CENTER ON CAPITALISM AND SOCIETY

COLUMBIA UNIVERSITY

http://www.capitalism.columbia.edu/

Working Paper No. 72, August 2011

AN EXCESS OF STATE BORROWING AND BANK LENDING: A SYMPTOM OF PRESENT-DAY CORPORATIST ECONOMIES

Edmund S. Phelps[*], Amar Bhidé [†] and John Kay [§]

---

[*] *Edmund Phelps is director of the Center on Capitalism and Society at Columbia University and winner of the 2006 Nobel Prize in economics.*

[†] *Amar Bhidé, author of A Call for Judgment, is a professor at the Fletcher School of Law and Diplomacy, Tufts University.*

[§] *John Kay is a visiting Professor of Economics at the London School of Economics, he contributes a weekly column to the Financial Times and is a Foreign Member of the Center on Capitalism and Society.*

4th Meeting in Economic Sciences
Lindau Meeting of the Nobel Laureates
Lindau, Germany
Friday, 26 August 2011

Modeling corporatist economies of the West and those of North Africa

By Edmund Phelps

Classic corporatism, such as Mussolini's, sought to restructure the capitalist economy so as to speed economic growth – growth of productivity and national power – beyond the capacity of Continental capitalism. This meant state initiatives to that end in both the public and private sectors. The quest for growth was to be subject to "solidarity" and "social protection." That meant "concertation" with the "social partners," subsidies for regions or industries, and social charges. Put equivalently, the state took whatever measures it deemed desirable in the name of solidarity and protection, constrained by the need to show efforts to restore growth whenever the economy flagged.

This system, in which, in principle, the state may intervene at its own discretion without any restraints, poses serious moral hazards. Self-interested legislators are apt to use their votes, and agency heads their powers, to award projects in order to win the support of interest groups that can keep them in office. For those in office dispensing patronage, it is more convenient to award clients and cronies monopoly power than to award them contracts paid with scarce tax revenue. The gain of these "insiders" disadvantages "outsiders," who may be unable to start a business, break into an industry or have a rewarding career – whether or not "protected" with subsidies for medical care, food and heat. This is the burden of extreme corporatism: the deprivations for few or many of basic goods like careers, which are not morally compensated by the spoils of the advantaged, few or many.

In Tunisia the insiders were those well connected to the ruling family and in Egypt the insiders were the members of the military, who had a share in the ownership or management of privatized enterprises. The youth protesting in Tunis and Cairo wanted to start businesses, enter industries, compete for places in companies and see an end to excessive licensing.

Now, in corporatist Tunisia, foreign banking interests are teaming up with Tunisian insiders to launch a new round of infrastructure projects, including important initiatives in the desert. These projects would not contribute to the advancement of the young Tunisians, who are looking for a career, not temporary construction work. In Egypt, the interim government and the military seek loans to start new infrastructure projects. In the past, if projects do not pay back, the IMF made it possible for governments in fiscal trouble to pay back their creditors. With the repayment of the loan from the IMF, the latter signaled it was safe for private creditors to resume lending, secure in the knowledge the IMF will guarantee repayment again.

In corporatist Europe, a new sort of alliance has emerged. The politicians want sovereign bonds rated risk-free in order to be able to borrow at very low interest rates and the banks want sovereign debt to be rated so risk-free that no capital is required against bank holdings of these assets. This was accomplished through an implicit commitment to bail out a government in the event that it has serious difficulty servicing its sovereign debt. This alliance may seem to benefit the insiders, both the politicians and the banks. But the implicit bond guarantees impose costs on the public. The economic system would work better if creditors bore the risk of the state's default and set interest rates correspondingly high. That way, the state would no longer have an artificial advantage in debt markets over the private enterprises that borrow – an advantage on top of the advantage the state derives from its size and whatever reputation it can establish. And the governments will no longer be subsidized to take the risks caused by heavy debt levels.

Project Syndicate
August 4 2011

The root of all sovereign-debt crises

By Amar Bhidé and Edmund Phelps

NEW YORK – The Greek debt crisis has prompted questions about whether the euro can survive without a nearly unimaginable centralization of fiscal policy. There is a simpler way. Irresponsible borrowing by governments in international credit markets requires irresponsible lending. Bank regulators should just say no to such lending by institutions that are already under their purview.

Lending to foreign governments is in many ways inherently riskier than unsecured private debt or junk bonds. Private borrowers often have to offer collateral, such as their houses. The collateral limits the lenders' downside risk, and the fear of losing the pledged assets encourages borrowers to act prudently.

But governments offer no collateral, and their principal incentive to repay – the fear of being cut off by international credit markets – derives from a perverse addiction. Only governments that are chronically unable to finance their outlays with domestic taxes or domestic debt must keep borrowing large sums abroad. A deep craving for the favor of foreign lenders usually derives from some deeply engrained form of misgoverance.

Commercial debt usually has covenants that limit the borrower's ability to roll the dice. Loan or bond covenants often require borrowers to agree to maintain a minimum level of equity capital or cash on hand. Government bonds, on the other hand, have no covenants.

Similarly, private borrowers can go to prison if they misrepresent their financial condition to secure bank loans. Securities laws require that issuers of corporate bonds spell out all possible risks. By contrast, governments pay no penalties for outrageous misrepresentation or fraudulent accounting, as the Greek debacle shows.

When private borrowers default, bankruptcy courts supervise a bankruptcy or reorganization process through which even unsecured creditors can hope to recover something. But there is no process for winding up a state and no legal venue for renegotiating its debts. Worse, the debt that states raise abroad is usually denominated in a currency whose value they cannot control. So a gradual, invisible reduction in the debt burden by debasing the currency is rarely an option.

The power to tax is thought to make government debt safer: private borrowers have no right to the profits or wages that they need to satisfy their obligations. But the power to tax has practical limits, and governments' moral or legal right to bind future generations of citizens to repay foreign creditors is questionable.

Lending to states thus involves unfathomable risks that ought to be borne by specialized players who are willing to live with the consequences. Historically, sovereign lending was a job for a few intrepid financiers, who drove shrewd bargains and were adept at statecraft. Lending to governments against the collateral of a port or railroad – or the use of military force to secure repayment – was not unknown.

After the 1970's, though, sovereign lending became institutionalized. Citibank – whose chief executive, Walter Wriston, famously declared that countries don't go bust – led the charge, recycling a flood of petrodollars to dubious regimes. It was more lucrative business than traditional lending: a few bankers could lend enormous sums with little due diligence – except for the small detail that governments plied with easy credit do sometimes default.

Later, the Basel accords whetted banks' appetite for more government bonds by ruling them virtually risk-free. Banks loaded up on the relatively high-yield debt of countries like Greece because they had to set aside very little capital. But, while the debt was highly rated, how could anyone objectively assess unsecured and virtually unenforceable obligations?

Bank lending to sovereign borrowers has been a double disaster, fostering over-indebtedness, especially in countries with irresponsible or corrupt governments. And, because much of the risk is borne by banks (rather than by, say, hedge funds), which play a central role in lubricating the payments system, a sovereign-debt crisis can cause widespread harm. The Greek debacle jeopardized the well-being of all of Europe, not only Greeks.

The solution to breaking the nexus between sovereign-debt crises and banking crises is straightforward: limit banks to lending where evaluation of borrowers' willingness and ability to repay isn't a great leap in the dark. This means no cross-border sovereign debt (or esoteric instruments, such as collateralized debt obligations).

This simple rule would require no complex reordering of European fiscal arrangements, nor would it require the creation of new supra-national entities. It would certainly make it difficult for governments to borrow abroad, but that would be a good outcome for their citizens, not an imposition. Moreover, curtailing governments' access to international credit (and, by extension, inducing more fiscal responsibility) could actually help more enterprising and productive borrowers.

Such constraints wouldn't solve the current crisis in Portugal, Ireland, Greece, or Spain. But it is high time that Europe, and the world, stopped lurching from one short-term fix to the next and addressed the real structural issues.

Amar Bhidé, author of A Call for Judgment, *is a professor at the Fletcher School of Law and Diplomacy, Tufts University. Edmund Phelps, a Nobel laureate*, *is a professor at Columbia University. Both are founding members of Columbia's Center on Capitalism and Society.*

Newsweek and *The Daily Beast*
August 15 2011

The road ahead: the monumental fiscal challenge

By Edmund Phelps

The latest major correction in the U.S. stock market has marked an abrupt change in economic thinking. Suddenly what used to be a minority view—a grim portrait drawn by myself and a few other observers—is widely accepted: some fundamental things are wrong with America's economy. But "too little money chasing too many goods"—a so-called deficiency of aggregate demand—is not one of them. A deficiency emerged last year, but the Federal Reserve's second round of "quantitative easing" got the inflation rate almost back to the target. A third round could be fired should the inflation rate sag again. The economy's real malfunctions are structural. When recognized, they reduce valuations of stocks, capital goods, and housing. That in turn leads to a contraction of investment activity—and hence of employment.

A big problem is that fiscal discipline was thrown to the winds after the presidencies of Ronald Reagan, George H.W. Bush, and Bill Clinton. When I first heard George W. Bush speak of "compassionate conservatism," I braced myself for a splurge of entitlement spending. The opening shot was Medicare Part D—free pills for seniors. To enact it, Congress had to abandon its 1990s rule that any bill for new spending had to provide new tax revenues to pay for it. I warned at the time that the bill violated the principle of "fiscal neutrality": such programs make people feel far wealthier than they are, leading to reductions in saving and domestic investment. But eventually people look to the horizon and see massive levels of public debt. Then markets get frightened, and asset prices plunge.

When Barack Obama took office after years living in the hometown of Chicago economics, I assumed he would be an economic conservative but keen on job subsidies. Instead he proposed the 2010 Medicare legislation that again threatened to increase outlays without any increase in taxes to offset them. And this July he inexplicably passed up an opportunity to cut $4 trillion in federal expenditures on the grounds that the debt deal would not tax the oil and gas industries.

These are just the highlights. Thanks to Bush's tax tables, a working-class couple with two minor children would pay no federal tax at all on income up to about $30,000 and would pay 15 percent on additional income up to about $25,000. Housing benefits, food stamps, and Medicaid might easily exceed the federal tax on a $50,000 income. The middle class gets off lightly too. The federal tax on $85,000 would be about $10,000. In effect, the bottom half of America's economy appears to be using its voting power to tax the top half.

That's bad government. There would be plenty of justification to raise revenues in order to subsidize businesses that employ low-wage workers. But there can be no justification for pandering to the economy's entire bottom half merely to attract its votes.

What makes the situation all the more unbelievable is that only 10 years ago it wasn't like this. Expressed as percentages of GDP, America's total federal outlay took off like a rocket in 2002, but federal revenue has declined steadily. Mary Meeker at the financial firm KPCB estimated earlier this year that the present value of America's existing entitlements has soared to $66 trillion: $35 trillion for Medicaid, $23 trillion for Medicare, and $8 trillion for Social Security. And we can't expect to "grow out" of this mountain; most signs suggest we're headed for years of slower innovation and reduced borrowing and lending—and hence slower growth.

In that case, how can Washington keep its commitments? Some economists have suggested "restructuring" the country's public debt—in effect, a default, which would likely cause a draconian downgrade of America's credit. Or we could "restructure" the entitlements, as former Fed chairman Alan Greenspan has suggested—also a default of sorts. Maybe a little chiseling is inevitable, but many Americans are counting on their entitlements in retirement. A major retreat from these commitments would be disgraceful.

The best solution of a bad lot is to boost revenues. Republicans can agree to cancel the free ride of the middle class. Democrats can end the free ride of the working class, but that will make subsidies to business for low-wage employment more necessary than ever. Both parties can agree to a value-added tax. If these changes are phased in gradually, they will not stop a recovery. The main cost of fiscal responsibility will not be jobs lost. Instead, it will be a setback in the rise of paychecks, profits, and wealth. Entitlements have to come from somewhere.

We can only hope Congress learns that lesson before it enacts any more.

Phelps, the 2006 Nobel laureate in economics, is director of the Center on Capitalism and Society at Columbia University and author of Rewarding Work.

Newsweek International
July 11 2011

More harm than good

By Amar Bhidé and Edmund Phelps

The International Monetary Fund's new managing director, Christine Lagarde, has inherited an IMF that has outlived its purpose. It takes just a bit of history to explain why. The IMF was created under the 1944 Bretton Woods agreement, a plan to promote open markets through exchange rates tied to the U.S. dollar. If a country couldn't cover its trade deficits, the IMF was to step in and lend it the needed dollars—on certain conditions. To ensure that the emergency loan would be repaid, and to clear the way for other financial institutions to make or renew longer-term loans in safety, the recipient nation had to adopt a program of strict austerity.

When the fixed-rate regime of Bretton Woods ended in 1971, economists imagined at first that a new era of freely floating exchange rates would keep imports and exports roughly in balance, thus eliminating large trade deficits and the need to borrow abroad to cover them. But many governments were loath to let exchange rates float freely. To hold down prices for imported food and energy, they kept their currencies at overvalued levels—and so their foreign debts mounted. They borrowed abroad for other reasons, too: for grandiose public-works projects; to keep state-owned industries afloat; and, not least, because it suited sticky-fingered ruling families.

Foreign lenders were untroubled; as former Citibank head Walter Wriston famously declared, countries don't go bust. Still, governments cannot borrow without limit. When the pretense that a country was creditworthy became impossible to sustain, the IMF was wheeled in to do the dirty work and make the country safe to lend to again—until the next crisis.

Bold reforms that transformed emerging economies like the BRICs—Brazil, Russia, India, and China—then nearly put the IMF out of business. The Chinese in particular showed that an undervalued currency can supercharge a country's export sector and turn trade deficits into huge surpluses. Privatization of state-owned enterprises became popular, and finance ministries shed their traditional reluctance to let domestic companies borrow abroad. With emerging economies riding high, their private borrowers received a warm welcome in international capital markets.

Their gain became the IMF's pain. Demand dried up for stopgap funding and austerity programs. By 2008 it was the IMF's turn to struggle with its own budget deficit of about $400 million through spending cuts, staff reductions, and sales of gold reserves. But just when the IMF seemed undone by the BRICs, it was saved by the PIGS—Portugal, Ireland, Greece, and Spain. Athens had been borrowing hand over fist for years, hiding its debts through dishonest accounting and duplicitous swap transactions. (That was in contrast to the Irish government, which landed in trouble practically overnight by taking over the bad assets of its insolvent banks.) In April 2010, when rating agencies downgraded Greek government bonds to junk, a familiar story unfolded. Athens negotiated the usual austerity package and secured a loan from the IMF and the EU.

Now, before Tunisia and Egypt even have new governments in place, the IMF has jumped to offer them loans for vast infrastructure projects in the desert—as if the fund didn't know that young Arabs there want ways to start businesses and have careers, not temporary construction jobs.

The Greek debacle and the North African drama raise existential questions about the IMF. Responsible governments have no business borrowing vast sums from abroad, rather than from domestic sources. That's what tinpot regimes do. And lending even more to borrowers who can't pay what they already owe? That's what loan sharks and mafiosi do.

The IMF's business model sabotages properly functioning capitalism, victimizing ordinary people while benefiting the elites. Do we need international agencies to enable irresponsible—verging on immoral—borrowing and lending? Instead of dreaming up too-clever-by-half schemes to stumble through crises after they happen, why not just stop imprudent banks from accommodating foreign borrowing by feckless governments? After all, it's French and German taxpayers who are on the hook—not just the Greeks and the Irish.

Amar Bhidé, author of A Call for Judgment, *is a professor at the Fletcher School of Law and Diplomacy, Tufts University. Edmund Phelps, a Nobel laureate*, *is a professor at Columbia University. Both are founding members of Columbia's Center on Capitalism and Society.*

The Financial Times
August 11 2011

Remember that a loan to the king does not always pay

By John Kay

The market panic began when the US succeeded in reaching settlement, not when it failed to do so. There is sense in this: the debate about the debt ceiling accelerated recognition that sovereign debt repayment is more about politics than economics.

Businesses and individuals pay their debts because they have to, but sovereign borrowers are in a different category. Sovereign immunity follows the logic of sovereignty. The courts impose the authority of the king and, therefore, cannot be used against the king.

The considerable assets of governments are generally not available to their creditors. Some arrangements pretend to bypass this principle - the UK Treasury building is the subject of a complex securitisation and the Athens metro might be privatised. But anyone who imagines that such security could be enforced is living a dream.

The spat between Standard & Poor’s and the US Treasury over accounting numbers similarly misses the point. The issue is not, and never will be, the capacity of government to repay; the issue is the willingness of government to repay. If sovereign borrowers meet their financial obligations, it is only because they want to.

For centuries people realised that the special status of the sovereign made lending to the king risky: rich individuals and sound ventures were generally safer investments. Kings could default, or pay in devalued coin, and there was nothing the angry lender could do about it. The sovereign lender must not only risk his capital but brave the ingratitude that borrowers often display.

When Walter Wriston observed of third world lending that “countries can’t go broke” he was describing a problem rather than an opportunity. If borrowers did offer to repay, that was generally because they wanted to borrow more. And borrowers did borrow more until their repayment capacity ceased to be credible.

Richer countries seemed a better bet because their citizens felt an obligation to meet public debts. But that sense of obligation based on a shared sense of the legitimacy of the obligation has recently been eroded.

In Iceland and Ireland, the public does not readily understand why it should be responsible for the follies of financiers. In the US, a minority seem to believe the federal government represents a hostile occupying power. Europe suffers from deliberate blurring of the distinction between the obligations of individual states and the obligations of the eurozone. These different phenomena are all manifestations of the same underlying cause - loss of confidence in governments and trust in the financial system.

The legal doctrine of sovereign immunity extends to foreign sovereigns. If the English courts would not enforce judgments against the king of England they would also decline to enforce them against the king of France. Partly from chivalrous reciprocity but also from pragmatism. Such enforcement could turn a private transaction into a war between states.

And could do so even today. Imagine a hedge fund seeking a sequestration order against Air Force One on the tarmac at Heathrow. State debt owed to foreigners and foreign ownership of key national assets have regularly created political problems. Think of the constant destabilising impact of economic colonialism in Latin America, the failed attempts to extract reparations from Germany after the first world war, the impact of petrodollars on the politics of the Middle East. Today we have to think about Asia's holdings of US bonds and the rise of sovereign wealth funds. In each case the interaction of economics and politics damages both sound economic policy and good international relations.

We have finally realised that these historic problems have not been solved by modern capital markets. Some hedge funds have done well by understanding the nexus between commercial reality and geopolitics. But most sovereign debt is now in the hands of traders with little knowledge or understanding of history, politics - or much else, with no sense of responsibility. We are all feeling the consequences.

John Kay is a visiting Professor of Economics at the London School of Economics, he contributes a weekly column to the Financial Times and is a Foreign Member of the Center on Capitalism and Society.