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Introduction: What Global Economic Crisis?

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The papers in this book were presented at a conference on Global Financial Crisis, held in Gonville and Caius College, Cambridge, UK, in early September 1999. The idea for the conference (and accompanying book) evolved during the Fifth Post Keynesian Workshop, held in Knoxville, Tennessee, in June 1998. At this workshop a number of us discussed our concern that economics has a reputation for being an excessively esoteric discipline; the opportunities to bridge the gap between economic theorizing and real-world policy-making are becoming increasingly limited. In addition, the increasing factionalism within economics is perhaps stifling important debates on issues of great concern to anyone interested in economic, social and political welfare. Thus, the aims of our conference were to make an important and lasting contribution to the policy debates, without adhering to any one dogmatic tradition. A further and no less important reason for the conference was to present to John Cornwall with his Festschrift.

In selecting a theme for our conference, we wanted to address an issue of great importance to policy-makers and also to enable academic economists to make a meaningful contribution (as well as promoting cooperation amongst academic economists). Examining the global implications of economic crises was an obvious choice. With unprecedented trends towards globalization (in part propelled by rapid developments in information technology), the global repercussions of economic crises are more profound than ever before, particularly for developing countries. Furthering our understanding of the destabilizing effects of financial crises on economic growth, stability and development, and designing institutions to foster effective policy coordination will be of tremendous importance as the pace of globalization accelerates in the twenty-first century.
The volume begins with a theoretical piece by Paul Davidson. This piece can be thought of as setting the theoretical scene for the rest of the book. In *If Markets are Efficient, Why Have There Been so Many International Financial Market Crises since the 1970s?*, Paul Davidson extends Keynes's principle of effective demand to an open economy setting. He develops Keynes's incompatibility thesis (that flexible exchange rates and free international capital mobility are incompatible with full employment and economic growth). He argues that changes in exchange rates reflect speculative positions not changes in trade patterns; thus flexible exchange rates contribute to volatility. Exchange rate fluctuations affect the trade balance, the interest rate and the rate of domestic investment and thus the level of aggregate demand. The resultant uncertainty undermines entrepreneurial confidence, depresses the inducement to invest in projects with irreversible sunk costs (particularly given the prospect of being lumbered with irreversible costly idle capacity). In this way, exchange rate uncertainty depresses global investment, output and employment.

Davidson describes how, on the basis of the efficient markets hypothesis, mainstream neoclassical economists alleged that Keynes's incompatibility thesis was wrong. The resultant orthodox policy prescriptions focus around promoting financial liberalization to ensure an optimal allocation of resources and mainstream economists argue that short-term financial crises are a necessary disciplinary device. Davidson also looks at the historical record. After the Golden Age, financial liberalization was accompanied not only by increasingly fragile global financial markets but also by a series of liquidity crises. In contrast, in periods such as the time of the gold standard, the absence of alternative currencies reduced the speculative element in short-term financial flows. Transparency and discipline alone do not overcome financial market instability but appropriate solutions are elusive. A Tobin tax probably would not solve these problems: the empirical evidence suggests that financial transactions costs increase rather than moderate market volatility. This evidence highlights the need both for central control of exchange rates and for international agreements to place more responsibility for resolving international payments imbalances on the creditor nations.

In contrast to the orthodox view, Keynes's liquidity preference theory suggests that there is no such thing as an efficient equilibrium price; efficient markets are not liquid, liquid markets are not efficient. Vigilant regulation is needed. So Davidson advocates a package of policy prescriptions centred about a profound overhaul of the entire international...