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Macroeconomics Discipline at the Cross-Roads

Murali Patibandla
Professor
Corporate Strategy & Policy
Indian Institute of Management Bangalore
Bannerghatta Road, Bangalore – 5600 76
Ph: 080-26993039
muralip@iimb.ernet.in

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Abstract

The 2008 financial crisis of the US was a watershed for economics discipline, especially macroeconomics. Several world leaders such as the Queen of England questioned distinguished economists of Ivey league schools such as the London School of Economics on why they failed to see what was happening and had not prevented the crisis through policy advice? Most did not have an answer. Why? One of the reasons is the supply side economics, which is also called Monetarism; and the Chicago School of Economics, which advocates that free markets function efficiently and self-regulate; and at best governments should tinker with monetary policy of money supply; has become the dominant intellectual basis for policy making for the last forty years. Models of this kind failed to predict the financial crisis because they are based on strong assumptions. I sketch out the causes of the crisis.

Keywords: Macroeconomics, financial crisis, market models

After 9/11, the Federal Bank Chairman Alan Greenspan used the monetary tool of cutting down the interest rate to a very low level to keep the economy going. This led to the process of leveraging- borrowing money to invest in stock markets, real estate, speculation and even buying of expensive paintings as investment. Low interest rates reduced incentive for savings and investment in bank deposits. As a consequence, there was significant increase in demand for credit and a drop in the supply of deposits. In response, merchant and investment bankers came up with the financial innovation of developing mortgage-based derivatives and aggressively marketed them to both low and high income groups. Low-income groups were provided mortgages without verifications based on contracts of asymmetric information about interest rate payments. People thought they were buying houses, but reality was that they were made to buy complex derivatives. The merchant and investment bankers sold these derivatives both within the US and globally to generate liquidity. By 2007-2008, people who bought the derivatives as investment realized that the price levels were not sustainable and started to sell them in a typical herd behavior which resulted in the crisis. As a consequence, trillion of dollars of public savings were destroyed, followed by forced evictions, and large scale unemployment. In the essence, the crisis was caused by generation of imperfect information, and high degree of moral hazard behavior of the bankers using other people's money to pay themselves high compensations and undertake excess risks.

Assumptions of supply side macroeconomics are as follows: people are perfectly rational, maximize self-interest as autonomous agents, markets are frictionless (no transaction costs), there is perfect information and there is no moral hazard behaviour for separation of ownership and control of capital.

Further extension of this thought is the rational expectations hypothesis. If a government attempts to stimulate the economy by budget deficit, people rationally expect that the government will raise taxes in the future and reduce their consumption at present to pay for higher taxes in the future. Increase in aggregate demand through government deficit spending will be neutralized by decrease in consumption demand of private agents. This gets the simple arithmetic wrong. If an economy reaches unemployment equilibrium, it reduces government revenues because the unemployed do not pay taxes and increases government expenditure on

payment of social security benefits resulting in budget deficit. If the economy is stimulated by government spending, it reduces government deficit gradually.

Based on these strong assumptions, as Nobel Laureate Joseph Stiglitz observes (2012), the supply side macroeconomics degenerated into a single agent model. If you and I are perfectly rational and have similar information, there is no difference between us. In these models there are no financial markets and associated moral hazard behaviour of economic agents. Credit is basically about transferring it from the right pocket to the left or the other way round.

Supply side economics was developed to negate Keynesian economics. Keynes was the first economist who showed the governments how to use macroeconomic policies of fiscal and monetary instruments to deal with business cycles. His main thesis was that when an economy gets stuck with unemployment equilibrium owing to mismatch between savings and investment identity and downward wage rigidity, government can stimulate the economy by using fiscal instruments of deficit spending and cutting taxes on the low income groups. A simple empirical verification of his thesis was the boom of the American economy during the Second World War and immediately after it. Unfortunately, both his followers and critics misunderstood and misinterpreted his thesis that he advocated a big government. An extreme case was the British government after the Second World War which nationalized all the industries including production of Land Rover and Jaguar cars. The consequence of this was pervasive inefficiencies. The reaction to this was Thatcherism in the U.K and Reagan economics in the US which were interpreted as triumph of the supply side economics that unfettered free markets function efficiently.

The fraudulent extension of supply side economics is the trickle-down theory that reducing taxes on the rich generates employment and economic growth. This ideology has its bearings in the classical doctrine of ‘libertarianism’. One of the arguments of this doctrine is that an individual is successful because of her/his talent and hard work and societies should not punish her/him for the success by taxing her/him at higher tax rate than the less-successful. The argument is flawed. Let us take the example of Bill Gates. He has made billions of dollars of wealth not only because of his talent and hard work but also because he has been able to draw from public stock of knowledge accumulated over centuries. Computers and computer software have become possible

because of fundamental contributions of mathematics over centuries starting from the invention of zero and numbers system in India more than two thousand years ago. Furthermore, Bill Gates have been able to make his fortune by employing thousands of skilled people produced by the public schools and universities that are highly subsidized with tax payers money. Societies have been investing in the generation of public stock of knowledge and institutions over centuries. A simple verification of this point is asking the question: what would have Bill Gates and Steve Jobs achieved if they were born and brought up in Afghanistan instead of the US? The rapidly growing income inequalities in India, the US and China and many other countries which pose serious threat to social fabric are partly a result of misinterpretation and policy practice of the libertarian doctrine.

While the supply side macroeconomics degenerated into a single agent model and glorification of unfettered free markets, microeconomics progressed over the years by systematically relaxing some of the assumptions. This led to rich and growing fields of transaction cost economics, game theory, information economics, corporate governance and behavioural economics. These developments help microeconomic policies of anti-trust, regulation of natural monopolies, designing auctions and negotiations and business policies of governance choices, insurance markets and strategy (Patibandla, 2006).

The lesson from the financial crisis is that macroeconomic models have to incorporate financial markets and account for asymmetric information, transaction costs and moral hazard behaviour of economic agents. Governments have to regulate especially the financial markets. Free market fundamentalist will ask the question as to why one should expect the government agents to do a better job than private agents because they are also subject to moral hazard behaviour of using tax payers' money. One answer to this is that if a large number of private agents act autonomously, the sum of average transaction and information costs of markets is higher than if one large agent pools these costs and realizes economies of scale. Government does this job- the tax collected from each agent could be lower than the average information and transaction costs of private agents. As far as the moral hazard behaviour of government agents is concerned, it is a political economy issue of designing and implementing institutions.

References

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