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FINANCIAL MARKETS AND
DEMOCRATIC SOVEREIGNTY

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Starting point

- Preamble = recent evolution of economic theory.
- During the '90s, new 'neo-classical synthesis':
Real business cycles + New Keynesian economics
based on monetary and 'real' rigidities →
DSGE models with endogenous rigidities (DSGER).
- DSGER → 'Great moderation' based on:
 - efficient market theory;
 - trickle down effect;
 - privatization and liberalization.

Starting point

- Mainstream in economic theory:
'Great moderation' → getting over economic cycles and economic crises.
- Hence, DSGER's institutional setting quite simple:
 - market as an efficient mechanism = main 'ordering principle' of the economic and social system;
 - polarization between market and State (government).
- DSGER's policy:
 - expansionary fiscal policy = distortionary ('crowding out' in the short-, medium-, and long-term);
 - monetary policy (interest rate policy) = effective in the short-term, neutral in the medium and long term.

Starting point

- Criticism towards mainstream based on:
 - capital market imperfections;
 - incomplete/asymmetric information;
 - rich set of intermediate institutions.
- Theoretical implications:
mechanism design for incentive schemes.
- Policy implications:
market regulation (also self-regulation), governance,
incentives, and public policies →
room for fiscal and monetary policies.
- Example: Italian reforms of the financial markets during
the 90's = inspired by this analytical approach.

Outline

- My presentation aims to show that:
 - (i) Mainstream as well as critical approach → break towards representative democracy and welfare state;
 - (ii) International financial crisis + European crises → inadequacy of both the approaches;
 - (iii) Hard failures of mechanism design and regulation → difficulties to address economic and social problems of the post-crises phase;
 - (iv) Lack of analytical innovations → shortage of alternatives.

Outline

- To analyze points (i)-(iv), seven sketchy steps:
 1. Breaking off of the old social arrangements;
 2. Few stylized facts from the crises also ← by (1);
 3. Regulation failures and reinstatement of the polarization between market and State;
 4. The new economic and social requirements;
 5. The lack of new ideas in social sciences;
 6. The role of supranational bodies (EMU);
 7. Still incentives, governance, and regulation?

1. Breaking off

- From the economic point of view, representative democracy centered on:
 - mediation of political parties towards different social components (rationalization + assemblage of heterogeneous interests);
 - welfare centered on public interventions.
- Main consequences:
 - decreasing inequalities inside a large number of advanced countries;
 - consequent enlargement of the middle class;
 - socialization of various economic and social risks (public/collective protections).

1. Breaking off

- Mainstream economics = market as the efficient allocative tool and as the crucial (or even single) mechanism for 'social ordering' →
 - privatization of large set of economic and social risks (from public to individuals);
 - growing inequalities in the income and wealth distribution;
 - dismantling of the middle class role and of the related social cohesion;
 - distortion of interests pursued by the declining components of the society (best example: Bush's proprietary society).

1. Breaking off

- Critical approach: incentive schemes and regulation →
 - general acceptance of the technological divide (ICT – ‘human capital’);
 - support to the opening of international markets and to the creation of supranational bodies;
 - faith in market competition and institutional simplification;
 - fragile “tools box” to modernize and reproduce social protection and consequent sharing of a partial privatization of economic and social risks.

2. Financial crisis: few stylized facts

- Six main phases of the financial crisis:
 - downfall of confidence in market contracts between financial intermediaries;
 - extreme strains in interbank interest rates and growing illiquidity in the chain of structured bonds;
 - dramatic restructuring of banks' balance sheet (from a high leverage to a chaotic deleveraging);
 - collapses in the share prices of banks and other financial institutions;
 - new form of "bank run" and bankruptcies of important US and European banks and non-bank intermediaries;
 - collapse of the financial markets and the deepest recession after the 1929-'33 crisis.

2. European crises: few stylized facts

- EMU's and EU's reaction to the first phase of the European crises (aids to Greece; Ireland, and Portugal):
 - "Case by case" interventions (Greece: bilateral agreements);
 - "Last minute" interventions implemented at the 25th hours and at growing costs (Ireland);
 - Too high interest rates (Greece and Ireland);
 - Too severe adjustment conditions (all cases);
 - Temporary interventions (all cases).

2. Crises: few stylized facts

- These few stylized facts emphasize:
 - market failures (example: market of structured bonds; rating agencies);
 - government failures (example: EMU and EU, but also Lehman Brothers v/s Fannie and Freddy, and AIG).
- However, main focus to be put on:
 - regulation and governance failures;
 - the inefficient impact of too complex incentive schemes.

3. Regulation failures

- Possible best examples:
 - Failures of too complex incentives schemes: banks' internal models and consequent leverage ratios out of control;
 - Failures of self-regulation: role played by rating agencies, and by 'mark to model' approach;
 - Excessive confidence in governance: inadequacy of internal risk management;
 - Failures of standard regulation: unmanageable information asymmetries of supervisors towards financial innovations and financial intermediaries.

3. Regulation failures

- Reaction to these regulation failures:
 - London G20 (April 2009) = attempt to design a stream of regulatory initiatives;
 - Dodd-Frank act (July 2010);
 - Various initiatives in EU and EMU flowed into the Banking Union process:
- However:
 - too late;
 - lack of implementation;
 - regulation of the previous stream of innovations

4. New requirements

- Contradictory economic objectives and tools:
Objectives:
 - path of strong and viable growth;
 - re-equilibrating fiscal policies.
- Tools:
 - 'spending review' despite the high values of the 'multipliers';
 - structural reforms + organizational innovations despite the high rate of unemployment.

4. New requirements

- Hence:
 - combination of economic change and social protection.
- This combination →
 - strengthening of 'technological divide';
 - new poor;
 - different but not lighter welfare (i.e.: public intervention to offer 'insurance of last resort').
- Problem: compatibility between new welfare, reduction of international imbalances, public debts under control?

5. New ideas in social sciences

- During the Thirties = spread of new ideas.
Economic theory:
 - disequilibrium models (see Hicks 1939);
 - sequential approaches (see Lundberg 1937);
 - foundation of macroeconomics (see Keynes 1936).
- Today = Old ideas (that is, 'zombie economics': see Quiggin 2011) v/s Keynes' framework.
Proof: Popper's falsification paradigm works.

5. New ideas in social sciences

- Policy consequences:
EMU: since the beginning of the European crises = few Member states meet the new SGP.
Crucial example: Public debt/GDP ratio (see Table 1).
EMU: long recession in peripheral Member states.
- Hence: tightening fiscal policies v/s increase in aggregate demand via public expenditures.

5. Public debt/GDP

	TABLE 1	
COUNTRY	PUBLIC DEBT/GDP 2010	COUNTRY PUBLIC DEBT/ TOTAL EMU DEBT (2010)
EURO AREA	84%	100%
GERMANY	76%	24,58%
EURO AREA – “AAA” COUNTRIES	76%	54,64%
AUSTRIA	71%	2,57%
FINLAND	50%	1,15%
FRANCE	84%	21,22%
LUXEMBOURG	20%	0,10%
NETHERLANDS	66%	5,02%
“AAA” COUNTRIES WITHOUT GERMANY	76%	30,06%
BELGIUM	100%	4,57%
CYPRUS	61%	0,14%
ESTONIA	8%	0,01%
GREECE	134%	3,97%
IRELAND	93%	1,89%
ITALY	119%	23,79%
MALTA	67%	0,05%
PORTUGAL	83%	1,83%
SLOVENIA	34%	0,15%
SLOVAK REPUBLIC	42%	0,36%
SPAIN	63%	8,60%
EURO AREA – NON “AAA” COUNTRIES	96%	45,36%
EURO AREA WITHOUT GERMANY	85%	75,42%

6. Supranational bodies

- These opposite positions on policy bring back to another and old opposition: market v/s State (government). Moreover, the latter fits with EMU's current representation. According to the majority of citizens in the peripheral Member states:
 - European institutions are responsible for austerity;
 - Possible way out = increase in the public expenditure to stimulate aggregate demand;
 - European rules are the main impediment to this solution.

6. Supranational bodies

- Moreover, European institutions and rules = lack of representation.
- Hence: problem of democracy in a framework characterized by the old polarization between the market and the State.
- This → misperception of the deep evolution in European economic governance during the last four years = creation of a rich set of new intermediate institutions.

7. Incentive schemes and regulation?

- Final questions:
 - how to overcome the lack of representation (political scientists, inspired by Machiavelli);
 - how to give room to new policies (besides non-conventional and temporary monetary policies);
 - how to combine these new policies with the new European institutions;
 - how to make it possible a positive interaction between these European institutions and the national one.

7. Incentive schemes and regulation?

- Possible general answers:
improving trust inside EMU;
overcoming pervasive 'rent seeking' positions;
opening economic and social system to changes;
redefining allocation of social expenditures.
- Without new analytical ideas, this →
reappraisal of incentive schemes, governance,
and regulation.
- Problem: may we forget regulation failures?