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Notes for the Shadow G8

In the last page of the *General Theory*, J.M.Keynes wrote: "*Practical men* (i.e. policy makers and politicians) *are slaves of some defunct economists*". Economists in turn are slaves of defunct physicists because they still adopt the reductionist approach pioneered by Newton (but someone suggests Archimedes. This is a convenient simplifying device to obtain an equilibrium solution but at the cost ofneglecting by construction interaction and coordination.

Starting from these premises, for the adherents to the mainstream approach it is straightforward to embrace the view that there is only one model, or one theory (*as there is* one *gravity law*), which produces a natural and optimal outcome. Given the assumptions of perfect information, full rationality and market clearing, the standard approach reaches the conclusion that the outcome of market processes is *optimal*: A shift has occurred from the implicit self-organization principle of the invisible hand to the Panglossian view of the market economy.

Because of the perfect information-full rationality assumption, the standard approach predicts that in the real world unemployment is voluntary; money, credit, and debt are not relevant; coordination, uncertainty and bankruptcy are simply not a problem.

Models developed according to this approach are usually *calibrated* to verify their predictions (*btw: the Ptolemaic system had an excellent calibration*). Most of the times the empirical analysis is conducted on US data, although many investigations have shown that the cross-correlations of the "aggregative time series" are *time*, *country* and *distribution* dependent.

It is only natural that from one theory one policy will be derived, good for all seasons. And, since the basic ingredients of the model are full rationality, perfect information and market clearing, the policy cannot be but one: the market can't fail, unless the Government "interferes". The Washington consensus prescribes more or less the same remedy for every country regardless their specificities and contingencies.

The one view of the economy is not without disclaimers. In particular, the hypothesis of asymmetric information leads to a shift of the economic paradigm. If information is asymmetric 2 consequences immediately emerge: (i) agents are heterogeneous and (ii) they interact (*with AI even if agents are fully rational, the outcome is suboptimal*).

The effects of asymmetric information on the standard model are devastating: one cannot aggregate heterogeneous interacting agents because of externalities (i.e. non linearities which rule out the law of large numbers). Being unable to aggregate, the demand-supply framework collapses: all in all, the market outcome is self-organization, not equilibrium.

The system is thus nonlinear (because of interaction) and populated by many heterogeneous agents: the reference model is in a series of papers by GS. Besides the well-known and very well ignored limitations of the standard model, as policy is concerned we have to point out that it has no room for credit-debt and time. We'll see some insight of the new economic policy box of tools.[1]

(I) MACROECONOMIC POLICIES WITH BANKRUPTCIES.

According to the conventional wisdom, an increase of the interest rate is required to fight inflation and/or eliminate the external deficit and "defend" the exchange rate. This approach simply neglects the basic fact that firms run financial debt to operate, and an increase of the interest rate may lead to bankruptcy, thus reducing output and export, possibly exacerbating the evil it was supposed to fight.

When the fixed exchange rate is abandoned, only exporting firms will benefit from a devaluation. If the central bank attempts to attenuate "excessive devaluation" by means of an interest rate hike, it will hurt both domestic and exporting firms' financial conditions forcing an avalanche of bankruptcies with negative repercussions on aggregate macroeconomic conditions.

The same policy may produce different effects depending on the type and extension of the network of financial and productive relations within the corporate and banking sectors and among firms and banks. One should emphasize that a one-size-fits-all policy is derived from fallacious premises. Some of the basic tenets of conventional wisdom, such as that European unemployment is due to rigidities of the labor market, are controversial when one considers the fact that at least in some countries the problem lies in an insufficient aggregate demand.

(II) CREDIT AND DEBT: BANKS, FIRMS AND COUNTRIES.

In the last twenty years The issue of financial crises has recently gained attention because of the Asian, Russian and Latin America macroeconomic turbulence. This issue is related to the network structure we are experiencing in the globalization process: new links are established among already connected countries and new nodes do appear due to the spreading of globalization. In this world financial contagion may develop easily. In a way developed countries should run the risk of financial troubles in the banking sector at home to reap the profits of using cheap labor force abroad. One should be able to conceive it as a coin with two faces: "bank losses" for the developed countries translate into "unemployment" in the emerging countries. We need a monetary policy, which goes beyond inflation control to sustain development via stability through a reform of the international monetary system (the old Keynes' plan.)

(III) INTERACTIONS AND THE ROLE OF INITIAL CONDITIONS.

Different countries experience different paths of development. For instance the European Recently Developed Countries (RDCs) i.e. Italy, Spain, Portugal, Ireland, Greece and Turkey have followed growth paths different from those of the Early Developed Countries (EDCs)It is hardly surprising that the new comers had to specialize in "Low Added Value" sectors and that the effects of this specialization were long lasting. The EDCs share the same structural characteristics: regional dualism, large shadow economy, large population of small firms, high inflation and public debt. Moreover, RDCs specialize in traditionalsectors, vulnerable to competition from the emerging countries.

One should recognize that different paths of development are possible and that globalization may have very different effects on different countries, depending on the level of development, the network straucture and the time of the take off.[2] In this sense, one should take a country specific approach.

(IV) MESO-LEVEL ECONOMIC POLICY.

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[1] Macroeconomic policy, its interaction and coordination with other policies.

[2] Globalisation and its interaction with the European economy.

Once the representative agent framework has been removed, one can appropriately tackle the issues of (re-) distribution of wealth, income and firms' size, resilience of a system and *growth with responsibility*.

The empirical evidence shows that a system without any other constraints than survival, tends to be very far from egalitarian (it is power law distributed) and polarized (there are exclusive clubs). World income distribution measured in terms of GDP per capita, show that: i) richer countries are characterized by fluctuations of smaller amplitude if compared to poorer countries; ii) such a difference in terms of the relative amplitude of fluctuations between richer and poorer countries is increasing over time; iii) the volatility of fluctuations decreases with size at a rate suggesting the presence of direct interactions among economic agents.

Rather than inquiring which is *the optimal level of poverty* to achieve an *optimal growth pace*, the policy question concerning distribution is how to improve meso policies in order to affect firms' size and growth (provided that the probability of survival, R&D expenditure etc. strongly depend on firms' size.)

This approach may lead to unconventional policy prescription such as some form of protection for the newly born industries (4 out of 5 firms are out of business in 3 years in developing countries, compared to a 2 out of 5 in the EDC).

(V) MARKET FAILURES

Market failures are widespred: everyone knows that markets produce too much pollution and too little R&D.

Government is of course also subject to "non-market failures", but there is no-one else able to promote infrastructural expenditure (*a must for the Developing Countries and a bug of the European Stability Pact*), insurance against unemployment (*the only way to have flexible, but not precarious jobs*), basic research or pollution-free production