

# Rethinking Economic Policy in the Age of Financialization: *Why the Barro-Ricardo Theory Cannot Make Sense*

**Giuseppe Mastromatteo**

*Research Scholar, Global Institute for Sustainable Prosperity  
Professor of Economics, Catholic University of Milan, Italy*

**Lorenzo Esposito**

*Research Scholar, Global Institute for Sustainable Prosperity  
Economist, Bank of Italy, Milan*

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The 2008 crisis brought forth a rethinking of the role of economic policies. We would like to analyze a specific point of this debate: the effect of financialization on fiscal policy. In doing so, we find it useful to analyze the debate on the Barro-Ricardo equivalence (BRE), which, since the 1970s, has played an important role in molding the economic policies that fostered the crisis. The original Barro article (1974) attacked counter-cyclical policies as futile, claiming that they could not boost the economy due to private investment crowding-out. We will try to explain why the traditionally understood assumptions of this theory and its conclusions are not helpful for analyzing the contemporary economy before finally offering alternative interpretations.

## **The meaning of BRE assumptions**

The theoretical consequences of a deductive reasoning are all in its assumptions. This may seem obvious, but it is easily forgotten in economics. In the case of BRE, we can divide its assumptions into two categories. The first one is founded on empirically implausible assumptions such as complete financial autarky (Bulow and Rogoff 1979), No Ponzi game condition (Tcherneva 2008), market completeness, and so on. The second one makes assumptions that rule out the very existence of the finance system and fiscal policy. In particular, the equivalence is based on a strong representative agent hypothesis (RAH) that assumes people are “identical in terms of tastes and productivity” (Barro); moreover, there are no liquidity or borrowing constraints (therefore “safe assets” or liquidity services offered by banks and governments are useless) and central banks do not exist.

For these reasons, fiscal policy cannot help because an increase in public debt today yields higher taxation in the future—a phenomenon that is observed through the behavior of taxpayers who tend to spend less when anticipating rising taxes; therefore net private wealth remains unchanged and the stimulus effect of the expansionary policy is nonexistent (Barro 2007). From its part, private debt cannot destabilize the economy because, as Stiglitz (2014) put it, private markets are considered to do everything right by definition.

Keep in mind, Barro, himself, (1989), took into consideration that many empirical objections to the equivalence, were implausible if taken literally. Nevertheless, he found discussing the different scenarios a useful practice. However, caution should be had exercised since his replies may lead to support for the first kind of assumptions. Our goal is to demonstrate that not only do the second type of assumptions make BRE useless but that financialization, as a global process, rules out the possibility of the first set of assumptions.

Let's start with the nature of assumptions. The RAH prevents many things to happen. First of all, on the financial dimension: the RAH implies that finance, debt, banks, and money play no role whatsoever. Therefore, financialization and debt growth are not of any concern. If every economic agent has the same income, assets, debt, and pay the same (lump sum) taxes, how can an increase in public or private debt change anything? Issues like the rate of saving or the household debt service ratio or even the debt to GDP ratio are irrelevant and “financial structure can't matter” (Stiglitz 2014). As for the political dimension, in the BRE context the government ceases to have a meaningful role. If there is only a single agent in the economy, how can the government do anything in contrast with its only elector? Certainly, “there is no need for government lending” (Canzoneri *et al.* 2013). More generally, why should a government then exist? In a nutshell, the society for whom the BRE speaks has neither need of a fiscal policy nor a financial dimension in which to apply this policy.

It is striking that this aspect of the theory is overlooked because finance is excluded from the theoretical analysis during the decades in which financialization becomes one of the most, if not the most important, aspect of the world economy. So, while BRE built a theoretical framework to criticize active fiscal policies, financialization made income and wealth distribution progressively unequal (thus making the RAH less and less realistic), produced the growth of private debt and financial leverage with an increasing importance of finance for the overall stability of the system. While policy conclusions of the BRE were a warning against public debt and public deficit, the fact that the weight of the financial system on world economy was growing apace, does not appear to have been of any concern. The conclusion was that although the 2008 crisis was not an out of the blue event but came after many other less important crises, BRE-based economics were not able to detect the extent to which the recession would affect long lasting trends linked to finance.

Given that the BRE is based on incorrect assumptions that make it impossible to detect the real dangers for world economy, one could simply suggest discarding it. And yet, we continue to think of it as useful.

### **How to use the BRE for good**

In the world of BRE, issuing public bonds induces substitutions (i.e. reductions) of other financial assets (Konzelmann 2014). The substitutability holds true for bonds and also for stocks because “equity and government bonds [are] perfect substitutes” (Barro 1974). Now, if public and private bonds are so close substitutes that they can be used indifferently as safe assets, every conclusion that is true for public bonds must also be true for private debt and vice versa. Therefore, from the BRE we understand that all bonds

and all financial instruments are basically the same as far as the economic policy is concerned. This is a very interesting perspective from which to look at financialization. Let's see what can stem from it.

First of all, the composition of debt is irrelevant, what matters is the overall debt. Sometimes public debt grows too much, in other instances private debt grows too much, resulting in socialization, or as Reinhart and Rogoff (2011) put it, "private debts become public debts after the crisis." The original nature of debt (public or private) is a secondary issue; what really matters is its dimension vis-à-vis the economy (Vague 2016). What is baffling is that international institutions knew long before 2008 that what matters is debt and not only public debt. For instance, among the financial soundness indicators utilized by the IMF, many deal with private debt, but none do so with public debt<sup>1</sup>.

Secondly, because what matters is the dimension of debt, in order to assess the overall financial stability, we should look at the general leverage (that is to financialization) because debt must be repaid or, as Barro points out: "the future interest payments on the government debt must be financed in some manner." The same is to be said for private bonds. If financial leverage increases, the debt service ratio will also increase unless interest rates go down. Debt and leverage growth explains why "Room for manoeuvre in macroeconomic policy has been narrowing with every passing year" (BIS 2015, 21). Economic growth is likewise negatively influenced by financial leverage via debt service burden (Juselius and Drehmann 2015).

The third point can be expressed through responding to the following question: what is net wealth? Barro (1974) concluded, "there is no persuasive theoretical case for treating government debt, at the margin, as a net component or perceived household wealth." Given that government and private debt are the same, we should conclude that, in general, debt cannot be social net wealth but only a shift of wealth among people (unless the RAH holds true, because in that case no redistribution is even conceivable). If debt cannot create wealth, what about productive investment? In the BRE context, productive public investments are not possible (Barro and Redlick 2009), even if economists that accept the BRE cite examples of them (Bailey 1993). This contradiction is negated through Barro's explanation that "the value of the project (counting, say, the whole flow of future benefits from a bridge or a road) has to justify the social cost. I think this perspective, not the supposed macroeconomic benefits from fiscal stimulus, is the right one to apply to the many new and expanded government programs that we are likely to see this year and next" (Barro, 2009). Therefore, the wealth coming from an investment will depend on its specific economic function, not on its nature (public or private). In fact, the 2008 crisis demonstrated many examples of private useless investment and of relevant public investment (for instance in lending of last resort). As for the link between public investment and interest rates, long ago Barro explained "If government bonds are not perceived as net wealth, then the demand for bonds rises one-to-one with the supply, there is no change in interest rates, and no displaced private borrowers" (Barro 1976). That the rates do not go up automatically with the debt was known long before the crisis (for instance, Metzler 1951). With the crisis, notwithstanding a massive public debt increase, rates did not go up, quite the contrary: "Interest rates have never been so low for so long [...]. Between December 2014 and end-May 2015, on average around \$2 trillion in global long-term sovereign debt [...] was trading at *negative* yields" (BIS 2015, 7). This is all thanks to the central banks (strictly speaking they cannot exist in a BRE context but this is not the main critique here). Therefore, the equivalence should dramatically change the way we look at financial wealth and interest rate dynamics.

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<sup>1</sup> See the documentation on the IMF website: <https://www.imf.org/external/np/sta/fsi/eng/fsi.htm>

We are in a good position to understand how to assess economic policies when we consider the above conclusions. As far as monetary policy is concerned, its stance is decided by the degree of financialization. All other things being equal, the higher the leverage, the lower the sustainable interest rate. Contrarily to the traditional analysis that links policy rates to inflation or output gap, the monetary policy stance can only be understood in the context of the financial fragility of the economy (especially of the banks). The debate about central banks independence also acquires a different meaning: central banks can be independent from the government political priorities but not from reality. i.e. from financialization. Taken in a nutshell, if economic policy is not able to reduce the overall leverage, it can only delay problems and not solve them.

As for the fiscal policy and its institutional set-up, every rule that singles out public debt cannot help. Therefore, for instance, the Maastricht Treaty-Stability and Growth Pact frameworks are totally mistaken. In fact, in 2008 the European economy was shattered by the crisis of its banks, not by the level of public debt, which increased by almost 20% as a consequence of banks bailing-out (EC 2011). Once again, financialization mattered; public debt *in itself* did not. This also explains the general role of the State in the economy. In a financialized world, the degree of the intervention is linked to the overall debt. As Minsky (1982) explained, the higher the leverage, the riskier the situation, hence the stronger the need for public intervention. Financialization means a higher leverage and therefore the structural need for more public intervention. This intervention could be ex post, as after the 2008 crisis or, more efficiently, before the collapse, but it cannot be avoided. Economists that are against a strong public intervention in the economy should suggest how to strongly decrease financial leverage; otherwise they propose to fight the consequences while leaving the causes intact. This never works.

Thirdly, the BRE compels a deep reconsideration of the meaning of wealth. In the light of our interpretation of the equivalence, private wealth is not automatically social wealth. Debt is wealth if investment where it is embedded is productive, a feature that has nothing to do with the nature of the issuer. In fact, the IMF (2015) and the German Ministry for Economic Affairs and Energy (Janssen 2016) have also explained that public investments are decisive in spurring world growth, which brings us back to fiscal policy. During the 80s and 90s, Italy, in order to justify privatizations, labeled the fact that State owned firms produced cakes or other foods as primitive. From the BRE we know that this is no more primitive than letting private bonds pay for the building of a cake factory. If this helps economic growth, it is positive, in that it produces net wealth. Over the last few decades, the fiscal policy debate was about taxes, public debt, and much less on what the government actually does with the money. It is time we start again to discuss more important issues such as industrial policies (Mazzucato 2014).

To conclude, we point out that the common interpretation of the BRE cannot help analyze the financialization epoch and, in particular, cannot help to design effective monetary and fiscal policies.

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