Development and Macroeconomic Policy in a Post Neo-liberal World

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For the past 40 years, economic policy has been dominated by a set of doctrines—neoliberalism

- Emphasized key role of markets
  - Stripping away role of state
- Ignoring role of civil society
- Focused on efficiency
  - Implicitly assuming distributional concerns could be addressed through political process
  - Invoking 2nd fundamental theorem of welfare economics
- Based on presumption that markets are efficient
  - Invoking 1st fundamental theorem of welfare economics

Cornerstone of policy

- In development—Washington Consensus doctrines
  - Though more careful policymakers noted that there were no grounds in standard theory for capital market liberalization
  - And that government had to play an important role in, e.g., education
- In globalization/international economic policy
- In macroeconomics
  - If only government kept deficits and debt low and monetary authorities kept inflation low, market would take care of rest
  - Argued for independent central banks focusing on inflation

Promise of neoliberalism

- Higher output
- Faster growth
- Everybody would be made better off—some variant of trickle-down economics
- Greater stability

The disappointment of neoliberalism

- **Growth lower** than in earlier era
- Fruits of growth went to small number at top—greater income and wealth inequality; stagnation at bottom: **inequality crisis**
- **Instability**—2008 crisis
- Failure to **address climate crisis**
- In some countries and some sectors a host of other problems
    - Opioid crisis; childhood diabetes; host of other examples of exploitation
    - Social media opened up a new era of viral misinformation/disinformation
    - Multiple political consequences
    - Including erosion of political support for certain aspects of neoliberalism—especially those associated with unfettered globalization
- Contrary to Fukuyama's "end of history"—all countries converging to liberal democracies and free market economies—world split into authoritarian regimes and those with stronger democracies

Accounting for the failures

Even as neoliberalism became the dominant dogma in economics, the intellectual underpinnings were being taken away

- Economics of information—with imperfect and asymmetric information and incomplete set of risk markets, even competitive economies were not constrained P.O.
- Game theory and other advances in the theory of imperfect competition highlighted the importance of these imperfections
- Behavioral economics undermined confidence in the rational actor model with preformed preferences
  - Cognitive limitations (Kahneman and Tversky, Thaler)
  - Endogenous preferences (World Bank, 2015, Hoff and Stiglitz 2016)

Pervasiveness of market failures/externalities

- Environment—climate
- Macro-economic externalities
  - Associated with excessive risk-taking by banks
  - Associated with excessive foreign-denominated borrowing by firms
- Externalities associated with inequality
- Societies with less inequality perform better
  - Agency costs/inefficiencies
  - Those of limited ability can’t live up to potential
  - Much of inequality arises from rent-seeking/market distortions

Pervasiveness of market power and exploitation

- Provides a better explanation of inequalities than “just desserts” (neoclassical) theory
- Exacerbated by new technologies
  - Network externalities
  - Innovation in exploiting market power (new contract provisions)
  - AI—extracting consumer surplus, undermining 1st welfare theorem

Importance of rules and institutions

- Markets don’t exist in a vacuum
  - Governed by rules, regulations, and institutions
  - Have implications for efficiency and distribution
- But because they have distributive effects, there is a distributive “battle” in which power matters
  - Labor laws weakening unions and workers’ bargaining power
  - Antitrust laws limiting (or not limiting) firms’ market power
  - Corporate governance laws limiting (or not) managerial power
  - Globalization rules affecting how gains from trade are shared
- Current rules may even make workers worse off

Reconstructing economics

- The nature of the human being
  - Cognitive limitations/only limited rationality
  - Endogenous preferences
- The nature of the firm
  - Not necessarily profit-maximizing
    - From shareholder capitalism to stakeholder capitalism
    - Shareholder capitalism never was theoretically defensible (Friedman vs. Grossman Stiglitz (1977)
  - Technology is endogenous

Reconstructing economics

- The nature of markets and economic interactions
  - Imperfections of competition/information at center
  - Rules matter—and rules are set by government
- Economics and politics (and the law, societal norms, etc.) can't be separated
- Critical is a better balance between markets, government, and other institutions
  - The importance of collective action
  - Given importance of externalities, inequalities, public goods—including innovation
- Constant evolution in response to changes/in an attempt to learn from mistakes—equilibrium models of only limited value
  - Neoliberalism was a powerful ideology; there is much to learn from its failures

Macroeconomics after neoliberalism

Macroeconomic theory—beyond DSGE

- Many critical flaws: assumption of equilibrium (no explanation of how attained); assumption of stationary stochastic processes, well-understood—no learning; disturbances exogenous
  - Major crises endogenous (2008, Great Depression)
  - Impossible to predict shocks with big effects—pandemic, Trump
  - Decentralized market adjustment processes may be disequibrating

Alternative approaches

- Dynamic Disequilibrium Theory with Noise (Guzman and Stiglitz)
- Uninsured shocks to firms in presence of endogenously imperfect capital markets (equity rationing) gives rise to fluctuations on both demand and supply side
- Shocks to banks lead to changes in credit availability, and the terms at which it is available, with both demand and supply side effects
- Without common knowledge, individuals will take bets, each side believing they will win, gives rise to pseudo-wealth, drives consumption, gives rise to macroeconomic inconsistencies, which eventually get resolved—often in a crisis
- Sluggish adjustment of wages and prices (more related to risk aversion than costs of adjustment) relative to changes in aggregate demand give rise to unemployment

Policy implications

- Fiscal policy matters—and can have large multipliers (even larger with rational expectations than with static expectations)
  - Discrediting Ricardian equivalence
- Monetary policy is ineffective in deep downturns
  - But not so much because of zero lower bound
  - But because can’t induce banks to lend (credit channel)
- More focus on limiting country’s exposure to shocks (dangers of CML)
- More focus on designing automatic stabilizers
  - Discrediting “top down anchors” such those of Growth and Stability Pact (limits on deficits and debts)—cannot incorporate deep uncertainty

Implications for monetary policy

- Monetary policy should *not* just focus on inflation/inflation targeting
- What matters is *real* stability, not price stability
  - And focus on price stability came partly at expense of real stability
- There is a value to being able to make commitments
  - But there are dangers of *excessive* constraints in a world of deep uncertainty
- One can have an independent central bank, which is *more representative*

Implications for globalization and development

- Strong critique of WC
  - Towards the Stockholm statement/consensus
  - Even IMF has joined critique of Capital Market Liberalization
  - Trade restrictions may enhance innovation (Korea, Stiglitz and Greenwald, *Creating a Learning Society)*
    - Recognizing attempts to increase static efficiency may impede learning
- New development tools
  - Sometimes less costly
  - Well beyond nudges (Sunnstein/Thaler)
  - Changing individuals deep preferences—savings, fertility, gender roles

Exciting time for economics

- Prevailing models and policies based on neoliberalism have been discredited
- Need to construct a new paradigm
- Many of building blocks are already there
- But in some critical areas, there has to be a big break from old paradigm
- The Neoliberal paradigm has not served the world well
  - Though its ascendancy may be understandable as a reaction to some of the ideas/doctrines that preceded it
- There is an opportunity to create an alternative paradigm that can help promote societal well-being--with greater inclusiveness, greater sustainability, and greater stability