

QUESTIONS FOR A MORAL ECONOMY: A RESPONSE TO REINHARD MARX

by Roger Myerson, 31 May 2012

http://home.uchicago.edu/~rmyerson/moral_economy.pdf

I am very grateful for the privilege of following Cardinal Marx here in discussing moral foundations for our global economic system.¹ Cardinal Marx has spoken about *ordoliberalism*, which aims to design fundamental rules for a sustainable social system based on individual choice and fair competition, both in markets and in politics. He has raised the greatest question of social science: how to build a prosperous moral society. As a game theorist, I love to talk about how rules of games could be better designed! As an economist, I recognize that the foundations of a better social system must be political and indeed also may be religious, that our best hopes for a moral economy should be based on our democratic political systems and on our deeply held sense of what our leaders should do. But we must try to understand better how a successful democratic society actually works.

Economists assume that any society is composed of selfish materialistic individuals. To bind us together into something greater, we must look first to political leadership and law. Leaders enjoy privileges of power when others in society broadly recognize their leadership. But this social recognition will depend on the leaders' reputation for conforming to accepted laws. One who loses this reputation will risk losing his or her status as a recognized leader. So the essential key to democratic development, I believe, is to increase the supply of political leaders who have good reputations for using public funds responsibly in public service.

New laws can provide the basis for fundamental social change only if people broadly understand these laws well enough to insist that their leaders must enforce them. Senator Dodd and Representative Frank should beware: If people do not understand a law, then they cannot hold their leaders responsible for failures to enforce it. A regulatory reform will be incomplete until political leaders explain the new regulatory principles to the public and begin developing reputations for appropriately enforcing them.

As I noted, game theorists like to talk in detail about how rules of games can affect the outcomes that people care about. Please let me list here five questions about key areas where fundamental rules of great social institutions may need to be rethought.

¹ The German text for Cardinal Marx's talk on "Toward a Moral Economy: Policies and Values for the 21st Century" is available at http://www.ksz.de/fileadmin/user_upload/Aktuelle_pdf_s/Rede_Kardinal_Marx_Chicago.pdf

(1) Before 2008, investments flowed from the whole world into Europe and North America because financial institutions here were considered the most reliable in the world, thanks to a system of law and regulation which in turn depended on our democratic political systems. But in 2008 we learned that these institutions were not reliable enough. Some well-focused financial regulatory reform was clearly needed. Such a focused reform could well have started at the heart of the system of bank regulation, in the capital-adequacy formulas. Under these formulas, if an asset is considered "very safe" then banks have been allowed to buy it with little or no investment of the capital that belongs to the owners of the bank. But if such assets turn out to be actually risky, then the whole banking system is put at risk. This has happened twice in recent years: for mortgage-backed securities and for sovereign debt. From the start, the Basel standards for bank regulation recognized foreign exchange as a serious source of risk, but these same standards treated sovereign national debt as "very safe." Thus, the formation of the euro-zone transferred massive risks from a category that bank regulators were supposed to scrutinize into a category that bank regulators were supposed to ignore. So my first question is:

Should regulators be telling banks that they need less capital to invest in mortgage-backed securities or sovereign debt than to invest in small businesses?

(2) Tension in the euro zone today is focused on a debate on austerity versus stimulus. They are not quite incompatible, however. Fiscal austerity could be matched with a monetary stimulus, as long as we use fiat money that a central bank can print (instead of a gold standard). Everybody understands that monetary policy must follow rules that restrict the printing of money, but it is hard to argue for keeping a fixed inflation target regardless of the low growth and terribly high unemployment in so much of the euro-zone. To be specific, I would ask:

Should the central bank's monetary-policy target be 2% current inflation or a long-term 4% nominal growth path for current-price gross domestic product (GDP) in the currency zone? (This 4% nominal-growth target would be the sum of real growth plus inflation per year.)

(3) In America today, a major political movement has developed around the argument that less public spending is always better. Some might blame Chicago economists for this view, but we know that prosperous nations actually tend to allocate a larger fraction of output to public spending. Indeed, poor nations may be so poor precisely because they lack political capacity to cut waste and corruption in public spending. In a democracy, voters' ability to monitor public

spending is a vital public good, and it may be one of the best areas where we could invest for better growth in the future. So I would next ask:

Could we get better democratic oversight of our public budgets if our public schools taught students how to read public financial statements?

(4) NATO's efforts to build a democratic government in Afghanistan have been badly frustrated, and many fear for the future of democracy in Egypt since the recent presidential election. It seems that we may need to think more carefully about how successful democracy develops. I have suggested that the key to democratic development may be to increase the nation's supply of leaders who have good reputations for spending public funds responsibly for public service, and not just to distribute patronage jobs to their cronies and supporters. Democratic local governments can offer many opportunities for politicians to begin cultivating such reputations, but presidential elections force voters to focus on just a couple of leaders. So let me ask:

What should come first in the development of a strong democratic system: a presidential election or elections to local councils?

(5) Finally, above all, we need globally accepted principles of international law to sustain a peaceful multi-polar world. Political power in the world must be decentralized to national and local levels, but nobody wants to return to the chronic dangers of global military rivalry among great powers that plagued the 20th century, in two world wars and a perilous nuclear cold war. A one-superpower world under American leadership can be peacefully sustained, however, only if other great nations trust that America will not abuse its military dominance. So my last question is:

To sustain a global peace without dangerous great-power rivalry, must the strongest nation in the world use military force only within specific limits that the world can judge?

In asking this last question as an American, I am inspired by the presence of Cardinal Marx as a German who has thought deeply about such matters. In the 19th century, Otto von Bismarck understood well that the strongest nation in the world may have the greatest need to accept constraints from the international community, to reassure its neighbors. But Kaiser Wilhelm II ignored this point disastrously in the early 20th century. For the safety of our civilization in the 21st century, Americans need to understand it now.