# Economic Policy and Business Activity

1st cycle, 3rd year, 2nd semester
"Licenciaturas" in Economics and in Management,
optional for Finance and Applied Mathematics
ISEG, 2016-2017

Chapter 1

# ECONOMIC POLICY: FOUNDATIONS, LIMITS AND METHODOLOGY

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# Index

1. Introduction
2. The *whys* and *hows* of public intervention
3. Evaluating public policies
4. The limits of economic policy
5. Living with interdependences: an updated view

# READINGS

## Theoretical Classes

| Weeks | Chapter of the program | Chapters of the textbook | Pages of the textbook[1] | Boxes |
|---|---|---|---|---|
| 1 and 2 | Chapter 1 | Chapters 1 and 2 | 3-42<br>57-59<br>62-128 | 1.1 to 1.3<br>1.5<br>2.5<br>2.7<br>2.10 |

[1] Boxes of the textbook not included in the last column in the right are not mandadory readings.

# Readings
# (Practical Classes)

**Text 1**

- **OECD (2011), Evolving Paradigms in Economic Policy Making, *OECD at 50: OECD Economic Outlook*, Vol. 2011/1, pp. 1-23**

**Text 2**

- **Thomas J. DiLorenzo (1996), The Myth of Natural Monopoly, The *Review of Austrian Economics*, Vol. 9, nº 2, pp. 43-58.**

**Text 3**

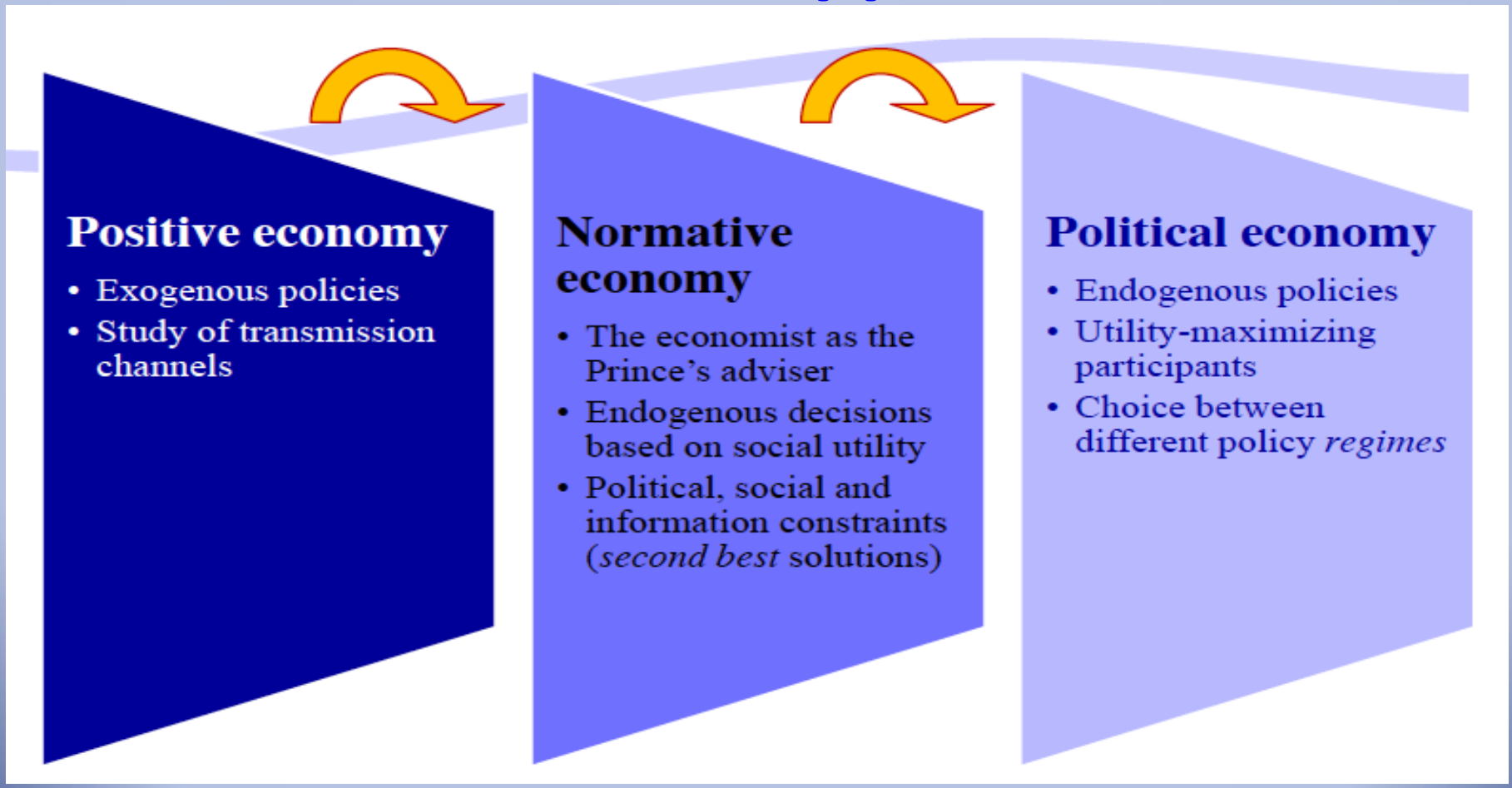
- **Friedrich von Hayek (1974), The Pretense of Knowledge, Nobel Lecture (December, 11).**

**(All these texts are included in the SEBENTA)**

**First Preliminary Test: March 3, Texts 1 and 3**

# INTRODUCTION

# Three basic approaches




**The approaches are not without reciprocal relations**

## *BACKGROUND*

***Laissez faire*** **versus interventionism or perhaps the more appropriately in the framework of economic policy the "*mix* between state and market".**

# What economic policy makers do?

- Set and enforce the rules of the economic game
- Tax and spend
- Issue and manage currencies
- Produce goods and services
- Fix problems (or pretend to)
- Negotiate one with each other

# The first and primary function of the state is the "night watchman"? The Smith's view

"Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, *but peace, easy taxes, and a tolerable administration of justice*; **all the rest being brought about by the natural course of things**." (italics JRS)

Quoted by E. L. Jones (1987), The European Miracle: Environmemts, Economies, and Geopolitics in the History of Europe and Asia, 2nd edition, Cambridge University Press, pp. 234-235.

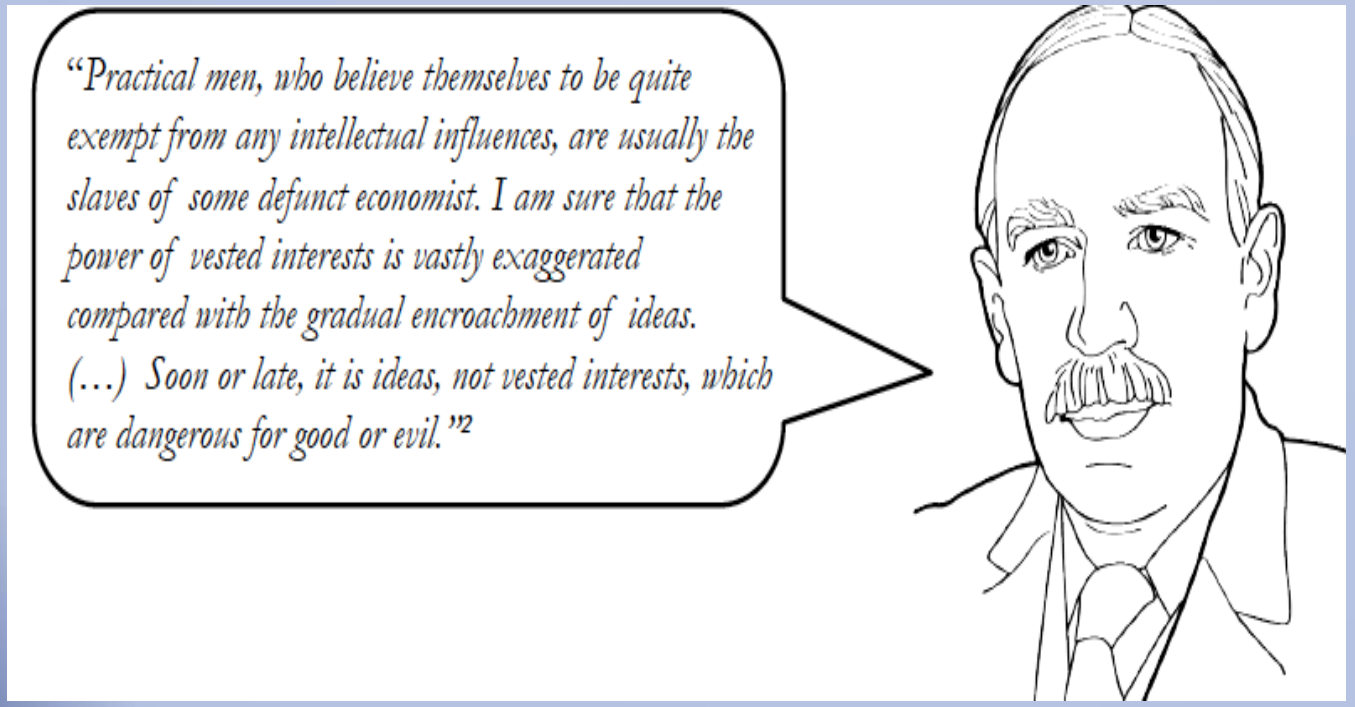
# JM Keynes praises the "wisdom" of mercantilists!

**"The mercantilists were under no illusions as to the nationalistic character of their policies and their tendency to promote war. It was national *advantage* and *relative* strength at which they were admittedly aiming. We may criticise them for the apparent indifference with which they accepted this inevitable consequence of an international monetary system. But intellectually their realism is much more preferable to the confused thinking of contemporary advocates of an international fixed gold standard and laissez faire in international lending, who believe that it is precisely these policies which will best promote peace."**

**(italics JMK)**
***The General Theory*, 1936, p. 348**

**"A sad aberration by a noble mind", Lionel ROBBINS**

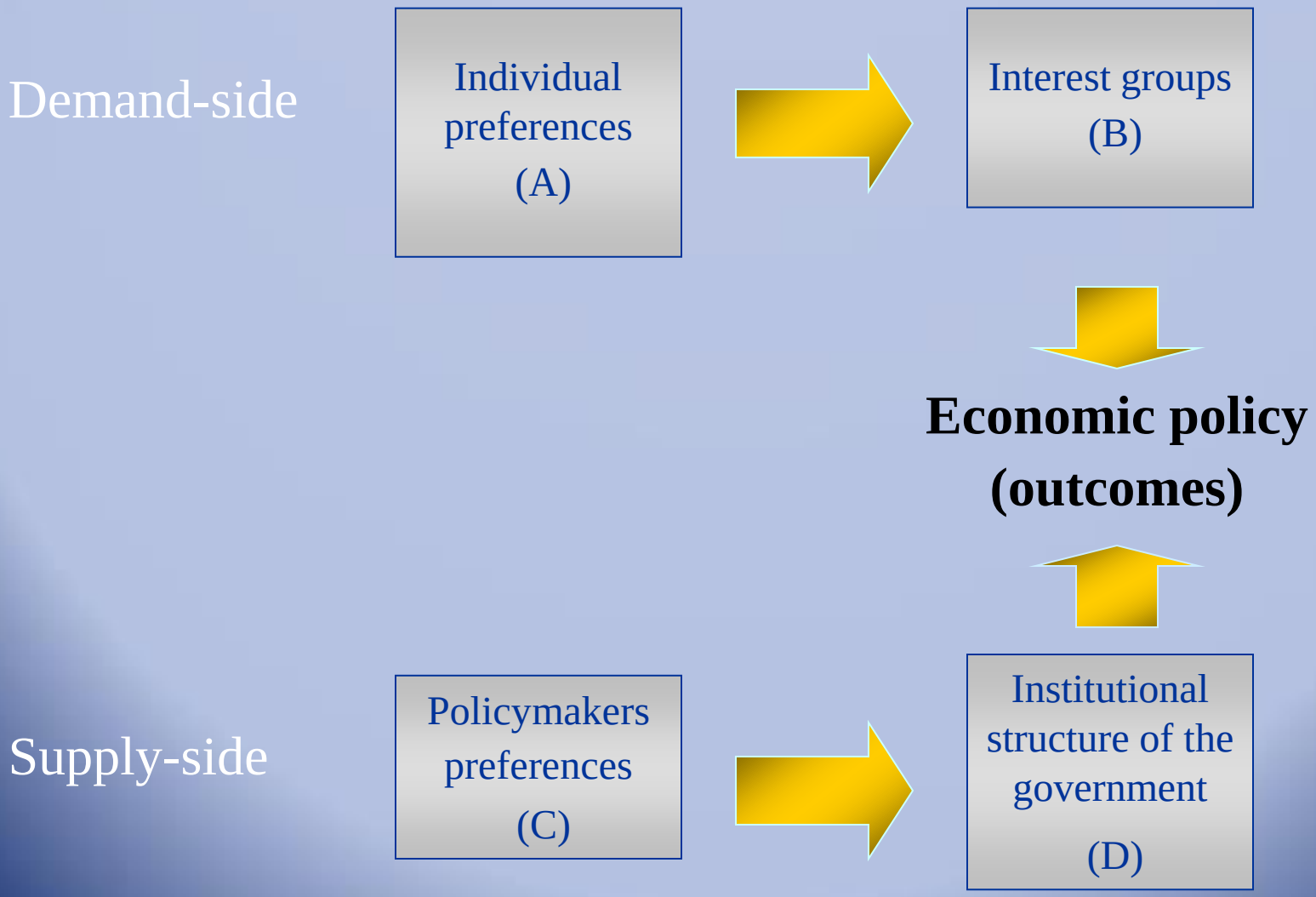
# J.M. Keynes/F. von Hayek on a relevant issue to EP: Vested interests or ideas?




***"I firmly believe that in the long run human questions are guided by the intellectual forces"***

F. A. von HAYEK (1937). *Monetary Nationalism and International Stability*, p. 94

# Determinants of Economic Policy



# THE FORCE OF IDEAS, NOT REALLY!

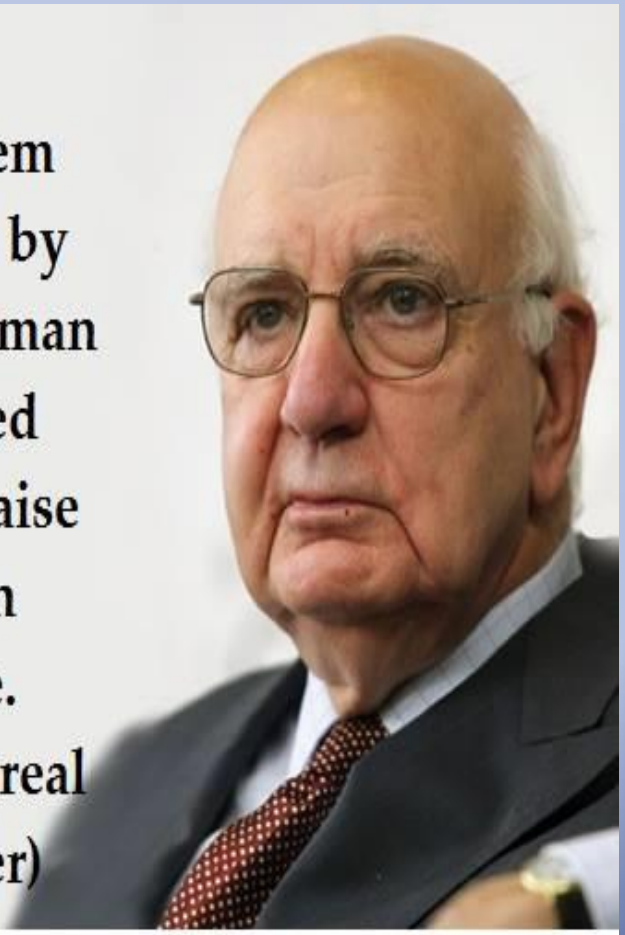
## (The point of view of a Keynes's biographer)

**"It was not theoretical elaborations that gave rise to postwar growth. Keynes overestimated the role of ideas and the power of reason and underestimated the role of political expediency. We have seen where this error led him in his negotiations with the Americans during the Second World War. He believed until the end that reason would prevail, when in reality it was the power of the victor that was imposed. It was the war that created full employment and not the publication of *The General Theory*. The Marshall Plan which followed and allowed for Europe's economic revival can appear as the late application of what Keynes had vainly hoped for in 1919. But this plan resulted more from the American desire to counter the Soviet bloc expansion than from reading *The Economic Consequences of the Peace*. The events that followed can be explained by the intersection of a series of factors in which political struggles, as much within countries as between countries and blocs of countries played a major role. Of course, Keynes's theory was extremely useful in understanding this dynamic."**

Dostaler, G. 2007, *Keynes and his Battles*, Edward Elgar, p. 258

# VOLCKER'S ADVICE: "PULL ECONOMICS BACK INTO THE REAL WORLD OF POLITICAL ECONOMY"

"The economics profession is in trouble... We are dealing with an intellectual problem —a profession that has been absorbed by theoretical constructs abstracting from human behavior. We are dealing with ingrained ways of thinking. The challenge is to raise questions about accepted approaches, in drawing lessons from recent experience. We need to pull economics back into the real world of political economy." (Paul Volcker)



*Economic Sociology and Political Economy community* @EconSociology

**PAUL VOLCKER (1927 - …)**
**President of the Federal Reserve during two mandates (1979-1987)**

# A simple representation of EP

- **Objectives:**

  **efficient utilization of resources, improvement of welfare, full employment, price stability, fair distribution of income, environmental sustainability, etcetera.**

- **Instruments**:

  **interest rate (monetary policy), level of public expenditures and taxes (fiscal policy), among others.**

- **Institutions:**

  **capital markets**
  **economic policy decisions**
  **social capital**

# The Economic Policy Regime

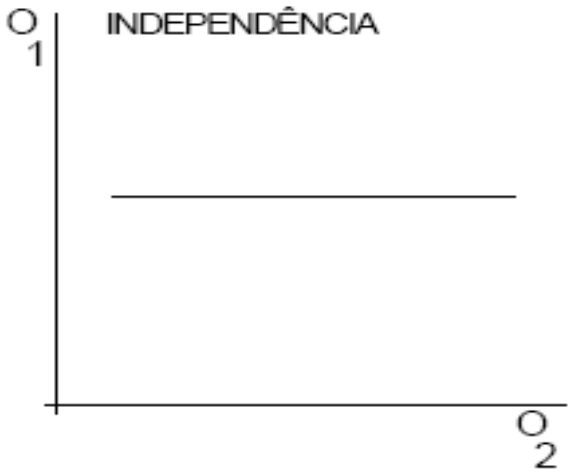
- A set of economic targets/priorities
- A nominal anchor
  - Fixed exchange rate/convertibility
  - Money supply rule
  - Inflation/price level target
- A division of labor (assignment)
  - The government (fiscal policy)
  - The central bank (monetary policy)
- A mode of conduct
  - Discretion
  - Rules - commitment
- A system of constraints
  - Political – declared policy
  - International –binding agreements
  - Constitutional
  - Expectational – anticipations, behavior

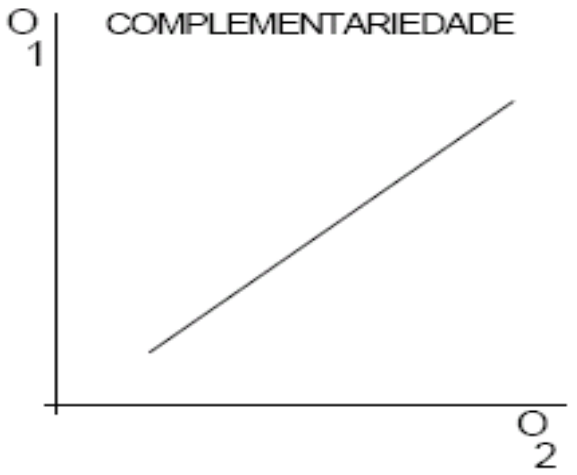
(From Hans Tson Soderstrom, Stockholm School of Economics)

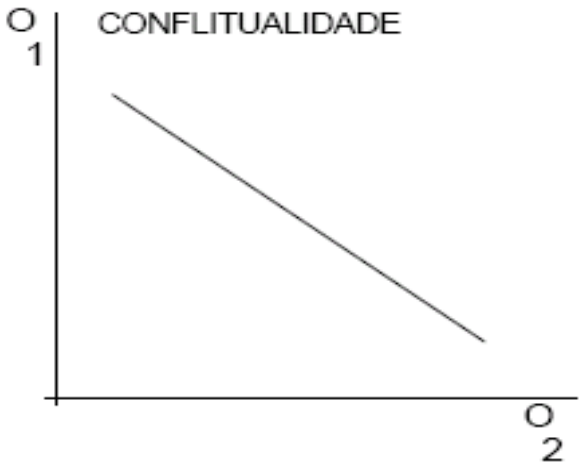
# DISCRETION *VERSUS* RULES

**DISCRETIONARY MEASURES are those taken by policy decision-makers, according to their own evaluation, and on a basis case by case. RULES (assignment) are instruments of economic policy put in force without the necessity of observing and deciding on the basis case by case.**

# Possible relations between objectives: independents, complements, conflicts, complements/conflicts




# Tinbergen Rule as a basic framework for EP

***Institutions***

In a broad sense, *e.g.* independent central banks, trade unions, wage-setting rules…

***Instruments***

*e.g.* policy interest rates, government spending …

→

***Objectives***

*e.g.* full employment, stable prices…

***P instruments…***
***… but P < N !!***
***N objectives…***

→ ***Trade-offs***

***Examples: Phillips curve, central banks' loss function***

*Jan Tinbergen (1903-1994)*

# TINBERGEN RULE

**With *n* objectives and *p* instruments we may conceive the following three cases:**

***a)*** ***p = n*** **the number of instruments equals the number of objectives allowing to reach a unique solution in the field of instruments.**

***b)*** ***p < n*** **the number of instruments is lower than the number of objectives what does not allow a solution for the problem because there are not sufficient instruments for the level of intended objectives.**

***c)*** ***p > n*** **the number of instruments is higher than the number of objectives what allows several solutions in the field of instruments.**

**Thus disequilibria may arise within the context of Tinbergen Rule, for example when the number of instruments is lower than that of objectives.**

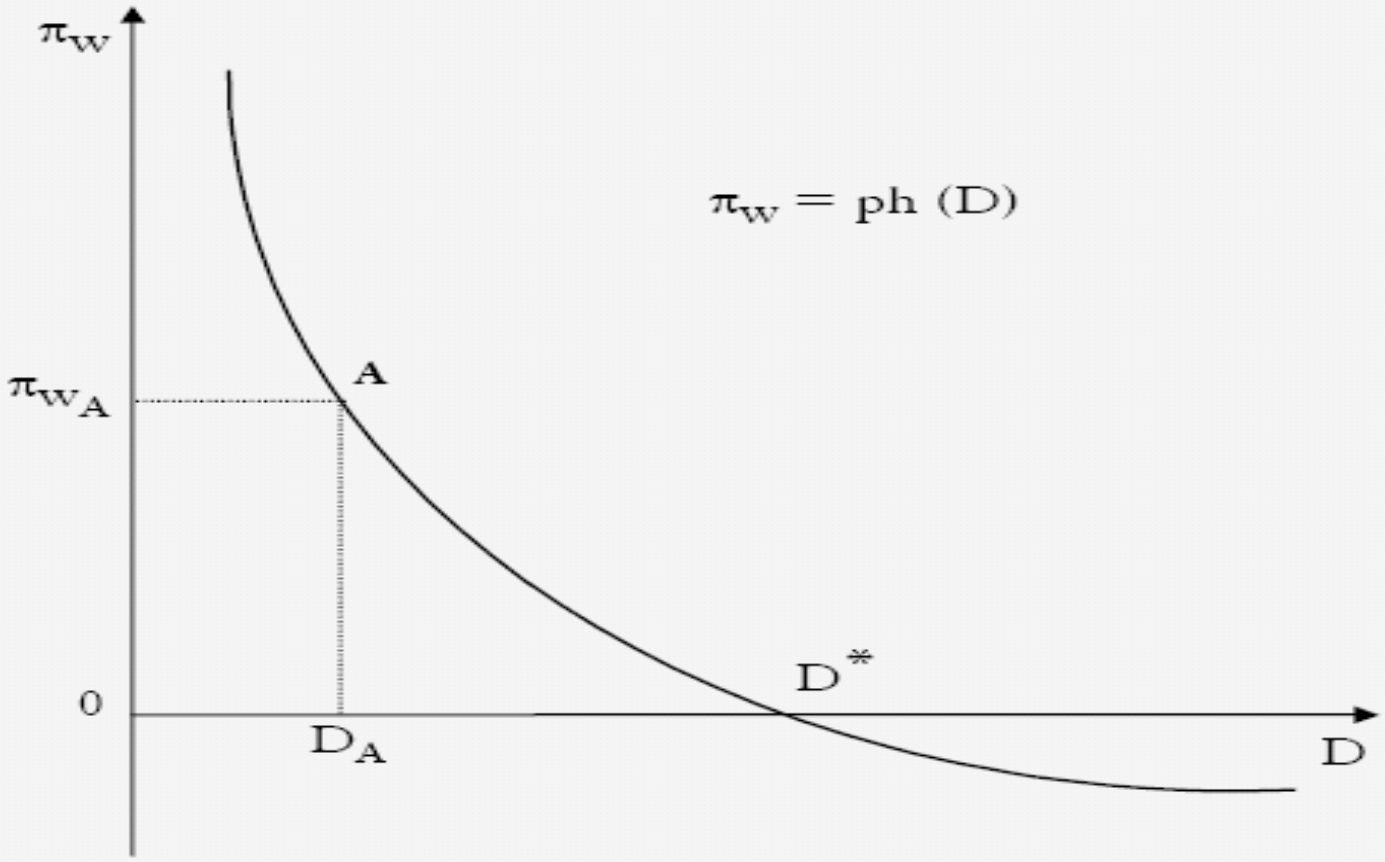
# Loss function (*F*) and the trade-offs in EP

**If the government has a higher number of objectives (*n*) than instruments (*p*) to attain them, its preferences can be expressed by a loss function that depends on the difference between each *n* variable and its desired value. This difference may be minimized, depending on the values attributed by government to the *p* policy variables.**
**Summarizing:**

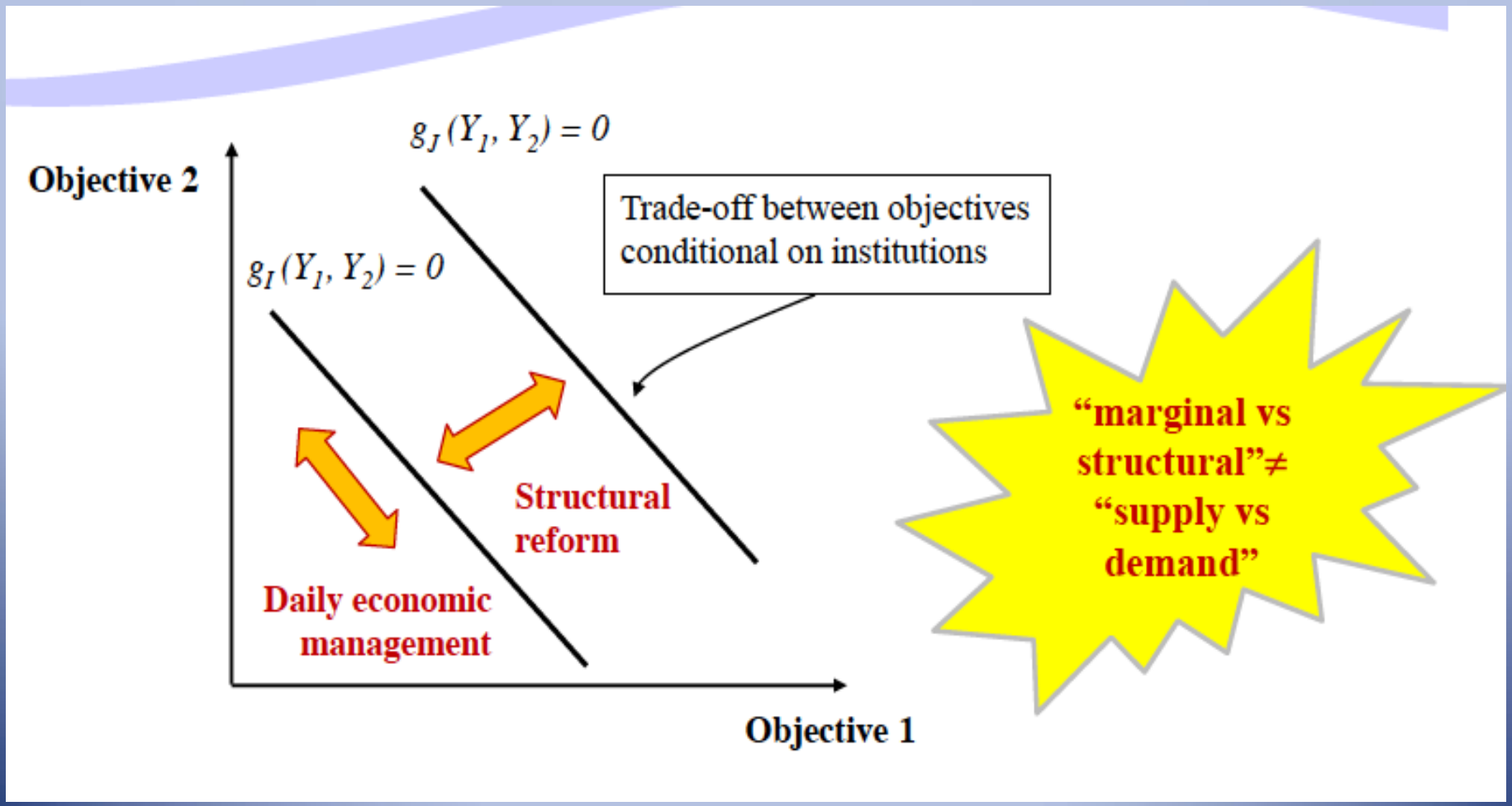
**TINBERGEN RULE:**

**To reach *n* independent policy objectives, needs at least an equal number of policy instruments (*p*).**

# Phillips curve: an example of contradictory objectives based on the inverse relationship between inflation and unemployment



# Marginal trade-offs versus structural reforms



# Inter-temporal trade-offs

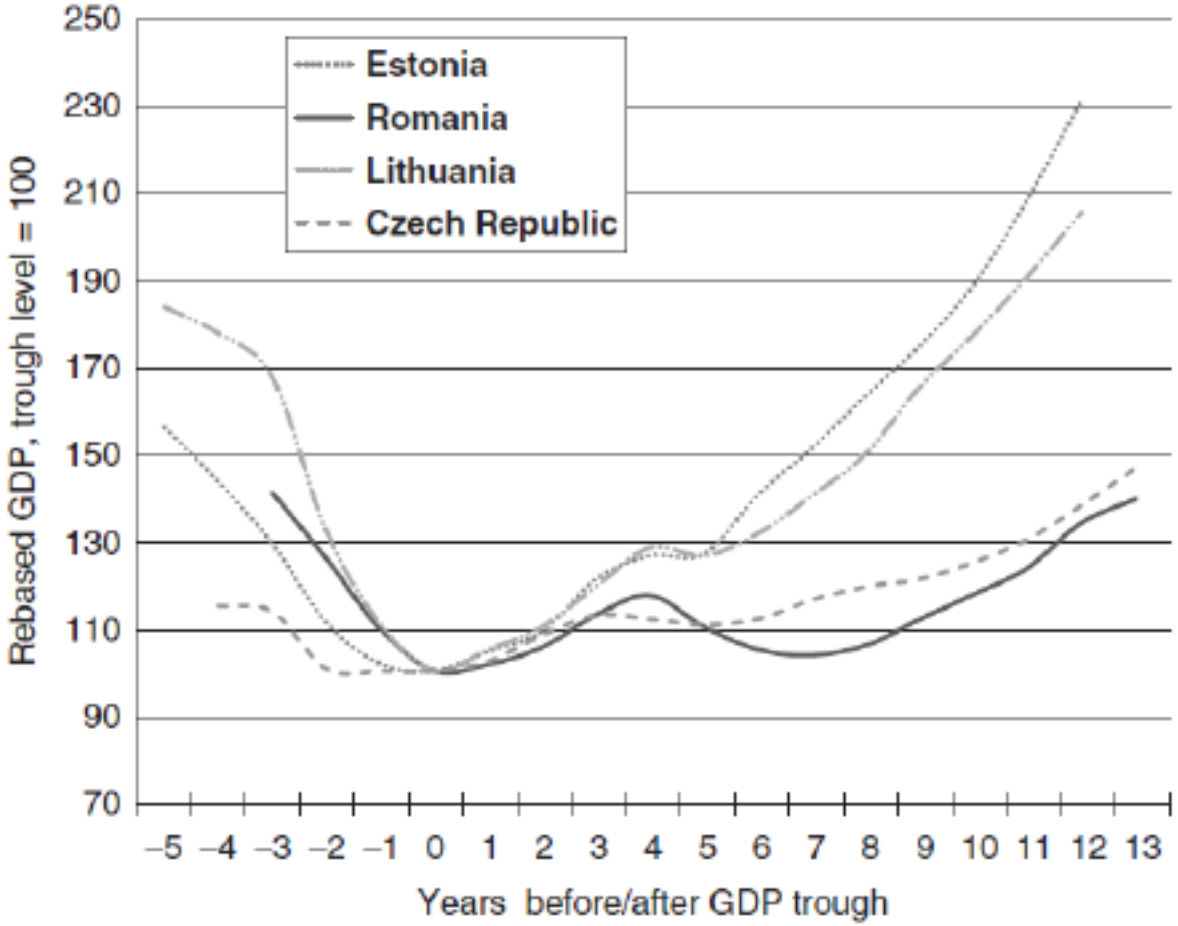



**Figure 1.4** GDP impact of the transition to the market economy.
Source: Authors' calculations based on the Groningen Growth and Development Center's Global Economic database.

**Structural reforms are often viewed as having negative short-term but positive long-term effects.**

# Employment versus productivity

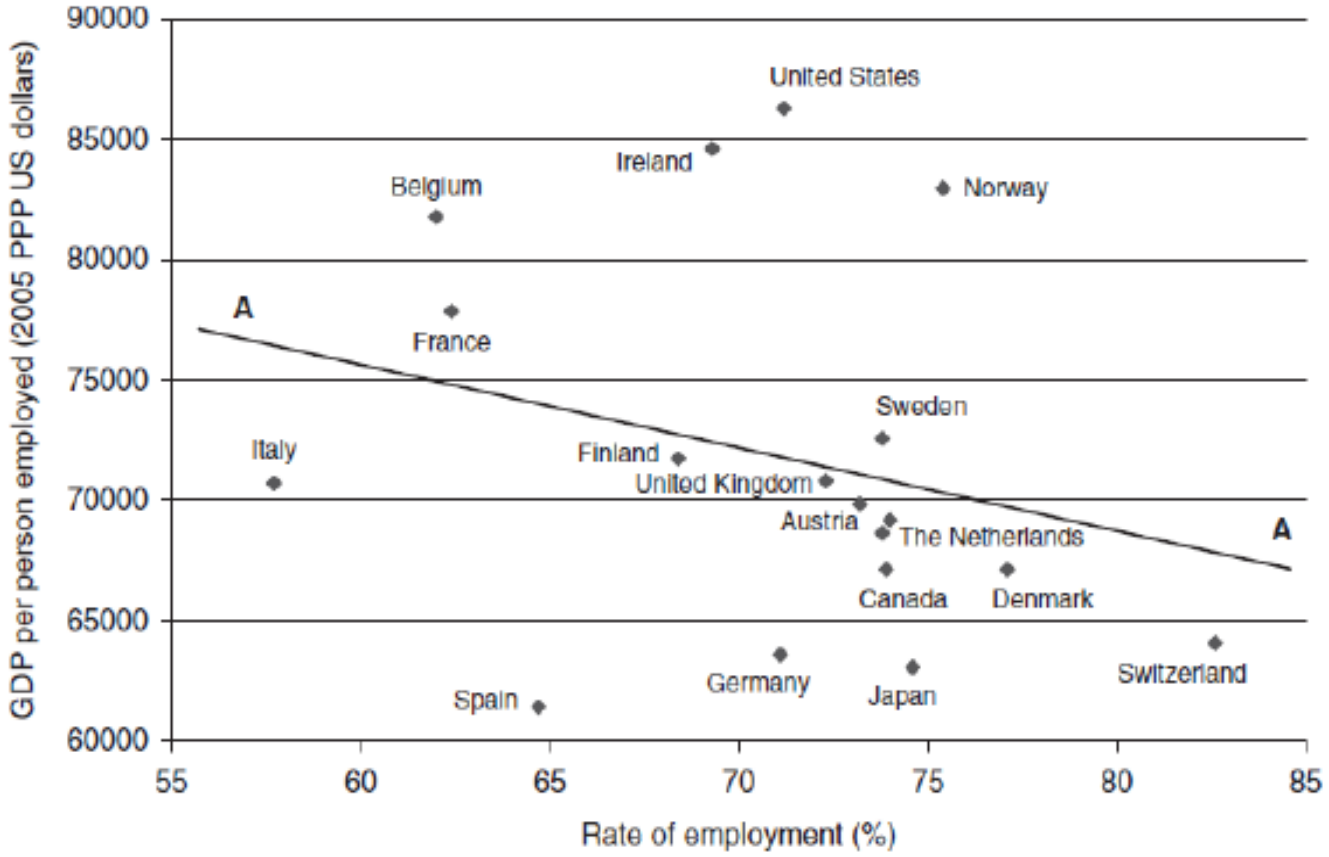



**Figure 1.2** The employment–productivity trade-off in 2005.
Source: Authors' calculations using Groningen Growth and Development Center and OECD data.

**THE EXAMPLE OF TWO OBJECTIVES SCARCELY COMPATIBLE.**

# THE *WHYS* AND *HOWS* OF PUBLIC INTERVENTION

# A Starting Point: Welfare Theory

- **First theorem of welfare (Arrow and Debreu)**
  - **"*Any competitive equilibrium is a Pareto optimum*"**
  - **In this case, *it is not possible to improve the* welfare of an economic *agent without reducing that of another one*.**
- **Redistribution is possible, but based on which criterion?**
- **Strong validity conditions:**
  - **perfect competition**
  - **perfect information**
  - **complete markets**

**For von Hayek "perfect competition" is the "competition without competition", and, in particular, he demolished one of its pillars that of free (or costless) and complete information. According to him, knowledge to compete is all but free!**

**For details, see F. Von Hayek (1946), "The Meaning of Competition", in *Individualism and Economic Order*, Chicago University Press (edition of 1980), pp. 92-106.**

# The Three Functions of Economic Policy

- ***Allocation*** ⇔ market inefficiency
  - ex. competition, education, infrastructures, climate...
- ***Macroeconomic stabilization*** ⇔ short-term nominal rigidities
  - ex. monetary and fiscal policies
- ***Income redistribution*** ⇔ corrects the primary distribution of income
  - ex. taxation, social transfers, housing, regional policies

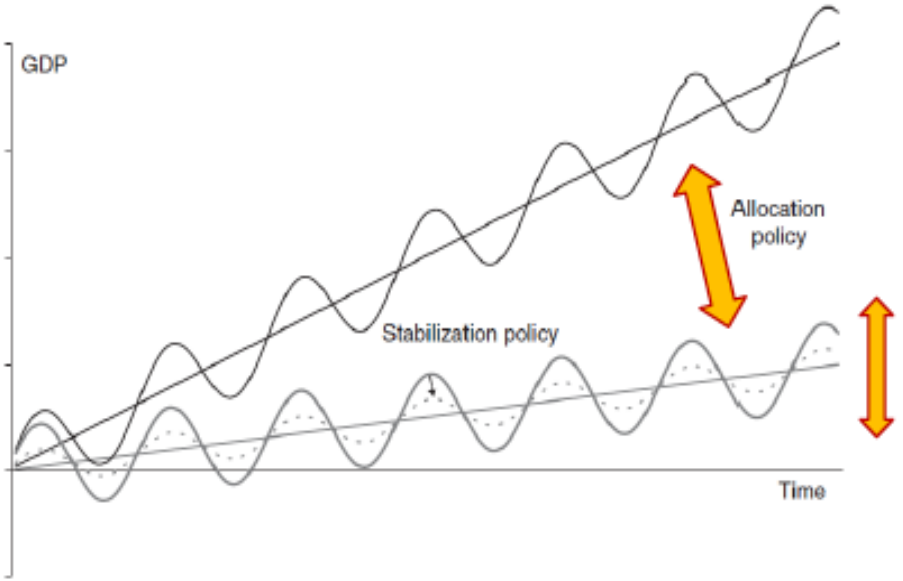



**Figure 1.5** Stabilization versus allocation policies.

- ***Allocation policies impact potential output***
- ***Stabilization policies impact the output gap***

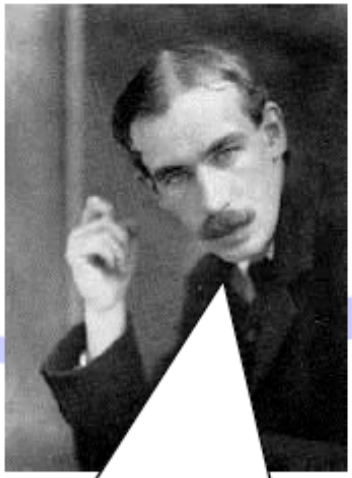
***Output gap*: the difference between actual ($Y_t$) and potential output ($\overline{Y_t}$).**

# Why to intervene for stabilization?

- **ACCORDING TO KEYNES THERE ARE TWO MAIN REASONS (macroeconomic arguments)**

- **Animal spirits: the instability of private behavior, particularly that of entrepreneurs, which is influenced by spontaneous expectations leading alternatively to excessive optimism or excessive pessimism.**
- **The nominal rigidity of wages and prices that prevents the auto correction of the market to reestablish full employment.**

# “Animal spirits *versus* savings”



## More on stabilization

*“A large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of* ***animal spirits.***”

J.M. Keynes, *General Theory*, Chapter 12.

- ***Expectation instability + short-term nominal rigidities preventing self-adjustment***
- ***Need for counter-cyclical policies to smooth economic fluctuations and face depressions***

### Supply and demand shocks

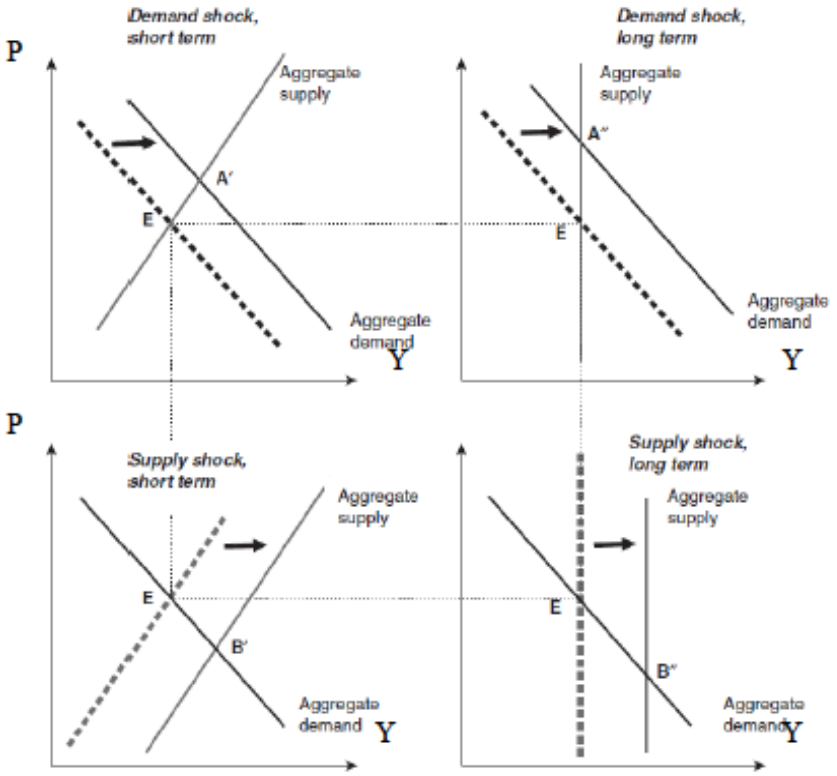


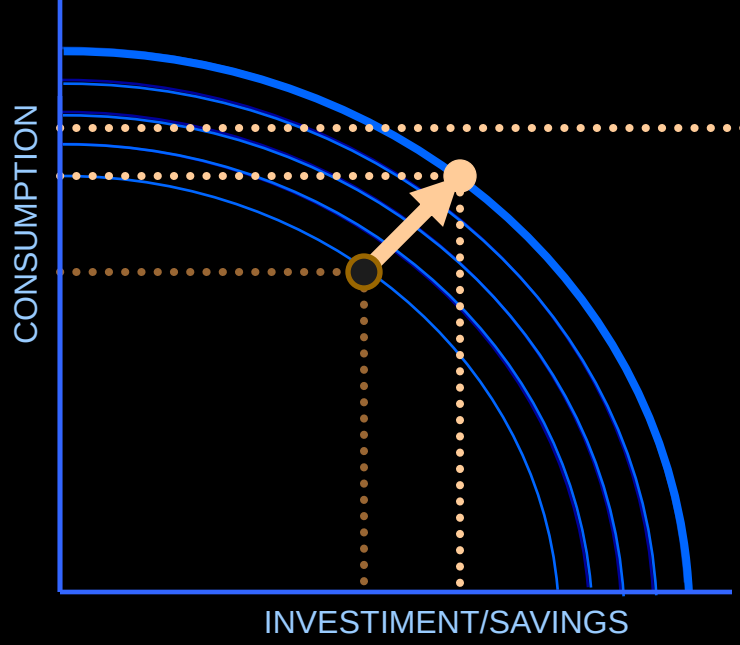

Figure 1.6 Supply-and-demand shocks in an aggregate supply–aggregate demand framework.

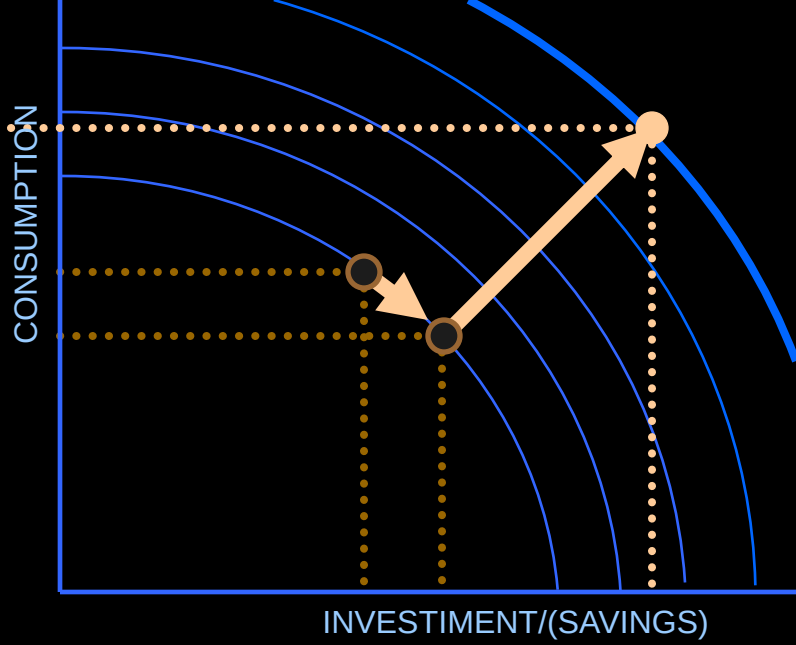
# BREAKING LINES

## The Austrian explanation of the economic process is based on the role of savings and time-preference (the trade off between immediate consumption and savings/investment).

From:

***Time and Money:***
***The Macroeconomics of Capital Structure***
**by Roger W. Garrison**
**London: Routledge, 2001**



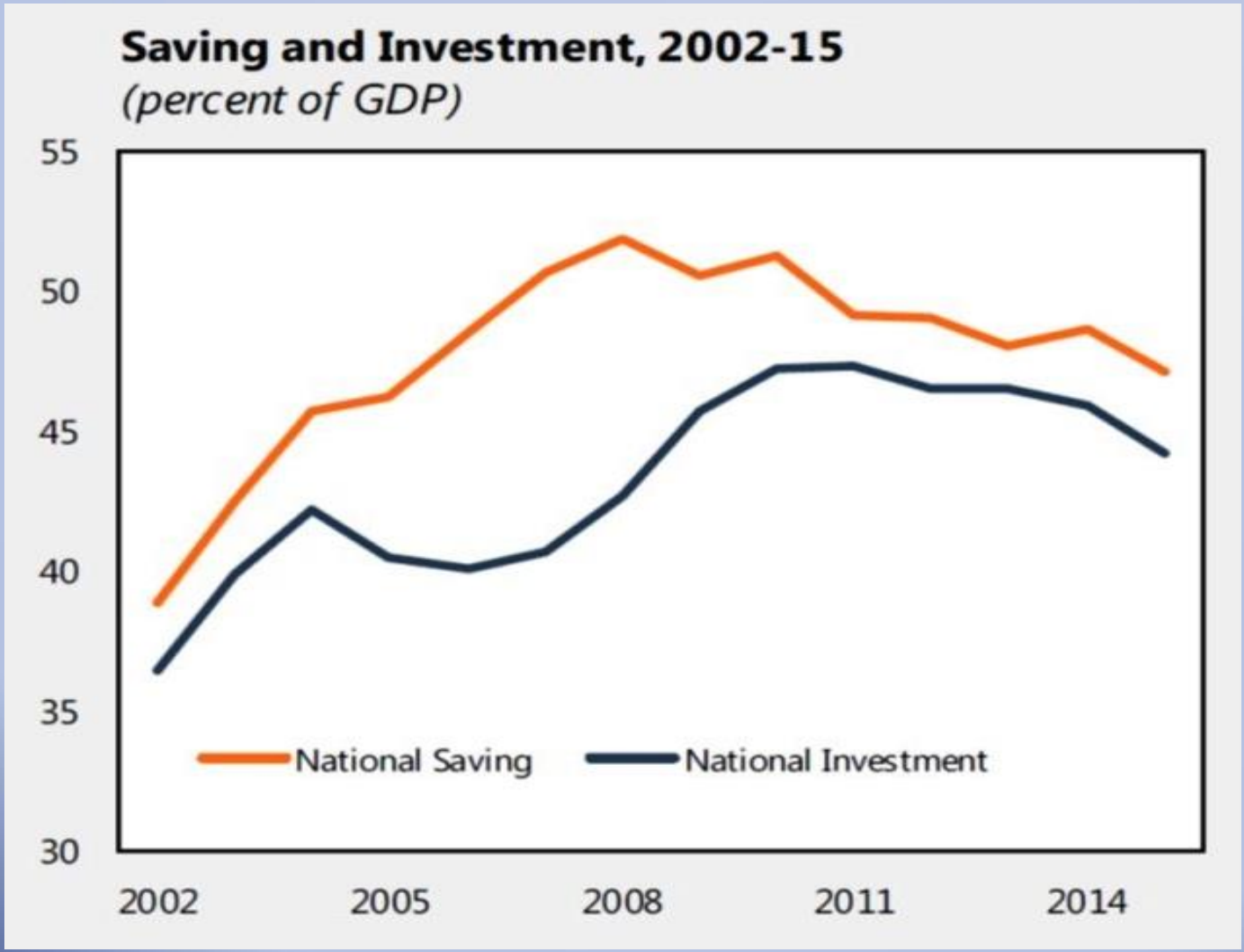

**Let's note the difference that an initial increase in savings brings to the pattern of consumption and investment (we are in the context of the well known PPF)**

**Without an initial increase in saving, consumption and investment increase modestly from one period to another.**

**With an initial increase in savings, investment increases at the expense of consumption, after which both consumption and investment increase dramatically from one period to the other.**

**Going to the fourth period, initial savings turned into a higher level of consumption than would otherwise have been possible.**

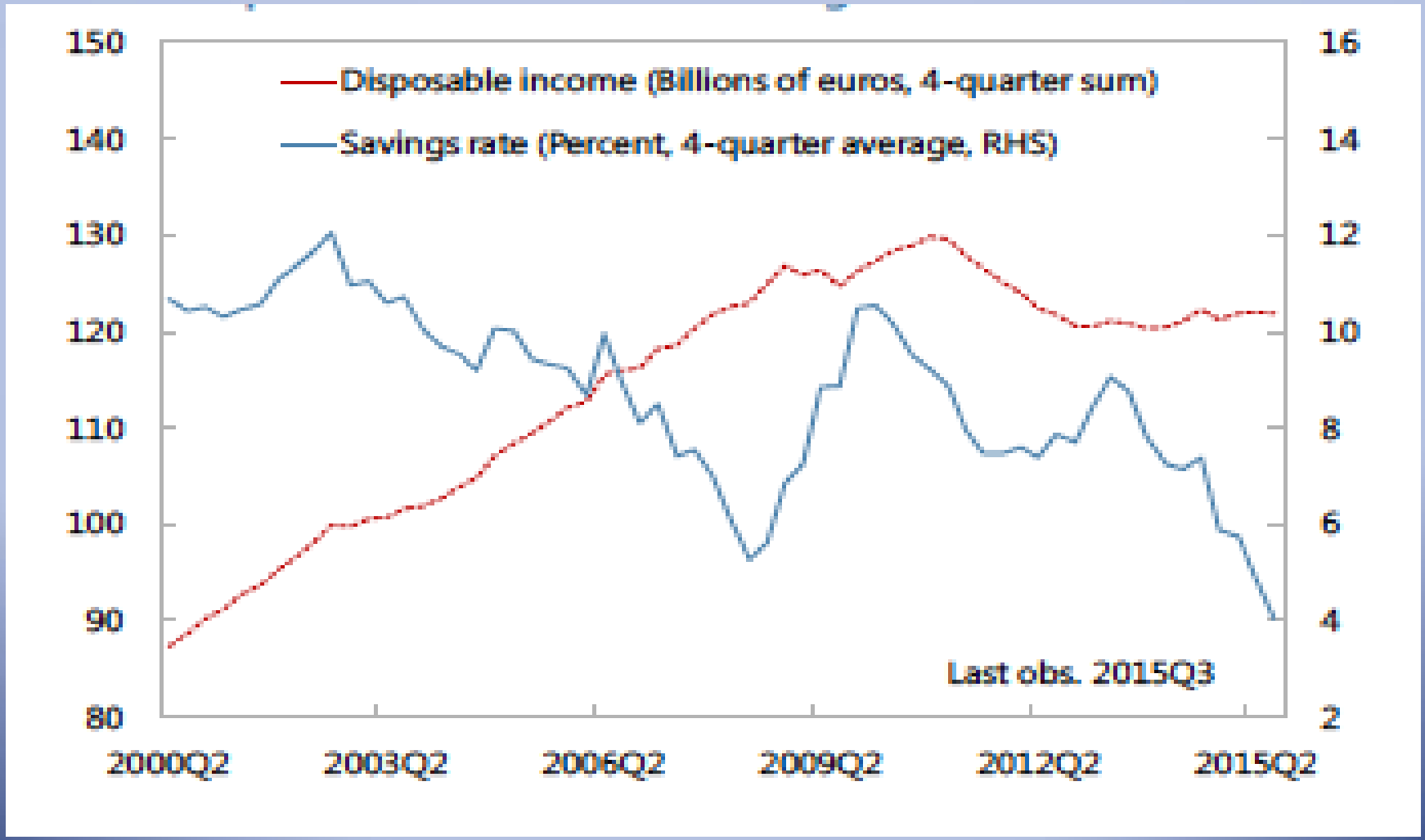
# CHINA: SAVING AND INVESTMENT, 2002-2015




**Source: IMF, 2016 External Sector Report, July 2016**

**What about "The Global Savings Glut" (Ben Bernanke)?**

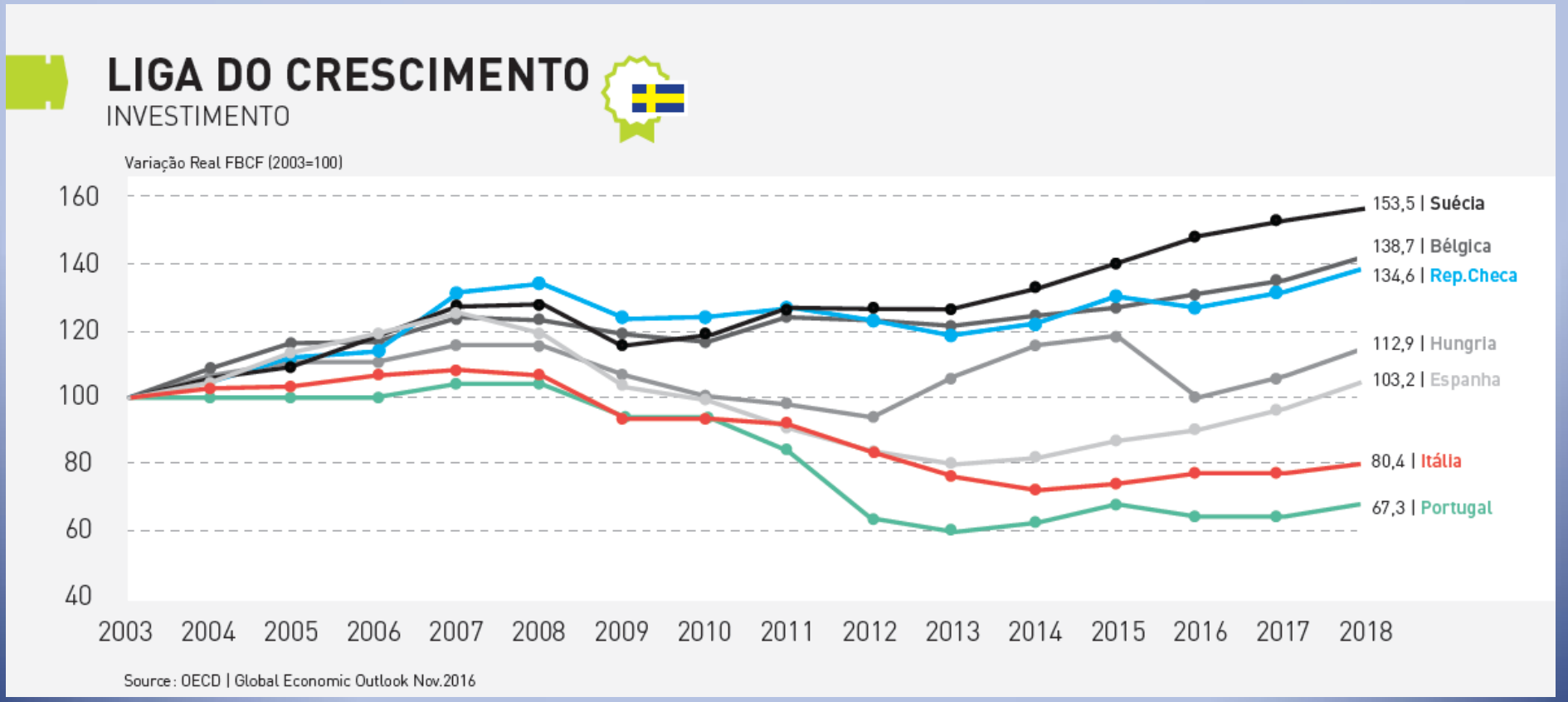
# DISPOSABLE INCOME AND SAVINGS RATE IN PORTUGAL SINCE 2000




SOURCE: IMF Report, 2016

# Investment growth in some EU member states, including Portugal

## (OECD forecasts for 2017-2018, February 2017)



# More on Redistribution

- ***Two arguments***
  - Pareto optimality (resulting from first welfare theorem) does not amount to social justice
  - Efficiency-enhancing policies (*e.g.* trade) make winners and losers
- Income distribution can be corrected in a non-distortionary way through lump-sum transfers
- Difficult to implement in practice => frequent ***equity-efficiency trade-offs***
- Need for ***social-welfare criteria***:
  - To compare gains and losses / Pareto optimum
  - To help address trade-offs
  - To act consistently

# Direct and indirect effects of typical EP measures

Direct and indirect effects of three public policies(direct effects are indicated in bold type)

| | Allocation | Stabilization | Redistribution |
|---|---|---|---|
| Reduction in income tax | + (**increase in labor supply**) | + (increase in demand for goods) | − (increase in inequalities) |
| Increase in government expenditures | +/− (depends on the content of expenditure and on the possibility of crowding out private expenditure) | + (**by hypothesis**) | +/− (depends on the content of expenditure) |
| Increase in social transfers | − (risk of inactivity trap) | + (increase in the demand for goods) | + (**reduction in inequalities**) |

Note: The initial situation is supposed to be characterized by Keynesian unemployment.

# EVALUATING PUBLIC POLICIES

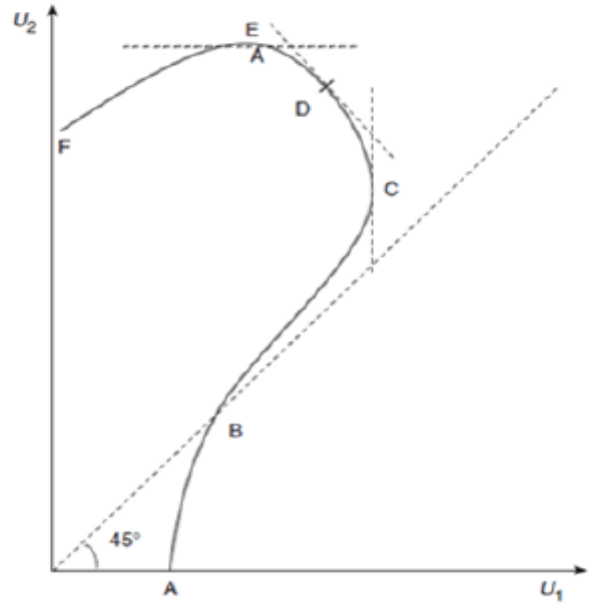
# Income distribution policies (or redistribution)

- Individual utility

$$U_i^t = U(C_{i1}^t, C_{i2}^t, \ldots C_{in}^t; N_i^t; E_i^t; \Xi_i^t)$$

- Intertemporal aggregation: $U_i = \sum_{t=0}^{\infty} \frac{U_i^t}{(1+\rho)^t}$

- Aggregation across individuals:
  - 'Benthamian': $\Gamma = \Sigma_i U_i$
  - 'Rawlsian': $\Gamma = \mathrm{Min}_i(U_i)$




*Rawlsian equilibrium can be closer to Benthamian one than to egalitarian one*

*John Rawls (1921-2002)*

*Jeremy Bentham (1748-1832)*

**In many countries, income and wealth distribution among individuals became one of the most important issues for economic policymakers, there is however substantial differences:**

**Benthamian function: maximum aggregate utility with present distribution**

**Rawlsian function: maximum utility of the poorest individual**

**Total equality function: equal utility among all individuals**

# Winners and losers in the economic policy realm:
# Two examples through partial and general equilibriums calculations

# Evaluating allocation policies: partial equilibrium

## Welfare impact of a 10% rise in the price of collective transport in the Paris region (areas 1-2)

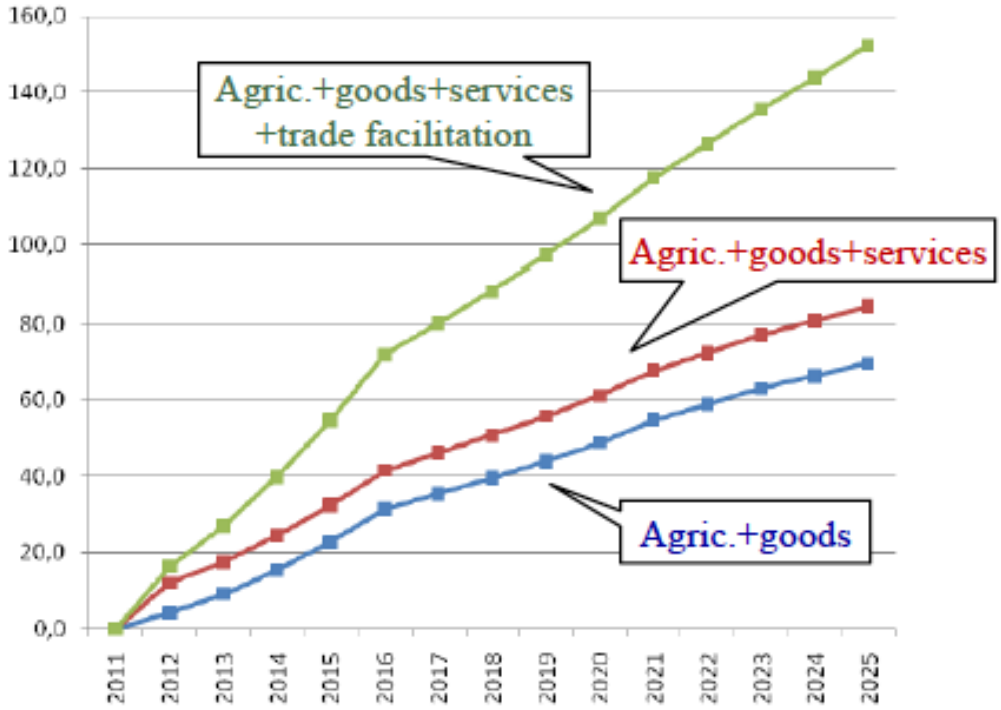
| | Inelastic supply | Elastic supply |
|---|---|---|
| Consumer surplus | -60,7 | -60,7 |
| Operator profit | 61,3 | 62,9 |
| Opportunity cost of public funding | 18,4 | 18,9 |
| Employer profit | -13,4 | -13,4 |
| Transport-related externalities | 0,7 | 0,9 |
| Individual cars-related externalities | -14,1 | -14,1 |
| Opportunity cost of taxes on cars | 0,3 | 0,3 |
| Total | -7,5 M€ | -5,3 M€ |

Source: B. Bureau, "Opportunité socioéconomique d'une hausse de prix des transports collectifs franciliens", doc. de travail DG Trésor, No. 2011/02.

# Evaluating allocation policies: general equilibrium

## Impact of a conclusion of the Doha Development Agenda using the MIRAGE model

### Yearly $Bn gain in GDP




### Geographical breakdown of total long-run welfare gains, in %

| | Agriculture | Industry | Services |
|---|---|---|---|
| Argentina | 4.86 | -0.47 | 1.11 |
| ASEAN | 4.43 | 3.64 | -2.62 |
| Australia & New Zealand | 13.75 | 0.83 | 0.67 |
| Brazil | 8.75 | 0.72 | 1.15 |
| Canada | 7.62 | -0.59 | 2.52 |
| Caribbean | 6.26 | 1.21 | -0.17 |
| China | 9.63 | 3.03 | -0.28 |
| EFTA | 6.35 | 1.16 | 2.56 |
| European Union | 6.42 | 3.47 | 2.17 |
| India | 4.63 | 2.09 | 0.42 |
| Japan | 7.99 | 4.73 | -2.93 |
| Korea | 7.37 | 4.19 | -0.88 |
| Mexico | 6.36 | 0.77 | 3.20 |
| North Africa | 15.80 | 2.42 | 6.88 |
| Rest of Africa (except South Africa) | 3.81 | 1.88 | 2.63 |
| Rest of Mercosur | 9.63 | 1.37 | 3.47 |
| Rest of South America | 6.19 | 0.77 | -0.33 |
| Rest of South Asia | 4.46 | 2.11 | -0.99 |
| Rest of World | 2.90 | 0.36 | 2.49 |
| Taiwan | 3.69 | 2.75 | -1.54 |
| USA | -1.29 | 3.42 | 1.90 |

Source: Y. Decreux and L. Fontagné, "Economic impact of potential outcome of the DDA", *CEPII Working Paper*, No. 2011-23

# The case for allocation policy and measures from the microeconomic point of view

1) ***Imperfect competition***: fight market power, regulate innovation rents and natural monopolies
   - Instruments: antitrust , intellectual property, regulation…
2) ***Externalities***
   - Instruments: regulation, taxes or markets (Coase theorem)
3) ***Imperfect information***: innovation rents, consumer illiteracy, moral hazard, conflicts of interest
   - Instruments: mandatory disclosure, financial regulation…
4) ***Incomplete markets***
   - Instruments: public education, credit enhancement…

# GDP as a proxy of welfare

- Widely used in practice
- Misleading because it overlooks leisure, natural resources depletion, negative and positive externalities
- Need to promote alternative measures
  - See Stiglitz-Sen-Fitoussi report (2009); EU 'Beyond GDP' project

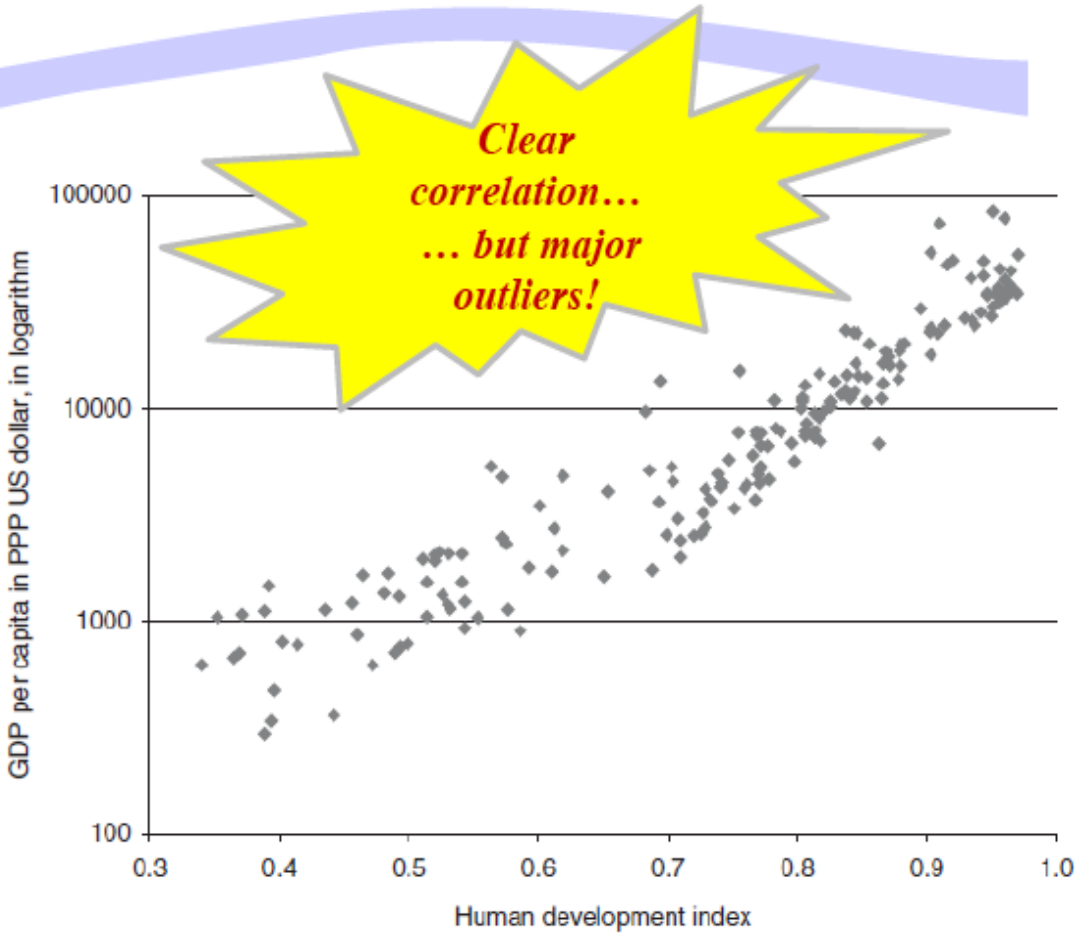


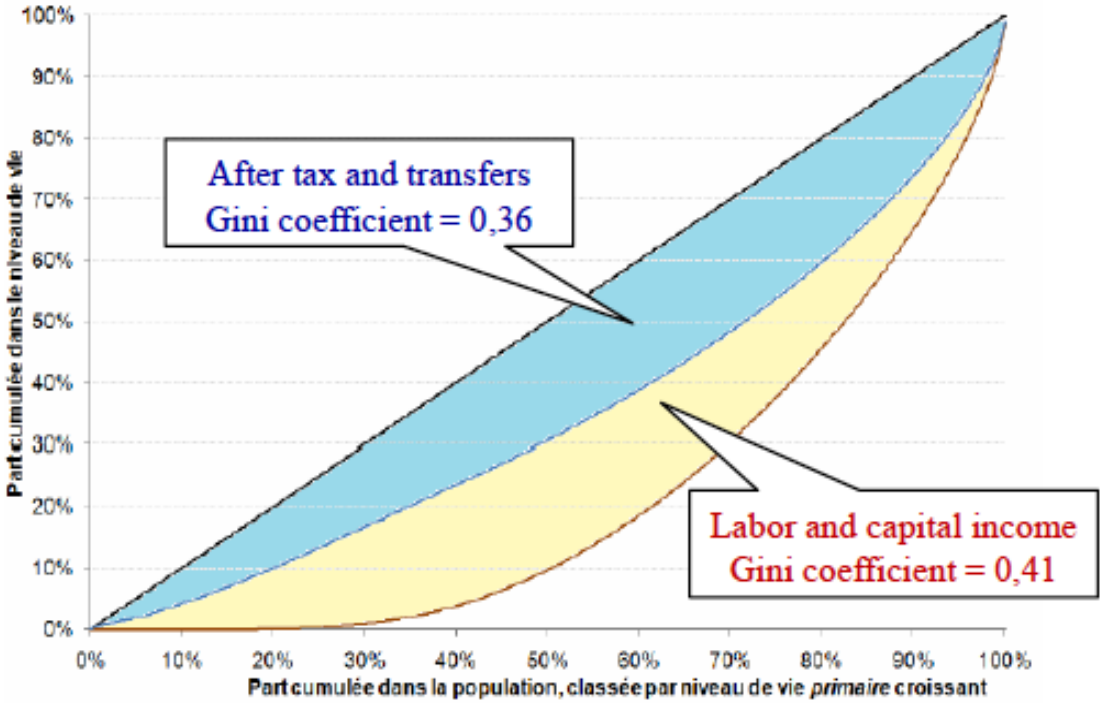

**Figure B1.9.1** GDP per capita and human development index in 182 countries, 2007.

Source: UNDP, Human Development Report 2009.

# Evaluating redistribution policies

- *Lorenz curve, Gini coefficient*
- *Micro-simulation models*

**The Lorenz curve of French personal income in 2009, before and after redistribution**




Source: M. Chanchole and G. Lalanne, "Photographie du système socio-fiscal et de sa progressivité", *Rapport particulier au Conseil des prélèvements obligatoires*, 2011.

# THE LIMITS OF ECONOMIC POLICY

# THE LIMITS OF ECONOMIC POLICY

- **Break with the representation of economic policy as an "engineer's science". To introduce limits of economic policy, criticisms, debate over its effectiveness. (The Nobel speech of Hayek in 1974 that largely focuses on the subject will be analyzed in the practical class).**
- **Break with the single-actor representation of economic policy. Introduce multi-level governance and international interdependence (at the end of this chapter).**

# Why do economic policy regimes change?

- **POLITICAL DISRUPTIONS**
  - War
  - Revolution
  - Constitutional changes
  - Elections

- **INTERNATIONAL ECONOMIC DEVELOPMENTS**
  - Global trading system
  - International financial system
  - Economic unions

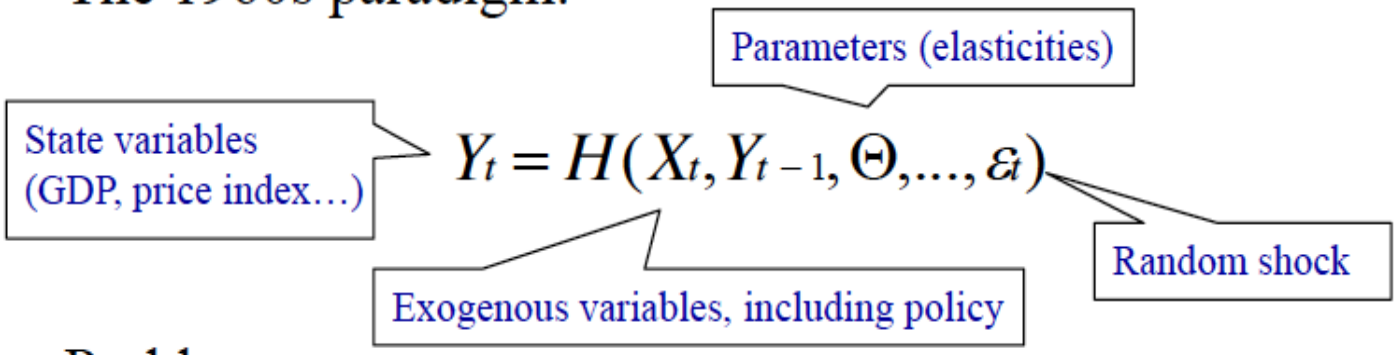
- **FAILURE OF EXISTING REGIME**
  - New types of shocks
  - Institutional changes
  - Changes in policy expectations

- **DEVELOPMENTS IN MACROECONOMIC THEORY**

(From Hans Tson Soderstrom, Stockholm School of Economics)

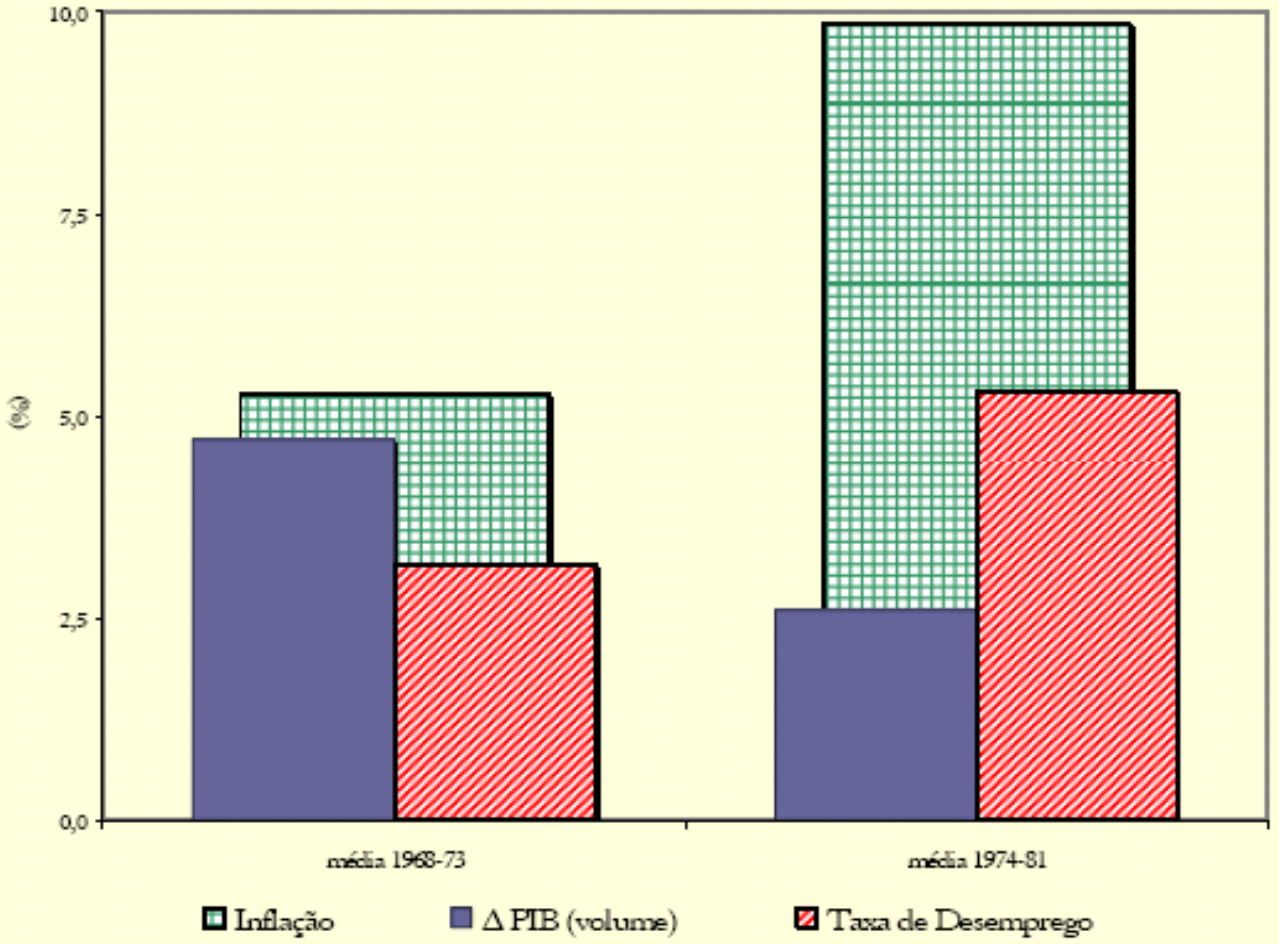
# THE DOMINANT PARADIGM OF THE FIRST DECADES OF ECONOMIC POLICY

- The 1960s paradigm:




- Problems:
  - Real-time data is often wrong
  - Model uncertainty: should the interest rate be included in the consumption function? are consumption, investment and export functions linear?
  - Model inadequacy (*e.g.* lack of financial variables)
  - Parameter uncertainty: confidence intervals
  - Lucas critique: $\Theta$ not independent from policies

# 1970s: The model in crisis, and the "stop and go" policies




Fonte: OCDE, Economic Outlook

# In the 1970s: The questioning of the economic policy bases of the first decades began

**<u>The target of the criticism</u>: The state, in its decisions, as omniscient, omnipotent, and benevolent.**

- **FOUR LIMITS**
  - **1. Policymakers have an imperfect knowledge of the economy and of future risks.**
  - **2. There is a question of confidence: policymakers may not convince economic agents that they will effectively do what they are saying.**
  - **3. Policymakers may not have the necessary information.**
  - **4. Policymakers may not prosecute the general interest.**

- **TWO RESPONSES**
  - **1. Independent agencies and bodies.**
  - **2. To create rules that limit the behavior of decisionmakers.**

# The limits of knowledge II

- Insufficient knowledge of the agents' preferences and the structure of the economy.
- Households and businesses react and anticipate EP measures.
- Uncertainties in models and parameters.
- Precautionary Principle.

- **LUCAS CRITIQUE**

  Parameters are estimated on the basis of what occurred in the past. Shifts in EP are incorporated in the agents' expectations and affect their behavior.

- **RATIONAL EXPECTATIONS**

  Agents have information and knowledge anticipating the effects of EP measures.

# Accounting for risk

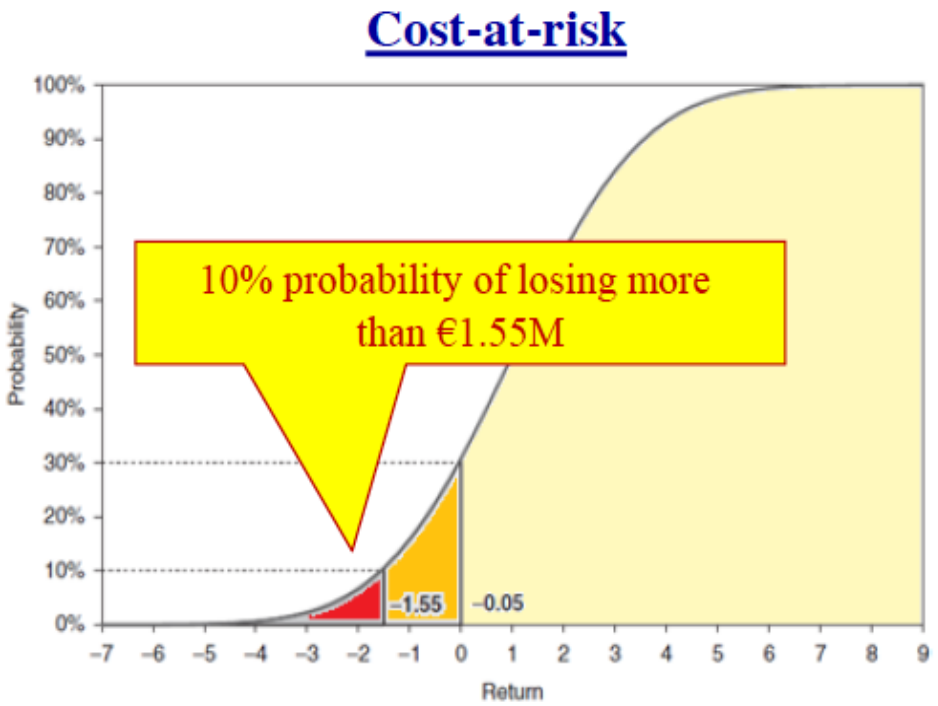
Standard approach relies on ***expected utility*** (Von Neumann-Morgenstern, 1944) and ***normally distributed*** shocks

But…

- Policymakers often do not rely on expected utility (ex. mad cow disease)
- Distribution of the shocks is generally not normal (***fat tails***) and unstable over time

➢ ***Hence the need for contingent policies and stress tests***

- Some decisions are ***irreversible*** or involve fixed costs, which create a



# The case against normal distributions as representative of major economic and financial trends: consequences for EP

## Benoît Mandelbrot

**(1924-2010)**

**It has usually been supposed … that financial asset returns follow a normal probability distribution. For financial economists this is a very convenient assumption, but, in practice, it is not valid and the 2007-09 financial meltdown provided a powerful example of an extreme financial risk. As noticed by Mandelbrot, there have been 48 days in the period 1916-2003 when the Dow Jones, moved by more than 7% in a single day, an event which should occur once every 300,000 years in a normal distribution. Mandelbrot has advocated using a more general class of distributions, the Pareto-Levy distribution, which exhibit fat tails and sometimes do not even have a finite variance. (pp. 69-70).**

## Fat Tails

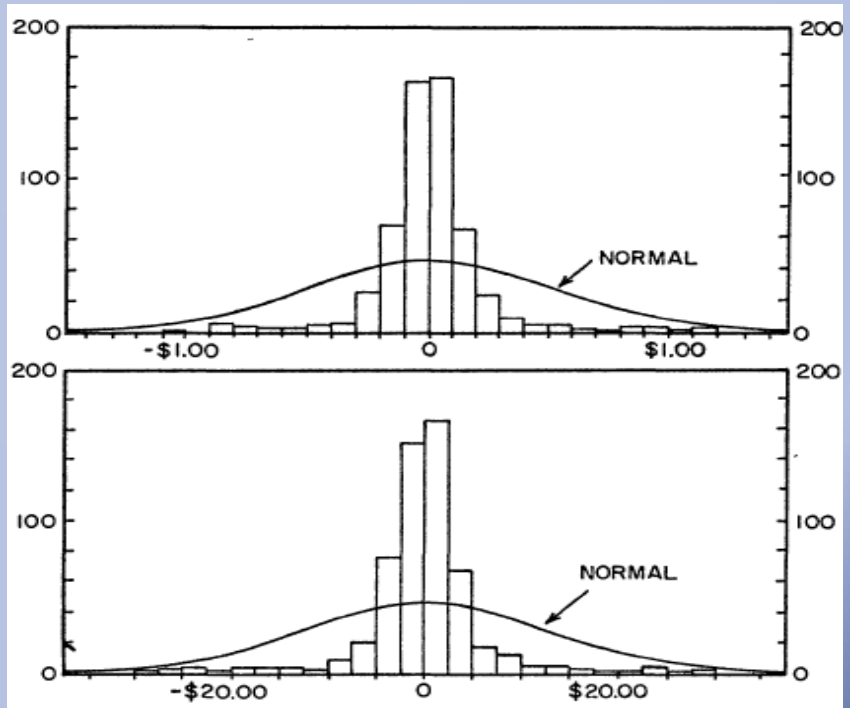


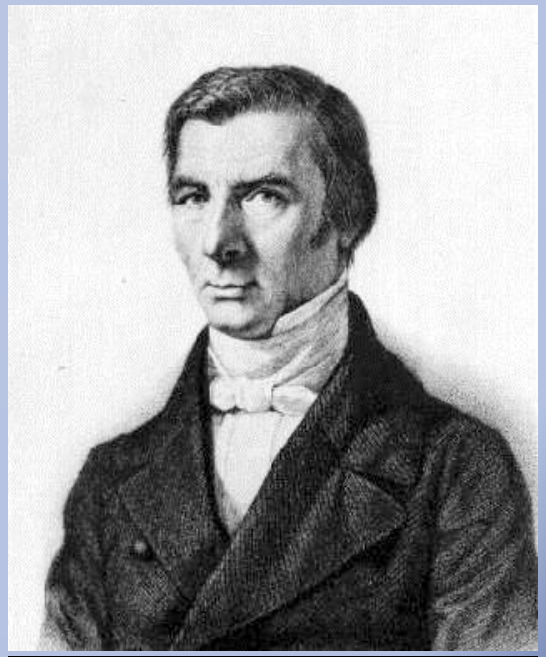

FIG. 1.—Two histograms illustrating departure from normality of the fifth and tenth difference of monthly wool prices, 1890–1937. In each case, the continuous bell-shaped curve represents the Gaussian "interpolate" based upon the sample variance. Source: Gerhard Tintner, *The Variate-Difference Method* (Bloomington, Ind., 1940).

B. MANDELBROT (1963). The Variation of Certain Speculative Prices. *The Journal of Business*, pp. 394-419.

# What distinguishes the bad economist from the good one, according to Bastiat, and its relevance for economic policy! Visible and Invisible Effects at Work

**In the economic sphere, an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them …**

**There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen. Yet this difference is tremendous; for it is almost always the case that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Hence it follows that the bad economist pursues a small present good that will be followed by a great evil, while the good economist pursues a great good to come, at the risk of a small present evil. (underlined by JRS)**



FRÉDÉRIC BASTIAT
(1801-1850)

From "***Ce qu'on voit et ce qu'on ne voit pas***" (1850)

"In the long run we are all dead."
JMK, *A Tract to Monetary Reform* (1923)

# In spite of all criticisms, past or present, JM Keynes is or even was any time "dead" in the post-war era?

In a very clairvoyant essay published right in the middle of the so-called 'New Classical Revolution' (1977), **James Tobin** (awarded with the Nobel Prize in 1981) considered that Keynes was far from dead and was in fact very much alive and kicking. A close look at modern economics will reveal that Keynes never left center stage in economic thought and **certainly not in policy circles** …

Adapted from P. BOETTKE and P. NEWMAN (2016), "The Keynesian liquidity trap: an Austrian critique", in S. Kates, ed. *What's Wrong with Keynesian Economic Theory*, Edward Elgar, p. 12.

Tobin's work: TOBIN, J. (1977). "How dead is Keynes?", *Economic Inquiry*, 15 (4), 459-468.

**IMPORTANT REMARK:**

**KEYNESIANISM *VERSUS* CLASSICAL AND AUSTRIAN APPROACHES OR EVEN THE "MARXISM OF MARX": Aggregate demand *versus* capital and its structure**

**Some minority views consider that, perhaps with the exception of finance (where the developments, although out of specific Keynesianism, were not necessarily better), Keynesian economics and policy largely prevailed during the last decades, no matter the short-term economic context, and the criticism was more often characterized by refinements or academic fashions of short duration, effectively marginal and without real and significant impact on the economic and policy design.**

# The limits of confidence

- ***Credibility*** problems arise from time inconsistency (Kydland-Prescott, 1977; Barro-Gordon, 1983), *i.e.* the temptation for governments to optimize at each period
  - Applications to monetary policy, exchange-rate policy, tax policy
- Solutions
  - Delegation to independent agencies
  - Policy rules: inflation targeting, fiscal rules, currency boards…
  - Longer time horizons; transparency

- ***Moral hazard*** arises from government intervention altering private behavior:
  - Ex: IMF interventions, central banks liquidity provision to banks, public insurance…
- Solution:
  - Provide ***partial insurance*** = make public intervention costly (*e.g.* lender-of-last-resort doctrine)

# The limits of information

- Policymakers do not have full access to information, which is used strategically by those with access to it.
- Risk of **REGULATORY CAPTURE**
- Major issue for:
  - Regulation and supervision in technical areas (telecom, energy, finance…)
  - Contracts (*e.g.* for provision of government-financed services such as health care)
  - Internal organization of government
- Theory **PRINCIPAL-AGENT, CONTRACT THEORY**:
  - Solution: incentive-compatible contracts, possibly within the government (such as performance-related compensation and promotion)

# STATE DECISION AND THE GENERAL INTEREST ("The limits of benevolence")

- QUESTIONING THE OBJECTIVES OF STATE DECISIONS

- CAUSES OF NOT COMPLYING WITH THE GENERAL INTEREST
    1. Capture – the pressure of interest groups
    2. Political cycle
    3. The decision maker is biased by some reason – party, region, class, corporation

- THE ROLE OF THE MEDIAN VOTER

# Politically-motivated decisions

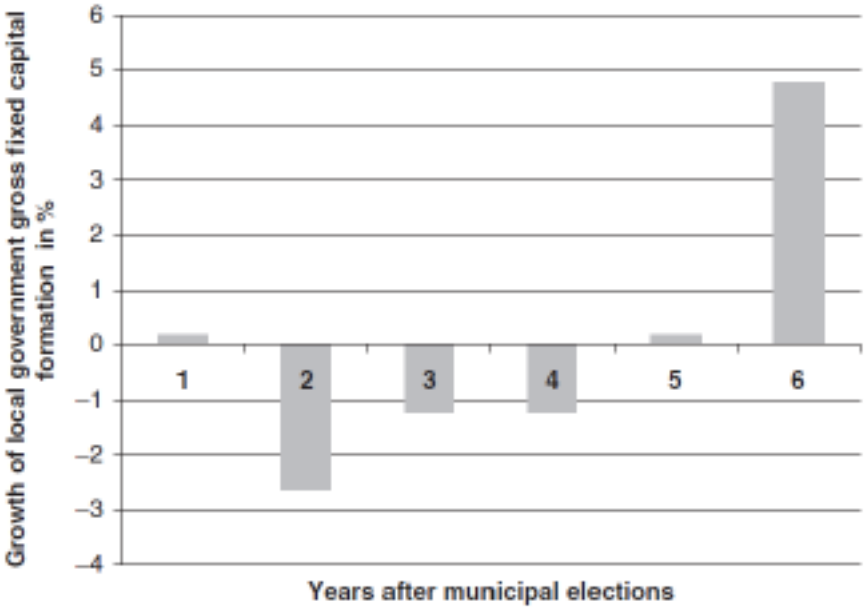



**Figure 2.3** Electoral cycle and local investment in France.
Source: Besson (2002).
Note: Contribution of the municipal electoral cycle to grass fixed capital formation, averaged over 1965–2000.

**Solutions: incentive contracts for politicians, procurement rules, anti-bribery, delegation to independent agencies, etc.**

# The median-voter model

## Hotelling, 1929; Black, 1948

• Voter choose the party whose preferences are close to his or her own: voters $V_1$ to $V_4$ will for example vote for candidate $C_1$ and voters $V_5$ to $V_7$ for candidate $C_2$.

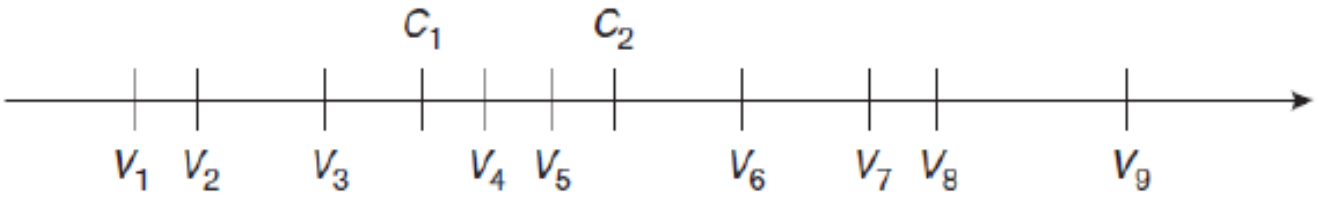



**Figure B2.10.1** Preferences, votes, and the median voter.

• ***Outcome = program differentiation***

• Suppose left-wing and right-wing parties disagree on the level of government transfers. Voters will choose the median level of transfers. Except under very specific assumptions, this coincides neither with the 'Benthamian' choice (maximize average welfare) nor with the 'Rawlsian' choice (concentrate transfers on the poorest)

# Should policymaking be delegated?

## Maskin &Tirole (2004) ; Alesina &Tabellini (2007)

- ***Technocrats are better in the presence of:***
  - Technical complexity (e.g. financial/safety regulation)
  - Judicial nature of decisions (merger control)
  - Undesirable trade-offs (public health and safety)
  - Intertemporal concerns (distribution across generations)
  - Significant international interdependence
  - Benefits to groups likely to engage into political lobbying
- ***Decision should remain political when:***
  - Social preferences are unstable
  - Policy involves unavoidable trade-offs
  - Policy involves significant redistribution

➢ ***Today's hot topics: balanced-budget rules, fiscal councils; risk of central banks becoming less independent?***

# LIVING WITH INTERDEPENDENCES: AN UPDATED VIEW

# Trade and financial openness

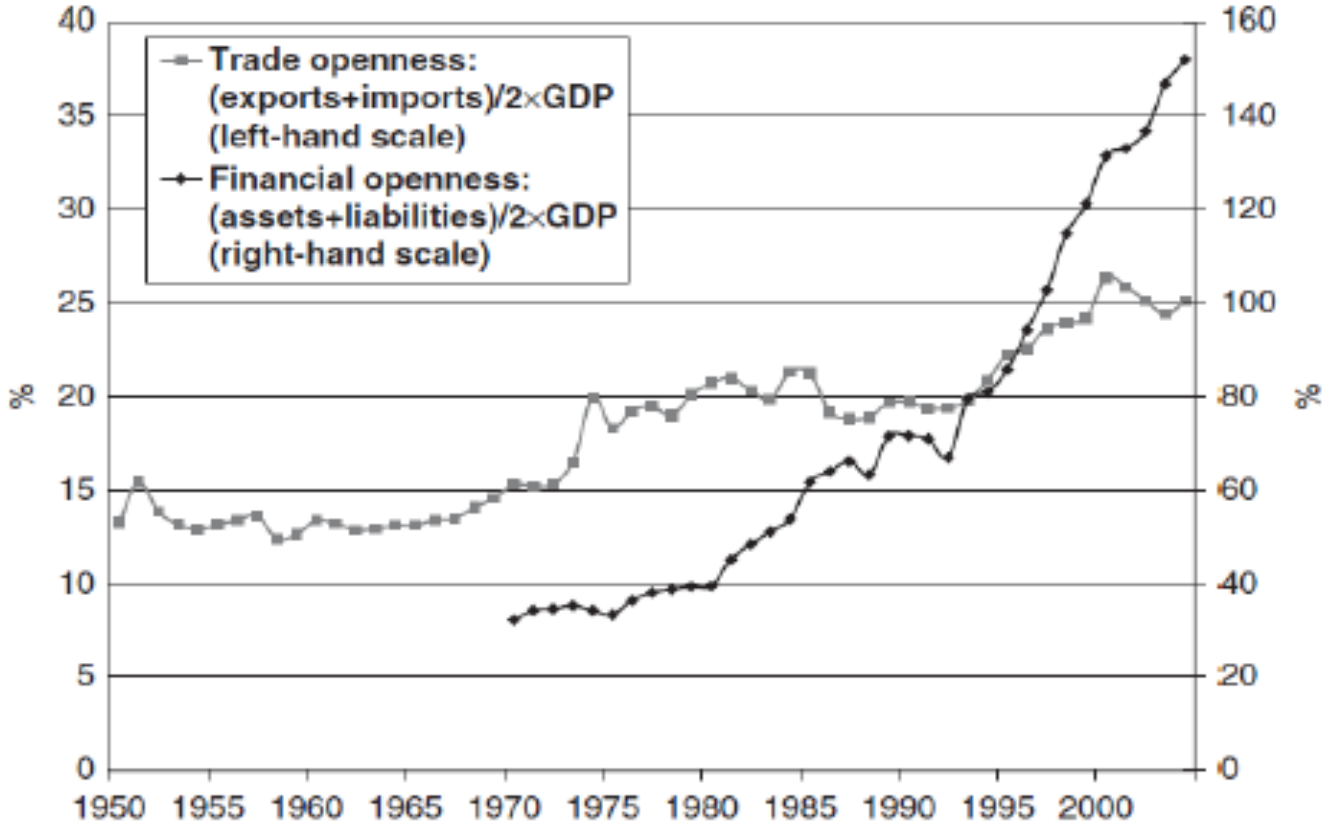
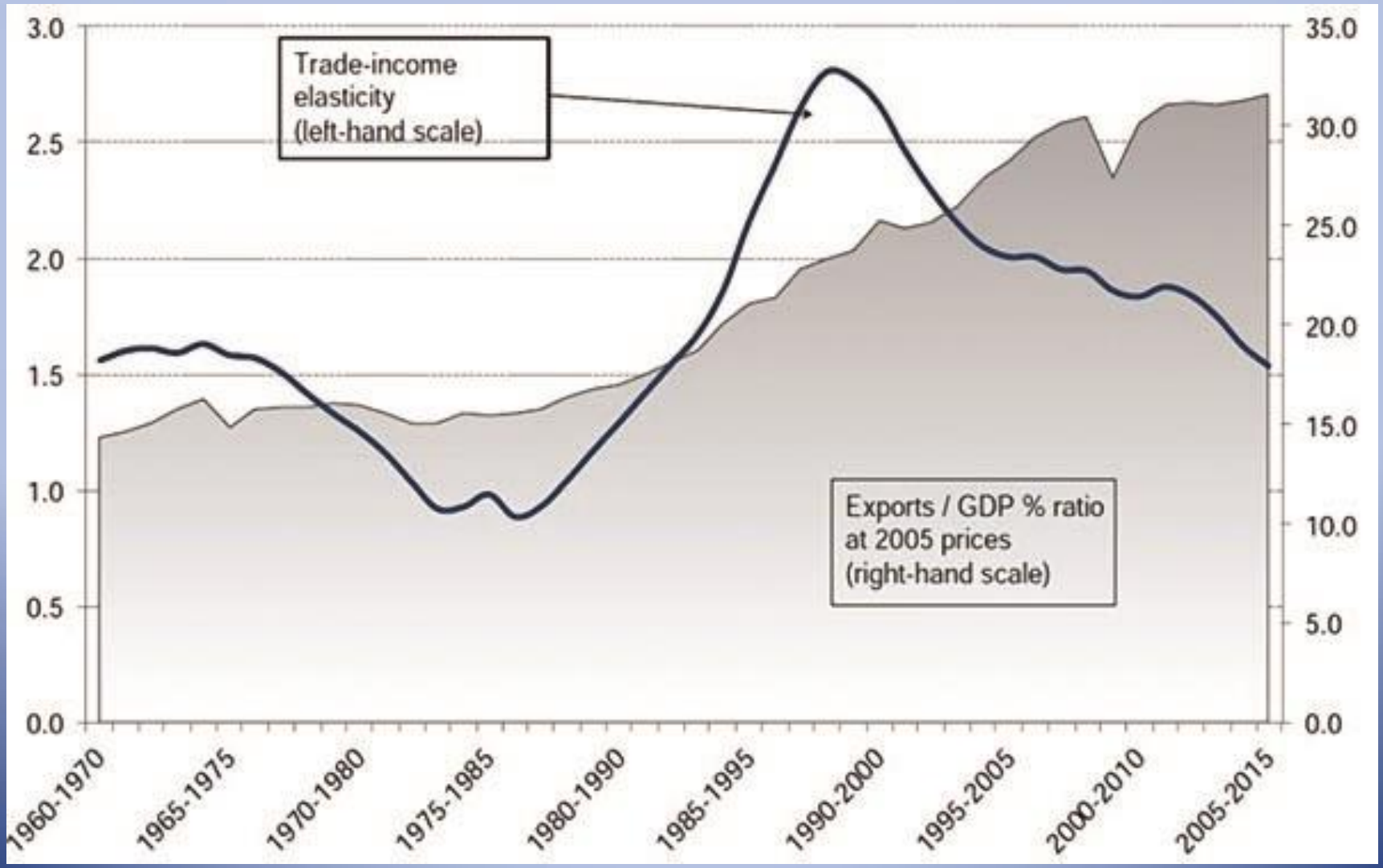



**Figure 2.4** Trade and financial openness for G7 countries, 1950–2004 (unweighted averages).

Source: Authors' calculations based on Penn World Tables and Lane and Milesi-Ferretti databases.

# Trade-income elasticity and Ratio Exports/GDP – Global Economy




*Source: Escaith and Miroudot, ch. 7 in Hoekman (2015).*

# World FDI Stock (Inward)

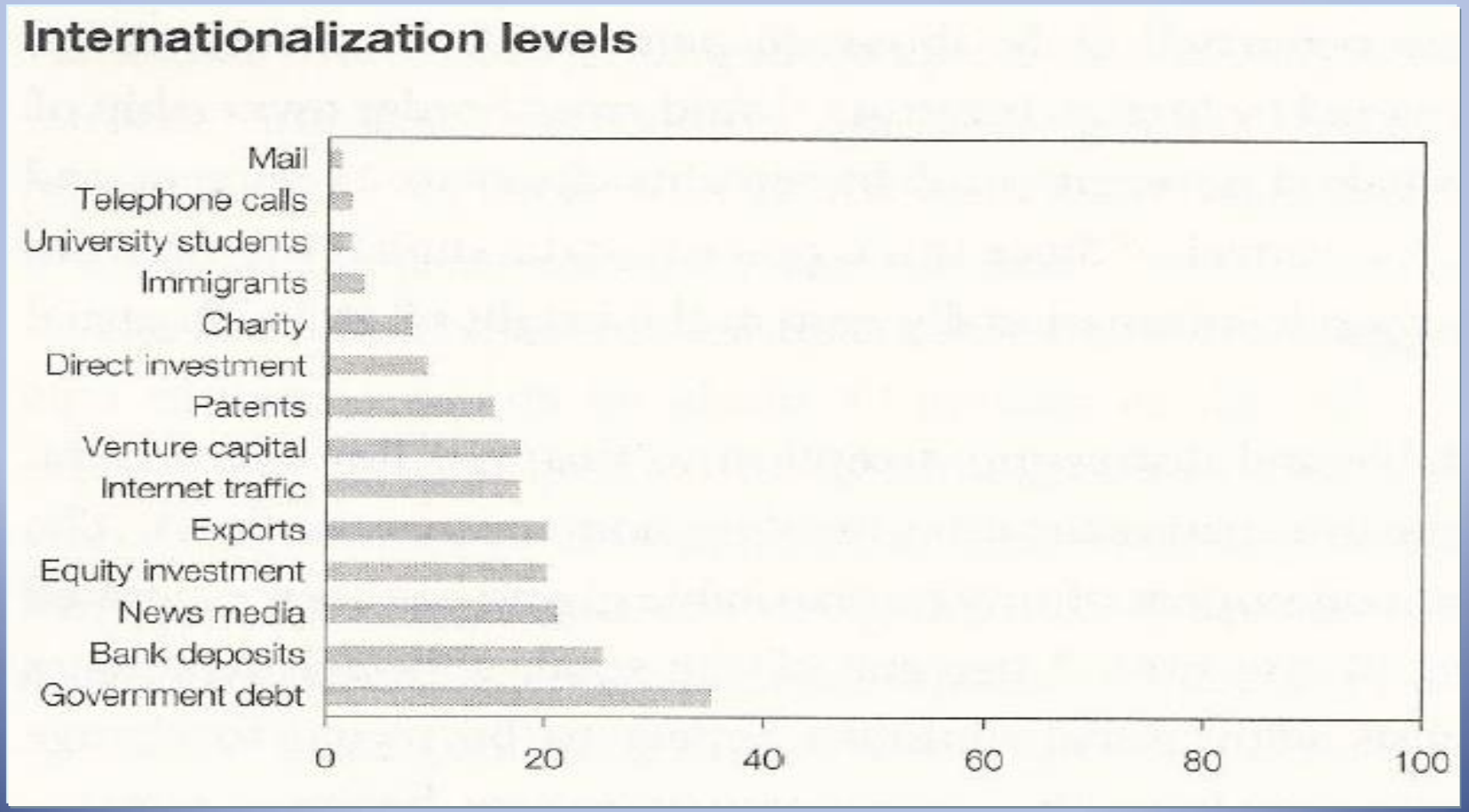
**(millions of USD, current prices)**

| | |
|---|---|
| 1980 | 506 602 |
| 1985 | 963 352 |
| 1990 | 1 941 252 |
| 1995 | 2 914 356 |
| 2000 | 5 786 700 |
| 2005 | 10 180 063 |
| 2007 | 15 210 560 |
| 2010 | 20 380 000 |
| 2013 | 24 665 000 |
| 2015 | 24 983 000 |

Source: UNCTAD, several years


**Source: The Economist, 27th January, 2017**

# How much global interdependencies actually limit national economic policies? Facing the risk of exaggeration by some voices a more careful analysis seems to be necessary.




Years 2007-2009, in P. Ghemawat (2011), *World 3.0*, HBRP, p. 30

# The pros and cons of coordination

- ***Arguments for coordination***
  - Global public goods

| | Excludable | Nonexcludable |
|---|---|---|
| Rival | Private good<br>*Ex: Shoes* | Common good<br>*Ex: A lake's fish resources* |
| Nonrival | Club good<br>*Ex: Patentable inventions* | Public good<br>*Ex: Financial stability* |

  - Policy spillovers
    - Demand, price and interest-rate spillovers
    - Competitiveness and the '*n-1*' problem

- ***Arguments against coordination***
  - Small gains (Oudiz-Sachs 1984): high negotiation costs, small welfare gains
  - Model and parameter uncertainty (Frankel-Rockett 1988): imperfect information may lead to wrong choices
  - Counterproductive when seen as a coalition among policymakers to weaken market discipline (Rogoff)
  - Partial coordination (*e.g.* within a subset of countries) may reduce welfare

# Policy assignment in the EU

## What the EU does

**Table 2.5**
A simplified outline of competence assignment within the EU

| | Member states | Union |
|---|---|---|
| *Allocation* | | |
| Regulation of markets for goods and services[a] | X | XX |
| Regulation of capital markets | X | XX |
| Regulation of labor markets | XX | X |
| Infrastructures, research, education | XX | X |
| Farm support | — | XXX |
| *Stabilization* | | |
| Monetary and exchange rate policy (Euro area) | — | XXX |
| Fiscal policies | XX | X |
| *Redistribution* | | |
| Interpersonal (direct taxation, social transfers) | XXX | — |
| Interregional | XX | X |
| International (within the Union) | — | XXX |

[a] Including indirect taxation

Key: By convention, the amount of the X is for each line equal to three. XX in a column indicates that the principal competence belongs at the corresponding level. XXX indicates exclusive competence.

## A limited budget

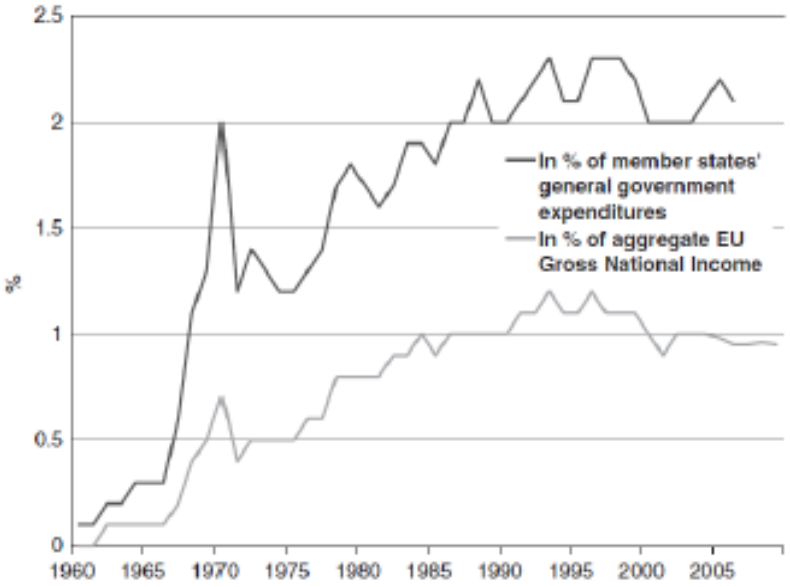



**Figure 2.7** The budget of the European Union, 1960–2009.
Source: European Commission.

# The spaghetti bowl of global governance

Table 2.4
Scope, rules, and means of the major international organizations

| Sector (institution, creation) | Voting rules | Institutional strength | Legal means | Financial strength |
|---|---|---|---|---|
| Trade (GATT, 1947 + WTO, 1995) | One country, one vote, simple or qualified majority for the application of the treaties, in practice consensus | Weak, except for dispute settlement | Arbitration and dispute settlement (through the Dispute Settlement Body) | Irrelevant |
| Currency and financial stability (IMF, 1945 + BIS, 1930) | IMF: Constituencies with weighted voting rights, simple or qualified majority; in practice consensus<br>BIS: Weighted voting rights | IMF: Strong institutional coherence plus strong G7 support<br>BIS: Important via the central banks | IMF: Limited power to set standards, indirect power on countries under IMF assistance<br>BIS: Indirect standard-setting power | Major vis-à-vis countries requesting assistance (mostly poor countries), nil vis-à-vis surplus countries<br>Potentially important via the central banks |
| Development finance (World Bank, 1945) | Like the IMF with greater role for developing countries | Same as IMF | Almost absent | Declining before the 2007–09 crisis as countries had gained access to financial markets, significantly expanding in the aftermath of the crisis |
| Environment (UNEP, 1972) | In theory geographical constituencies, in practice depends on the United Nations | Weak and dispersed | Weak | Weak |
| Health (WHO, 1946) | General Assembly: One country, one vote;<br>Board: One person, one vote | Significant, but strong decentralization | Important (immediately enforceable health standards) | Limited |
| Labor (ILO, 1919) | Parity between governments, employers and employees.<br>General Assembly: One country, one vote<br>Board: Permanent seats for large countries | Weak | Weak (implementation of agreed standards left to the goodwill of member states) | Weak |

Source: Jacquet et al. (2002).

*"These projected figures are a figment of our imagination. We hope you like them."*