

Discussion of the paper “**Macroeconomics  
and the Crisis: A Personal Appraisal**” by Axel  
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# The criticism to the Old and New neoclassical system

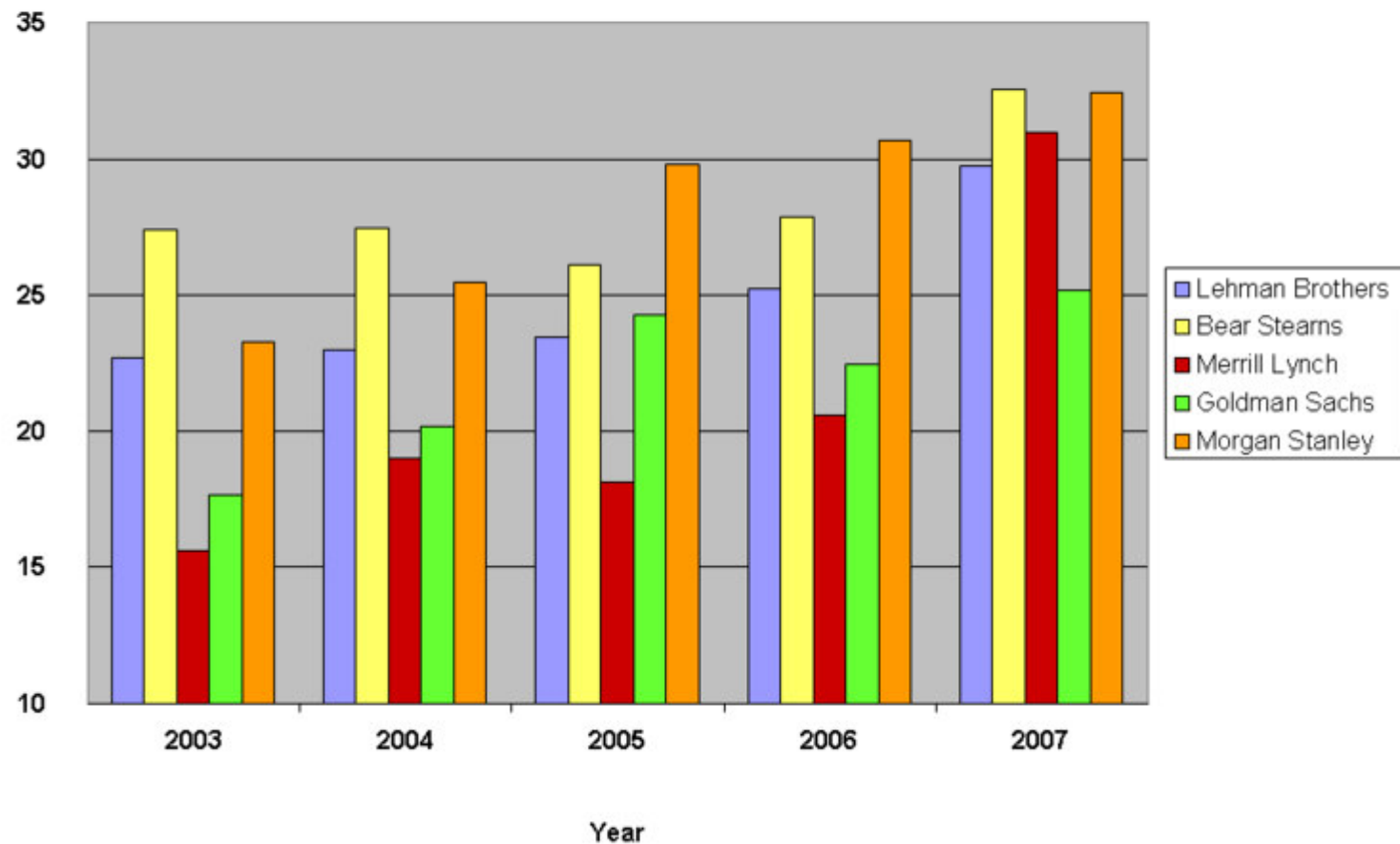
- I criticized the Old Neoclassical Synthesis forty years ago -- to little effect. I think the New Neoclassical Synthesis is on the wrong track today. The reasons are basically the same. The technically sophisticated DSGE theory of today shares with the simple atemporal GE theory of 1950s vintage a fundamental preconception, namely, that the economy can be truly represented as a *stable self-regulating system in which effective "market forces" will always tend to bring it into a state of general equilibrium* except in so far as "frictions" of one sort or another brake down the equilibrating process.
- I believe that this macrotheoretical preconception is false, that it is based on a fundamental misunderstanding of the nature of the market economy, and that further technical innovations in mathematical modeling or econometrics will not bring real progress as long as this remains the ruling paradigm.

# Three factors of instability

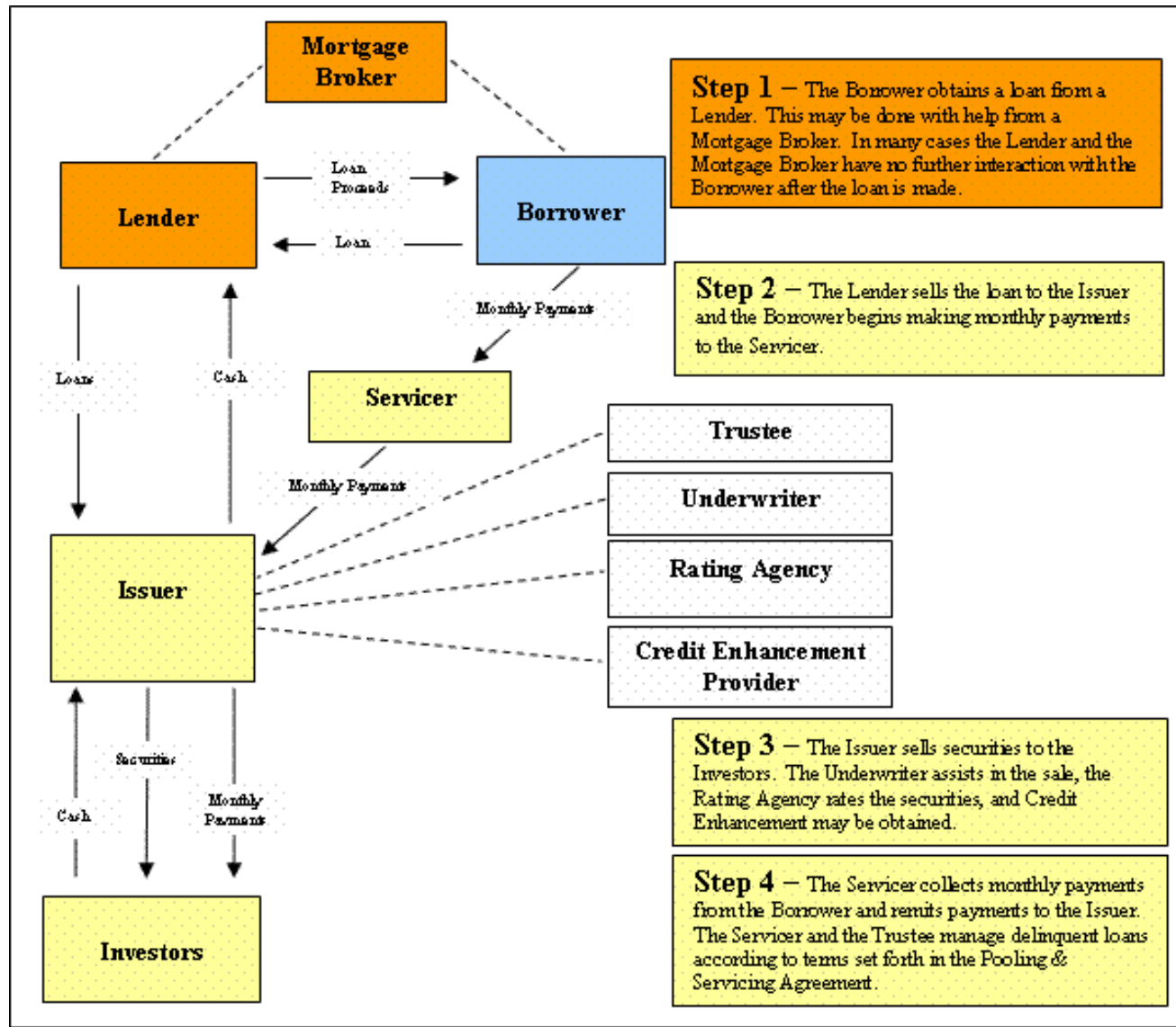
- the instability of leverage in the economy, (2)
- the increased connectivity of the global financial network,
- the potential instability of the price level.

## Leverage Ratios For Major Investment Banks

The leverage ratio is a measure of the risk taken by a firm; a higher ratio indicates more risk. It is calculated as total debt divided by stockholders equity. Each firm's ratio increased between 2003-2007.



Source Data: Company Annual Reports (SEC Form 10K)



# Causes of the financial crisis

- Abundance of liquidity at low or negative real interest rates create conditions for carry trade
- Overlending (as in the Latinamerican debt crisis)
- From originate to hold to originate to distribute
- Conflicts of interest of rating agencies (and the neglected signals from social rating agencies and the “nun early warning system”)
- Regulatory capture (the Madoff case example)

# Comments

- Not interested in static equilibrium with 1 billion poor. The question is about convergence.
- Re-equilibrating forces at stake: conditional convergence, migration (large divides trigger capital and workers movement which painfully and in the long run may reduce imbalances)
- Forces leading the system out of equilibrium:  
The asymmetric information pyramid of non commercial banks and the effect on it of wrongly designed incentives (traders' and Ceo bonuses)
- Interaction of chartists and fundamentalists on stock markets



## Country level results on the determinants of growth

Conditional convergence is confirmed and support interpretation C

- A. Pessimistic (deterministic) perspective: inequalities are inevitably bound to increase;
- B. Optimistic (deterministic) perspective: inequalities are inevitably bound to reduce (*catching up*);
- C. Halfway path: conditional convergence arises if developing countries catch up in terms of factors of conditional convergence:
  - 1) *Physical capital investment and infrastructure*
  - 2) *Human capital investment*
  - 3) *Information Technology*
  - 4) *Quality of institutions and social capital*

Temple (1999 JEL), Sala-I-Martin (2002), Aghion and Durlauf (2005)



# Forces leading the system out of equilibrium

- The literature tells that noise traders create their own space (De Long et al., 1990) and rational investors find it optimal to ride the wave
- in the short run (De Long et al., 1990). (“trend conventions” )
- The “fundamental” value of a stock is undefined since it depend from a purely psychological variable (risk premium). Risk premium is erratic and does not revert to its historical long term mean.
- Systematic and documented earning forecast bias (Lim, 2001)

# Limits of macroeconomics of understanding financial markets

- Abundance of liquidity generates asset price bubbles, financial market forces do not prevent bubbles bringing the system toward equilibrium
- Bubble bursts have serious consequences on real economy. Bubbles on oil and commodities have strong real effects also outside financial crises
- Before: real economy events affected financial markets. Now: financial markets determine real events

# The dismal outlook of mainstream economics

- Anthropological reductionism
- (the homo oeconomicus has no sympathy or commitment)
  
- Corporate reductionism  
(only profit maximising firm can survive. The Lehman story tells exactly the contrary)
  
- Wrong ranking of values  
(the dictatorship of shareholders)

# Ground zero economics

- Theoretical models and lab experiments to replace the “anthropological reductionism” with motivational complexity
- Analysis of the interaction (and competition) between multistakeholder and profit maximising corporations

# We need Copernican “ground zero” economics (1)

- Lab and field experiments show that only a tiny share of individuals behaves as the textbook homo oeconomicus

Experimental results on Ultimatum games (Güth, Schmittberger and Schwarze, 1982, Camerer and Thaler 1995), Dictator Games (Andreoni and Miller 2002), Gift Exchange Games (Fehr, Kirchsteiger and Reidl, 1993, Fehr, Kirchler, Weichbold and Gächter 1998), Trust Games (Berg, Dickhaut and McCabe 1995, Ben-Ner e Putterman 2006) and Public Good Games (Fischbacher, Gächter and Fehr 2001, Sonnemans, Schram and Offerman 1999, Fehr and Gächter 2000)

Such behaviour is harmful for the economy since markets are thin and the most important interactions have the form of “prisoner’s dilemmas” and “investment games” where deviations from the purely self interested behaviour increase the individual and social payoff

# The solutions: bottom-up reequilibrium factor

- Diversity of organisational forms (for profit, not for profit corporations, cooperatives, etc.) where pioneers with non profit maximising goals compete with profit maximising corporations generating imitation and making CSR a competitive factor
- Civil society economics needed to create those values (trust, responsibility, civic values) which the market needs to function

# The role of government and regulation

- Acknowledge that multistakeholder firms internalise externalities
- De Grauwe tax: large banks must pay the premium for the “too big to fail” insurance they enjoy
- Anticyclical capital requirements
- Reform of the market of rating agencies
- More severe capital requirements for larger banks
- Limits to leverage
- Consolidation of participated vehicles into bank balance sheet
- Regulation of derivative markets (no OTC products)

The crisis is a financial and not a  
macroeconomic problem

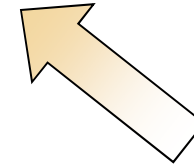
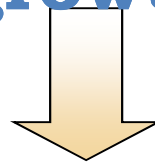
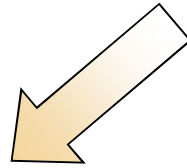


- But the special responsibility of the macroeconomist, I believe, is to try to improve our understanding of what is going on in the boundary regions of the corridor, of how one might prevent the economy from transgressing the bounds, and of what to do when this nonetheless happens.

- It only takes relatively small shocks to cause a fragile system to crash. In our present case, the cause was a rising rate of default on subprime US mortgages. If *all subprime mortgages had* gone into default the total loss to investors would have amounted to a few hundred billion dollars.<sup>10</sup> A tidy sum, to be sure, but at this time American and European governments and international agencies have committed more than 10 times that amount trying to stabilize the system. It has not been to overcome “frictions” that they have allocated trillions in bail-outs, loan guarantees and stimulus spending. It has been done to stop the collapse of an unstable financial house of cards before it draws us all into another Great Depression.

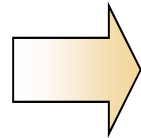


## E. op. and growth



### **Endowments:**

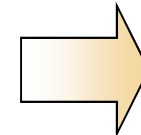
wealth, land,  
social group,  
family  
background,...



### **Process:**

investment,  
schooling,  
market  
transactions,  
political  
process.

*Limits to equal  
opportunities:  
lack of access  
to education  
and credit*



### **Outcomes:**

income,  
consumption,  
health,  
environment,  
...

### **Individual traits and preferences:**

tastes, talents,  
efforts,...

