

Economic policy dilemmas in front of the crisis

ALESSANDRO RONCAGLIA*

The financial and economic crisis has been the central issue for applied and theoretical debate in economics over the past two years and is likely to remain so for the months to come. Thus, it is once again the central issue for our *Review*. The three papers published in the following pages, together with the present introduction, are all connected to the crisis, though they approach the issue under different perspectives.

Fratianni and Marchionne (2010) provide an in-depth analysis of the size and effects of the banking bailouts consequent to the subprime crisis, focusing on the fiscal side of the intervention. Their analysis sheds light on an important new dimension of what in the past has been called the fiscal crisis of the state. Since the 1970s this term has been utilized with reference to the growing extension of the so-called welfare state, namely the dimension of social public expenditure (retirement pensions and unemployment benefits, public health services and public education expenditure). Presently, the fiscal crisis of the state is rather connected to the sudden explosion of expenditure related to the rescue not so much of individual financial institutions as of the international financial system as a whole, as well as to the effects of the financial crisis on the real economy.

Year after year, for more than three decades a retrenchment of social expenditure has been requested as a central policy requirement of the so-called Washington consensus; in some measure, it has been realized in many countries. Now, the booming public expenditure induced by the banking bailout has brought fiscal deficits to previously unknown heights, up to an expected 32% of GNP in Ireland in 2010. Moreover, due to the piling up of public debt, interest on public debt is also growing in size as a share of GNP. Thus, retrenchment of public expenditure is once again being called for by international agencies as well as by leading

* Sapienza University of Rome, E-mail: alessandro.roncaglia@uniroma1.it

economists and politicians. Indeed, the expanded size of public deficits has been utilized as an argument for the proposal to strengthen the Maastricht rules: more stringent sanctions on excessive deficit countries and abatement of the excessive debt by one-twentieth of the excess per fiscal year (which in the case of Italy amounts to about 40 billion euros each year).¹

The irony of this all is that by rescuing financial institutions the policy authorities – which up to now have totally ignored the problems posed by an excessive increase of private debt, focusing attention on public debt alone – have dealt with a crisis originating in the private debt area by shifting part of its weight to the public sector. This should call for some reconsideration of macroeconomic views: if the public sector acts as a rescuer of last resort for the private sector, then the amount (relative to GNP) of private debt cannot be ignored.

In any case, for any individual country considered in isolation, it is rather difficult to ignore the mainstream recommendations. Countries with already large public deficits and debt risk coming under attack on the side of financial speculation if they ignore the consensus recipes; as happened to Greece, Portugal, Ireland, Spain and in some measure to Italy as well, spreads on the rates of interest on Treasury bills and bonds can increase by hundreds of basis points; let us recall that with a public debt of, say, a 100% of GNP, each hundred basis points of increase in the spread implies a full percentage point increase in public expenditure for interest payments over time (as soon as outstanding Treasury bills and bonds are renewed). Financial markets can then foresee a spiral of growing public expenditure for interest payments, growing deficits and growing public debt, further increasing the spread up to the point of collapse. Fiscal retrenchment then takes place, so to say, at gunpoint.

There is little choice, thus, for many countries on the sign of their fiscal policies. However, this constraint leaves various options open. First, countries in better conditions could re-equilibrate the balance of fiscal stimuli to the global economy by adopting expansionary policies, with an international coordination of policy choices. Second, for each

¹ See Quadrio Curzio (2010).

individual country the choice remains open as to how to reduce public deficits: which expenditures should be cut, and whether tax increases can take the place of expenditure cuts. In doing this, in the present situation it would be important to pay attention to the issue of social inequalities: both on account of the increases in wealth and income inequalities which took place more or less all over the world in the past three decades, and on account of the heavy costs the crisis is inflicting on the less well-to-do. Some form of taxation on financial activities and on banks appears as a natural measure to be considered; on the contrary, the Prime Ministers of the European Union (under the leadership of the Italian Prime Minister, according to himself) have recently rejected the proposal to introduce some form of tax on banking and financial activities.

The effects of fiscal retrenchment policies are already apparent for Greece and Ireland, where GNP is expected to fall in 2011. The simple end of the financial stimulus provided by most governments in the immediate aftermath of the crisis is already expected to have a negative impact on output and employment in OECD countries. If fiscal retrenchment aimed at reducing public debt stemming from banks' bailouts is added on top of this, perspectives cannot help but be dim indeed. Moreover, it is nearly unavoidable for retrenchment policies to hit, in a greater or lesser measure, social expenditure. This would come in addition to the gigantic changes in income distribution which took place over the past thirty years² and to unemployment and the uncertainty on job tenures connected to the increasing flexibility in the labour market. If the already widespread social malaise transforms itself into social unrest, the countries first hit by these phenomena may easily originate a new financial crisis: the too often forgotten strict connection between economic and social events is likely to reaffirm itself in the near future.

There is no simple recipe for answering this situation. Financial re-regulation and international coordination of macroeconomic policies, as well as national strategies for economic growth are all required. It is on these latter that the paper by Sabbatini and Zollino (2010) provides important insights, by focusing on the case of Germany over the past two

² See for instance Galbraith and Garcilazo (2004).

decades. This was an eventful period, starting with the unification shock. In the first quinquennium it brought about a decline in price competitiveness, which was more than reversed in the subsequent five years, mainly through restructuring of the productive system and concertation between the social partners, reinforced in the first half of the current decade by an incisive action aimed at implementing structural reforms to increase the efficiency of the labour market and reduce the social security tax burden. The successes of these policies are undeniable. However, worsening income inequality followed, with the consequence that “the disparity between rapidly expanding exports and sluggish domestic demand was aggravated” (Sabbatini and Zollino 2010, p. 247), which was also due to the fact that the increased profits translated (and keep on translating) into foreign rather than internal investments. Furthermore, at the sectoral level the modernization and reform process has so far been mainly focused on manufacturing industry, while services are lagging behind.

This also implies increasing tensions in the euro area, between surplus (Germany) and deficit countries, which may reach the point of putting the monetary union itself at risk. Germany is thus confronted with a policy dilemma: though its policies for increasing competitiveness in the international arena have been a success and could be suggested as an example to other countries in the European Union, continuing reliance on them with no attention for stagnating internal demand, growing income inequality and increasing tensions in the European Union may not be the best course to follow.³

An important issue in this respect is the necessary connection between public deficits, private sector deficits and external deficits, and

³ The Italian press recently took the occasion of two apparently conflicting declarations by the Governor of the Bank of Italy, Mario Draghi, and the Economics Minister, Giulio Tremonti, for suggesting a clash on economic policies between the two. In fact, if my interpretation is correct, what Draghi was suggesting with his reference to Germany’s example was the need for Italy to adopt policies aimed at increasing her competitiveness in international markets, while Tremonti, with his critical reference to Germany’s sluggish internal demand, was pointing to the need for greater policy coordination at the international level in which surplus countries should play a more expansionary role.

the ensuing connection between internal and external debt.⁴ In many European countries the main risks come from external indebtedness more than from the public sector debt. In fact, this latter can be an easier target of international financial speculation when a sufficiently large share of it is held by foreign financial institutions.

The closing article of the present issue, Maes (2010), illustrates Alexandre Lamfalussy's views on the way of functioning of the economy in general and financial markets in particular, and their influence on the macro-prudential approach to financial stability within the Bank for International Settlements, a rare case among international economic institutions to clearly see the growing fragility of the financial sector, and to warn the international economic community about it.

Thus, in different ways and focusing on different issues, the three articles which follow provide important contributions to the analytical and applied debate which underlies the policy choices required to tackle the crisis and its evolution.

BIBLIOGRAPHY

- FRATIANNI M., MARCHIONNE F. (2010), "The banking bailout of the subprime crisis: size and effects", *PSL Quarterly Review*, vol. 63 n. 254, pp. 185-231.
- GALBRAITH J. K., GARCILAZO E. (2004), "Unemployment, inequality and the policy of Europe: 1984-2000", *BNL Quarterly Review*, vol. 57 n. 228, pp. 3-28.
- GODLEY W., IZURIETA A. (2009) [1995], "The US economy: weaknesses of the 'strong' recovery", *PSL Quarterly Review*, vol. 62 nn. 248-251, pp. 97-105; reprinted from *BNL Quarterly Review*, vol. 57 n. 229, June 1995, pp. 131-9.
- MAES I. (2010), "Alexandre Lamfalussy and the origin of the IS macro-prudential approach to financial stability", *PSL Quarterly Review*, vol. 63 n. 254, pp. 263-290.
- QUADRIO CURZIO A. (2010), "All'economia dell'Europa servono rigore e crescita, non burocrazia", *Corriere della Sera*, 7 ottobre.
- SABBATINI R., ZOLLINO F. (2010), "Macroeconomic trends and reforms in Germany", *PSL Quarterly Review*, vol. 63 n. 254, pp. 233-261.

⁴ Cf. Godley and Izurieta (2009) [1995].