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Abstract

[The current financial crisis has created a consensus among the population in favour of strengthening the ethical dimension in economic and financial regulation and policy making. The paper argues that, even though the root of the crisis lies in the inherent dynamic functioning of capitalist system and not in the unethical behaviour of key agents say bankers or government officers, it is urgently need to pay much more attention to the ethical dimension in decisions related to economic and financial regulation. By this we suggest that a good basis to do so would be the Hippocratic principle of first do no harm or, in more modern term, the precautionary principle. We then give some examples of how this principle could be used to improve macroeconomic policy design and implementation in Latin America and, in general, emerging markets.

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The 2008-09 international financial crisis and its aftermath dramatically reminded the economic profession in particular, and the world at large, of the grave consequences that the neglect of ethics in financial -private or public- decision making or regulation can have on macroeconomic stability and the overall welfare of the population. Citizens in many countries wonder why should a few private, very wealthy bankers, big banks or large manufacturing firms be rescued by their governments at the same time that thousands of families lose their homes or jobs? Is it ethical, not to mention efficient, that Greece is treated, on matters regarding fiscal policy, in a way analogous to that of an international protectorate? Why should workers, in say Spain, accept sharp reductions in their nominal wages -and in real terms- without a similar commitment on the part of the business community to cut down consumer prices for final goods and services? Why should emerging economies accumulate vast amount of foreign reserves, and thus transfer resources to rich industrialized countries, instead of these resources to alleviate poverty and promote economic growth?

In our view, there is a consensus that ethics must be a guiding principle of State intervention on economic matters. In other words, ethics and equity and not only efficiency must guide economic policy design, application and regulation, especially on issues and areas that are crucial for development. This is not to say that the root of the recent financial crisis, or for that matter other such crisis, is the unethical behavior of bankers, CEOs of financial institutions or of governments. Its root lies essentially, following Minsky, in the inherent instability of the capitalist system. But, undoubtedly its depth is determined by the fact that national and international regulators of the financial system failed to comply with the ethical dictum of Medicine: *primum non nocere*, attributed to Hippocrates and translated as "the obligation of, before anything else, not to cause any harm" (First, do no harm). This recommendation has become the central maxim of every physician and it can be interpreted in a more modern and general way as the precautionary principle. This principle states that "…if an action or policy has a suspected risk of causing harm to the public or to the environment, in the absence of scientific consensus that the action or policy is harmful, the burden of proof that it is not harmful falls on those taking the action." In other words as Montague (1998) expressed: "..In this context the proponent of an activity rather than the public should bear the burden of proof..". In its Hippocratic form it contemplates three additional ethical commitments: i) to prevent harm; ii) to remove or extract all cause of harm; and iii) to promote all that has beneficial effects.

The Hippocratic dictum applied to economic policy making and regulation implies that State´s intervention on matters related to production of goods and services, distribution, saving, investment and financial intermediation should, first and foremost, avoid causing harm to the population. Or, more precisely, it would imply carefully evaluating a priori the potential risks and dangers to the population and ensuring the options that have the minimum risk of harm to the majority of the population instead of advocating either the one with the greatest likelihood of success or the option much more in line with an orthodox view of how markets should work. This implies avoiding the implementation of actions that increase the likelihood or impact of adverse shocks from international markets, including financial ones. Indeed, in the case of Latin America, many of its economic crises have been detonated by external shocks that come from the global economy. Among these shocks are the sharp deteriorations of the terms of trade, abrupt restrictions in the access to international financial markets that have led to a drastic credit rationing and jumps in interest rates. Such shocks have derailed apparently sound growth trajectories by making suddenly and acutely binding the restriction of the balance of payments or of the fiscal budget. Certainly, there have been multiple episodes in the region of *endogenously* created economic collapses, triggered by poorly designed economic policies that have led to unsustainable imbalances in income-expenditure and financing patterns. Such imbalances appear in diverse forms, like the unacceptable expansions of the fiscal deficit, boom-bust episodes, massive losses of international reserves, inflationary spirals, black markets etc. that ultimately lead to a slowdown or collapse of productive activity, decline in employment and reductions in households incomes, that affect particularly the poor.

A firm commitment with the Hippocratic dictum, cum precautionary principle, would lead governments to apply macroeconomic policies consistent with a sustainable path of public and private indebtedness as well as of the balance of payments and with an acceptable rate of economic growth, distribution of income and rate of inflation. Such commitment should not be taken to imply that the fiscal balance, the current account of the balance of payments and inflation must all be close to nil. It means that the pattern of debt accumulation, of the public and of the private sector, denominated in local as well as in foreign currency, must be sustainable and -most important- instrumental to achieve a high long-run rate of expansion of output and of employment, with low inflation. It is important to point out that the target for the desired rate of long–run expansion of GDP or of inflation are not necessarily the same for each and every country at all times. The quantitative targets for such key goals of economic performance and the choice of policy instruments to meet them are government decisions. Whether these goals can actually be met is a matter of the government’s commitment and ability to put forward a successful development agenda with the business community, workers and other key actors of the economy. The external macroeconomic context must not be ignored.

Fiscal and financial imbalances as well as external account disequilibria, and inflation spirals tend to bring about an increased volatility in the growth path of economic activity, employment or inflation; with particularly adverse effects on the poor. But, the adoption of a zero fiscal deficit rule such as the one adopted by the Mexican Congress some years ago or proposed more recently by the European Union is far from a solution. On the contrary, it automatically introduces a pro-cyclical element in fiscal policy given that when government revenues decline –as it occurs in downward phases of the business cycle or in recessions- fiscal expenditure must be reduced pari passu. This reduction introduces additional contractive forces and slows down more the economic activity and tends to shrink employment. Such fiscal rules tend to bring about an extra and most likely unnecessary stimulus to economy activity from government expenditure on the upswing of the business cycle and viceversa to introduce additional contractive forces from the fiscal side in periods of slowdown or recession.

To avoid these effects, it is far more convenient to establish a rule of structural balance for the public finances, similar to the one operating in Chile. Such rule would reduce the fluctuations of the economic cycle, while simultaneously maintaining a long-run equilibrium compatible with the economy's potential growth rate. An additional advantage of this option is that it emits clear and firm signals to the markets concerning the government's obligation to act in a countercyclical way: to register fiscal surplus in the dynamic phases of economic activity and to incur in fiscal deficits in recessive phases. When the fiscal deficit evolves according to such a pre-established and well publicized rule it is rather unlikely that it gives rise to allegations of lack of fiscal discipline amongst the international financing institutions or the capital markets. On the contrary, the application of such structural rule practically guarantees that public debt and fiscal balances will be in the long-run, sustainable as a proportion of GDP.

The *primum non nocere*, if applied properly, guarantees that State intervention in the economy would neither lead to inflationary pressures nor to unsustainable distortions in the structure of relative prices. This is expressed in various concrete recommendations of special relevance in the Latin American context. The first is that public policy in matters of regulation has to avoid being based on the one hand in an excessive faith on the hypothetical advantages of market forces independent of the specific institutional, historical and geographical context. On the other hand it should also avoid relying in an extended and quasi permanent good will of the population, or in the merits of prolonged and extended price or quantitative controls. Good will tends to ultimately be scarce. Price controls, or quantitative ceilings, serve to temporarily protect the population from the adverse impact of supply side shocks in selected markets. But tend to fail miserably when their application is excessively prolonged as they begin to cause shortages, black markets, illegal parallel markets and inflation. Thus they should not be seen as an autonomous pillar for long-term policy and the agenda of development.

Another recommendation relates to the conduction of monetary and exchange rate policies. Indeed, a central factor behind numerous balance of payments crises throughout the region could be found in the persistent trend to appreciate the real exchange rate. Such appreciations help to reduce inflation, but erode capital formation in tradable activities as well as international competitiveness of the local industry. It is thus recommendable that monetary policies, including particularly the Central Bank, besides being having a low and stable inflation as their goal, should aim to avoid the persistent and significant appreciation of the real exchange rate. This advice has gained special relevance for various countries in the region that receive vast amounts of short term capital flows, family remittances or that have benefitted for sharp improvements in their terms of trade. All of them need to sooner or later reverse the trend to appreciate their real exchange rate. This may require special policies to regulate short term capital inflows, to promote industrial development and the production of tradeable goods and additional measure to compensate for the adverse effects such an exchange rate appreciation would have on international competitiveness.

In accordance with the precautionary principle, both fiscal and monetary policy must be subject to strict practices, standards of transparency and accountability. Hence, not only some economic institutions but the main institutions responsible for macroeconomic policy, i.e. tax administration services, the offices of public spending and investment allocation, and the Central Bank need to be coordinated specifically in the application of their respective mandates. In this regard, it seems desirable to extend the Central Bank's mandate in order to cover not only price stabilization but also high and sustained economic growth in accordance with the country's potential of expansion.

Exploring the remaining Hippocratic prescriptions beyond the *primum non nocere,* additional tasks can be detected that public policy in emerging economies, like the Mexican one, in principle should embark on in order to promote economic development. The first one relates to the finance system: it would be pertinent to find ways to increase the credit supply at reasonable rates and terms of access to the poor population and small and medium enterprises. In some countries it is necessary to promote competition in the financial and banking sector. In all of them it seems necessary to strengthen regulation authorities and banking supervision capabilities, as well as granting more resources to development banks. Another equally important task concerns sectoral policies to encourage productive development and technological innovation. Empirical evidence shows that an economy's productive structure, i.e. the types of goods and services that its production specializes on, is a fundamental determinant of its performance and pace of expansion in the long run. Finally, to end this brief text on ethics and macroeconomics, we share our ideas on a strongly related issue most relevant for growth and inflation performance: the role of equality on development. [1]

The relationships between inequality in the distribution of income and growth, as well as between polarization and development must be specially considered when thinking about economic policies with redistributive aims. The level of inequality in distribution is, in Latin America and the Caribbean, significantly higher than in other regions of the world. At the same time, its evolution has been growing in the last three decades. Also, in the larger economies of the region, Brazil and Mexico, and for a long period this distribution is associated with a larger influence of the sectors of very high income on decisions about public policy than it has been observed in most countries.

International evidence is not conclusive for all countries in that the more inequality the less growth. Nevertheless, when Latin America and the Caribbean are compared with East Asia, it can be observed that in our region there is a more negative association between both processes than in Southeast Asia. There are two hypotheses about the relationship between inequality and growth: Kuznets curve and the trade-off between the two variables. The concentrations of human and physical assets, the consequential influence of those owners on the governments, and the disregard of the governments for the provision of health care, education and social security give room for inequality to reinforce a slow or insufficient growth according to the minimum requirements of the population.

In some economies of the subcontinent, alongside inequality comes a polarization of the income about two distant and homogenously concentrated groups, with consequences that go beyond growth as it generates potential and probable social conflicts. In general, inequality negatively affects the rhythm of growth, but polarization creates risks of conflict, diminishes the quality of growth and threatens when it impedes social cohesion. These unfavorable consequences impose the need to determine the channels and means through which the distortions in the distributions of income and wealth affect the development and growth of economies.

In fact, the acute inequality expressed in polarization tends to foster conflict, reduce social cohesion

[1] This last section borrows heavily from a lecture given by both authors in Naples, Italy in 2004 called: Aims and scope of economic policies against inequality.

and –occasionally– turn contingent the respect of public functionaries for property rights depending on the economic power of the claimant. Therefore, transaction costs are raised and, concomitantly, the perception of transparency and equity of the justice system, base of a state of law, is eroded.

At the same time, as inequality translates into marked regional divergences within the country, the quality and productivity of human capital and infrastructure become very heterogenic and reduce the competitiveness of the economy as a whole. Similarly, highly unequal incomes have an influence on the composition of public income and expenditure. On one hand, they tend to raise the regressivity of the tax system along with a reduction in the global tax load; on the other hand, they force the allocation of higher expenditures toward social issues and the fight against poverty, which almost always turn out to be lower than desired. Also, the presence of low incomes in certain segments of the population restrains their access to funding and physical assets (land or machinery), thus weakening the opportunities of investment and economic growth of the society as a whole.

Finally, inequalities of income and wealth, in developing economies with incipient democracies and scarce fiscal resources, produce a marked inequity in the access to education and quality health care in disadvantage for the poor, thus affecting their human capital and helping to perpetuate the intergenerational circle of poverty reproduction. Then, inequality affects growth through institutional and functional characters. Inequality weakens the state of law that is a crucial condition for the functioning of the markets, and raises the transaction costs of the least fortunate to access equitable conditions for the defense of their property rights and juridical security. At the same time, it generates a regional heterogeneity by making the functioning of the markets and their efficiency dissimilar in each place, with the consequent diminution in the average performance of the productive factors at a national level.

From the government's point of view, the fiscal system becomes more regressive as the number of low income recipients increases, and a social policy directed towards the protection of these sectors leads to a higher budget expenditure which almost never satisfies the growing needs. At the same time, the extension of low incomes implies a lower capacity of these sectors to access credit and physical assets, therefore impeding the whole economy from reaching the levels of investment required.

Markets functioning under the conditions of a weakened state of law and with elevated costs of transaction for the majorities, governments acting regressively, from a fiscal point of view, and insufficiently, from the perspective of expenditure and investment, contribute to reproduce social sectors with low incomes and a scarce, if not null, capacity to access quality health care and education. Thus the vicious circle that produces more inequality in the subsequent generation is closed. In consequence, the reduction of extreme inequality plays a crucial role in the efficient and competitive functioning of the markets in line with keeping a fiscally sound and socially inclusive role of the government. Both, the adequate functioning of the markets and a firm intervention of the government in promoting economic growth structural transformation and a more progressive distribution of income are necessary elements of the development agenda of emerging economies. Our populations would gain much if such actions and economic policies were implemented by the government, in strict accordance with the Hippocratic oaths -cum the precautionary principle.

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