

Economics, Politics and Democracy in the Age of Credit-Rating Capitalism

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Unlike in earlier major economic crises, the current turmoil in the global economy has seen the consolidation of orthodoxy as the dominant paradigm. This essay traces the political economy of change in the current situation and discusses how credit-rating agencies have assumed a pivotal role in delinking politics from the conduct of economic policy, thereby undermining the legitimate role of the state in the economic domain.

Every crisis in society is also an opportunity for change. This is no less true for economic crises. Major economic crises in the past have overthrown the incumbent orthodoxy in economic thinking and replaced them with an alternative. The Great Depression in the 1930s stands out as the most striking example both as the severest in living memory and for the sharpest change in economic theorising and style of management that it induced. Neoclassical thinking based on the belief that the market mechanism of demand and supply has the inherent capacity to recover automatically from a crisis was replaced by a new vision.

The chief architect of the new paradigm, John Maynard Keynes urged his fellow economists to break away from the “habitual modes of thought” for solving one of the worst economic crisis capitalism ever faced. The change in economic thinking had a profound impact on many spheres ranging from teaching economics¹ to economic policymaking; indeed, it is aptly called the Keynesian Revolution. The revolution brought about a change in the political nature of the state. While both fiscal and monetary policies were informed by scientific research based on Keynesian economic theory, the politics of feasibility and implementation of those policies was very much at the centre of policy debates at that time.

The post-war political climate with systemic competition between capitalism and Soviet socialism also contributed to the winds of change in economic thinking, which in turn provided an economic rationale for the welfare state. The post-war reconstruction aid from the us was instrumental, not by design, in experimenting with the economic policies of the Keynesian revolution in Europe. Not

only did Keynesian policies demonstrate, based on the new theory of how even unproductive war expenditure could result in full employment and turn around ailing economies, it also provided the intellectual basis for the politics of social democracy to bring about cooperation between the contending economic classes of labour and capital. Furthermore, with the advent of the welfare state, there followed one of the most prosperous periods in European history, dubbed the “Golden Age of Capitalism” (Epstein and Schor 1990; Bhaduri and Marglin 1990).

The uninterrupted growth in western economies created a kind of positive feedback between the politics of the welfare state and Keynesian style economic management. They reinforced one another over time and became institutionalised, and, in Keynes’ own phrase, had evolved into a habitual mode of thought. The state was seen as the driver of the economy and its political nature was not questioned. More importantly, state action was not seen as detrimental to the interest of capitalists as long as Keynesian style class cooperation created an investment climate conducive to private investment driven by profit.

However, profit as the engine of growth slowed down with an ensuing profit squeeze in the 1970s and the limit to such cooperation began to emerge. The twin oil shocks (1973 and 1979) created inflationary pressures on already stagnating economies and questions were raised about the suitability of Keynesian policies, which by then had become conventional wisdom. As economists led by Milton Friedman, in particular, began to question the established doctrine of Keynesianism, the foundational behavioural assumption of the money wage bargain on which Keynes’ *General Theory* was built was challenged.

Friedman argued against expansionary fiscal policy on the ground that it could provide more employment only if real wages were lowered to satisfy the profit maximising firms. But this requires money illusion on the part of the workers, which would at best be transitory and ineffective in the long run simply because you cannot fool all the people all the time.

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With the argument that fiscal policies of the state-influenced inflationary expectations of the economic agents, Friedman went on to prove that those policies would be ineffective in the long run and the economy could end up having a “natural” level of unemployment so long as it is consistent with the individual labourer’s choice between work and leisure.

The argument in effect resurrected the notion of “voluntary unemployment” (i.e., unemployment was a matter of individual choice), which is the core of the neo-classical orthodoxy argument that counterposes individual freedom against state intervention. The fiscal policies of the state were seen as distorting the “expectations” of the agents in the economy while it had no real impact on the level of output and employment in the long run. The second phase in the development of Friedman’s theory, often referred to as Monetarism Mark II, or the “New Classical School” led by Robert Lucas, demonstrated the ineffectiveness of monetary policy because workers endowed with rational expectations would not be fooled by money illusion even in the short run. Crucial to the argument is the idea that every agent determines his or her action by adapting and forecasting the future on the basis of the same model so that no space is left for surprise effects of economic policy of the state. Paraphrasing the poet T S Eliot: “[I]ndeed after such awesome rational knowledge (of individual agents), what forgiveness (for the state)”!

Monetarist Counter-Revolution

From the Keynesian revolution to monetarist counter-revolution, macroeconomics underwent a full circle² comprising both fiscal and monetary policy ineffectiveness. The counter-revolution had a profound impact on the style of economic management. The new classical model claimed that monetary policy is ineffective because economic agents are rational in a sense that they would adjust their supply decisions even when the policy is simply announced by the monetary authority or the state. This allowed them to take the argument further and claim that given its political compulsions, the democratic state may not be in a position to stick to its monetary policy

commitments and this would cause inconsistencies in individuals’ expectations about the future conduct of monetary policy. Such inconsistencies would have a negative impact on the sentiment of the investor about the future growth of the economy and thereby affect their supply decisions. Hence, the proponents of the new classical school argued for an “independent” monetary authority, viz, a central bank that would conduct a rule-based monetary policy devoid of political interference from the state. The idea was set in motion of delinking politics of the state from the conduct of the monetary policy by the central bank.

The idea of an independent, objective, non-partisan and apolitical central bank targeting exclusively the inflation rate resonated well within the financial community and was initiated in New Zealand. Many developed and developing countries today claim to have an independent central bank. Thus the monetarist counter-revolution, like the Keynesian Revolution, redefined the role of the state in the economic sphere. In the pursuit of its ideal of a minimalist state as a counter to the Keynesian Revolution, it took away from the state, as a first step, its control over monetary policy. However, fiscal policy still remained within the control of the state.

The counter-revolution provided a perfect economic rationale for the conservative political ideology that advocated a minimalist state. The economics of the counter-revolution and the politics of conservatism centred on the minimalist state aligned perfectly at the turn of the 1980s. This is hailed as a period that ushered in the “second wave of globalisation”. It was marked by the rise of “high finance” – the financialisation phase of globalisation. With the counter-revolution providing an intellectual justification for “freeing” monetary policy from the politics of the state via an independent central bank, the stage was set for the development of an unfettered financial sector around the globe.

Fiscal policy was reined in to create a conducive tax climate and boost private investors’ sentiment vis-à-vis the financial markets.³ Even though the financial market went through a few “shocks” in

the late 1980s and the 1990s, e.g., the 1987 one-day crash and the dotcom meltdown in 2000, the resilience of the modern financial sector was hailed as robust⁴ and its contribution to the overall prosperity of the economic expansion was applauded. Indeed, the relatively uninterrupted growth in the second phase prompted Robert Lucas, a leader of the second phase of monetarism or rational expectation-based macroeconomics, to unequivocally declare,

[I]ts [macroeconomics] central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades (Lucas Jr 2003).

New Consensus Macroeconomics

The enthusiastic declaration of depression prevention had to bite the dust with the onset of the “Great Recession” in 2007 in both the US and Europe. The weight of history was pointing unequivocally towards a new revolution that would dismantle the incumbent monetarist orthodoxy. However, it did not repeat itself; on the contrary it rhymed, as Mark Twain would have insisted, better with the pre-Keynesian era of the 1920s. Monetarist orthodoxy has returned although under a different guise called the New Consensus Macroeconomics and it would appear to have consolidated its position during this recession.

The orthodoxy that dislodged the state from its monetary policy commitments by invoking market sentiments got irrevocably locked into the process of circular reasoning in a self-referential way. Monetary policy was conducted by independent central banks, which supported the expansion of the financial sector that was to be overseen by an objective and scientific risk-rating mechanism. Credit rating agencies provided such a service and gradually they became the underwriters of risk for the entire financial system, including central banks, for their financial market operations conducted within the ambit of monetary policy. The apparently objective and scientific process of underwriting risk provided a perfect barometer that gauged market sentiments. In this process, the logic of market sentiments became institutionalised via the risk-rating mechanism of the credit

rating agencies. A pliable theory was restored from pre-Keynesian history to put in place a perfect self-referential setting by which an independent central bank was assumed to deliver consistent and credible monetary policies that supported the expansion of the financial sector, which was certified in turn as sound by a presumably objective process of risk-rating by the credit rating agencies. The result was massive financialisation driven by financial innovations justified by this self-referential logic, which circumvented the state during the so-called second wave of globalisation.

As the rating agencies began playing a more central role, the process of financialisation in the 1990s was characterised by the expanding capacity of the credit rating agencies to underwrite complex debt instruments. The developing system of an extremely complex network of claims and counterclaims was justified in terms of the same self-referential logic and was believed to have efficiently allocated the available liquidity to optimally distribute risk across the financial sector. In hindsight, it is clear nobody understood this enormously complex and opaque system but it went largely uncontested because almost all the players were willing or unwilling victims of that self-referential system of rationalisation.

Rise of Rating Agencies

During the expansion, it was understood that financial innovation, which improved the efficiency of the resource allocation function, combined with the objective of a scientific underwriting process would improve the resilience of the overall financial system by sharing and distributing risk. A “competitive” market for the underwriting process⁵ developed and the efficiency of that market was considered vital for the resilience of the financial system and the overall economy. As the process of financialisation deepened, the business and influence of rating agencies grew in proportion and began to shape market sentiments and their activities became integral to the functioning of the modern market economy.

The catastrophic collapse of the financial markets in 2008 and the ensuing economic crisis in the western economies

did not affect the influence of the rating agencies. On the contrary, the agencies that endorsed as optimal the rising level of systemic risk before the crisis have strengthened their position, which now seems politically unassailable despite the deepening of the crisis. In fact, using the current crisis the agencies have moved beyond rating the risk of private financial institutions to decisively underwrite the capacity of the nation state in conducting its economic affairs.

Such a position of power of the rating agencies and their influence during a crisis, comparable in proportion to that of the Great Depression, should be seen in the broader context of the dominance of the monetarist paradigm that still governs policymaking in many central banks and in the International Monetary Fund (IMF). This dominant monetarist paradigm, which is endorsed by the respectability of the award of several Nobel prizes in economic sciences to their theorists, reinforces its unwavering commitment to the primacy of the role of market sentiments for the growth of the capitalist system and in turn provides the intellectual source from which the rating agencies draw their economic justification for the underwriting process. Moreover, in the current crisis the rating agencies began to perform the role of “enforcer of discipline”, i e, disciplining the state from its extravagances via the rating of sovereign debt using an “objective and scientific underwriting process”, reinforcing the dominance of the monetarist orthodoxy and, in fact, providing it a great opportunity to implement its vision of a minimalist state.

The self-proclaimed disciplining role played by the rating agencies is not legally prosecutable for the reason that they merely give “opinions” on the riskiness of assets, including sovereign debt. For instance, in the us the rating agencies claim protection under the First Amendment as a matter of free speech and freedom of the press.⁶ This advantage without accountability, ironically protected by the us constitution, makes the self-referential system dangerously powerful as the rating agencies assume a pivotal role in the economy and polity in capitalist democracies. As a result, they shape

market sentiments and through their *opinions* control almost every domain of economic policymaking, laying the foundation for “Credit Rating Capitalism”. Their power does not merely stop at inhibiting the state and its agencies from borrowing from the market, it goes beyond the bond markets into the realm where it is beginning to reshape the politics of representative democracy in the conduct of the fiscal affairs of the state.

The economic rationale for delinking politics from fiscal affairs is to eliminate uncertainties concerning the conduct of economic policy in general and fiscal policy in particular. The discretionary nature of fiscal policy is questioned because it adversely affects investors’ expectations and market sentiments, and it is desirable to minimise uncertainties in the conduct of fiscal policy. This argument echoes the 1980s debate when monetary policy was delinked from the politics of the state on the ground that discretionary monetary policies induced inconsistencies in individual investors’ minds regarding their expectations about future policy change, which, in turn, adversely affected market sentiments. Similarly, it is now argued that discretionary fiscal policy should be replaced by “fiscal policy rules”, which enhance transparency and consistency to sustain the stability of the markets.

Such a move to impose fiscal policy rules without discretion and separating it from “political pressures” is clearly articulated in the economic policy framework of the European Central Bank (ECB). The framework is succinctly described by the ECB as follows:

The (Maastricht) Treaty foresees three different modes of policy-making in the various fields of EMU: (i) full transfer of competence to the Community level for monetary policy; (ii) rules-based coordination of fiscal policy; (iii) ‘soft’ coordination for other economic policies (ECB 2008: 22).

Having reached the limit of manoeuvrability in terms of monetary policies, the ECB has broadened its remit by using its “technical” capacity to advise and influence both the formulation and conduct of fiscal and other structural policies in the member countries of the eurozone. Drawing from the intellectual wisdom of the New Consensus Macroeconomics, the ECB has been pushing the so-called

expansionary fiscal austerity or fiscal consolidation view⁷ in the conduct of fiscal policy to boost market sentiments in favour of the troubled countries, viz, Ireland, Italy, Greece, Portugal and Spain. Moreover, the ECB has also been using the soft coordination approach using both “peer pressure and support” and, more importantly, the logic of market sentiments to influence the structural policies in reforming the labour markets in the troubled countries.

Thus, the ECB has engineered its way to control fiscal policy indirectly through various means, including the way it pressed the Government of Ireland to seek a bailout using the argument of contagion risk to other European countries.⁸ Again, using the bailout terms and conditions, the ECB has insisted on the establishment of fiscal councils in bailout countries like Ireland, Portugal and Greece to advise the government in fiscal matters. These independent technical experts will assess and advise the government on various aspects of fiscal policy. For example, the role of the Irish Fiscal Advisory Council is:

[T]o provide an assessment of, and comment publicly on, whether the Government is meeting its own stated budgetary targets and objectives. It will also be charged with assessing the appropriateness and soundness of the government's fiscal stance and macroeconomic projections as well as an assessment of the extent of compliance with the government's fiscal rules. The latter are also to be brought forward in the proposed Fiscal Responsibility Bill.⁹

The argument of a rule-based fiscal policy devoid of any political interference echoes both in ideology and in substance the argument in the late 1980s for rule-based monetary policy and for an independent central bank that could conduct monetary policies without any political interference.

Final Act of Drama

However, in contrast to the rule versus discretion debate of the 1980s over monetary policy, the monetarist counter-revolution is no longer replacing the incumbent Keynesian orthodoxy. Instead, in the current crisis the incumbent monetarist orthodoxy is getting further entrenched in the same economic rationale that pushed the western economies to the

brink of collapse. The final act of this drama has just begun to unfold. The central banks themselves, once the bastion of the monetarist counter-revolution against Keynesianism, are now being coerced and dictated to by the rating agencies based on their power to shape market sentiments. Has Aladdin's genie gone out of control?

The emerging politics of the present crisis is driven by the coercive power of the rating agencies over the institutions of the state through the delinking of the politics of deliberative democracy from the conduct of economic policy in general and fiscal policy in particular. Ironically, the rationale and justification for delinking politics from economic policy is derived from overlooking diverse political representations that characterise western democracies in Europe.

In Europe, three-quarters of the governments formed after the second world war were comprised of multiple political parties. With increased political diversity and wider representation in government, it is recognised that policymaking has become even more challenging than in single-party governments. The challenges of consensus building by democratic means in policymaking arise not only from the inevitable tension between the parties on compromising their ideals, but also reflect the reality that coalition partners must compete separately at election time. Hence, unlike authoritarian regimes or single-party democracies, compromise is at the heart of politics, particularly when it comes to diverse multiparty coalition governments (Martin and Vanberg 2012).

Two major problems have emerged in recent academic debates: the “principal-agent problem” and the “common-pool problem”. Research on the principal-agent problem has documented how politicians can extract rents from being in office, but voters might wish to limit these rents by subjecting politicians to stricter rules (see von Hagen 2005 for a detailed analysis). However, the uncertainty and complexity of economic and political developments induced by multiparty coalition governments, it is argued, prohibit the writing of complete contracts. Therefore, the principal-agent relation resembles an

“incomplete contract”, leaving politicians with some undesirable discretionary powers (Kassim and Menon 2002).

Research on the so-called common pool problem has documented how problems arise when politicians can spend money from a general tax fund on targeted public policies (Hallerberg et al 2009). The fact that the group that pays for specific targeted policies (the general taxpayer) is larger than the group that benefits from them creates a divergence between the net benefits accruing to the targeted groups and the net benefits to society as a whole. This divergence, it is argued, induces the targeted groups and politicians representing them to demand excess spending which is sub-optimal for society as a whole. Thus, the common pool problem leads to excessive levels of public spending (Bawn and Rosenbluth 2006; Roubini and Sachs 1989). This excessive spending is the source of increased deficits and debt. Moreover, it is documented that ethnic divisions and/or ethno-linguistic and religious fractionalisation of society increase the asymmetry of the tax burden, making the common pool problem even more severe (Alesina et al 1997).

Unsurprisingly, academic research under the influence of monetarist orthodoxy analyses the shortcomings of the diversity and wider political representation in government. Its recommendations articulate a case for reshaping institutions that govern decisions over public finances.¹⁰ Three types of fiscal institutions are prescribed: (1) Ex ante rules, such as constitutional limits on deficits, spending or taxes, (2) electoral rules fostering political accountability and competition, and (3) procedural rules for the budget process. Research on these types of fiscal institutions has produced voluminous literature, which in turn has provided an intellectual basis for the argument of conducting rule-based fiscal policy for minimising the distortionary effects of discretionary policymaking by coalition governments in the west and developing countries alike (Haan et al 1999; von Hagen 2005; Fabrizio and Mody 2006).

While academic research under the influence of the monetarist orthodoxy

has further intensified the orthodoxy's intellectual dominance, the credit-rating agencies, drawing their rationale from the dominant intellectual paradigm, have become the "enforcers of discipline" against discretionary excesses by the multiparty democratic state. During the current crisis, the credit rating agencies have further consolidated their role as enforcers of discipline by severely restricting the state from implementing its duty of democratic accountability. The capacity of the state is undermined by the credit-rating agencies, through both overt and covert actions. The credit-rating agencies directly inhibit the state and its agencies from borrowing from the market by downgrading the state using the credit-rating mechanism. Covertly, the rating agencies have moved beyond the bond market and have entered the political realm by rating "democracies" and forcing the state to delink the politics of deliberative democracy from the conduct of its economic affairs. Such a covert coercion is visible in the eurozone, where the peripheral member states' credit ratings also depend on the reform of their fiscal and budgetary institutions.

It is quite extraordinary that the logic of market sentiments that drove the western economies to the brink of disaster has become the economic rationale for the basis of economic recovery and for reforming the state. Furthermore, insulating policymaking of the state and its institutions from the so-called political pressures seems to be the emerging politics of this crisis and is being aggressively enforced through the veil of market sentiments by the apparently objective risk-rating mechanism of the credit rating agencies. Thus, it could result in delinking and disengaging the politics of deliberative democracy from the conduct of economic policies of the state and is tantamount to undermining the very foundations of democracy in that it seems that the state is more accountable to the invisible sentiments of the market and not to its own people.

NOTES

- 1 Although Hick's (1937) paper is hailed for its pedagogic impact for it helped in bringing Keynes' *General Theory* to the classroom, it should be borne in mind that the paper in a subtle

way restated Keynes' theory, particularly in deriving the "Investment Savings" curve, using the theoretical foundations of the neoclassical economics.

- 2 For example, if one looks at the theory from the point of view of explaining unemployment in the real economy, starting from the pre-Keynesian era of explaining unemployment in terms of a voluntary decision of labourers to the Keynesian phase where unemployment was seen as involuntary due to the inability of markets for products to clear due to insufficiency of demand. In the monetarist counter-revolution phase, the pre-Keynesian notion of choice was resurrected in a different guise. It was indeed old wine in a new bottle, and perhaps not as good as vintage wine!
- 3 The effective marginal tax rate (economy-wide weighted by sector) on capital income during 1953-59 was 47.3%. It was gradually reduced to 35.3% in the 1980s and further reduced to 28.3% during 2000-03, amounting to an almost 40% reduction during the period 1953-2003 (cf Gravelle 2004).
- 4 "The use of a growing array of derivatives and the related application of more sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions ... Derivatives have permitted the unbundling of financial risks" – Alan Greenspan (May 2003).
- 5 Three major players are Moody's, Standard & Poor's (S&P) and Fitch; however, Moody's and S&P dominate the rating market. An interesting question arises as to who owns these rating agencies. Moody's was sold as a separate corporation by Dun and Bradstreet in 1998 and is now quoted on NYSE; S&P is owned by publishers McGraw-Hill. There has been a massive growth in the number of rating firms in OECD countries (including Japan after 1985 and Germany during the late 1990s) and in the developing countries. See T J Sinclair (2010) for further analysis on the competitive nature of the rating market.
- 6 See Nagy (2009) for a detailed legal analysis of how the credit-rating agencies in the United States successfully defended lawsuits using the First Amendment shield in the case of Residential Mortgage-Backed Securities.
- 7 "Fiscal discipline is required for the smooth functioning of Monetary Union, as unsound fiscal policies may create expectations or lead to *political pressures* upon the central bank to accommodate higher inflation in order to alleviate the debt of the government sector or to keep interest rates low" (ECB 2008: 25) (Italics added).
- 8 While writing this article it has emerged that there was a letter from Jean Claude Trichet, the former chairman of ECB to the late Brian Lenihan, the former minister of finance of Ireland, dated 12 November 2010. The letter itself was not released to the public but it is believed to have threatened the withdrawal of Exceptional Liquidity Assistance (ELA) to Ireland if the then government refused to accept the bailout that included a ban on burning the bondholders (Cf. *Irish Times*, 1 September 2012. weblink: <http://www.irishtimes.com/newspaper/ireland/2012/0901/1224323462435.html>).
- 9 Ministry of Finance, Ireland, <http://www.finance.gov.ie/viewdoc.asp?DocID=6927>
- 10 See Besley (2004) for an overview of the "New Political Economy" literature that analyses the issue of how the institutional structures affect policy outcomes.

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