

Heterodox Economics Newsletter

ECONOMIC REFORM NOW: A GLOBAL MANIFESTO TO RESCUE OUR SINKING ECONOMIES, by Heiner Flassbeck, Paul Davidson, James K. Galbraith, Richard Koo, and Jayati Ghosh. New York: Palgrave Macmillan, 2013. ISBN: 978-1-137-36165-3; 180 pages.

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Davidson, as the Post-Keynesian authority he is, deals (in the first chapter of this interesting and highly recommended book) with a fundamental theoretical issue: uncertainty. According to his arguments, Keynesian economists distinguish ourselves from mainstream economists in that we recognize that the future is uncertain and that this fundamental difference leads not only to a different form of analysis (and, as a consequence, a different set of concepts), but also to different policy recommendations. Basically, he argues, mainstream authors have aspired to make economics look like a hard science and in their attempt to do so they have done more harm than good. One of the main axioms they make use of is “ergodicity,” a statistical property of time series and a term often used (though not exclusively) by orthodox economists¹.

The main purpose of Davidson’s article is to discuss the link between this axiom and austerity policy. Such a link is possible through Ricardian equivalence. The acceptance of this concept leads its defendants to propose fiscal austerity in the face of the current financial crisis on the basis that if public deficit spending increases: (a) private savings will increase above investment in anticipation of private agents having to repay public debt in the “certain” future, (b) “crowding-out” will occur as a consequence of the expected increase in the interest rate and/or because of the fall in confidence on well-predicted future consequences, and (c) this will create an undesired intervention for market forces to optimally operate, now and in the future, and will make it difficult to find the single existing equilibrium, as expected by micro-inspired macroeconomics textbooks. Of course, Keynesians do not recognize the validity of Ricardian equivalence, thus tend to make different policy proposals which sometimes even turn out to be the opposite of those of their counterparts.

Having discussed this rich and timely theoretical conceptual background, let us now discuss the arguments for the need for economic reform and the corresponding proposals of Ghosh (who focuses on developing economies) and Galbraith, Koo, and Flassbeck (who focus mainly on developed economies).

The Need for Economic Reform

Ghosh raises important questions concerning the role of the developing world in the context of the ongoing crisis. She mentions that the “decoupling” argument (the expectation of emerging economies being able to withstand the last round of economic crisis) does not seem to hold. In other words, the periphery is still greatly dependent of the core, and this dependence seems to hold for still some time. Moreover, the evolution of fundamentals in the periphery remains fragile and subject to more volatility than at the core. This stylized fact is enhanced thanks to globalization, deregulation, and liberalization. She states that, in order to provide an answer for developing economies, there are at least three aspects to consider: (1) the impact of financial liberalization, (2) the mercantilist obsession with export-led oriented growth strategies, and (3) the inadequate attention paid to ecological imbalances. A

¹ *Ergodicity* (or *stationarity*, a precondition of it) as “redefined” by DSGE model builders/defenders, and as used by Davidson, might in fact be equivalent to assuming certainty about the future, predetermined outcomes and so

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particularly interesting argument concerning financial fragility in developing countries is that their financial structures were created to deal with the difficulties associated with late industrial entry, thus that when these were created they were strongly regulated. Moreover, “[b]y dismantling these structures financial liberalization destroys an important instrument that historically evolved in late industrializers to deal with the difficulties of ensuring growth...” (p. 148).

Galbraith presents a review of the evolution of economic events and ideas stating that, as the former unfolded, the latter “were again very slow to change” (p. 40). His main diagnoses are that (1) the burden of the financial sector is too large because financial institutions impose large fixed costs on nonfinancial companies, (2) households in the US and governments in the European periphery are burdened by unpayable debts, (3) markets for securities created by banks are tainted by the reputation for shady dealing, and (4) that wealthy countries lack alternative, low-cost ways to supply finance to business.

Koo masterfully summarizes his idea of balance sheet recessions² and, in a nutshell, says that the US and some countries in Europe (notably Ireland and Spain) suffer from this disease. In contrast, Japan is on its way out of this type of recession and Greece is not in such a situation. What is perhaps most interesting in his article is (1) his critical analysis of the foundations of the European Union as well as (2) what he calls the difficulty of maintaining lasting³ fiscal stimulus (his proposed solution to balance sheet recessions) in a democracy. Regarding the first point (and referring to the Maastricht Treaty), he mentions that if the saving rate of a country stuck in a balance sheet recession (say, Spain) is 8 % of GDP and its government is allowed to borrow only 3 % of GDP, the remaining 5 % “will leak out of the income stream and the (...) economy will shrink by 5 percent per year” (p. 109). As for the difficulties of maintaining fiscal stimulus in democracies he mentions that *fiscal hawks* demanding to end the stimulus as soon as the economy shows the first signs of revival are out in numbers. This problem (absent, for instance in China, as Koo suggested in his 2009 book) arises mainly due to misinformation.

Flassbeck warns about the dangers of following orthodox prescriptions in labor markets. The conventional measures international organizations recommend tend towards stubborn and overrated liberalization and deregulation. The German model of wage restraint is put forward by the orthodoxy as an example of what other countries must follow, and the corresponding trade surplus as the potential reward. Instead, Germany has been sort of free-riding on other European countries thanks to the real exchange rate devaluation of the deutsche mark (or *real* “German euro”) since the creation of the EMU.

Policy Recommendations

The reaction to this non-comprehensive list of facts is, obviously, a set of proposals.

Ghosh proposes to reform the financial system, a switch from export-led to wage-led growth strategies, by bringing back fiscal policy and public expenditure to center stage, reducing economic inequalities between and within countries, and introducing new patterns of environmentally-friendly demand and production as well as a more democratic framework for international trade, investment, and production decisions.

² See his book “The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession”, or the following link for a review: <http://www.heterodoxnews.com/n/htm154.html#cat-17592186045702>.

³ “Lasting” in the sense that fiscal stimulus must go on until nonfinancial firms’ balance sheets allow them to afford borrowing again.

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For Galbraith, the financial sector must be shrunk and made more internally competitive, regulation must be brought back to center stage to effectively deal with the complex and opaque world of financial derivatives, and environmental-friendly policies must be in check.

For Koo, economies stuck in balance sheet recessions need (lasting) fiscal stimulus. For Europe, the solution he suggests (which considers the “transition period”) would imply a major revision of the rules upon which the Union was founded; the 3 % cap on budget deficits and lack of capital controls, mainly. He does not provide a proposal for the developing world.

In order to guarantee competitiveness without sacrificing workers’ purchasing power (or the other way around) Flassbeck proposes to follow what he calls the “golden rule” of the wage share, which consists in maintaining it at a stable level. For this to happen, the aim should be *rigid nominal wages* while having *flexible real wages*. He argues that profits, rather than wages, should be the adjusting variable.

Of course, these “unpopular” proposals are different from the usual discourse which, up to now, has led to (at best) no change from the situation since the financial crisis first hit. Heterodox economists agree (that is why we are heterodox) in that market forces have failed to provide employment, growth and well-being for all social classes. However, there is no clear consensus on the alternative to follow, and the proposals presented in this book are unfortunately not the exception. This is not bad. On the contrary, a variety of ideas is much better than all agreeing on a single undisputed universal “truth”. However, it is surprising to find diverging ideas among the authors of a single *manifesto*.

Despite some cross-references by Davidson, Koo, and Flassbeck, as well as a thorough revision and summary of all the proposals by Ghosh in the last chapter, some important differences in diagnoses and policy recommendations might lead the reader to believe these are contradictory, though they might not be!

Koo, for instance, mentions that “[i]f labor unions in countries with high unemployment like Spain and Greece were to accept *wage cuts in exchange for job security*, the competitiveness problem could resolve itself even sooner” (p. 119, italics added). In contrast, Flassbeck states that “[d]espite the *failure of labor market flexibilization to solve the unemployment problem* in the past, this [flexibility] hype came in response to the new spike in unemployment in the aftermath of the financial crisis” (p. 83, emphasis added).

As mentioned above, Galbraith suggests (without providing any theoretical or empirical justification) that the burden of the financial sector is too large and must, therefore, be reduced. However, Ghosh and Koo recognize that what matters is not the size of the financial sector, but its functionality. For Ghosh, the financial sector must, in the case of developing economies, focus on providing the necessary means to promote environmentally-friendly growth and decent living standards for all (starting with the unprivileged). For Koo, the financial sector must allocate credit from sectors unwilling/unable to borrow (e.g., private firms after a major asset price bubble burst) to those capable of borrowing and spending (e.g., the public sector during a balance sheet recession).

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Regarding ideological differences (even among authors adopting a similar theoretical approach), it is perhaps particularly relevant to cite, in full, Koo's wise words in the conclusions of his chapter:

“If John Maynard Keynes had written in 1936 that fiscal stimulus should be used only when the private sector is minimizing debt despite near-zero interest rates, his [often misread! LR] policy recommendations would not have been *abused* during the 1950s and 1960s and his theories would not have been discredited. Similarly, if Milton Friedman and his followers had realized that the linkage between central bank action and economic activity is valid only when the private sector has a clean balance sheet and is maximizing profits, many countries experiencing a balance sheet recession would not have wasted precious time tinkering with monetary policy when what they need was a fiscal response” (p. 131, emphasis added).