerability implies the instability or disturbance caused by a crisis situation in the inferior economy. It is measured by the loss in GDP of that country due to such disturbance. On the horizontal axis we plot the demand of funds by Y and the supply of funds by X.

Up to point A, Y can handle any disturbance on its own beyond which it will have to rely on external aid. The demand for funds is positively dependent on the level of vulnerability of Y. Moreover, as vulnerability rises, the demand for external aid rises at an increasing rate as can be seen in the above diagram where the inverse demand function plotted is thus concave.

Now X, because it is a powerful country, would not be affected much by an initial increase in vulnerability of Y. But after a critical level B, it will be induced to tackle the problem and hence the supply of funds

is dependent on the level of vulnerability of Y. Also, as vulnerability rises, supply initially rises at an increasing rate (X will try to urgently fix the crisis), and after a point it starts rising at a decreasing rate, till it becomes vertical or inelastic at point Q (the exogenous upper limit to the aid given by X). Again, by plotting the inverse supply function; the supply curve will first be concave, then convex and finally vertical.

Equilibrium, in this model, would imply equality between the demand and supply of funds such that vulnerability remains stable i.e. the situation does not worsen even if it does not improve. We have two equilibrium points E and F. Note that E is a stable equilibrium because any divergence from E will lead to a movement back towards E. For instance, at any vulnerability level slightly greater than E, the external assistance to mitigate the instability is greater than what is demanded by Y. Hence, with time, Y will recover and its vulnerability would come down. On the other hand, by the same logic, F is an unstable equilibrium. E is also a 'good' equilibrium because with a relatively lower aid (q^*), X has succeeded in stabilizing Y with vulnerability at a lower level (V^*).

Starting from V^* , if there is a shock in Y (a sudden crisis), then vulnerability abruptly rises to a level, say V' . Since at this higher level, the supply of funds exceeds the demand, therefore, over time, solely X's aid will bail Y out of the crisis. But, if it so happens that a massive crisis hits Y then vulnerability will suddenly shoot up to a very high level, say V'' . At this level, Y is demanding more funds to deal with the crisis than the maximum that X can provide, i.e. point Q. Due to the paucity of funds, the situation aggravates further as vulnerability keeps on increasing. Thus, unless X increases the exogenously determined maximum aid, Q, the future of Y is at stake.

It is at this critical juncture that the role of international bodies like UN, IMF and World Bank is appreciated. These organizations can be instrumental in coming “to the rescue” of Y by providing a grant equal to the differential, CD, between the demand and supply of funds at V”. As a consequence, the combined supply curve of external aid (that provided by X plus that provided by the IMF or any other international body) shifts rightwards by CD (new supply curve is S’) and vulnerability will be stabilized at V”. Thus, an imminent danger of the collapse of Y will be mitigated.

Moreover, if these world financial organizations grant an aid, which is slightly greater than CD, say CG, then the combined supply curve of external aid shifts further towards the right (say S”). With the new supply curve (S”) and the existing demand curve (DD), at V” the supply of external aid now exceeds the demand resulting in a fall in vulnerability over time. Thus, in the long run, Y’s situation will significantly improve.

At this point what needs to be answered is that ‘for how long should the IMF continue providing aid to Y?’ The answer would be that once vulnerability falls below V” (the level corresponding to the earlier unstable equilibrium, F), the IMF can start phasing out its aid. This is because once the level of vulnerability is pushed below the unstable equilibrium level; it will automatically come down to the good equilibrium E. In this manner, international organizations play a crucial role in “bailing-out” inferior economies from crises.

The above model, with certain modifications with regard to the definition of vulnerability, can also be applied to the problem of “credit crunch” in commercial banks. Banks make profits by lending at a higher rate of interest than that paid to the depositors.

Ideally, banks would like to “borrow short-term” at a low rate of interest and “lend long-term” at a higher rate of interest. However, banks have to be able to meet their customers’ demands for cash at any point of time or else there would be what is called a ‘financial panic’. The liquidity ratio is the proportion of a bank’s assets held in liquid form (cash, balances at the central bank, short-term loans and government bonds with a year to maturity). Banks therefore have to balance their desire for profitability (requiring a low liquidity ratio) with the need to avoid a financial panic (requiring a high liquidity ratio).

In this context an example of Northern Rock, which was UK’s fifth largest mortgage lender, can be cited. It became a prey to the “credit crunch” as it had grown by raising increasing amounts of finance from the short-term money market and lending it for long-term mortgages. In September 2007, Northern Rock obtained emergency financial support from the Bank of England. Thus, it became the first bank in over 150 years to suffer a bank run and was ultimately nationalized in February 2008. Hence, in this regard the role of the central bank of a country as the “lender of the last resort” is akin to the role played by IMF in the context of the earlier model.

The inferior countries necessarily need to ensure that there are no lapses on their part as far as the interests of the superior economies are concerned. The US deferred nearly by \$800 million in counter terrorism funding to Pakistan in July 2011, which was followed by the US raid on Osama bin Laden’s hideout in Abbottabad. However, this is not an isolated incident, arrest of a CIA contractor in Lahore and assassination of a Pakistani journalist (allegedly involving the ISI) further fuelled tension in an already sour relationship. The United States alleges that Pakistan is unable or rather unwilling

to take decisive actions against militant groups attacking its troops in and around Afghanistan. Thus, withholding aid was the only logical step available to them.

The over simplifying assumption of the efficient utilization of funds by the crises ridden economy was the driving force of the above model. Unfortunately, its validity seems to be highly questionable in reality. As they say, 'Beggars can't be choosers'. Hence, it is in the interest of the inferior country to ensure that there are hardly any lapses and certainly, no mismanagement of funds.

The Economics of Love

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During the Valentine's Day week, everything is packaged and painted in the colours of love- from discounts on diamonds to couple passes in clubs. Love, therefore does play a role in encouraging consumption and driving the economy, but is there any economic principle that could drive love?

The real subject of economics isn't supply and demand, but people, and to love liberty is to love people and all that is best in them. And it is something that can only be done when we are free to choose. As our fine professors of economics tell us, economics is the study of the allocation of scarce goods and services. What could be scarcer than true love? It is rare, hard to come by and often fragile. At heart, the study of economics is all about maximising utility or "happiness". It is based around the premise

that left to their own devices, individuals will come together to make mutually beneficial trades.

The market of love

It was an American economist, Gary Becker, who first began extending these principles from markets for goods and services to the market for potential partners. He argued that the market for love and marriage was like any other, with individuals coming together to make mutually beneficial trades and to sign a contract ensuring future beneficial transactions. And because individuals compete for mates, a truly competitive market for marriage partners exists. Assuming there are benefits from marriage - a stable relationship in which to care for children for example - there are risks from leaving marriage too. As more people couple-up, the pool of potential partners diminishes. But perhaps, grandma is right- "if you don't find "him" when you are young enough, chances are, you won't find him". Hence, don't shop around for a mate forever as there will only be a diminishing pool to choose from. Go with someone with the "highest weighted average" of the qualities you are looking for...!

Now that it is decided to get down with this business, given below are the costs involved:

Transaction costs involved in searching for a partner - all those flowers, phone calls, gifts, dinner dates etc.

Opportunity costs - All the fun and hobbies forgone because of being in a relationship.

Sunk costs - All the investments on the person which are lost if it does not work out, in other words, the 'break-up' costs.

If the relationship gets serious, then