

Chapter 11

BBNN: Social Peace

In this chapter I want to expand the standard framework to deal with political, social and environmental constraints. I start discussing political and social constraints in this chapter, and the environmental issues in the following one. I discuss the conflict that might arise between political and economic objectives. The framework allows us to understand when these conflicts arise, and what are the implications to the economy. Finally, a detailed discussion of political cycles, and crisis cycles is covered.

11.1 Social and Political Sustainability

In this section we add one more schedule to the BBNN. The purpose of that schedule is to highlight what is the standard of living at which there is social peace. In other words, at what level of demand and real wages do citizens start to complain.

Summarizing all possible social and political constraints with one schedule is a daunting exercise – not to mention quite insulting to the whole sociology and political science profession. But since when insulting others have ever stopped economists? However, before proceeding I want to reemphasize the issue that this framework is truly oversimplifying everything. It is oversimplifying the production side, the labor side, etc. And therefore, oversimplifying political constraints is just one more step. However, in doing so, the richness of the model’s implications is truly marvelous, and worth doing it.¹

11.1.1 Social Peace Line

As we have seen, the real exchange rate is associated with the inverse of the real wage. The idea is that a lower real wage makes an economy more competitive abroad (and this is good in some social circles.) However, greater competitiveness implies a lower wage in foreign currency to the workers and therefore a lower standard of living (and this does not sound so good in other social circles.) Also, standard’s of living are related to the public provision of goods and the level of the demand. So, a higher demand implies a higher standard of living – all other things equal. The way I want to understand the social peace lines is as the minimum standard of living acceptable by our citizens. Hence, define the social peace curve “SP” as the minimum standard of living below which we experience social problems.

¹So, to all my political scientists friends (Rick Locke for starters) I am going to summarize your whole science by one line – an horizontal line. International economics was summarized by two lines which makes economics twice as important as political science – but who is counting.

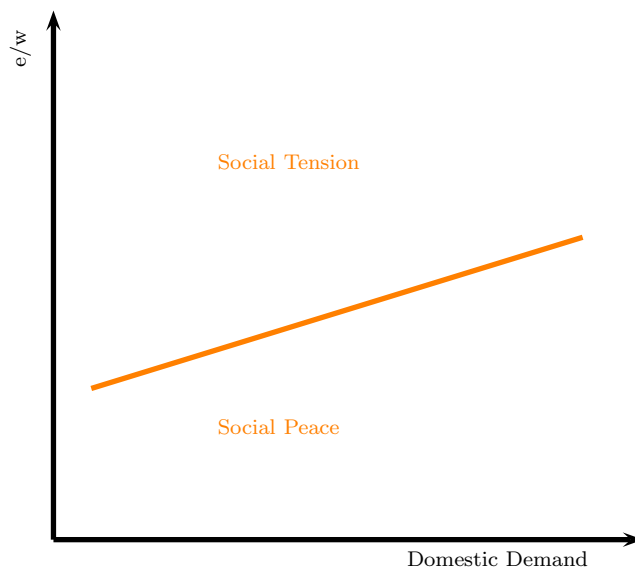


Figure 11.1: Social Peace Line:
Happiness from Wages and Public Provision of Goods

The SP line is upward sloping because we can substitute wage income by consumption or government expenditures. For instance, imagine the following tradeoff: improve healthcare and reduce wages. Clearly there is some degree at which most people would be willing to exchange one for the other. Another tradeoff: improve the quality of the goods consumed and reduce wages. Again, if we assume that better quality goods provide “happiness” then we would be willing to consume more of those goods in exchange of a lower level of income. Of course, there is a question about how to finance such exchange, but the social peace line is not about financing; that is what the BB is for. Here we are mostly interested in happiness.

In general, the way I think about this tradeoff, however, is that most people are willing to give-up a very small reduction of wages for a lot of demand. In other words, the SP line is quite flat. It does not have to be that way, but I think most people will require a very large improvement in public good’s provision to be willing to accept a reduction in wages. So, for the purpose of this discussion I am going to assume that the SP line is flat. In other words, I will assume that social conflict arises exclusively from the wages. This is one important simplification. It assumes that the social peace does not depend on unemployment or aggregate demand. Of course this is a huge simplification, but one that buys a lot of understanding. However, I want to discuss everyone of those issues. Those aspects and circumstances that are left out of the schedule will be considered “shifters” of the schedule. So, those are the “shocks” to the SP line. Therefore, even though the schedule only depends on wages when drawn in the BBNN map, changes in inequality, quality of democracy, legitimacy of the government, corruption, crime, freedom of speech, etc. are analyzed as shocks that move the schedule. We did the exact same thing to the other schedules.

In fact, a nice “good” shock for the SP lines, that I discuss bellow, is the presence of “social pacts” as means to move the SP line up. I will come back to the question of development and growth and you there one very important ingredient to the success of nations is the presence of a coordinating device; which is usually postulated in political circles as a social pact. The coordinating device is something that keeps the

citizens from rioting when wages are too low, when they are making significant sacrifices for the greater good of the country, etc.

In Figure 11.2 the SP line is presented. The idea is that there is a wage level above which citizens are “happy”. So, assume that at $(w/e)_{sp}$ citizens do not complain. That means that for all wages higher than this citizens do not complain either. Remember that in the vertical axis we depict the inverse of the wage in dollars. Therefore, higher wages mean lower e/w . The SP line is an horizontal line that crosses the vertical axis at the minimum wage at which there are no social or political conflicts. Below the schedule salaries are *higher* and therefore there is social peace; above the schedule the salaries are *smaller* and social tensions appear.

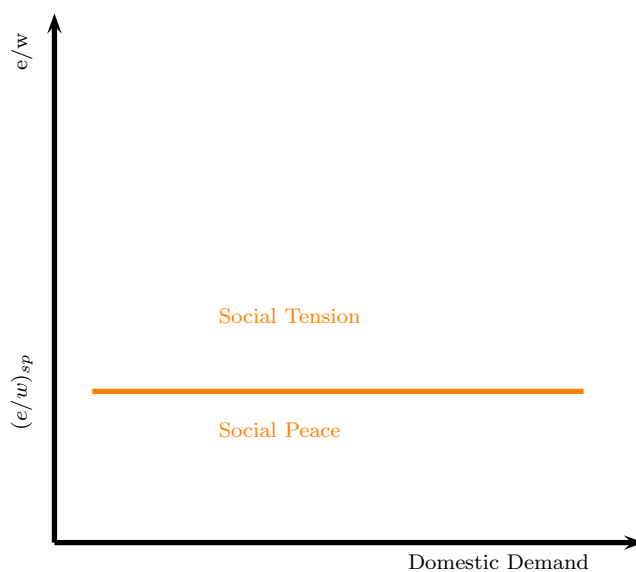


Figure 11.2: Social Peace Line

Of course the schedule moves with these shocks. So, if the quality of democracy improves and citizens experience an increase in the standard of living because of these changes, then they are willing to accept a lower wage without complaining – hence the SP moves up. Similarly, if there are improvements in civil rights, freedom of speech, etc. the idea is that these policies improve standards of living allowing workers to be happier at lower real wages. This is an incredible oversimplification of the problem, but one that is very useful. I come back to these points later.

11.1.2 Latin Triangle

The next step is to put the SP line within the framework we have derived so far. Where does the SP line crosses? Above, below, or through the equilibrium. In principle, nothing forces these curves to cross in the same point. The most interesting case is when the SP line is below the BBNN equilibrium.

The first time the SP line was introduced into the BBNN framework was when Rudi Dornbusch wrote the preface to Ricardo Hausmann book on structural adjustment. This is a book that develops in detail

the BBNN, and Rudi wanted to contribute to the book doing something as “original” to what Ricardo was doing. Well, this is extraordinarily original; and not only original but because it reduces the whole political and social science to one boring horizontal flat line, it is both insulting and accurate. Years later Rudi called it the Latin Triangle – to be more politically correct. Let’s see.

In Figure 11.3 we depicted the three schedules, and as can be seen, there are three equilibria. What is the situation in each equilibrium? In equilibrium A, the economy is on full employment, with the current account in equilibrium, but wages are too small and citizens are rioting. In equilibrium B, the wages are high enough for the citizens not to complain, the external accounts are in equilibrium, but the economy suffers from unemployment. Finally, in equilibrium C wages are high enough to achieve social piece, the economy is un full employment, but the country is running a current account deficit.

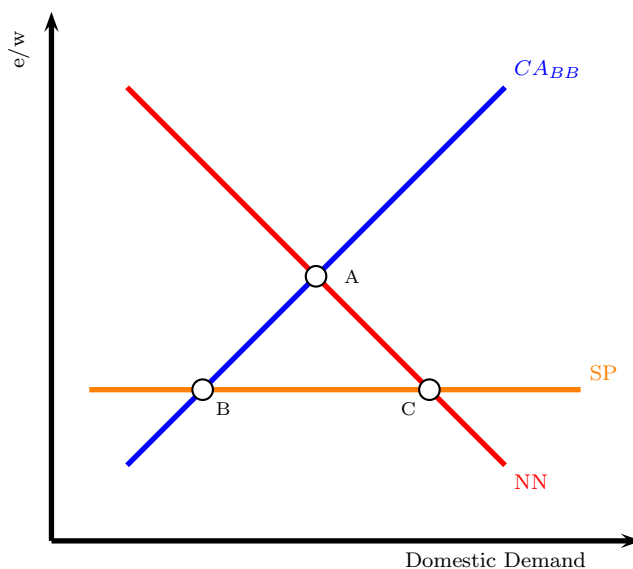


Figure 11.3: BBNN Latin Triangle

The question is, which one shall we choose? There is no simple answer. These three equilibria exactly highlight the conflict between social and economic objectives. Rudi did not called these equilibria A, B, and C. He called A the *IMF* equilibrium, B is *Europe’s* equilibrium, and C is *Populism*.

Each equilibrium has a problem. In the IMF, the economic equilibrium has been achieved, but socially and politically the situation is unsustainable. In equilibrium Europe, even though salaries are high, and standards of living are high, and the current account is in equilibrium, the labor market exhibits significant unemployment. So, wages are high, but for the few that are working. Finally, in the populist equilibrium, wages are high and unemployment is low, but this is at the expenses of a significant current account deficit. Borrowing is needed to keep the economy in this equilibrium, and borrowing forever is not sustainable. In Table 11.1 I have summarized the disequilibrium exhibited by each “equilibrium”.

So, again, which point would you choose? A? B? C? in the middle? Because none of these equilibria are sustainable in the long run, actually the economy cannot be on anyone forever. What happens in reality is that economies cycle among these equilibria.

	Equilibrium	Internal Accounts	External Accounts	Social Peace
A	IMF	✓	✓	Conflict
B	Europe	Unemployment	✓	✓
C	Populism	✓	Deficit	✓

Table 11.1: Characteristics of the Possible Equilibria

Assume the government is relatively conservative starts the economy in A (the IMF). Of course wages are low, but everybody is working and the current account is in equilibrium. The low standards of living slowly leads citizens to some complains. Later the complains increase enough to reach levels where public demonstrations and even riots occur. The complaining takes a toll on the political landscape. The government responds by increasing wages, but because the government is relatively conservative what they do is to move along the BB schedule from point A to point B. As the economy is moving from one to the other, unemployment starts to increase. However, at the beginning the unemployed are few and disorganized, so, politically speaking it is easy to increase wages to calm the masses and make the unemployed – and usually less skilled – pay the cost of the adjustment. However, when the economy reaches point B, the unemployment rate is large enough that workers get organized, and they start putting political pressure. Elections are approaching, and now is the time to make everybody happy. The government keeps salaries high and implements expansionary fiscal and monetary policy. Interest rates drop, taxes are cut, highways are built, and the party is all over the place. The incumbent government moves to C and makes all citizens happy. Of course, they are financing all the expansion through a tremendous current account deficit, and borrowing (usually internationally). Just after the elections, and after there are no resources in the national coffer, the country enters a crisis and needs to cut expenses, increase taxes, and devalue the exchange rate. The country is in a crisis and calls the IMF for help. Of course the IMF is willing to help, but the assessment of the situation reveals that the economy is not competitive, that wages are too high, and that the economy needs and adjustment program. The economy needs to return to conservativeness. And the cycle starts again.

If you do not see yourselves in this cycle, you are from a Nordic country; and you are too young; and you have never read the newspaper or visited any country south of Denmark in your life; and my advice to you is to get a passport and not be afraid to use it. For the rest of you that actually have paid attention to human kind, this cycle is remarkably and scarily realistic.

This cycle runs deep into the economy and comes entirely from the fact that economic objectives sometimes collide with political and social aspirations. It is that simple. Figure 11.4 depicts the cycle. The dotted arrows highlight slow movements, while the solid arrows reflect fast movements. This is not the outcome of stupidity. I know politicians are incompetent. Of course they are. they even need to take an exam to guarantee they are myopic and idiotic enough to run for office. But explaining the outcome of the world as the result of exclusively idiocy is a futile exercise. What is the policy advise? If in a country everybody is incompetent then what should we do? Is there any hope? Why do we even bother to study the situation? I actually think the world has hope, and that most politicians even though extraordinarily incompetent and corrupt are also well intentioned. Hence, I prefer to explain the history of thousands of failures as a problem of inconsistencies and incentives. If that is the case, then we can actually do something to improve the standards of living.

Because I love the implications of this model in this regard, I believe it is worth repeating the cycle not only concentrating on the economics but also on the how the society sees itself, or enjoys its standard of living. A country in the populist equilibrium is financing a standard of living with borrowing. Unemployment is at record low levels, salaries are high, the aggregate demand is at record levels, and the economy has been doing “well” for quite a while. The only bad indicator in the economy is that it is running a current account deficit. So, yes, the economy is not competitive, but if the future is as bright as the past, this is transitory. This false sense of invincibility, mostly driven by repeated previous successes, masks the underlying problems. This is a time of *excess optimism*. The future and present are perceived to be much better than what truly it is.

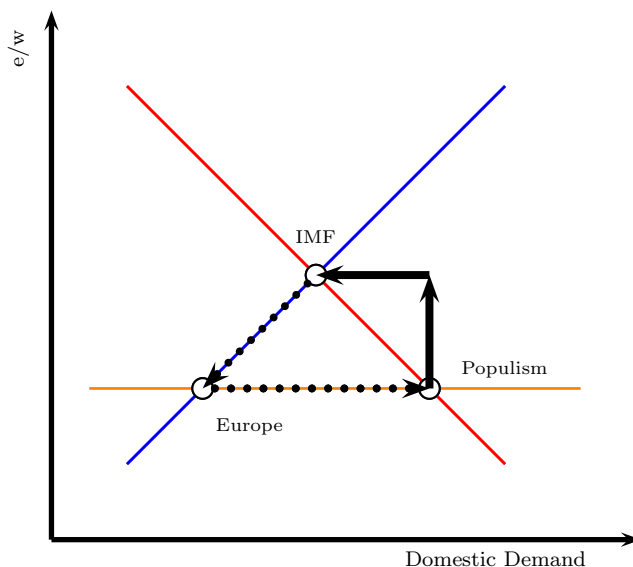


Figure 11.4: Cycle through the Latin Triangle

Elections take place and the incumbent government wins. Of course just after the elections the continuing borrowing takes a toll on the central bank balance sheet. Reserves have plummeted to dangerous levels and the country is attacked. How is that possible? How is it possible that a successful country with a minor weakness is being so unfairly treated? Financial speculation is blamed for the unwarranted attack, of course. The country has no option than to devalue, cut aggregate demand, and call international institutions to repair the damaged financial situation. In fact, in some cases the country defaults on its debt obligations, or at least needs to restructure them. The country is excluded from international financial markets, the interest rate increases to infinity, and a massive credit drought takes place. The government claims that the unfair adjustment is being imposed by these evil international financial institution, and that the country has “no other option”; it is almost as if the country has lost part of its sovereignty. At the IMF equilibrium, economic equilibrium is reestablished, but at expenses of a significant drop in standards of living. On the economic side, the government runs a tight fiscal ship. There is no fiscal deficit, nor an external deficit, and there is full employment. On the social side, however, real wages dropped significantly, the depreciation leads to domestic inflation, and slowly (but surely) the purchasing power of consumers declines. So, even though the economics is sound, the social conditions are not. Poverty increases, inequality deteriorates, and consumers start expressing their discontent privately and publicly. This is a time in which consumers are depressed. The bright future they thought they had has disappeared. The complains make it to the government which deals with the low standards of living by compensating workers with salary increases, or any other favor such as increases in social safety net, transfers, etc. The outcome is that the cost of the workers goes up, but because the country has been excluded from borrowing they cannot run a current account deficit. Hence, the only option is increase the wages by cutting aggregate demand. The expenses by the government are increasing, but at the same time taxes are increasing as well. Slowly the economy is moving to the european equilibrium. Unemployment starts to increase slowly but wages are higher. In other words, at the beginning everybody is employed but upset, and slowly the majority is getting happier (salaries are going up) and few are getting even more upset (the unemployed). Politically this is palatable. Initially the problem can

be addressed by raising unemployment insurance, and the safety net in place. In the mean time, because the country has been running relatively good economic policy, it reenters international financial markets. However, at some time the number of unemployed have increased so much that it is clear that the situation is unsustainable. The government needs to “recover its sovereignty”. In fact, political rhetoric becomes more populist and continuously drills a message where the impositions by foreigners cannot determine the fate of millions of citizens; or that it is unfair that a country that once was successful is at the mercy of heartless financial markets. In response expenses are increased, taxes are cut, interest rates are cut, and all is financed with small doses of borrowing at the beginning. The situation improves and governments wonder why not do more of the same; and they do. Slowly the economy moves toward the populist equilibrium. Every day borrowing more, increasing aggregate demand, and keeping wages high. Citizens feel better, and such is shown in the polls. Elections are nearby and there is no incentives to go back to orthodoxy. This is the time to concentrate on what is important: the welfare of our citizens, and their votes. And so, the cycle repeats itself. Rudi called this the Latin Triangle because in the history of Latin America this event and cycle occurs so many times, and it is so clearly the outcome of the inconsistencies between economic and political goals that is scary.²

Nice intuition for an extraordinarily oversimplified framework, isn't it?

11.1.2.1 What determines the Social Peace line?

It is clear that some societies are happier than other. What determines that level of happiness? or willingness of citizens to be patient with the government? or what determines the “political capital”, and how it deteriorates? There are whole professions and careers devoted to these questions, and I recommend you take one of those classes to understand how these social and political events develop. We all, after all, live in places surrounded by social and political conflict.

Expectations, however, play an important role. Expectations on what is the “usual” or “acceptable” standard of living determines the degree of disappointment. How to understand this? Try to answer the following question, why Venezuelans are so happy? If you have ever met a Venezuelan you will realize that we come from a really crappy country – conceivable the crappiest of them all. We have a president that makes every other president look like a genius. And if you ever feel ashamed about the actions of your political elite, you can always observe the clowns we have. Everything looks horrible! politics, firms, workers, roads, poverty, corruption, crime, etc. By the way, read below some of the crime statistics in Caracas. So, a valid question is, why on earth we are so happy? A simple story might help.

A day in Switzerland: You wake up! Then you go to the bathroom and take a shower. Eat some breakfast. Check the internet. Call a friend. Read the newspaper. Watch some TV for the news and the incorrect weather forecast. Take the car to the train or subway station. Then walk to your office. Work. Back home... more food, more TV, talk to kids and wife, help on the homework, and go to sleep. That is probably it.

A day in Venezuela: You wake up! Then you go to the bathroom and suddenly you realize that you have water. “OH MY GOD!!!!” you start yelling. “There is water!!! Run, take a shower!!!” Then you go to the kitchen. “YES!!! I have electricity! Lets cook some crap!” You received two of the four newspapers you wanted. All of them exclusively talk about Chavez disasters the last 24 hours. Then you watch TV and see Chavez talk about his valve movements – which is way better than the newspapers. Then there is a report that Chavez has died several months before but we still want to watch the reruns. Then “I can't believe it!!!”. Yes, you realize you have internet connection, and you finally have the chance to check that web page you have been meaning to visit for so long. With a tear in your eyes you can watch the weather report, and you gasp with excitement when you can finally see live the weather person making a wrong prediction. You go down the apartment and suddenly “This has to be my day, man!!! The car has not been

²See HBS Case 9-796-123 and HBS Case 9-700-061.

stolen” You drive for two hours for work while everybody is yelling at you. You witness two crashes and 4 muggings while standing in traffic. “*A Miracle!!!*” Yes, you miraculously find a parking spot three miles from the office. You run trying to hide the suitcase while jumping over people that are trying to sell you something, pickpocketing, or both. Then you get to the office. “*Yahoo!!! The elevator is working! I do not have to take the stairs up to the 17th floor*”. When the door opens, with trepidation, you pick to your right. You drop to your knees and you kiss the floor! “*The company has not been expropriated by Chavez, yet*”. 30 second later, “*Yes!!!*”, you still have a job, and an office. You kiss and hug everyone while you enter the office. “*I know that you might never see me again*”. You have a window, but for the first time in 25 years they have cleaned the glass and you realize that you can finally see the building in front of you. “*Yes! They exist!!!*”. When you walk back to your car, you scape three attempts of robbery, and two shootings. You go back to your home after a 3 and a half hour commute that was shorter than your typical 4 hours, and to your surprise, not only your wife is still there, but the house still is. Eat. Talk. Teach your kids how to cheat on the exam. Suddenly, you realize that you have a phone line, and you, voice-cracking, whisper to your wife: *This has to be the best day of my life! There are so many reasons to be happy!*; and she ignores and snores.

Our expectations in Venezuela are so low that we are continuously positively surprised. The poor swiss guy, because he takes everything for granted, simply has no ability to appreciate what we get as a gift every day – hence, that is why we hug and kiss everybody we meet after a 15 second conversation. That is why we are so “happy” and “laid back”. In fact, one person once emailed me a truth for us Venezuelans: “The Australians to us look as laid back as Austrians – and that is not a typo”.

We come back to some of this discussion – on a more serious note, of course – to try to determine what moves the SP curve. In general, it is much easier to understand what moves it as opposed to determine where it actually is.

11.1.2.2 Solutions to the Latin Triangle

How can we solve the problem of indeterminacy? How can we stop the cycle? Notice that in the cycle story the only policies implemented by the government are those that deal with the short run: fiscal expenditures and taxes, monetary policy, wages, and exchange rates. In fact, the cycle cannot be resolved with these tools. As I said in Chapter 8 these are short term tools. So, the answer is not there. Schedules need to be moved. Either the BB moves to the right (or down), the NN moves to the left (or down), or the SP moves up. That simple! We have to make the IMF equilibrium lie within the social peace region.

How can we move the NN to the left? Emigration! And indeed this happens. The country is just a disaster, with one crisis following the other, with one riot following the other, etc. The social situation is so bad that it causes emigration. This is obviously not the best solution, because generally the best human resources are the first ones to leave. But, from a theoretical point of view, this would shift the NN curve down, moving the equilibrium into the social peace area. Another possibility is to increase the social safety net so much that unemployment does not become a problem. Unemployment insurance is so good that the unemployed are not that unhappy. Can you remember the example of the French unemployment insurance in section 9.2.2? The increase in all safety net benefits moves the NN to the left – again, making the economic equilibrium consistent with social peace.

We can move the SP line up. We can either promise the world, and not deliver. Try to get a social pact, and then violate it. In other words, governments can lie to their citizens and teach them to get used to the misery of a lower standard of living. Of course this is the “bad” movement of the SP but I want to highlight it. It does happen that some governments hide the real situation and manipulate their citizens. It does happen that countries try to find a common enemy to distract the nation from the social tensions and increase their nationalistic sentiment: “so we all work and sacrifice for a greater nation”. Argentina in 1983 decided to invade the Malvinas (Faulkland for the British) just to pick a fight. It is the case that

Chavez in Venezuela, and Fidel in Cuba have blamed their domestic disastrous economy on the fact that a powerful enemy, the US, is hurting them. How much of the misery in Cuba is the embargo and how much is incompetence? I know incompetence is a huge part of the explanation, but 100 percent? No way! So, if we cannot disentangle the exact share, imagine someone with less resources than us! Can you see North Korea in the story?

There are other forms to move the SP, but a country that is in the middle of these political cycles looks for a shortcut. What are the incentives to allow for freedom of speech? Better civil right, like the right to protest and meet? Better representation of minorities? More transparency? Yeah right! Let us be more transparent so everyone can actually see how incompetent the government is. Any democratic and political improvement indeed makes the protests deeper and harder to manage. So, a government unwilling to think in the long run does not pursue any of these reforms. The SP moves up, but because individuals get used to misery, not because things truly improve.

Let me show you how flexible you guys are. Let me give you some statistics that are truly scary. Between 2009 and 2011 in Iraq about 3500 civilians have been killed every year. Yes, every year! Iraq has a population of 32 million. So, this is a massive proportion of deaths a year. Venezuela, during the same time, with a population of 25 million, has suffered of 13000 violent civilians deaths! Last time I checked Venezuela is not at war (yet). More importantly, a significant proportion of those are in Caracas. The situation in Venezuela is sad in several dimensions, and crime is just one of them.

I imagine you are shocked by the information. So, with this new info, assume I send you to Caracas and put you in a random hotel. Of course most of you do not speak Spanish, and if you do, you do not have my accent. So, sorry, they will know you are a *gringo*, or *musiu*, as we call you. The question is, do you dare leave your hotel room? Are you courageous enough to show your face out of the window? The first week you will be so scared that I can assure you, you will be bunkered in the room, and praying for the hotel to have room service. But after spending a month watching Venezuelan and Colombian soap operas, you will start figuring out what you can do to avoid crime. Where is it safe to go? Where not to go? How to dress? How to talk? etc. And then you will come out during the day. Looking less touristy, but scared like a turkey before Thanksgiving. Through time, you will learn Spanish, and you will start going out at night. Survival depends on the accent, so natural selection will get you the right one. You will find a job and start a “normal” life. In all this story, crime has not changed. You just adapted to it. Your SP just moved up. Sad but true. We get used to misery – either in the form of crime or on any other form of lower standards of living. In the end, politicians just need to abuse their societies enough, so they get accustomed to it.

Therefore, what is truly the solution? Move the BB to the right. The country needs to generate a productivity increase that guarantees that the labor market and the external equilibria occur in the region of social peace. In this case, we have an equilibrium that is obviously preferable. Clearly, we need a sufficiently big increase in productivity to do so. The economy needs to **grow**! This is the reason why in emerging markets they are so obsessed with growth.

If you were in China in the early 70's, after having gone through the cultural revolution and the hunger it created, do you think you might find yourself in the Latin Triangle. Will you allow protests? Democracy? Will you concentrate on growth? no, no, and yes. And so they did! In fact, today they are in much better shape to allow for more freedoms (civil, speech, opinions, etc.) than 40 years ago. A very interesting case is Singapore. The same situation as in China where at the beginning of its growth process the interventionism and lack of freedoms of the government were massive. Today it is a much freer economy and society. They have a long way to go, of course; but certainly they are in much better shape than in 1965.³

It is critical to understand that the problem cannot be solved with any macroeconomic cosmetics. For example, if we move to a flexible exchange rate, the sustainability of the equilibrium does not change. The real exchange rate is a relative price and therefore does not depend on the nominal regime (for instance,

³See HBS Case 9-794-019 and HBS Case 9-703-040.

the real equilibrium exchange rate would be the same under a fixed or a flexible exchange rate system). Monetary, fiscal, or exchange rate policies do have no impact on the real equilibrium exchange rate. Only structural measures can modify the situation. In other words, the IMF equilibrium is desirable from the point of view of economic equilibria, however it is not sustainable from the social point of view, regardless of the economic policy. When the society is not ready to sustain the IMF equilibrium, only by making structural changes (moving the BB, NN and SP curves) can reach a permanently sustainable equilibrium – to set the equilibrium real exchange rate within the social peace region.

In summary, when we include the social aspects in our model, we find an indeterminacy of the equilibrium, which makes the analysis of adjustment programs quite interesting. In this case, we are talking about social peace, but many other considerations could be included. Keep in mind that the world is a complex place and simple solutions are not always available. The inclusion of the social peace curve in this model gives a quite interesting slant to the discussion and the explanation of historical events. Moreover, it allows us to rationalize past decisions without having to blame ignorance or stupidity. This is fundamental for the study of economic history.

11.1.3 Shocks to the SP line

In this subsection I would like to enumerate and describe in detail all the ways the SP line moves.

11.1.3.1 Habit Formation: Getting used to Misery

As the example I described in the previous subsection where a person gets used to the level of crime, our standards of living evolve through time through different dimensions, and we get used to them. In economics this is called habit formation. The idea is that once a person has had a certain level of consumption, its level of satisfaction decreases for the same level of consumption. In other words, the person takes for granted that such level of consumption is “usual”. This is something that happens quite vividly in housing, entertainment, and food.

The interesting aspect of habit formation is that people get used to lower and higher levels of consumption, and standards of living. The discussion that follows is depicted in Figure 11.5.

Imagine that you keep a country below the SP line for a while. Assume that it is at point B. This means that the standards of living are higher than the minimum acceptable standard of living. The level of happiness of the people is related to the distance between the point and the SP line. If the economy is kept at that point for quite some time, then the consumers start to get used to such level of consumption and wages. In other words, for the same wage and same level of demand, the degree of happiness drops, i.e. they take such standard of living as granted and therefore they are a little bit less happy than before. Less happy means that the distance between the point and the schedule needs to reduce. This only happens if the schedule moves down. The SP schedule shifts from the SP to the SP' line as shown in Figure 11.5.

Similarly, if we keep the economy struggling with a standard of living smaller than the acceptable one – the point is above the SP. This is point A. Agents will get used to the lower standards of living and they will accept them at some point. They reduce their expectations, or hopes, or both. In the end, the degree of unhappiness needs to drop which means that the distance between the point and the schedule drops as well. This only happens if the schedule moves up. The SP schedule shifts from the SP to the SP'' line (see Figure 11.5).

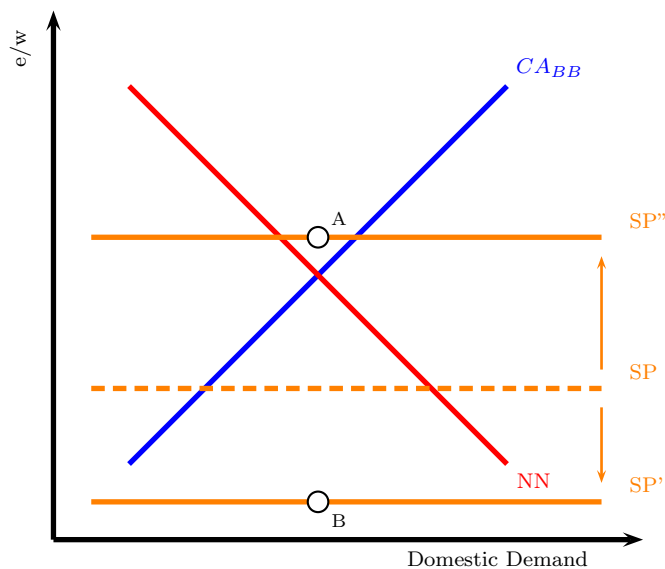


Figure 11.5: Habit Formation: “Getting used to”

11.1.3.2 Political and Social reforms

It is hard to write this section without expressing my own views. I know they are biased, and I apologize ex ante; but I cannot imagine doing this without revealing what I think. I truly believe that every nation, once developed, is going to need some form of freedom of speech, representations of minorities, civil rights, freedom of choice, women empowerment and active participation in economics and politics, and equality etc. In other words, I do believe that independently of the path followed by a country we will all end up in something similar, and similar to a democracy. I know not many agree with that, but that is o.k. with me. Having said that, the path of every nation and society is going to be clearly different. Some will start with autocratic and interventionist governments, others will start with immature and dysfunctional democracies.

Given my beliefs, there are some reforms that clearly improve the standards of living: Improve democracy, freedom of speech, improve representation of minorities, improve civil right, women empowerment, less discrimination (in labor markets and everywhere), lower corruption, less crime, lower income inequality, less poverty, etc. Any of these reforms should improve standards of living.

How does the SP move? As in the previous case, assume the economy is over equilibrium A before the reforms. At the given salary and standards of living, citizens are upset. If democracy is improved, for instance, then citizens will be less upset. In the end, if the improvements are large enough citizens will consider the standards of living given by the wage in equilibrium A as acceptable. This situation is depicted in Figure 11.6.

Again, going back to getting used to misery. I am always baffled by the tremendous degree of adaptation we have. I react very badly to corruption today. I remember, however, how used to that I was 30 years ago in Venezuela. In other words, there might be something incredibly costly in the society that we get used to it. It causes inefficiencies but we do not complain about it.

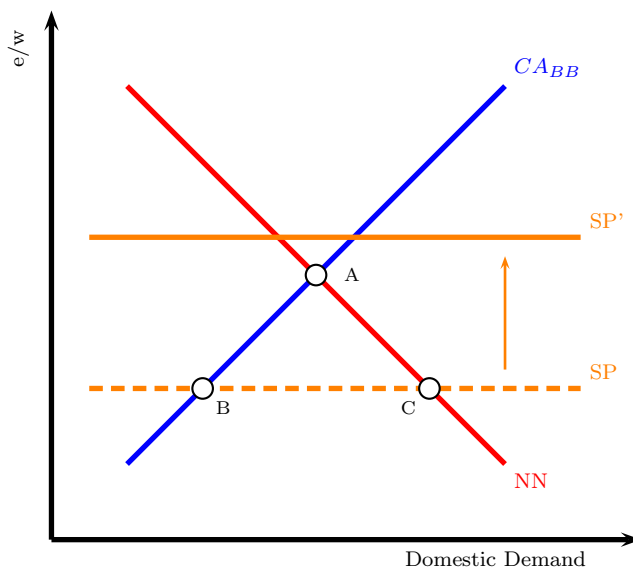


Figure 11.6: Improvements in SP

The most striking experience in this regard, that I know of course, is with my brother. I am going to substitute Bolivars for Dollars so it make sense to you, but the amount I discuss are roughly what was involved in the transaction. This is 30 years ago, when things were much better in Venezuela. Even that long time ago, if you were driving in the middle of the night you could not stop on a stop-sign or a light. Red meant move slowly, and green meant move even more slowly. My brother, following this strategy, just runs over a red light. A policeman stops him. This is roughly the conversation....

- Policeman: “You ran over the read light”.
- Brother: “Yes, just give me the ticket”
- Policeman: “But you are not going to pay the ticket”
- Brother: “Pay? of course not, just give me the ticket”
- Policeman: “But if you want we can solve this thing here”
- Brother: “I have nothing to resolve”
- Policeman: “Well, maybe this will affect you”
- Brother: “But I have no money, only 20 dollars”
- Policeman: “20 will do it”
- Brother: “But I need 10 of those. I’ll give you five”

And the conversation moved on from that until they settled the bribe at about 7 dollars. Bargaining a bribe is perhaps the best reflection that no one cares about it. It is just a tax or a normal transaction that needs to be performed. By the way, this happens in a lot of countries, it is just that bargaining on the bribe in a traffic violation is just beyond pathetic. Bargaining on 10 or 12 percent commission on a construction of a highway is understandable, but this?

I have found many funny cartoon related to crime in governments. This is one of the best I have encountered.



Figure 11.7: Organized Crime

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Reductions in corruption produce massive welfare gains, especially when the environment has accepted corruption as an everyday tax. So, in practice, it is equivalent to a tax cut – that conveys both a sense of fairness and increases aggregate demand.

11.1.3.3 Coordinating Device

What is a coordinating device?

11.1.4 Europe 2011

Europe's sovereign debt situation since 2010 has been a complete mess (just for the record, I'm writing this section in January of 2012).

I would like to look at their experience from the BB-NN-SP point of view. The story is depicted in Figure 11.8.

Assume the periphery countries in Europe (Ireland, Portugal, Spain, Italy, and Greece) start from equilibrium (panel (a)). At this point economic and political equilibrium is feasible. This is of course a simplifying assumption but makes the point. The idea is to assume that these economies start from a situation in which their inconsistencies and internal conflicts are relatively small. When these countries joined the Euro, great expectations were formed; expectations of future growth, and hopes of a more prosperous economy. For consumers and government, they are expecting the BB to move to the right. It has not moved yet, but they

believe it will. If the future is so good, the economy can start spending the money, increasing the salaries, and already enjoy the brighter future. Why not? We do the same! When you guys get a job offer, do you have a party? You do not have the party because you got the money today. You have the party because you know you will have the money for sure in the future. These countries thought so. They truly believe the future was going to be much better and starting enjoying today.

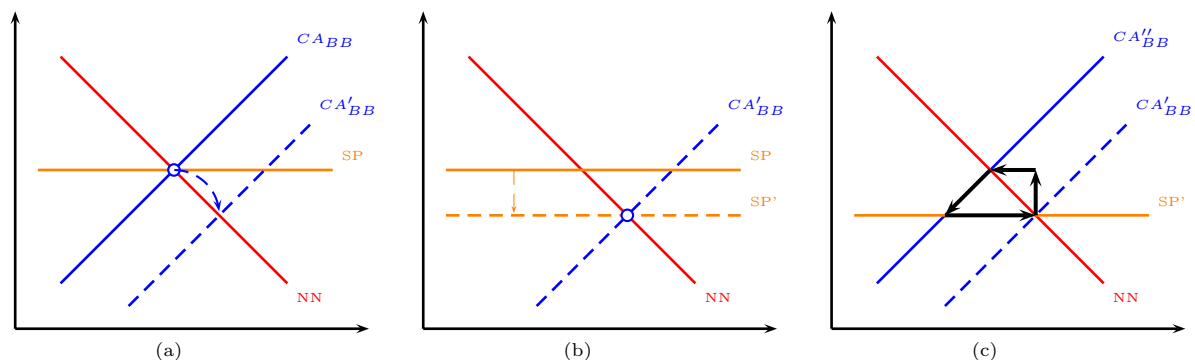


Figure 11.8: Europe 2011's Sovereign Debt

The economy places itself in the equilibrium shown in panel (b). They are acting as if the BB is in BB' . Therefore, the country is running a current account deficit; wages are too high; the economy is not competitive; and the aggregate demand is very large. This is an equilibrium driven by *excessive optimism*. In fact, fiscal accounts look incredibly good. Most taxes are associated to aggregate demand and wages. All personal and payroll taxes are indexed to wages, corporate taxes (profits) will go up when aggregate demand is high, and more importantly, VAT taxes are directly related to consumption. In the excessively optimistic equilibrium wages are too high, and aggregate demand is too high. Hence, fiscal revenues are fictitiously high. The fiscal accounts look in great shape in the medium run. From the social point of view, in the same way citizens get used to misery, they also get used to happiness. The SP line starts to move down slowly. Citizens are used to the higher standards of living, and now they expect them to be permanent.

After several years in the excessive optimism equilibrium, suddenly an event makes the countries realize that the “brighter future” is not that brilliant. Most of the times this is the outcome of a large current account deficit that needs to be corrected. When that happens the economy shifts to panel (c). In this case, the original equilibrium is not consistent with social aspirations, and therefore, the economy enters the Latin Triangle cycle. In the case of Europe, they can't devalue the currency, but they have been decreasing nominal wages. But the reduction of the real wage, leads to riots, and complains. We are at that stage right now.

What is the solution for Europe? Well, one is a prolonged recession and getting used to misery. The idea is to return to the levels of expenditure they had before, and relearn to live with less. That is not always an easy transition, but this is the one that the ECB, Germany and France would like to pursue. That there is a real depreciation through reduction of wages, and that the periphery countries learn to live with a lower level of consumption. Another solution is that they produce the growth they were expecting to generate. This requires, as we have seen, dramatic reforms: to help[firms invest and restructure, to change labor markets, to change the safety net, etc. Growth is the cure for all these inconsistencies; but growth requires policies that are politically costly. Portugal is doing some, Greece is doing none, and Italy is just having fun.

11.1.5 Why is the US sustainable? Institutions for solidarity.

11.1.5.1 Labor Mobility

11.1.5.2 Fiscal Cross-Insurance

11.1.5.3 Fiscal Cross-Subsidy

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