

Introduction: the crisis of economies and economics

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Securing the orderly functioning of the international monetary and financial system continues to be the main priority for economic policy. Accordingly, it is the main topic of the articles collected in the present issue of our *Review* as well.

Masera (2011) opens this issue with an essay on the moral hazard issue in the banking sector. While usually associated with the too-big-to-fail problem, it seems necessary to emphasize that moral hazard also concerns the small but highly interconnected financial institutions, which similarly to the big ones may enjoy an implicit bail-out guarantee in so far as their interconnection (however measured) may pose similar threats to macro-stability.

The subsequent paper by Connell (2011) reconstructs some formal and informal discussions within the Bellagio Group. Besides the historical interest in the cultural and political debate that led to the adoption of a flexible exchange rates regime, the paper is interesting both for the example lent by Fritz Machlup of how to create a consensus around shared policy and institutional reforms, and for its review of the arguments on exchange rate solutions to balance of payments problems.

The paper by Roncaglia (2011) closes the present issue with an update to a speech he gave at the workshop on “The crisis of macroeconomics” (*La crisi della macroeconomia*) held in Rome at the Accademia Nazionale dei Lincei on November 30th 2010. The other speeches at the workshop have already been published in *Moneta e Credito*, the sister journal to the present one, in the March and June 2011 issues (Quadrio Curzio, 2011; Bosi and D’Adda, 2011; Cozzi, 2011; Kregel, 2011; Pedone, 2011).

Following the March issue of our journal, the fast sequence of several new facts confirms that the ongoing crisis has opened a period of

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high uncertainty. Along Keynesian lines, it is easy to see how uncertainty may well be one of the main channels through which the financial crisis and the related monetary turbulence are affecting economic activity. Unfortunately, particularly in Europe wrong policy choices may be a relevant second channel. As it turns out, austerity programs are weighing in a further burden on the real economy in Europe, casting gloom expectations on a prompt reduction of massive unemployment and underemployment, while short-sighted and highly partisan political tactics cast a long shadow over the US economy (Kregel, 2011). The length of this situation may even pose a threat to the faster growing developing countries, as worries are growing on the sustainability of their debts (e.g. China's local governments debt) and/or the stability of their financial systems.

At the international level, further uncertainty reigns concerning the institutional and political regime of the post-crisis global economy. The post-Bretton Woods system, whose ideological emergence is partly described in the article by Connell in this issue, seems growingly inadequate to provide financial stability and full employment. And yet, agreed upon reforms are not visible on the horizon.

In the field of financial market regulation, arguably the most pressing issue at the moment, some countries are proceeding in relative autonomy. Thus, after several papers on prudential regulation (see for example Masera, 2010; or Tonveronachi, 2011), the journal features in this issue a paper by Masera, member of the High Level Group on Financial Supervision in the EU (the de Larosière Group) on the issue of moral hazard. Moral hazard emerges as a prime "explanation" of the financial crisis by mainstream economists, in particular with respect to the subprime mortgages market. Possibly also for this reason, the issue is given considerably less attention by heterodox economists, who on the contrary highlight as more fundamental causes of the crisis such issues as the deregulation of banking and financial markets, the surge of income inequality, the shift of income shares from wages to profits, and balance of payments imbalances. Yet, moral hazard plays a key role in the recent developments of the crisis, e.g. with respect to the apparent dominance of financial speculation over democratic policymaking. Indeed, while in

several countries public finances have been used to rescue financial institutions (Fratianni and Marchionne, 2010) and unconventional monetary policies aim at making them overcome liquidity (sometimes possibly solvability) issues by increasing profitability, these institutions were all the more quick in returning to speculative activity. In 2009 and 2010, for example, net trading income amounted to 0.18% and 0.17% respectively of the total assets of European financial institutions (weighted average) as opposed to losses as (relatively) small as -0.14% in 2008 (ECB, 2011, p. S30). These figures suggest that the very institutions that are targeted by monetary and fiscal relief measures may be taking on new risks possibly even including speculating against European sovereign debt. It certainly seems evident that moral hazard is part of this story.

Another institutional issue requiring prompt reform at the international level is the mechanism of addressing balance of payments problems and the extent to which exchange rate flexibility is an adequate and sufficient equilibrating mechanism. As mentioned, this issue is discussed from a historic point of view in the paper by Connell (2011). Connell highlights in particular the role played by Machlup and from a contemporary perspective it may exemplify the role that intellectuals can play in inspiring and consulting policy makers. The present days may carry the right momentum for a similar endeavor on the side of heterodox economists in so far as shifting economic and political power is taking place at the global level.

Thus, along “German” lines the European Central Bank (ECB) seems to back a European development strategy based on making the euro a (the?) lead reserve currency, for example aiming at a structurally lower inflation rate than the Federal Reserve, or by consistently keeping the policy interest rates higher than in the USA. Yet, even abstracting from the role of the so-called emergent countries (for example with the Chinese proposal for an international basket reserve currency) and despite possibly even higher uncertainty concerning the US dollar, the lack of coordination in European policy making prevents the euro from firmly establishing itself.

It is worth focussing here on Europe to show the impact of mainstream economic ideology over policy making and thus over the

economy. Before and partly independently of the crisis, several “peripheral” European Monetary Union (EMU) countries were unprepared and unable to adapt to the mentioned unusual monetary and exchange rate policy regime, and had to face both higher constraints to the support of domestic demand and lower external demand (due to real exchange rate appreciation). Thus, a process of macroeconomic divergence between EMU countries had already started in the 1990s, before the launch of the euro itself, when it was decided that policy coordination across EMU Member States was to mean convergence of all Member States towards a one-size-fits-all (German) macroeconomic policy model.

Since the crisis, the lack of coordination among European policy-making authorities (European Commission, European Council, ECB) and between them and the Member States soared. Portugal has finally applied for European Financial Stability Facility (EFSF) support and nonetheless sees its credit quality rating sink to the junk-bond level. Similarly, Greece has not had access to the financial market for over a year. One does not see what other proof is needed to show that the austerity program mandated by ESFS conditionality, implying severe austerity, is not really a market-friendly feature of European policy. And yet, untouched by the evidence, the defendants of mainstream economics recommend even more of the same medicine, claiming that in fact markets are dissatisfied with the too little (*sic*) burden imposed on Greek and Portuguese (and Irish) taxpayers and welfare recipients, rather than being skeptical over the possibility of avoiding a default by embarking on crudest austerity strategies (see for example Caruana, 2011).

As highlighted by Quadrio Curzio (2011) among others, it is important to stress the different origin of the solvency problems faced by the so-called PIGS. As it is well known, Greece for example had indulged in substantial national accounts “massaging” with the aim of letting public deficit spending run at unsustainable levels, while Ireland was consistently pointed out as the model student (i.e. it exhibited high growth and low public debt) until its public deficit had to soar spectacularly in the attempt to rescue its collapsing financial system.

Thus, on the one hand the Greek case is to be seen as an exceptional pathology and in principle should not lead to any contagion besides the financial distress on the country's creditors (among which the other PIGS do not figure prominently). It rather conducts to the question of how it was possible for a Member State of the EU and of the EMU to produce and disclose falsified accounts for several subsequent years without the other Member States (i.e. the European Council) and the European Commission noticing it. Indeed, a recent paper by de Castro *et al.* (2011) shows how ex-post rectification of the national accounts (though at a significantly smaller scale) has so far been a fairly diffused practice across the EMU. Thus, if we are to exclude the hypothesis of connivance on the side of the other EU countries and institutions, what the Greek case highlights is the inadequacy of a European governance. Near full economic and financial integration does not correspond to an adequate extension of supranational institutions and/or sufficient political integration. Even here the mainstream economic ideology, according to which there is virtually no role for a governance of the economic system provided that the market is free to operate without constraints or borders, may have played a role in dismissing the argument that active and efficient political institutions were and are needed.

On the other hand, a clearer role for mainstream economics is visible in the Irish case. An obviously unsustainable level of debt was being piled up in the very same moment when the Celtic tiger was praised in contrast to the Club Med, the Mediterranean countries affected by fiscal incontinence. Roncaglia (2011) has already highlighted how such a myopia is made possible only by the ideological aversion of mainstream economics against the state and its a priori trust in the self-equilibrating nature of market economies. Thus, a complete neglect of private debt was "coherently" associated to the minutest scrutiny of public debt dynamics within the Stability and Growth Pact (SGP) on account that private lenders can correctly assess the riskiness of their clients when dealing with private debt, but on the contrary they need state protection against

inconsiderate public debtors.¹ Needless to say, such a position still dominates the political debate in Europe and elsewhere, leading policy-makers and commentators to worry about a risk of contagion from Greece and Ireland to the Spanish and Italian public debts and not, for example, to German and French banks.

Indeed, the different sources of public finance imbalances suggest that the fears of further contagion of the European sovereign debt crisis may be more a sort of intellectual speculation over financial speculation (though this has the unfortunate characteristic of proving self-fulfilling) than a rational analysis of the near future prospects. On the one hand, the PIGS appear to share more of a stereotyped prejudice (hinted at in the very name chosen for this group of countries) than objective economic conditions (apart from the point of view of deteriorating international competitiveness and balance of payments imbalances, referred to above and completely neglected by mainstream economists: this is certainly not the reason they were joined under the PIGS label). On the other hand, the sustainability of the financial sector balance sheets in many “central” European countries may be more at risk than is implicitly assumed by neglecting the fact that, for example, the private sectors in these countries are the largest creditors of the public sectors of the PIGS (Maserà, 2010).

This second issue has so far been tackled by means of the repeated attempt to avoid (officially) or postpone (actually) any sovereign default in Europe. Mainly for reasons of domestic politics, EFSF intervention has been accompanied not only by strict requirements in terms of austerity measures, but also by high interest rates. As has been well known since (at least) the works by Pasinetti (1998a; 1998b) countries facing low rates of GDP growth and high rates of interest need large primary surpluses to make their debt sustainable – possibly too large a surplus if the starting level of debt is very high. However, at the EU level expansionary policies are ruled out (for example by refusing to discuss eurobonds-like projects) and it

¹ Though, as mentioned, even this scrutiny proved largely inefficient. Obviously, there are other reasons for mainstream economic aversion against public debt, among which the hypothesis of a causal nexus from debt to inflation or the crowding out of private investment.

is hardly the case that aggregate demand will suddenly recover to the point of alleviating the debt burden of these countries. Thus, it must be the case that European governments have been buying time to make the likely default less harmful to their financial institutions, specifically by letting part of the debt to be gradually transferred to public institutions such as the EFSF or the IMF, that is by imposing part of the cost of the delayed default on the taxpayer. Besides its inequitable stance, this strategy may even prove inadequate in so far as (i) financial institutions are increasingly recurring to financial derivatives and high financial leverage to secure solvency and decent capital ratios by means of retained profits, though leverage and derivatives bring about more risks and fragility; (ii) the ECB appears determined to proceed over a strategy of gradually raising its target interest rates; (iii) small financial sector losses in the face of sovereign defaults are nonetheless being asked for political reasons, though how such “small” losses may impact Europe’s banking sector remains uncertain.

As mentioned, such lack of coordination between the different EU institutions (including discordance of views among Member States) contributes to increasing the already high uncertainty in Europe, with the result of the crisis having an even greater impact than in the USA. Indeed, it is especially at the EU-level that expansionary policies may and should be carried out, given the tight constraints faced by Member States and the need for increased macroeconomic coordination and political integration.

On the contrary, the “Pact for the euro” assumes austerity as the main goal for all EMU Member States – again conflating coordination of macroeconomic policy across Member States with the adoption of a same (mainstream oriented) policy in each Member State. Moreover, the Pact includes several cosmetic measures and a few regressive ones, such as for example the postponement of retirement age. Such a measure is regressive because income is a good predictor of life expectancy (see for example Tarkiainen *et al.*, 2011) and limits workers’ liberty to decide when to retire (though facing actuarial adjustments). Instead, as discussed in D’Ippoliti (2011) for example, even within European austerity

programs there may be room for redistribution. Thus, a similar reduction of public expenditure for pensions may be reached by counterbalancing the general trend towards individualization of benefits (advocated for by the old Washington Consensus) and introducing progressive schemes: for example by cutting on pension payments above several times the minimum or the average pension.

Other examples could be made, but on the whole redistribution does not appear to be a prime political goal throughout Europe, despite increased inequality having been pointed out as a major source of the imbalances at the root of the current crisis (among the earliest contributions, Sylos Labini [2003] 2009). Here again several aspects of the mainstream vision of the economy seem to be at stake, such as the representation of unemployment as an individual problem or of territorial underdevelopment as a simple issue of corruption or inefficient resource allocation.

Roncaglia (2011) proposes an optimistic point of view, stating that “we can hardly expect dramatic events with far-reaching consequences not to have repercussions on the theoretical debate” (p. 167). A similar position has been maintained for example by Reati (2010). While there is certainly reason to hold a more pessimistic view, some signs of change are indeed beginning to take place.

For example, since the previous issue of the journal the International Monetary Fund has published in its homepage the report of its Independent Evaluation Office (IEO, 2011). The report identifies several analytical and theoretical biases as the root of the failure of the IMF, if not to foresee the crisis, at least to notice the increasing fragility of the financial system that was taking place in the developed countries. These biases, according to the report, should be attributed to *group thinking* (intellectual conformism that discourages critical engagement in an organization) as well as the adoption of inadequate theoretical models. The report explicitly mentions DSGE models (pagg. 20 and ff.) and more in general all macroeconomic models that ignore financial variables or that assume perfectly efficient financial markets (on a similar vein, Cozzi, 2011). Alas, on this very specific charge the replies by the Fund’s managing director

and by the staff (also published on the website) interpreted the report's recommendations to increase the diversity of views in the IMF exclusively in terms of geographical diversity. These replies expose a certain aversion to intellectual pluralism within the IMF that has frequently been pointed out. However, as Anelli (2011) suggests, the World Bank had a similar story of initial orthodoxy then relaxed for example in favour of the human development paradigm. Given the nature of the interest at stake, it may be the case the IMF requires more time (and higher political commitment) to reach similar results. As mentioned, there appears to be room for heterodox economists to try to take part in this process.

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