TIGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER **Working Paper Series**

No. 126

After The Global Crisis

Domenico Mario Nuti

Warsaw, October 2011

After The Global Crisis[1]

Domenico Mario Nuti[2]

ABSTRACT

Conjectures about the post-crisis future of the global economy are path-dependent, i.e. they necessarily depend on the course of events envisaged for getting out of the crisis.

By and large, the economic system emerging from the crisis is bound to be substantially very similar to the pre-crisis one, improved in some respects, but worsened by large scale cuts in welfare expenditure made necessary by the (debatable) purpose of achieving fiscal balance. The post-crisis system will be more conflictual and insecure, more unequal and less cohesive, less rather than more "green" - basically a more unpleasant world in which to live. It need not be so.

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[1] This paper was presented to the World Public Forum "Dialogue of Civilizations", 9-th Annual Meeting, 6-10 October 2011, Rhodes.

[2] D. Mario Nuti is Professor of Comparative Economic Systems, University of Rome "La Sapienza"; e-mail: dmarionuti@gmail.com. Website http://sites.google.com/site/dmarionuti/ Blog "Transition" http://dmarionuti.blogspot.com/

After The Global Crisis

Conjectures about the post-crisis future of the global economy are path-dependent, i.e. they necessarily depend on the course of events envisaged for getting out of the crisis.

The current global crisis was the consequence of financial de-regulation and the general dominance of hyper-liberal policies in the United States, in the UK and in the global economy. It started around August 2007 as a US banking crisis arising from toxic sub-prime assets in banks' balance sheets; it turned into a credit crisis that depressed enterprise investment; it spread globally through the decline of foreign trade and the slowdown and often reversal of capital flows, including Foreign Direct Investment; and then - with the large scale cost of rescuing financial institutions by government budgets, the rising cost of labour unemployment and the decline in governments revenue - it grew into a fiscal crisis and, ultimately, a widespread crisis of sovereign debt, particularly in the Euro-zone.

Initially the decline in industrial output, foreign trade volume and stock exchange values replicated the scale and the pattern of the 1929-32 crisis. Soon the impact of the crisis and cross-country contagion were mitigated by simultaneous, internationally co-ordinated, monetary expansion and fiscal stimulus, introduced at the end of 2008 and early 2009. But monetary expansion failed to re-launch economic growth, while concern about fiscal sustainability soon led to a simultaneous, premature exit from fiscal stimulus in most countries. Current prospects - apart from those of BRICS (China, Russia, India, Brasil, South Africa, now accounting for 18% of world GDP and the bulk of its growth) - are of widespread stagnation and double-dip, indeed of a second and even more serious recession.

The macroeconomic policies followed appeared to have a keynesian flavour, stimulating aggregate demand via tax cuts, monetary expansion and low interest rates. But keynesian remedies would have required public investment instead, whereas tax cuts temporarily fuelled private consumption, and the effectiveness of low interest rates - which mostly were not passed on to borrowers and simply involved higher profits for financial intermediaries - was limited by liquidity preference.

The rescue of financial institutions involved a massive transfer of wealth from taxpayers to bank creditors, including depositors and shareholders. This solution was clearly inferior to any of the alternatives, whether support for bank debtors, or partial nationalization of supported financial institutions, or outright loss-taking by imprudent lenders. Income inequality, whose depressive effect on effective demand had been reduced by credit expansion - one of the contributory factors of the crisis - increased further as a result of labour unemployment and continued payment of managerial super-bonuses awarded mostly to those responsible for the financial debacle not by markets but by a semi-feudal process of self-serving decisions by a managerial caste.

The current generalized advocacy of strict fiscal discipline, demanded by international financial institutions and often enshrined in national constitutions as a balanced budget obligation, is particularly anti-keynesian, and is bound to be counter-productive in the middle of a recession.

First, a balanced budget is neither sufficient nor necessary to the sustainability of government debt, because a primary surplus (net of interest payments) may or may not be necessary to debt sustainability - depending on whether the economy grows at a rate slower or faster than the average interest paid on government debt.

Second, the keynesian lesson has been forgotten or ignored, that the balance of government expenditures minus revenues, plus the balance of private investment minus savings, plus the external balance of exports minus imports, must necessarily add up to zero as a matter not of theory but of accounting consistency. Therefore the budget balance cannot be a policy instrument, but only a target that may or may not be achievable depending heavily also on the behavior of national economic agents and of global trade partners (including the elimination or large reduction of Germany's trade surplus vis-à-vis the rest of Europe, and China's gigantic trade surplus). Generalized efforts by all governments to balance their budgets simultaneously might actually result in a perverse combination of budgetary (and trade) imbalances as well as a lower level of employment and income worldwide than would be the case without such efforts.

By the same token, generalized efforts to promote employment and growth via higher international competitiveness - whether achieved by external devaluations or by domestic deflation of wages and prices - can also be competitively self-defeating: another clear keynesian lesson is that lower wages can raise employment through higher exports in one country, but cannot resolve unemployment as a world problem. Nor can world unemployment necessarily be reduced by a generalized reduction of employment tenure and other labour welfare provisions, or the replacement of collective bargaining by firm-level bargaining: the only certain effect of such policies, also very popular in anti-crisis policy packages under the pretext of “structural reforms” (e.g. see the European Central Bank’s guidelines to the Italian government in their letter of 5 August 2011) is the deterioration of the quality of work and labour incentives.

Often it is believed that the impelling necessity of environmental improvements, required by the reduction of global warming and of general pollution, and the forthcoming exhaustion of natural resources, will create a new important opportunity for investment and growth. However - apart from the observably controversial nature of global warming - these are all opportunities for *public* or *public-funded* investment, desirable in itself (not absolutely but up to some point) but competing with alternative uses of scarce public funds whose expenditure today is supposed to be kept under control in the interests of fiscal sustainability.

The chances of world leaders suddenly learning keynesian lessons, *and* implementing them *with the speed and on a scale* adequate to propel the global economy out of stagnation are remote, indeed would amount to a miracle. Even those who would like to do it are prevented by the electoral challenge of populist competitors (as is Barack Obama by his Tea-Party Republican challengers). By comparison the prospect of Wealth Sovereign Funds coming to the rescue of highly indebted governments might seem a more normal occurrence, but this would be the true miracle and is simply not going to happen: it worked in 2008 to the advantage of financial stabilization, but now WSFs have run out of trust.

The fact that the US can always “print” the dollars it owns to pay its creditors does not make the US debt indefinitely sustainable: at some point the resulting dollar inflation will make dollar bonds unpalatable at less than crippling interest rates so high that they would necessarily involve eventual insolvency. Other countries face even stricter debt sustainability conditions, without the same initial room for manoeuvre. Where private wealth largely exceeds the difference between current debt and its sustainable level, it is always possible to apply a once-and-for-all or recurring wealth surcharge to achieve solvency. Italy, for instance, has a public debt of euro 1,900 bn, but in 2008 it had a household wealth of euro 8,600 bn, 45% of which was concentrated in the top 10% of households; but wealth taxation is unpopular and the political will to introduce it is scarce. Privatization of public assets is often considered as a way to reduce sovereign debt, but the potential revenue obtainable from this source is usually overstated with respect to the depressed values realizable during a crisis, when it is infelicitously timed.

An insolvent country, like Greece, has only three alternative options: 1) instant orderly default with significant “hair-cuts” negotiated with creditors; or 2) instant dis-orderly default; or

3) delayed default, whether orderly or dis-orderly, preceded by roll-over of debt with the assistance of international financial organizations (like the IMF, or the European Financial Stability Fund soon to become the European Stability Mechanism, or the European Central Bank with its controversial purchases of government bonds in secondary markets) followed eventually by actual default, as in all schemes of pyramid banking, to which such rollover of uncovered debt has been likened.

The three default options are ranked above in order of increasing cost. However it should be remembered that non-default by insolvent debtors is also very expensive, as witnessed for instance in the large scale fall (of the order of 25%-30% in just one quarter in mid-2011) in the capitalization value of stock exchanges in temporarily solvent Euro-zone countries with uncertain longer-term solvency.

Partly the probability of default, assessed by Rating Agencies (like the oligopolistic three: Standard and Poor's, Moody's, Fitch), reflected in the interest spreads with respect of bonds regarded as totally secure (like German *Bunds*) and in the price of insuring bonds against default by buying Credit Default Swaps, expresses political as well as economic judgments (as in the recent case of Italy, handicapped by a corrupt, disreputable and divided government short on credibility).

Of course Rating Agencies have proven to be highly fallible and often biased, for they have their own agendas to drive forward, have positions of conflict of interests ("issuer pays" instead of "buyer pays") and opportunities for insider trading. Alternative, *public* Rating Agencies have been advocated, for instance in Europe, but such institutions could not be regarded as independent and therefore their credibility would be low. Better still, "*the use of ratings in financial regulations should be significantly reduced over time"* (as was suggested in the de Larosière Report of 2009 under Recommendation 3, but never acted upon by European authorities).

In order to contain the unavoidable disruption and turmoil involved by a country's default, it would be essential to anticipate its adverse effects and counteract them beforehand, by re-capitalizing commercial banks exposed to the cross-effects of default, including central banks and above all the European Central Bank that has been acting (probably exceeding its mandate) as Lender of Last Resort to the governments of "peripheral" (meaning "high spread") countries. An experience of default is bound to depress the price of, and thus raise yields on, old and new government bonds for the whole area; therefore contagion would worsen the sustainability conditions of debt, and therefore slow down the speed of subsequent recovery.

Furthermore, a post-crisis global economy should have renewed efforts to establish some form of global governance rather than have in place the many and inadequate *ad hoc* institutions cobbled together to, at present, provide some semblance of governance. But in order to be established global government now would have to be universally accepted not only in its initial form, but also in all its rules for the continuous adjustment to future, unforeseen and unforeseeable, circumstances: such acceptance now is probably out of the question. Besides, the demotion of the nation state is not necessarily desirable. For the nation state provides a layer of authority that can protect citizens from global corporations as well as from a necessarily monopolistic global governance authority that could easily misbehave out of democratic control, and without any remaining territory to which one could run for cover.

Eventually the post-crisis economy - sooner or later - will begin to recover, thanks to the profitability of production and investment being raised by depressed wages (due to mass unemployment), the accumulation of new profitable technical inventions and opportunities, the progressive depletion of existing inventories and production capacity. Once started, recovery would tend to be amplified by indirect effects, such as the usual interaction between multiplier and accelerator, until potential capacity constraints are met again and some cyclical mechanism is set in motion again in reverse. Such is the inexorable logic of the market economy. But reliance simply on market self-regulation will most probably lead to recovery much later than possible with government intervention and jump-starting. It is unfortunate that the inadequate policy responses of 2008 and their premature withdrawal should have grossly diluted their effectiveness thus making the implementation of growth policies harder today.

Changes must also be attempted in order to prevent the operation of factors that facilitated the last global crisis, or to better cope with them. The increase in banks' capitalization, envisaged by the Basel-3 new rules, will have an initial adverse effect on the volume of lending but longer term benefits for financial stability. A new composite currency is bound to emerge, in place of the US dollar or the euro.

Regulations on the separation of credit and investment operations of banks (*à la* Glass-Steagall Act) are bound to be reintroduced, as already proposed in the UK by the Vickers Commission. The Over The Counter derivatives trade might be subjected to stricter regulations, such as the requirement of an underlying "insurable" interest for taking up a position in that market, or the prohibition of short-selling, temporarily introduced in the European Union on shares and government bonds. The traditional principle of Central Bank independence in the exclusive pursuit of inflation targeting - based on the now discredited theory of rational expectations and the consequent de-coupling of inflation and unemployment - is bound to change into the even more independent pursuit of multiple targets including employment and competitiveness. We might witness attempts to protect domestic industries and stop immigration - largely unsuccessful in view of the irresistible force of underlying trends.

Currently, by and large, the economic system emerging from the crisis is bound to be substantially very similar to the pre-crisis one, improved in some respects, but worsened by large scale cuts in welfare expenditure made necessary by the (debatable) purpose of achieving fiscal balance. The post-crisis system will be more conflictual and insecure, more unequal and less cohesive, less rather than more “green” - basically a more unpleasant world in which to live. It need not be so.

Summary

Conjectures about the post-crisis future of the global economy are path-dependent, i.e. they necessarily depend on the course of events envisaged for getting out of the crisis.

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