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The Cambridge Diagnosis on the State of Economic Science

Reflections of the Observatoire de la Finance on the conference of the Institute for New Economic Thinking (INET), *The Economic crisis and the Crisis in Economics*, Cambridge, 8-11 April 2010

1. Background

The inaugural conference of the Institute for New Economic Thinking (INET) was attended by more than 190 participants. The list of speakers and session moderators included several well-known academic economists including winners of the Alfred Nobel Memorial Prize as well as economists from governmental and intergovernmental institutions, bankers and financial journalists. Among the current or recently retired participants from the official sector were Dominique Strauss-Kahn, Managing Director of the IMF; Guillermo Ortiz, Governor of the Bank of Mexico; Lord Adair Turner, Chairman of the United Kingdom Financial Services Authority and recently in the news owing to remarks questioning the social value of many activities in the financial sector; Tommaso Padoa-Schioppa, whose career has included the post of Italian Minister of Finance as well as senior international and national central banking and regulatory positions; William White, until mid-2008 Head of the Monetary Department of the Bank for International Settlements and thus of a team of economists who as early as 2004 began to warn about the build-up of dangers to macroeconomic and financial stability beneath the surface of the favourable economic conditions still prevailing; Dr Yaga Reddy, Governor of the Reserve Bank of India during 2003-2008 and before that holder of several senior financial positions in the Indian government; and Justin Lin, Chief Economist at the World Bank. The financial sector was represented by George Soros himself, the principal figure behind the launching and financing of INET and since the end of the 1980s a prolific commentator on financial markets; Charles Dallara, Managing Director of the Institute of International Finance, an industry body with a membership of large international banks; and Richard Koo, Chief Economist of the Nomura Research Institute which is linked to Nomura Securities.

Presentations and discussion at the conference ranged widely over the conceptual, historical and policy dimensions of the current financial and macroeconomic crisis. Other subjects covered were economic and econometric modelling, the history of economic doctrine, the national and international agenda of financial reform, and the economic and political dimensions of trends in international inequality of income and wealth.

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[1] The goal of the Observatoire is to encourage new thinking, debate and proposals to back up the financial sector's contributions to the common good. By its activities the Observatoire aims at meeting the challenge facing the due to the development of financial activities.

The following are major subjects related to the concerns of the Observatoire[1] which seem appropriate for inclusion in the new economic thinking that INET is proposing to promote:

1. ethical dimensions of economics, with special reference to financial economics;
2. conceptualisation of the behaviour of economic actors;
3. the organisation and sociology of economics;
4. corporate governance;
5. economic modelling and efficient markets;
6. economic and social inequality;
7. the political economy of stabilisation policies and systemic financial risk;
8. financial globalisation;
9. the implications of climate change for economic thinking;
10. international trade and investment.

The headings from 4 to 10 would be generally considered standard for new economic thinking with a policy orientation. However, this may seem less true of 1, 2, and 3. These headings involve the values which underpin economic behaviour and economic policy, the epistemology or methodological foundations of economics, and the sociology and organisation of the discipline (which initiatives for reform of the discipline must address).

The reflections on the conference which follow are organised under the headings listed above and are directed in the first instance at surveying coverage in relation to the intellectual agenda of the Observatoire de la Finance. They may also prove a useful input into the deliberations of INET.

2. Commentary on the conference: coverage and omissions

Ethical dimensions of economics

Ethical issues were raised in different sessions of the conference but in a piecemeal rather than a systematic way. The session on Keynes and Hayek touched on Keynes's belief that a good, less acquisitive life would become more widely possible as the satisfaction of material needs was achieved – a situation which he believed to be a prospect for the not too distant future. During the same session the ethical as well as the pragmatic dimension of Hayek's concept of liberty was brought out in discussion of the focus of his work after its shift from macroeconomics to the optimal structure or constitution for economies and societies.

Many observations during the conference on the causes of and policy response to the financial crisis (such as that of Adair Turner) bore on its ethical dimension. But it was the presentation of Sheila Dow (during the session on the theory required to guide reform and restructuring) which addressed this dimension more directly. She criticised the most common approach of contemporary economics in her view to the subject, an approach which justifies a calculative, individually self-interested approach to trust on the basis of game theory. As an alternative she proposed an approach which can be found in the writings of Adam Smith and Keynes and which emphasises the essential role in market activity of social conventions, especially trust which Dow was clearly using here as an umbrella term to cover several of the ethical failures that were a feature of the financial crisis. Outside the ranks of economic theorists many would be likely to consider the central role accorded by Dow to trust as having wider and richer implications for unders-

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tanding and policy than an approach to ethics primarily emphasising self-interested, calculation.

Owing to their pervasive, even if often implicit or unrecognised, presence new economic thinking should address the actual and potential ethical dimensions of economic activity. As an historical approximation it is possible to associate the conscious effort by economists to distinguish positive from normative economics with the rise of marginal economics from the 1870s (the pioneers being William Stanley Jevons in Britain and Karl Menger and his followers in Austria). The aim of positive economics was to explain the behaviour of economic actors, while the value-laden parts of economics were to be consigned to subdivisions of the discipline such as welfare and public economics. However, application of the distinction between positive and normative economics in practice has proved neither simple nor particularly successful. The choice of subjects in positive economics tends to reflect judgements as to what is important, which consciously or subconsciously reflect an economist's values. Moreover the analysis of economic behaviour usually incorporates assumptions concerning the institutional and psychological framework of this behaviour which cannot be completely abstracted from the values incorporated in the framework. Moreover the specification of agents, institutions, and objectives is often broadly similar in both positive and normative economics, contributing to a blurring of the distinction. Positive economics is thus far from having achieved a cleansing of normative elements analogous to the elimination since Galileo of the teleological elements of medieval natural science.[2]

While the Observatoire does not downplay the importance of values - and thus also ethics - as these are traditionally treated in welfare and public economics, in the context of the financial crisis and the increasingly overweening importance attributed to finance in recent years the Observatoire has been more concerned with the relationship between ethics and the structural and psychological foundations of the economy and society. The conduct of a society's business (not to mention several other interactions between its members) takes place within a framework of norms, laws, and institutions (the last being defined to include ways of doing things as well as organisational structures). The respective roles of these features of society are a product of time and place, and entail a balance determined by the power of the society's major groups, by experience, and by ceremonial elements.

The rules governing business conduct combine norms, on the one hand, and laws and regulations, on the other. The balance between the two typically reflects some kind of consensus as to the extent to which society can rely on the former and thus does not require the formal rules and sanctions of the latter. Historically constraints on behaviour have involved both. Some of these constraints are directed at the ethics of interpersonal and inter-institutional relations within the financial sector and of relations between the sector and its non-financial clients. Others are structural, involving, for example, firewalls between different financial activities, some with a legal basis like the Glass-Steagall Act and others with one with a basis in custom. Since shortcomings on the fronts of both norms and regulation were notable features of the financial crisis, the reforms envisaged

[2] This is not to deny that natural science still contains subjective elements which cannot be dissociated from intellectual and social contact. As Henry Margenau, the physicist and philosopher of science, puts it; "A fact is, and nobody can make an is into an ought. Does this leave science without normative qualities altogether ?... it should be clear that this belief is erroneous; science contains rational elements whose status in experience is quite different from the coercive, existential indubitable character of facts. Constructs of science are to a large extent man's own additions to the spontaneity of the factual, and their coupling with facts is not absolutely rigid." (Margenau, 1964: 125).

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in the policy response are likely to include changes not only in the rules of financial regulation but also in the balance between society's reliance on regulation and norms. If only for this reason, ethics should be part of new thinking about finance. But more generally ethics has helped shape national and international finance since the Middle Ages and will continue to do so in the future, so that financial analysis and policy design cannot avoid finance's ethical dimensions.

Consideration of ethics at the conference was not limited to finance. For example, ethics also figured prominently in the session on global inequality and wealth distribution.

Alternative models of economic man and his behaviour

Closely related to the ethical dimensions of economics is the way in which economists typically represent or model economic actors. Here there has long been a divergence between representations of economic actors as rational and calculating – sometimes to the exclusion of other dimensions of the human personality - and representations in which these other dimensions are regarded as an essential part of both positive and normative economics.

Although no conference session was devoted to the conceptualisation of individual economic agents as such, the role of rational economic man in contemporary theory figured critically in several speakers' presentations (for example those of Akerlof, Dow and Stiglitz). Moreover conference participants were provided with copies of the recently published book of George Akerlof and Rachel Kranton, *Identity Economics How Our Identities Shape Our Work, Wages, and Well-Being*. This book provides the following succinct summary of the flawed conceptualisation to which the approach proposed by the authors is intended to be an alternative:

> "Modern economics follows Adam Smith's attempt to turn moral philosophy into a social science designed to create a good society. Smith enlisted all human passions and social institutions in this effort. In the nineteenth century, economists began to build mathematical models of how the economy worked, using a stick figure of a rationaliy optimizing human with only economic motivations. As economics evolved into the twentieth century, the models grew more sophisticated, but Homo economicus lagged behind. This began to change when Gary Becker developed ways to represent a variety of realistic tastes, such as for discrimination, children, and altruism. Fairly recently, behavioural economics has introduced cognitive bias and other psychological findings. Identity Economics, in its turn, brings in social context – with a new economic man and woman who resemble real people in real situations" (Akerlof and Kranton, 2010: 7)

The shaping of people's choices by their experience, in particular their experience as producers at work, was a standard subject of classical American institutional economics from Thorstein Veblen onwards. This literature stressed the endogeneity of major determinants of economic choice. For example, in the writing on the social control of economic activity of a major figure of this school, John Maurice Clark, once a foremost United States economist but now largely forgotten, this idea plays an important role in his comparison of alternative economic and social arrangements, as in the following passage:

> "And in a more fundamental way still, the individual is so molded in body, mind, and his character by his economic activities and relations, stimuli and

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disabilities, freedoms and servitude, that industry can be truly be said to make the men and women who work in it no less truly than the commodities it turns out for the market” (Clark, 1939: 46).

Clark’s remarks reflected evidence concerning economic activity from an earlier era than ours. But with appropriate regard for shift in historical context they are still relevant, as abundantly illustrated by behaviours highlighted in literature spawned by the financial crisis on the internal functioning and culture of major Wall Street firms.[3]

When the new behavioural economics began to attract attention, one wondered whether the result would be simply a new set of models based admittedly on a better rounded view of individuals, or whether it would lead to greater openness on the part of the economics profession towards other disciplines and other types of knowledge (an openness which was characteristic of the institutionalists). The latter is clearly the intention of Akerlof and Kranton: “Social scientists in other disciplines should find identity economics useful because it connects economic models with their own work, enabling the development of richer accounts of social processes” (Akerlof and Kranton, 2010: 8). The new economic thinking could greatly benefit from such interpenetration of different disciplines – and one might hope of greater interpenetration of social sciences and other parts of culture.

Organisation and sociology of economics

New approaches to economic thinking about values and epistemological issues - not to mention the more policy-oriented subjects taken up below - will require far-reaching changes in the organisation of research and teaching in economics and in the approach to the discipline of professional – and most importantly academic - economists. Yet such changes were addressed only to a limited degree at the conference despite the evident preference of many speakers for changes for changes on this front, in particular changes which would accommodate increased intellectual pluralism.

There is a widespread view that the failure of a large part of the economics establishment to identify the weaknesses which led to the current crisis and have determined its subsequent unfolding must lead to the wider acceptance of new approaches to the discipline, especially in the areas of macroeconomics and finance. In support of this can be cited the thaw in both thinking and policy approaches evident in the response of national governments and of the IMF to the crisis. But there is an alternative view that future changes in economics will be at best gradual and possibly very limited. In his reply to John Cassidy’s question as to what the economics profession has learned from the crisis (put to him during one of Cassidy’s interviews of Chicago economists for The New Yorker) Judge Richard Posner, much of whose writing has concerned the interplay between common law and economic incentives and sanctions, gave reasons for the alternative view: “Well, one possibility is that they have learned nothing. Because...market correctives work very slowly in dealing with academic markets. Professors have tenure. They have a lot of graduate students in the pipeline who need to get their Ph.Ds. They have techniques that they know and are comfortable with. It takes a great deal to drive them out of their accustomed way of doing business” (Cassidy, 2010: 4).

[3] The character of the trading space at Lehman Brothers, as described by Andrew Ross Sorkin (Sorkin, 2009: 22), provides a graphic example, “Glucksman had the windows blacked out in a bid to re-create a Las Vegas casino atmosphere, with traders focused only on the Quotron and Telerate machines that were standard-issue on Wall Street then [the 1970s]. Phones were thrown; wastebaskets were kicked. And as in a Vegas casino, a miasma of cigarette hung everywhere.”

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Unsurprisingly there were references during the conference to the sociology of the economics profession and its effects on research and teaching. Tommaso Padoa-Schioppa, for example, emphasised the breakdown in communication between academic economists, on the one hand, and those involved in the design and implementation of economic policy, on the other, a breakdown which he clearly believed benefited neither side. And in his wide-ranging review of mathematical modelling and other forms of conceptualisation in economics Duncan Foley made a number of references to the sociology of the discipline. Coming at the problem from a different perspective than Posner, Foley none the less also believes that changing the direction of a well-established academic field like economics will not be an easy project. As he emphasised in his presentation, "It would be a mistake to limit the ambitions of the Institute for New Economic Thinking too narrowly, and particularly to focus disproportionately on the specific flaws of recent work in macroeconomics and finance...In the long run the discipline of economics will be shaped as much by its sociology and the philosophy of science and scientific interchange that commands its consensus as by particular methods or theoretical approaches".

Foley's point has important implications for the effort to acquire intellectual space for new economic thinking. Achievement of the objectives of those responsible for this effort will require changes in many dimensions of the framework within which economic thinking is carried out. The problems to be confronted here are not only the inertia mentioned by Posner and the current approaches to their responsibilities of academic administrators and tenure review committees mentioned by Foley but also external pressures on economic research in universities and other bodies discussed further in the last part of these reflections on the conference.

Corporate governance

Corporate governance brings together issues involving society's values, on the one hand, and issues involving microeconomic efficiency, on the other. The subject covers the framework which determines the scope of corporations' activities, their control, and the allocation of risks and returns to the different parties affected by these activities. Although corporate governance was addressed incidentally rather than directly during the conference, the subject merits a place of its own in any agenda of new economic thinking.

Much recent economic thinking concerning corporate governance has been dominated by variants of the Efficient Market Hypothesis (conference contributions concerning which are discussed below). This hypothesis has served to justify attributing to financial markets the key role in determining the intertemporal allocation of resources for major parts of the economy. However, if financial markets are to perform as this hypothesis requires, prerequisites must be met regarding the conduct of major economic actors, the availability of techniques for short selling, and an effective regulatory framework. Writers on corporate governance accepting variants of this hypothesis typically attach special importance to the discipline regarding firms' pursuit of profitability imposed by shareholders, boards of directors, and unfettered markets for corporate control, and to transparency, which is the domain of watchdogs such as credit rating agencies, lenders and investors, and financial analysts as well as of regulatory rules.

The idea that financial markets and corporate governance, at least in Anglo-Saxon countries, had achieved a reasonable approximation of this idealised model was severely shaken by the failings of major parties revealed in the Enron case and subsequent corporate scandals. Reform in response to these scandals has largely focussed on measures which tighten the regulatory framework for corporations and are designed to ensure that different parties to good corporate governance do a better job of pursuing profitability for their firms and of protecting shareholders' interests.

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However, good corporate governance is also widely considered to transcend the mere protection of shareholders' rights. Thus the internationally agreed OECD Principles of Corporate Governance include the following: "The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises". Stakeholders are defined to include not only investors and creditors but also "resource providers" such as employees and suppliers. The same section of the Principles continues with the statement that "performance-enhancing mechanisms for employee participation should be permitted to develop".

The OECD Principles are of course only one – and in many countries a minor – influence on actual regimes of corporate governance but the references in the Code to the need for good corporate governance to include appropriate recognition of the interests of groups other than shareholders do none the less reflect an international political consensus.

Such a broader view suggests the need to develop an alternative conceptual framework to that which reduces good corporate governance to the exclusive objective of maximising shareholder value. This framework would provide guidelines concerning the weights to be attributed to the interests of all of a corporation's different stakeholders, recognising in this context the important differences which exist among countries regarding what are the appropriate weights – differences that reflect countries' histories and value systems. Moreover potentially such framework also requires a revisiting of longstanding questions concerning whose interests a corporation should serve. Addressing this question requires examination or re-examination of legal and accounting as well as economic issues since typically embedded in corporation law and accounting are assumptions about the interests to be served by corporations as well as the distribution of the responsibilities of different corporate actors.[4] New economic thinking on this subject could make an important contribution to the development of better rules for financial and other categories of globalisation.

Economic modelling and the Efficient Market Hypothesis

Modelling was explicitly addressed in two sessions, one devoted to econometrics and statistical inference and the other to mathematical modelling. There were also several references to modelling in other sessions.

The first of the two sessions explicitly devoted to modelling, that on econometrics, included d a lucid exposé by David Hendry of a large-scale modelling system which a team directed by him is currently developing in Oxford. Especially interesting in his presentation was his account of the way in which the system addressed not only technical issues such as variables' non-stationarity but what has always arguably been the most awkward problem confronting econometrics since its beginnings - arguably its Achilles heel - , namely the choice and specification of models. Other speakers at the session on econometrics addressed stochastic general equilibrium models, placing more emphasis on the strengths of these models than on their failure to throw light on the causes and unfolding of the current crisis.

[4] A particularly concise overview integrating accounting, legal, and societal issues of corporate governance from a United States perspective can be found in the book, Accounting principles for the Autonomous Corporate Entity, of Henry Hill, a former National Director of Accounting and Auditing Services for Price Waterhouse (Hill, 1987).

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The shortcomings of empirical modelling in finance and macroeconomics were the subject of more attention but at a less technical level during the two sessions on the crisis and in Adair Turner's speech. George Soros explained his principle of reflexivity, which draws upon his many years of experience as a fund manager. The process of reflexivity starts from investment decisions taken in the light of partial and distorted understanding of current indicators in financial markets; these decisions then contribute to a feedback process since they help to shape new realities and new financial indicators, thus setting the scene for a new round of decisions based on incomplete and distorted understanding; and so on. William White ranged widely over the intellectual and associated policy failures which led to the crisis. Jeremy Siegel focussed more narrowly on the role of the Efficient Market Hypothesis. This hypothesis, he noted, does not claim that market prices of securities are correct but only that they reflect known information that affects their value. During much of the Great Moderation the trend in securities prices at least could be justified on the basis of fundamentals, and only in the immediate pre-crisis years did both investors and policy makers ignore warning signs from the rapidly increasing divergence between house prices and other prices and incomes. The delay in responding to this divergence, which was to play a major role in triggering the crisis, did in Siegel's view reflect an exaggerated faith in market efficiency for which the incorrect, popular version the Efficient Market Hypothesis was partly responsible.

Both White and Siegel flagged strongly the contribution of increased leverage in the financial sector to the crisis, White attaching considerable importance to the inadequacies of the way in which balance sheets were incorporated in much recent macroeconomic and financial modelling. As explained below, balance sheets also played an important role in Koo's account of the way in which balance sheet management by the private sector is capable of changing the relative effectiveness of the instruments of macroeconomic policy, elevating that of fiscal policy and reducing that of monetary policy.

However, the balance-sheet issues raised by White, Siegel and Koo did not figure in the more technical discussion of economic and econometric modelling. *Inter alia*, such a discussion might have addressed how accounting information could be better incorporated conceptually into the microfoundations of macroeconomics. The discussion of modelling could also have drawn attention to continuing shortcomings of data not only on this front but also on other subjects bearing on financial stability. A much greater wealth of statistics has become available in recent years through the IMF's Financial Sector Assessment Programme, the publications of the Bank for International Settlements and the Financial Stability Reviews or Reports now published by several countries and by the European Central Bank.[5] However, the crisis has highlighted gaps in areas such as the maturity structure and currency denomination of banks' assets and liabilities, the interconnectedness of financial institutions, the off-balance entities which have been characterised as the shadow banking system, and the activities of non-bank financial institutions (Hannoun, 2010).

Interestingly the posthumous revival of interest in the work of Hyman Minsky on financial instability has focussed largely on his conceptualisation of the development of financial risks and the way in which current information and that concerning the recent past can distort decision making, in particular by leading to the erosion of cushions of financial

[5] The principal categories of data in national financial stabilitiy reviews or reports include balance-sheets and income for the banking sector, the non-bank financial sector, standard macrofinancial indicators, financial markets broken down by major financial instrument, and financial infrastructure (such as payment and settlement systems) (Yamaguchi, 2005).

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safety during long periods of benign economic conditions. Largely ignored has been Minsky's integration of accounting concepts into his analysis of financial decisions at the microeconomic level and of the macrofinancial consequences of these decisions.[6] Further work on such integration could prove a fruitful direction for new economic thinking, in particular as part of replacement of the flawed microfoundations of the new classical macroeconomics. .

Perhaps surprisingly there was limited attention in the conference presentations to non-linear dynamics and chaos theory, work on which has been important in raising questions about the underlying statistical and behavioural assumptions of much work in financial economics, in particular that on the Efficient Market ypothesis. One speaker who did touch on this subject was Foley who drew attention to the potential importance for theory and modelling of the general type of dynamics which complex systems exhibit –a subject which would necessarily include work on non-linear dynamics. However, in his wide-ranging presentation on both epistemological and sociological issues posed by mathematical formalism he presumably lacked the time to take up the importance of the modelling of complex systems for financial economics.

Work on non-linear dynamics has pointed to the importance of intertemporal correlations in time series for financial prices. Such correlations are also a central subject of the less rigorous and largely ignored work of technical analysts of financial markets. The apparently alchemical and mystical dimensions of much of this analysis has led most of the academic profession to ignore the way in which such analysis addresses collective and crowd behaviour in financial markets, in some cases incorporating the results of psychological research into the roots of human motivation.[7] New economic thinking might benefit from a more thorough examination of implications of the work of technical analysts.

James Mirrlees gave a lucid apologia of the Arrow-Debreu model, which in his view provides a starting-point for analysis of and recommendations concerning particular economic problems superior to less comprehensive and general conceptual approaches such as analogies from other disciplines, etc. However, Mirrlees's speech brought out the problems which financial crises and instability pose for the Arrow–Debreu model, since this model is not designed to handle markets characterised by what he denoted as "moral hazard", i.e. unpredictable conditions and events. Such "moral hazard" is an integral feature of the financial innovation and other conditions in financial markets with which policy makers and regulators must deal. In the present state of knowledge they thus have no alternative to trial-and-error approaches involving deployment not only of many different contents of the economists' box of tools but also of concepts drawn from insurance, historical experience, and non-financial branches of law. The development of economic concepts in response to the now acknowledged need for a macroprudential approach to financial regulation, i.e. one which addresses systemic issues as well as microprudential, firm-level measures, promises a more comprehensive, overall conceptual framework for financial analysis and policy but one which still seems very much in the future.

[6] Such integration is especially evident in Minsky's discussion of banking (Minsky, 1986: chapter 10). Efforts to integrate accounting concepts into the microfoundations of modern macroeconomics since the publication of Keynes's *General Theory* seem to be very few despite the early pioneering work along these lines of Kenneth Boulding in *A Reconstruction of Economics* (Boulding, 1950).

[7] For an example of a sophisticated approach to technical analysis see Plummer (1998).

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Economic and social inequality

The presentations on this subject provided overviews of alternative ways of measuring inequality at the global level, of some major trends in international inequality in a sample of countries, and of the relationship of economic inequality to indicators of social well-being again in a sample of countries. Explanations of underlying causes of these trends were largely eclectic, relying on statistical analysis of factors important at different times in countries' development. James Galbraith, however, did attribute general importance to the terms of trade, financial openness, and the terms and availability of international financing as determinants of fluctuations in measures of inequality since the 1970s. The mechanisms to which he drew attention under these headings are both macroeconomic and political. The evidence presented by Galbraith does not support a close relation between equality and parliamentary democracy per se but a stronger one between equality and the overall thrust of countries' economic policy.

The directions for future economic thinking to which Galbraith's paper points are more in-depth investigation of the relationship between political and policy regimes and inequality as well as of the potential for increasing general welfare of improved international governance which starts from acknowledgement that countries now have only limited capacity to insulate themselves from the forces of global capitalism. What was largely missing from the conference's discussion of inequality was the issue, much discussed since the outbreak of the crisis, of whether in major developed countries, in particular the United States and United Kingdom, as a force sustaining aggregate demand in good times but also contributing the difficulty of recovery from recession or depression, rises in personal debt had replaced the rises in personal income. The positive contribution to macroeconomic stability of an egalitarian distribution of income has long been a prominent feature of most Keynesian economics.

The political economy of stabilisation policies and systemic financial risk

Keynes the man and Keynesian policies were omnipresent at the conference. Very much in the spirit of Keynes's thinking was Richard Koo's analysis of why depressions and entrenched recessions like that of Japan in the 1990s can prove so resistant to the traditional instruments of countercyclical policy. Koo's analysis was complemented by explorations into the political economy of systemic financial risk by Edward Kane, by Thomas Ferguson and Rob Johnson, and by Simon Johnson.

Japan's extended recession of the 1990s was characterised by Koo as a balance-sheet recession. During such a recession, which follows a debt-financed bubble of asset prices, the private sector's priority becomes the repair of balance sheets through deleveraging. The result is a shortage of borrowers even at very low interest rates – a situation which Keynes denoted as a liquidity trap. The stimulus from monetary policy then becomes incapable of enabling an economy's exit from recession, and avoidance of a deflationary spiral requires expansionary fiscal policy to offset the savings of the private sector – and Koo here drew attention not only to contemporary history but also to the critical role of fiscal policy in stabilising the United States and German economies during the 1930s.

While the principal inspiration for Koo's thesis is the recent Japanese experience, he also pointed to parallels in the sluggish demand for credit since mid-2008 in United States, United Kingdom and the Eurozone. Premature fiscal tightening in Japan in 1997 and 2001 actually weakened the economy, reduced tax revenues and increased fiscal deficits, and Koo clearly believes that there is a danger that pressures for fiscal consolidation in United States and Europe will lead to similar policy mistakes. Beyond the

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policy issues Koo's presentation provided a concrete illustration of the danger stressed by White (as noted earlier) of paying insufficient attention to balance sheets in macroeconomic modelling and forecasting.

The presentations of Edward Kane and of Thomas Ferguson and Rob Johnson were both concerned with the role of distorted incentives in financial crises. Kane's focus was the way in which the impact of distorted incentives on regulation and supervision actually increased systemic risk, while that of Ferguson and Johnson was on the socio-political forces that influenced the shape of policy responses to financial crisis in a number of developed countries with particular emphasis on the extent to which these forces limited moral hazard by penalizing, managements, creditors and equity investors as part of the aim of deterring future risky behaviour.

Kane criticised the standard definition of systemic risk with its emphasis on what are (more often than not in his view hypothetical rather than experienced) spillover and contagion effects. Such a definition has led to inadequate attention to the huge tax-financed subsidies which result from policy interventions in support of large financial firms to avert systemic risk. Moreover firms' awareness of the central role of this definition in policy towards the financial sector has led them to shape their lobbying, product lines, accounting systems and organizational forms around the objective of ensuring the continuation of the national safety nets which underpin and thus subsidise their leveraged risk taking. Policy towards the financial sector should thus shift towards a focus on the scale of subsidised safety-net support (for which Kane believes there are now several promising metrics) and a reshaping of the incentives of both firms and supervisors to minimise this support.

For firms Kane recommends the now widely accepted idea that financial firms should prepare and file with their regulators "living wills", which would contain stand-by reorganisation plans to be activated in the event of the firms' demise, as well as extended shareholder liability under which a supervisors decision to liquidate a bank would entail the right to collect specified additional funds from assessable shareholders. For supervisors Kane proposes a regime with rules putting a greater emphasis on their fiduciary responsibilities. The most original element of this regime would be an extension to high-level supervisors of the principle of deferred compensation sanctioning errors *ex post facto*, application of which to high-level management of financial firms is now a widely accepted component of the official reform agenda.

Ferguson and Johnson reviewed policy towards financial crises according to various dimensions, all of which affect the scale and distribution of bail-out costs as well as the likelihood of future crisis recurrence: for example, the speed of the authorities' reactions to a crisis and the methods employed as part of bail-outs; restriction of the gouging of customers through higher fees and other charges by banks enjoying state support; and keeping policy interest rates exceptionally low during long periods. The survey by Ferguson and Johnson of the stringency of controls over moral hazard as part of the crisis response in a number of countries indicates that this is strongly related to typical voter turn-out and the parliamentary strength of socialist or social democratic parties. The unsatisfactory performance of United States is predictable according to these indicators, reflecting as it does the decline of the institutions of countervailing power (to use the phrase of John Kenneth Galbraith in Galbraith, 1957: 111-112) put in place by the New Deal of the 1930s as well as the framing of the current political agenda by well-financed lobbies to the increasing exclusion of the views of large parts of the country's citizenry. The pessimistic presentation of Simon Johnson provided a coda to Kane and to Ferguson and Rob Johnson, highlighting regulatory capture by the financial sector which

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is likely to ensure the perpetuation of the doomsday cycle of financial crises requiring bail-outs followed by inadequate efforts at reform.

Financial globalisation

Like macroeconomics and financial economics, financial globalisation was a pervasive theme of the conference. Global payments imbalances received relatively little attention. Franklin Allen commented on some of the causes and implications of the build-up of these imbalances but regarding appropriate policy responses limited himself to supporting the addition of the Chinese Renminbi to the ranks of reserve currencies. Charles Dallara advocated better macroeconomic policy coordination through the G20 as a way of addressing global imbalances but acknowledged that past experience indicated that success here would be slow. In current circumstances trying to reduce imbalances through the classical remedies of real currency appreciation in surplus countries and depreciation in deficit countries would be risky since it would be likely to lead to excessively deflationary policies. Other recent proposals such as recourse to WTO rules as a response to undervalued currencies and taxation or other controls on foreign exchange transactions as a way of dealing with excessive or perverse international capital movements were covered by speakers during the conference at best incidentally.

The session on the economic theory, history, politics, and policy responses of the crisis as an international phenomenon ranged widely over the historical background (George Soros), causes (William White), and the way in which, in response to trends in financial markets closely related to the crisis, the role of central banks in major developed countries has been expanded from lender of last resort to one now also including securities dealer of last resort (Perry Mehrling). Adair Turner and Guillermo Ortiz commented on many of the subjects in the current agenda of financial reform, with a primary emphasis the regulatory agenda. Dallara and Dr Yaga Reddy outlined two alternative and in significant respects conflicting perspectives on the basic shape of this agenda.

Dallara expressed overall support for global financial integration in which a key role in the promotion of international trade and investment is played by large, globally integrated financial institutions. Recent failures should be addressed through improvements regarding governance, risk, liquidity management, clearing mechanisms, and executive compensation as well as a strengthening of the framework within which global supervisory cooperation takes place – all important elements of the existing reform agenda. The framework for supervisory cooperation should include extension to institutions not currently covered, the development of macroprudential supervisory techniques to identify the dynamics of systemic risk, and arrangements under which large global institutions are allowed to fail and the consequences of such failures are dealt with through internationally agreed procedures. The emphasis of Dallara's presentation was on regulatory and supervisory harmonisation which might be best achieved through the establishment of a global body which could bring together the Financial Stability Board, the Basel Committee on Banking Supervision, and IOSCO.

Reddy by contrast brought to the debate a developing-country perspective whose significance lies in the fact that developing countries, in one way or another, have borne the principal costs of pre-2007 international financial crises since the 1980s while, at least until very recently, having little say in formulation of the international financial policies adopted to deal with them. Reddy's own standing has been enhanced by the regulatory reforms introduced pre-emptively by India since the beginning of the new millennium regarding such subjects as countercyclical bank reserves and regulatory capital requirements, stringent management of banks' liquidity, and prudent policies towards mana-

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gement of India's capital account. In Reddy's view future thinking on the global financial architecture should entail questioning of fundamental assumptions about the risks and benefits of financial deregulation and liberalization in the light of recent experience where crisis arose in the traditional international financial centres with consequences largely avoided by developing countries that had maintained tight control over financial opening. The agenda of reform should focus on minimum international standards of regulation accompanied by appropriate acknowledgement that beyond these standards financial regulation should be the responsibility of national authorities. A major focus of global regulatory rules would be the activities of international banking entities with balance sheets indicating heavy dependence on cross-border business as opposed to those operating though foreign branches and subsidiaries in multiple jurisdictions.

In addition to the subjects covered at the conference new thinking about the benefits of financial globalisation should also cover many other subjects: for example, the absence of evidence that uncontrolled capital movements are generally beneficial; estimates indicating that banks above a certain size benefit from few, if any, economies of scale but pose extremely difficult problems of management and internal control; the doubtful social benefits of competition between financial centres in the provision of services such as new stock exchanges; and the irrelevance of much cross-border banking activity to meeting the needs of SMEs and the rural poor.

Conference omissions: climate change and international trade

Climate change received little attention during the conference. From the point of view of the Observatoire this was a regrettable omission since the management of climate change targets collective wants or the common good on a global scale. However, the subject is so vast that it would have been difficult to fit its different dimensions into a single conference session.

It might be mentioned here that one subject covered at the conference, namely the way in which economic men and women are conceptualised in economics, should be a feature of new economic thinking on climate change. The narrow concept of economic rationality of much traditional economics – with utility and thus individuals' well-being determined solely by goods, services, and labour inputs – seems inappropriate for a world where constraints on certain kinds of economic growth may become increasingly binding and a changed relationship between individuals and their natural environment will probably be needed. Alternative ways of conceptualising individual utility and well-being should arguably accord greater importance to non-material and social or collective determinants (some of which are flagged in the book of Akerlof and Kranton mentioned above).

Similarly international trade was the subject of at best incidental attention during the conference. Nevertheless, international trade seems likely to be an inescapable subject for new economic thinking. Recent new contributions to the theoretical framework of the economics of international trade have an ad hoc character and have yet to lead to radical revision of a dominant underlying conceptual framework which was originally designed as a vehicle for arguments targeting conditions in countries' internal and external trade of the eighteenth and early nineteenth centuries. The lack of a conceptual framework better designed to accommodate the realities of contemporary cross-border transactions has contributed to the stand-off between supporters and opponents of further liberalisation of international trade, and to the absence of an economics which addresses so-called international trade in services, a subject which, owing to the inclusion of a mode of supply involving commercial presence as well as that involving traditional cross-border transactions, now includes cross-border investment as well as trade.

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3. Thoughts concerning the sequel to the conference

Participants at the conference clearly found it a vibrant event because of both the superb organisation and the opportunity it provided for an overview of shoots of alternative thinking in several areas of economics. But the question remains how to translate the good intentions evident into longer-term change in the discipline.

An overriding theme of the conference was the need for – perhaps one should say for a return to – greater intellectual pluralism. The questioning of fundamental tenets of current economic doctrine concerning finance which would accompany such pluralism would contribute to a context in which it would be easier to achieve increased convergence between finance and major societal goals, i.e. the raison d'être of the Observatoire. But there is a danger that new economic thinking, that resulting from INET's initiatives as well as that promoted in other alternative intellectual fora (journals, research programmes, etc.) will simply coexist with - without having a major impact on - structures and thinking long in place.

The context in which INET has been established is characterised by both favourable and unfavourable conditions for new economic thinking. Amongst the favourable are the following:

- the failures of the great majority of economists working within the framework of orthodox macroeconomics and financial economics either to identify the circumstances which were likely to lead to the current crisis or to have much useful to say about the way in which it has unfolded. The failures have been accompanied by an increase in self-questioning within the economics profession;

- what increasingly appears to be a permanent shift in the distribution of wealth and consequently economic weight away from United States and Western Europe. This shift, which has already been accompanied by an enhanced role for the G20 in global economic governance and other institutional changes in the same direction, is likely to be accompanied by a loss of prestige for the institutions and thinking of the old developed regions – and thus increased space for new economic thinking.

- a cupboard of ideas of alternative thinking in economics which already exists and is anything but empty as is evident, for example, from scrutiny of the regular Heterodox News Letter [joth@buffalostate.edu]. Heterodox academic economics boasts several intellectual clans, and parts of its output are directed primarily at other members of the author's clan or clans. But alongside of such output are work and ideas of much wider potential interest which none the less is all too often ignored within orthodox faculties and institutions.

Amongst the unfavourable conditions (in addition to the forces of inertia in economics faculties mentioned earlier under the organisation and sociology of economics) are the following:

- pressures to conform with the prevailing orthodoxy in economics - always an integral part of the discipline's history - which in recent years have been given a new structure and force by formal systems for the assessment of research and thus the allocation of research funding that place the primary emphasis on publication in a limited number of prestigious journals. Such

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assessment exercises not only fail to take proper account of the several other forms which valuable research can take but and have also proved a threat to intellectual pluralism. Moreover such assessment exercises place great - some would maintain unjustifiably great – weight on the peer review process for publication in the selected journals. The resulting pressures can be expected to be especially great for economists at the beginning of their careers. Casual empiricism suggests that, amongst the better known professional economists, those who question current trends in research and teaching frequently enjoy the protection of being at an advanced stage in their careers.

• academic curricula which often fail to expose students to alternative currents of thought and to the history of economics. Actual experience on this front is far from uniform but shortcomings are evident not only in North America and Western Europe but also in the newly capitalist countries of Eastern Europe. Such lack of exposure risks inhibiting intellectual innovation in economics and impoverishing discussion of economic policy.

• financial incentive structures which are heavily biased in favour of orthodox thinking. Important here are the generally higher salaries at major universities with orthodox faculties, openings in governmental and intergovernmental organisations for which applications from economists who have proved themselves in the orthodox milieu are received more favourably, and opportunities for large consulting fees. The latter can distort economists' pronouncements on events and policy and protect the institutions paying the fees from critical scrutiny.

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