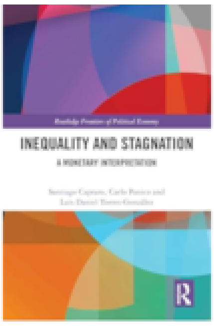
Interview With Economists Santiago Capraro, Carlo Panico & Luis Daniel Torres-Gonzàles On The Causes Of Inequality



09-26-2024 ~ Economic inequality is one of the most pressing issues of our times. Inequality has pernicious effects on individuals and society at large. It causes a wide range of health and social problems, from reduced life expectancy and lower social mobility to violence and mental illness. Economic inequality erodes societal cohesion and fuels support for authoritarian leaders. But what is driving inequality in the contemporary world? A recently published book, titled *Inequality and Stagnation: A Monetary Interpretation*, and co-authored by academic economists Santiago Capraro, Carlo Panico and Luis Daniel Torres-Gonzàles, attributes rising inequality to the outgrowth of the financial sector. In the interview that follows, Santiago Capraro, Carlo Panico and Luis Daniel Torres-Gonzàles make the case for an economic approach that, in their own view, offers the best explanatory framework for understanding the driving forces behind inequality.

J. Polychroniou: Income and wealth inequality has risen sharply since the 1980s in most advanced economies around the world and has been blamed for many of the social ills facing capitalist societies in the 21st century. Economic inequality is also particularly problematic in most emerging and developing economies–and there is little evidence to suggest that this is due to less redistributive pressures in the developing world than there are in advanced liberal democracies. Indeed, in your new book titled Inequality and Stagnation: A Monetary Interpretation, it is argued that the cause of inequality, along with the sluggish growth of recent decades, is the outgrowth of the financial sector. In your view, how did the changing character of the financial system following the collapse of the Bretton Woods system lead to rising inequality and sluggish growth?

Caprano, Panico & Torres-Gonzàlez: Our book addresses theoretical, historical, and institutional issues, deriving from the writings of Keynes and Sraffa a Classical-Keynesian approach that focuses on the interactions between political arrangements, distributional variables, and the level of output and growth. This approach is used to argue that the outgrowth of the financial sector is the main cause of low growth and rising inequality observed during the last decades.

The Classical-Keynesian approach denies that money is neutral in long-period analysis, i.e. denies the absence of persistent monetary influence on the levels of growth and distribution. It highlights that monetary factors and the institutional organization and conduct of economic policy play a key role in affecting the path of the economy, offering the following interpretation of recent events.

After the abandonment of the Bretton Woods Agreements, financial regulation shifted from an approach based on the discretionary powers of the authorities over the managers of financial firms to one based on fixed rules, such as capital requirements. The pressures of the financial sector on the political world favored this change that led to the transformation of the *specialized* system, which forces financial companies to operate in a single type of activity, into a *universal* one, which allows them to operate in multiple businesses, such as credit intermediation, capital market operations and insurance.

The new approach to regulation has allowed for the introduction of a wide range of financial innovations and has made speculative activity predominant over the funding of production and international trade. As a result, the sector has grown at higher rates than the rest of the economy and has increased its degree of concentration and its ability to obtain legislation favorable to its interests.

The outgrowth of the financial sector has raised its share of national income and intensified distributional conflicts to the detriment of workers. Other effects have been the rise of instability and of a number of crises, which have
– forced central banks to cut interest rates;
– led to a modification of the process of coordination between monetary and fiscal policies;
– restricted the use of fiscal policy;
– generated negative effects on effective demand and growth;
– increased job insecurity;
– reduced workers' bargaining power.

At the same time, the alterations of the financial markets have modified the behavior of corporate firms, which have replaced a *short-period capital gains* strategy for that previously adopted known as *retain and reinvest*.

This course of action has increased managers' incomes and produced negative effects on investment, which have further contributed to the decline of effective demand and growth.

This monetary interpretation differs from those offered by other literature.

How did the outgrowth of the financial sector affect the working of the economy?

The book focuses on the distributional motivations of the pressures of the financial industry on the political world to describe how it has played a key role in shaping the recent behavior of the economy. The changes in legislation, caused by the large expenditures of this sector in lobbying activities, has led to its outgrowth and to a large number of modifications in the working of the economy and in the organization and conduct of economic policy.

Chapter 2 of our book presents information on these changes starting with those caused by the financial regulation introduced after the Bretton Woods era. The new legislation has allowed the financial sector to grow at higher rates than the rest of the economy. Among the evidence of the expansion of this sector we can here recall that, from 1977 to 2007, the annual growth rate of international financial transactions at constant dollars was 18.33%, while international trade grew by 8.76% and world GDP by 3.12%.

A process of concentration of the sector has accompanied this expansion. In 2007 the gigantic international financial business was dominated by 17 *mega-banks*. Now 12 dominate it. In addition, between 1984 and 2021, the number of financial companies protected by FDIC has decreased by 70%, from 14,261 to 4,236.

While the financial industry grew and concentrated, instability and the number of crises worldwide increased after the long period of stability of the Bretton Woods era. The following table, based on data presented by Laeven and Valencia (2020), reports the number of banking, debt and currency crises that have occurred since 1970.

1970-79	35

1980-89	164
1990-99	211
2000-17	130

The large number of crises in the 1990s induced national governments to consider financial stability as the prior objective of fiscal policy. Austerity began to dominate in many countries and the authorities changed the organization of policy. For the first time in history, monetary policy became the leading part of economic policy and the public sector became a big creditor of the central bank.

Instability has also manifested itself through exchange rate volatility. This has modified the conduct of monetary policy in less rich countries, imposing a large accumulation of international reserves and huge sterilizing operations that have further promoted the use of austere fiscal policies (see Chapter 12 of the book).

In the richest countries financial instability has imposed the conduct of a monetary policy based on large liquidity issues and low interest rates. As argued in Chapter 11 of our book, the Federal Reserve has been forced, since the early 1990s, to a persistent and widespread fall in interest rates, which has also reduced the rate of return of shares causing other relevant effects on income distribution.

These results have been accompanied by a marked reduction in the annual growth rate of global GDP from around 5% in the 1960s to around 2% in the 2010s. Job insecurity has increased plummeting the ability of workers to appropriate productivity gains, as shown by the following Figure.

Productivity-compensation gap for the US economy,
1950-2019

Low wage increases have reduced inflation. Thus, while instability grew, inflation vanished for a long period of time, inducing the monetary authorities to be more concerned about the former and to implement a policy of *financial stability targeting*, instead of the announced *inflation targeting*.

The effects on income distribution have been that the wage share has fallen. At the same time, the remunerations of the managers of large corporations have risen sharply. Taking advantage both of workers' difficulty in appropriating productivity gains and of the declining path of stock rates of return, managers have been able to attribute to themselves a large portion of firms' value-added gains. As Piketty (2014: 278, 302–3, 334) points out, in recent years 65% of those who make up the top 1% group in the US are managers of large corporations, mainly those of the financial sector.

The new position of managers has generated a rising distribution of dividends that has negatively influenced the funding of investment, further contributing to the fall in effective demand and growth.

To what extent did the technological advances of the 1970s contribute to the reshaping of the financial industry?

Technological advances are always relevant in the restructuring of an industry. Nonetheless, one can argue that the new approach to financial regulation, spawned by the change in legislation after the Breton Woods era, has been the main source of the reshaping of the financial industry and its outgrowth.

Chapter 9 of the book employs the Classical-Keynesian approach to examine the evolution of financial regulation in the United States, arguing that, without the introduction of these changes, legislation would have prohibited the explosive growth of the financial sector. Based on the Classical-Keynesian approach, the chapter interprets the evolution of regulation as the result of the pressures of the financial industry on the political world. It presents statistical information showing that this industry has constantly spent more than the others in lobbying activities.

After the Bretton Woods era financial regulation has changed from an approach based on the discretionary powers of the financial authorities over the managers of financial firms, which was introduced by Roosevelt after the crisis of 1929, to one based on pre-established rules, like capital requirements. The new regulation has permitted the introduction of different forms of financial innovation and has favored the outgrowth of the financial sector. Moreover, it has contributed to

– modifying the functioning of markets,

– altering the strategy of corporate enterprises,

– increasing financial instability and the number of crises,

– reordering the conduct and organization of economic policy,

– influencing negatively income distribution and growth.

Financial crises have become more common and more intense during the last decades. Is it simply because of deregulation?

>Always employing a Classical-Keynesian approach, Chapter 10 of our book examines the causes of the increase in systemic risk and the number of crises. It considers the powers that legislation attributes to the authorities as the crucial element in the analysis of financial stability, stressing that the study of crises should focus on the formation of legislation and financial policy.

The chapter argues that the failures of the institutional organization of financial markets can destabilize the operators' expectations that determine the degree of liquidity of assets and thus cause solvency problems and crises. In addition, it shows that the same failures of institutional organization can be observed in the periods that preceded the crises of 1929 and 2007. In the years prior to the two crises the same conflicts developed between the financial industry and the rest of society over the transformation of the *specialized* system into *universal*. During those years one can also observe

– the same explosive growth of the financial industry,

– the same process of concentration of this sector,

– the introduction of the same forms of financial innovation,

– the use of the same incentives for managers, executives and employees of the sector,

– the presence of the same deceptive behaviors in the financial world.

Thus, the Classical-Keynesian approach allows one to state – as Stiglitz (2003: 79) does – that the crises are characterized by *irrational exuberance* and speculative bubbles. Yet, unlike Stiglitz, the Classical-Keynesian approach leads to make the crucial addition that the exuberance and the bubbles are caused by the faults of the legislation regarding the institutional organization of markets and the powers of the authorities.

The post-Bretton Woods Monetary System ushered in a new era of economic policies and brought into play different theories of income distribution. In Inequality and Stagnation, you propose a monetary interpretation based on the Classical-Keynesian model of inequality and stagnation. What are the advantages of this approach for understanding the role of the organization of financial markets and in explaining financial crises?

The advantages of using a Classical-Keynesian approach for interpreting the role of the financial sector in recent years can be perceived by recalling the main interpretations of the rising inequality proposed by the literature.

The dominant interpretations, which our book names "real", accept the neutrality of money in long-period analysis. Some "real" interpretations try to acknowledge that monetary and financial factors can play a role. Yet, the way they integrate these factors in the theoretical foundations of the discipline leads them to offer a false description of how these elements operate.

An important review of this literature states that the weakness of these interpretations is due to the lack of 'a satisfactory theoretical framework for considering the joint and endogenous evolution of finance, growth and inequality' (Demirgüç-Kunt and Levine, 2009: 289). Our book uses the Classical-Keynesian approach to provide the interpretation of the recent inequality and stagnation with a satisfactory theoretical framework.

The literature also presents a group of Post Keynesian interpretations emphasizing the role of monetary and financial factors. The Classical-Keynesian approach belongs to this group. It considers that the analysis of monetary and financial events must move from the distributional conflicts that shape political agreements and influence legislation and financial policies (see Palma, 2009). These elements define the technical aspects of the working of financial markets and the way the authorities can intervene to stabilize them.

By adopting this perspective, the Classical-Keynesian approach avoids assuming the existence of 'ironclad tendencies' in the working of the economy. It allows understanding why processes of greater or lesser growth and inequality are observed over time, inciting to inquire how the political setting can be modified and the current tendencies reversed.

The following summary of the main interpretations of recent inequality and stagnation can better clarify the convenience of adopting a Classical-Keynesian approach.

“Real” interpretations

The interpretation of our book differs from that derived from neoclassical theory, which accept the tendency to full employment, the neutrality of money in long-period analysis, and the view that the level of distributive variables depends on the relative scarcity of productive factors. Mankiw (2013) uses this theory to argue that the recent rise in inequality is due to the increased demand for the talents of sports and music stars.

Alvaredo, Atkinson, Piketty and Saez (2013) criticize Mankiw presenting statistical information, which shows that the group that has benefited most from the recent change in distribution is not composed of sports and music stars, but of the managers of large corporations, particularly of financial companies.

Piketty’s (2014) interpretation argues that the greater inequality has been caused by an *exogenous* and *inevitable* reduction in the growth rate of economies.

Acemoğlu and Robinson (2015) criticize Piketty (2014) saying that his description of the dynamics of technology and growth fails to capture crucial elements of the functioning of the economy and to understand why, over time, processes of greater or lesser growth and equality are generated. Acemoğlu and Robinson recall some examples in which increases in inequality caused social reactions that changed political balances and legislation and favored a better distribution of income. However, when Acemoğlu and Robinson (2015) describe the aforementioned dynamics, they focus on the evolution of “real” factors such as technology, education, and labor market institutions, overlooking the evolution of monetary and financial institutions and the legislation that generates them. Acemoğlu and Robinson (2015) have inspired a wide body of literature, which has also overlooked the evolution of financial institutions (see De Loeker, Eeckhout, & Unger, 2020).

“Real” interpretations that recognize the role of some monetary factors

While accepting the view of Acemoğlu and Robinson, Rajan (2010) acknowledges the role of financial institutions but does not admit that the rise in inequality depends on the pressures of the financial industry to obtain legislation favoring their incomes. According to him, the rise is the result of the increased instability and of the fact that it is not possible to prevent greedy operators and inept and corrupt public officials from harming the work of spontaneous market forces that guarantees the efficient functioning of a competitive economy. The effects of incompetence, cheating and corruption – Rajan says – have been even felt in the American system, despite it enjoys well-shaped institutions. Rajan (2010) concludes that the presence of elements of inefficiency and corruption has increased with the recent integration of emerging countries into international markets.

Stiglitz (2012) too refers to monetary factors but, unlike Rajan, recognizes the role of lobbying activity in influencing the behavior of the authorities. Stiglitz (2012: 111-2 and 119-120) accepts the neoclassical view that in a competitive economy money is neutral in long-period analysis and spontaneous market forces produce efficient results that make government interventions unnecessary.

According to him, market imperfections generate the problems of inequality that economic policy must eliminate. Unfortunately, in recent decades governments have been more likely to favor the interests of rich and powerful groups than social justice.

Stiglitz's interpretation presents two elements of weakness. First, it does not analyze the distributional conflicts that have influenced the behavior of the authorities. Second, accepting the neoclassical foundations, Stiglitz does not have a logical critique of this theory and must prove, through empirical analyses that are difficult to elaborate, that the effects of imperfections are more relevant than those of "real" factors. Mankiw (2013: 30) has highlighted the weakness of this position, observing that Stiglitz would have had to empirically demonstrate that the high incomes of the top 1% are the result of the operation of market imperfections and do not reflect the greater demand for the talents of the people who make up this group.

In the 1990s, the essays of the *New Growth Theories* also asserted that, when markets are not competitive, financial policies and innovation influence inequality and the growth of economies (see Greenwood and Jovanovic, 1990; King & Levine, 1993; Pagano, 1993). The review by Demirgüç-Kunt and Levine (2009) recognizes that this literature ‘underestimates the potentially enormous impact of financial policies on inequality… Financial regulation legislation deserves a much more prominent place in the study of inequality… Literature … lacks a satisfactory theoretical framework to consider the joint and endogenous evolution of finance, growth and inequality … There is good reason to believe that income distribution shapes public policy, including financial policy. Thus, understanding the channels through which income distribution shapes the functioning of financial systems and financial policies are extraordinarily valuable lines of research (Demirgüç-Kunt and Levine, 2009: 289-290).’

Citing the *Handbook of Income Distribution* by Atkinson and Bourguignon (2000), Demirgüç-Kunt and Levine (2009) conclude that this literature has failed to develop these lines of research. The Classical-Keynesian approach used by our book attributes to these lines of research a central position.

“Monetary” interpretations

A large part of the Post Keynesian literature emphasizes the role of monetary and financial factors. It proposes a homogeneous view on the functioning of the economy, examining it from various perspectives but elaborating them through different methodological procedures.

Lavoie (2016: 60) states that ‘the drawbacks and weaknesses of modern capitalism are due not to price rigidities or market imperfections, but rather to the intrinsic dynamics of the market system’. He recalls Minsky’s financial fragility hypothesis to argue that ‘capitalism is inherently unstable [because] … in a world of fundamental uncertainty … speculative euphoria … is an inevitable outcome’ (Lavoie, 2016: 61).

Boyer (2000), on the other hand, focuses on the changes in the relationships between shareholders, managers and workers of large corporations, formalizing a *finance-led growth model*, which competes with the *wage-led* and *profit-led models* of Bhaduri and Marglin (1990).

A different line of research in Post Keynesian literature argues that analyses of monetary phenomena make theoretical sense if, instead of merely examining the technical aspects, they consider the distributional conflicts that shape political agreements and influence legislation and financial policies (see Palma, 2009).

This line of research can be found in the Classical-Keynesian approach, derived from the writings of Keynes and Sraffa, which moves from the degree of liquidity of assets and argues that it ends up being shaped by the institutional organization of markets and the ability of the authorities to control stability. As Crotty (2019: 239-57) points out, in the *General Theory*, Keynes (1936: 162) argued that, if political agreements establish legislation that generates a well-set institutional organization and regulation, expectations are directed towards stability and the economy lives 'normal times'. On the contrary, when the pressures of economic groups succeed in shaping legislation, the work on institutional organization must be considered 'ill done' (Keynes, 1936: 154) and the economy will live through 'abnormal times', during which the functioning of markets is close to that of a casino.

According to the Classical-Keynesian approach, distributional conflicts are key elements in the analysis of financial stability. The adoption of this approach makes it possible to clarify how political elements shape the ordinary functioning of a competitive economy and allows for an analytical critique of the logical coherence of neoclassical theory.

What about Thomas Piketty's documentation of the long-term evolution of wealth and income distributions? What are the strengths and shortcomings of his approach to income and wealth distribution?

Piketty (2014) offers a great contribution to the long-term evolution of wealth and income distributions. His empirical reconstruction allows a deep comprehension of these phenomena. His theoretical positions are however weak. Acemoğlu and Robinson (2015) rightly criticize his view that the greater inequality has been caused by an *exogenous* and *inevitable*reduction in the growth rate of economies. Moreover, his sparse and meager references to the role of monetary and financial factors highlight the defective way he integrates these factors in the theoretical foundations of the discipline.

The weakness of his theoretical positions is also exposed by Piketty's (2014: 215-216) statement that the assumption of decreasing marginal productivities is something *natural* to accept. He fails to appreciate that this assumption was at the center of the 1966 debate on capital theory published by the *Quarterly Journal of Economics*, which proved that this assumption faces serious logical shortcomings when the analysis supposes that the economy produces more than one commodity.

Piketty (2014: 200, 215-216, 231-232) provides an account of that debate in terms of ‘postcolonial behavior’ ignoring that in its *Summing up* Samuelson (1966: 583) recognized that, being derived from mathematical procedures, the shortcomings of the assumption of decreasing marginal productivities represent ‘facts’ that everybody can verify and not personal or ideological standpoints.

Part 2 of our book deals with the state of scientific knowledge on the theoretical foundations of the economic discipline, highlighting the consequences of the logical shortcomings of neoclassical theory. Then, Part 3 highlights that Keynes and Sraffa jointly worked to *revolutionize* the theoretical foundations of the discipline, proposing a monetary theory of production and distribution and identifying what must be done from a scientific perspective to achieve this result.

What sorts of reforms are needed to counter the problems generated by the dominance of finance in the 21stcentury?

The main problem that countries face nowadays is the imbalance in power relations that the dominance of finance has generated. The history of human societies teaches us that the concentrations of power are the worst enemy of democracy. They influence political life, changing the distribution of income to favor their interests while impairing social and economic stability. Thus, each country has to strengthen, in the first place, the unity and the security of its national institutions.

Achieving positive results is not easy, particularly when the concentration of power enjoyed by the financial industry has reached the current levels. It requires long period commitments and a broad consensus on the need to introduce indirect measures like

– improving the education system,

– reforming the funding of parties and electoral campaigns,

– regulating the media,

– strengthening the institutions that guarantee the balance of powers and the democratic game.

The political strategy is difficult. Yet, it is important to consider it because the problems that the dominance of finance will continue to generate are not sustainable over time from an economic, social, and political point of view.

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