NEW ATLANTIC CAPITALISM
RESHAPING THE ECONOMIC MODEL IN THE EU AND THE US

Did governments draw the right lessons from the crisis?

Analytical Paper, New Atlantic Capitalism, 20-21 June 2011, Paris

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The biggest economic and financial crisis since the Second World War has not only been overcome surprisingly rapidly but has also been followed by a robust growth, employment and export momentum. Yet this happy turn of events does not of itself answer the question of whether the right lessons have been learned from the crisis so as to avert the danger of such turmoil, with its associated economic, social and human costs, recurring in future.

1. The decisive question: What balance between government and the market?

The crucial issue going forward must be to find the right **mix between government and market involvement** in economic affairs. The range of options can be quickly narrowed to a central kernel by eliminating the extremes. Thus the advocates of restoring centrally planned economies are today just as isolated as the supporters of a 19th century-type *laisser faire* free-for-all in which the role of the state is confined to protecting property or life and limb. But any attempt to precisely gauge the optimal balance between government and market involvement in the economy unleashes a protracted and fierce debate among professional economists which also spills over into the public and political domain.

In the years **preceding the financial crisis** a majority of academics and policymakers signed up to the idea that the role of government should be minimised and the scope of the market correspondingly maximised. This "Washington Consensus" appeared convincing in an era of dynamic global growth triggered, in particular, by the fall of the Iron Curtain and the opening of the Chinese economy. This global and apparently unstoppable forward march of the market, which persisted into the second half of the past decade, came to a shuddering halt in the summer of 2007 with the near-collapse of a small German bank, the IKB-Bank in Dusseldorf.

The ensuing rude awakening has sensitised the world both to the destructive potential of unfettered markets and to the propensity of financial institutions to frivolously squander the funds entrusted to them on a breathtaking scale. In the past few years market forces have left a huge trail of devastation in their wake stretching from California via Iceland, Ireland and the United Kingdom to Spain which has robbed countless people of their savings, jobs and future prospects. The worst-hit countries are now saddled with enormous debts and in some cases are tottering on the brink of insolvency. As a result of the resulting kill-or-cure therapy applied at the IMF's behest, those

countries are now having to impose huge burdens on their populations and to massively curtail macroeconomic investments.

Following this spectacular failure of the market, it has become apparent that states with **traditionally strong government involvement** in the economic process have coped with the crisis very well. This is especially true of China, whose political leaders have not only steered their heavily export-oriented country through what was the most serious economic crisis of the post-war era virtually unscathed but have also enabled it play a key stabilising role within the world economy. The Scandinavian countries, where government intervention in economic affairs is very extensive, have likewise weathered the storms of the past few years particularly well. By contrast, countries like Ireland, the United Kingdom or the United States, which long trumpeted the virtues of a lean state and low taxation, are currently facing the biggest fiscal difficulties.

Given such clear evidence, it might be assumed that, following decades of pro-market credulity, the balance of popular opinion on the "government versus market" issue would now tip decisively in favour of greater government involvement. Yet precisely the opposite appears to be happening.

2. Germany's straightjacket for the government

This can be illustrated by the example of **Germany**. A key lesson of the crisis is that financial markets evidently find it very hard to identify meaningful macroeconomic investment projects and thus to channel private savings into such rational ventures. This implies the need for a stronger interventionist role for the state in order to ensure that sufficient capital is invested in areas that are vital for the ongoing development of the economy and society: education, infrastructure, environment, energy as well as research and development.

Yet in July 2009, exactly two years after the outbreak of the financial crisis, Germany's lower house of parliament (*Bundestag*) passed an amendment of **Article 115 of the Basic Law** (*Grundgesetz*) which effectively prohibits government borrowing for investment purposes. The fact that this "debt brake" (*Schuldenbremse*) flies in the face of an elementary and long-established principle of economics evidently did not worry the parliamentarians. Most of them have probably never heard of the "**golden rule**" of public finance economics, which says that a state may borrow in order to invest as this will also benefit future generations. This has led to the absurd situation that the German government sector could currently take out long-term loans on the financial markets at an interest rate of 3% so as to finance investments in education that would yield a rate of return to the economy as a whole of 10 %, but is banned from doing so by the new amendment to the Basic Law – the avowed aim of which is to improve the lot of future generations.

The situation is rendered even more absurd by the fact that German **private households**, prompted by government subsidies targeted at encouraging supplementary old-age provision, are generating net financial savings of around 150 billion euro each year. But where can they invest their financial surpluses? For years now German firms have been generating such large earnings that the corporate sector as a whole can fully finance its investments out of profits and accumulate net financial assets on top. Given the prohibition of debt incurrence by the public sector, the only alternative is to invest these savings *in toto* outside Germany, where they are likely to be gobbled up by foreign governments or new real estate investments. And those countries that might appear attractive to German investors, such as Switzerland, the Netherlands or China, do not need German households'

savings as they have more than enough of their own. In effect, this means that the conclusion that German policymakers have drawn from the financial crisis is to make domestic savers more reliant than ever on the financial market for channelling their savings abroad.

3. Euro area: markets decide on the fate of states and the euro

Looking at the **European level**, four member states of the euro area are at present in deep crisis. In the case of Greece, this is undoubtedly due to a failure of the government, which even in economically buoyant years failed to achieve a balanced budget. In Spain and Ireland, by contrast, the crisis has a very different cause. Both countries recorded a very good fiscal position up to 2007 and in fact were seen by the IMF and others as shining examples of budgetary discipline. The fact that today they are on the edge of, or at least close to, the precipice is due solely to the enormous dislocations brought about by the financial crisis, prior to which both the markets and the rating agencies for years abandoned any pretence of level-headed business practices and threw caution to the winds as they bankrolled gigantic real estate investments.

What consequences have been drawn from all these failures? Instead of ensuring that economies are better protected against the manic-depressive mood swings of investors and the blindness of the rating agencies, the fate of whole nations and, ultimately, of the entire euro area, has been placed completely in the hands of the market. This is exemplified by the experience of **Spain**. The country is undertaking strenuous efforts to consolidate its public finances through very tough retrenchment measures. Up to now the markets have taken a benign view of this but, as the example of Ireland showed, that can change dramatically at any time. And if and when the markets give it the thumbs-down, Spain will have lost its fight and will have to enter the debtors' prison which has been erected for the euro area over the past twelve months. In concrete terms this means that the triad consisting of the IMF, the ECB and the EU will sweep into Madrid and take over the country's public finances. A new radical austerity programme will then be imposed on the Spanish people regardless of the retrenchment measures already undertaken. While money will then be released from the European Financial Stabilisation Fund (EFSF), it will only be available at punitive rates of interest and not on the favourable terms on which the EFSF can refinance itself on the market. And once Spain has been condemned by the markets in this way, the game can go on. Maybe it will then be Italy's or Belgium's turn to face the music.

Any realistic attempt to safeguard the **stability of monetary union** can only succeed by stopping the market from being the arbiter of the individual member states. In turn, that can only be achieved by introducing a common financing instrument for all euro countries in which no distinction is made between the nationality of the issuers, in other words by launching euro-bonds. If the euro area presents a united front in this way, the market will only be left a choice between euro-bonds and dollar-bonds. Hence it will no longer be able to divide and conquer the individual member states. This will naturally require the umpiring of economic policy in the individual countries, since euro-bonds must not be abused as a *carte blanche*. This requires policy action at the European level. Given that joint and several liability for the policy mistakes of individual members is already a fact of life in the euro area, there is a pressing need for a much more effective joint control of the national budgetary policies. The Stability and Growth Pact is unsuited to this task as it focuses solely on budget deficits rather than the overall income and revenue situation, and, moreover, any sanctions have to be agreed by the actual or potential perpetrators themselves, i.e. the economic and finance

ministers. In future it is imperative that the basic budget numbers of states with high indebtedness are approved by the European Commission or a committee of the European Parliament. And if a country does not stick to the rules, it will have to face the ultimate punishment of being expelled from the euro area.

President Trichet has currently made a proposal which goes in this direction:

"Would it go too far if we envisaged, at this second stage, giving euro area authorities a much deeper and authoritative say in the formation of the country's economic policies if these go harmfully astray? A direct influence, well over and above the reinforced surveillance that is presently envisaged?"[1]

4. Inadequate reform of financial market supervision

Turning to the **reform of financial market oversight**, there can be little doubt that the existing structures have proved to be totally inadequate. And that is hardly surprising given the divergent evolution of the markets and prudential practice. Following the dismantling of all national barriers for the financial markets, it is a pretty obvious step to shift financial market supervision, too, to the supranational level. In view of the enormous amounts of money needed, for example, to prop up the Irish banking system, there is a need at the very least for a fully integrated banking supervision system for the euro area which is able to act independently of national influences and, in addition, to draw on a comprehensive microeconomic database.

Despite extensive discussions about reform, Europe is still a long way off reaching such a solution. Although a new European Banking Authority has now been set up and a new European Systemic Risk Board has been established, neither institution has direct competencies or can draw on direct information on the transactions of the national financial institutions. The European Systemic Risk Board, with its 63 members, was designed from the outset as an unwieldy bureaucracy. Just how tortuous the road to an efficient and, above all, integrated banking supervision system is can be seen from the fact that the German government has not even managed to put in place a single banking supervision structure for Germany. German banks must therefore carry on reporting to the joint supervisors Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin), a two-headed monster which, despite its dual failings and shortcomings in the past, has been left to duplicate its duties in the future.

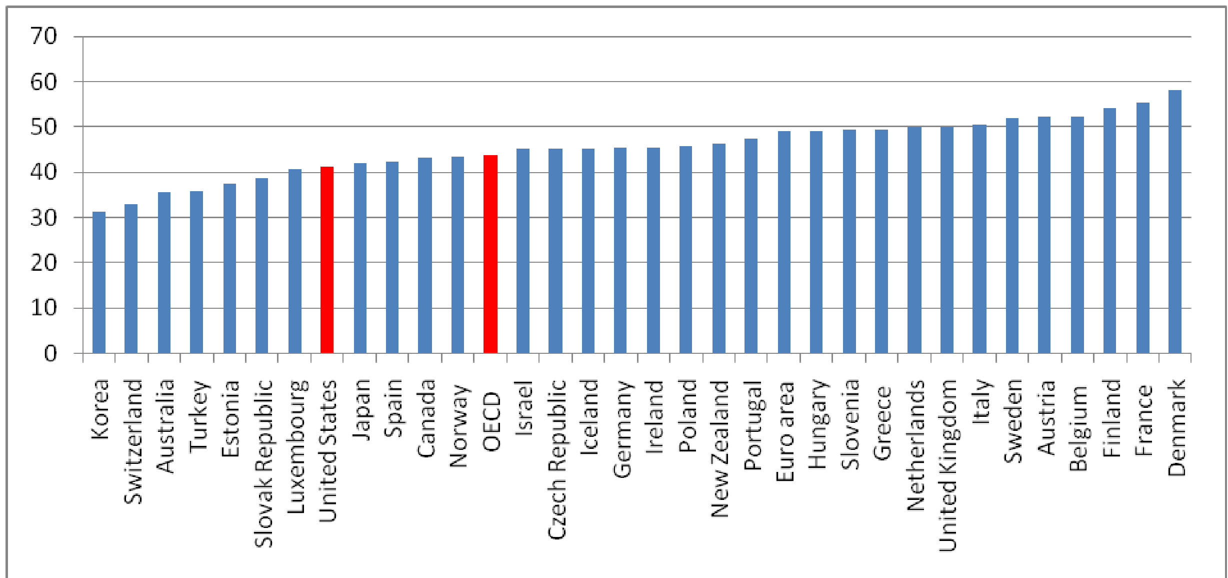
5. Governments become the victim of fiscal consolidation

False conclusions have been drawn from the crisis especially in those countries which hitherto have placed excessive trust in the supposed virtues of a lean state and are now confronted with massive problems of public debt. Prominent among this group of countries are Ireland, Japan, the United Kingdom, Spain and, in particular, the United States, which currently has a huge budget deficit of 10.1 % of GDP. This is not attributable, however, to excessive public spending in the USA. At 41.3 %

[1] "Building Europe, building institutions", Speech by Jean-Claude Trichet, President of the ECB on receiving the Karlspreis 2011 in Aachen, 2 June 2011. Internet: http://www.ecb.int/press/key/date/2011/html/sp110602.en.html

of GDP in the current year, the US government spending ratio is actually below the level of OECD economies, which averages 43.7 % (Chart 1).

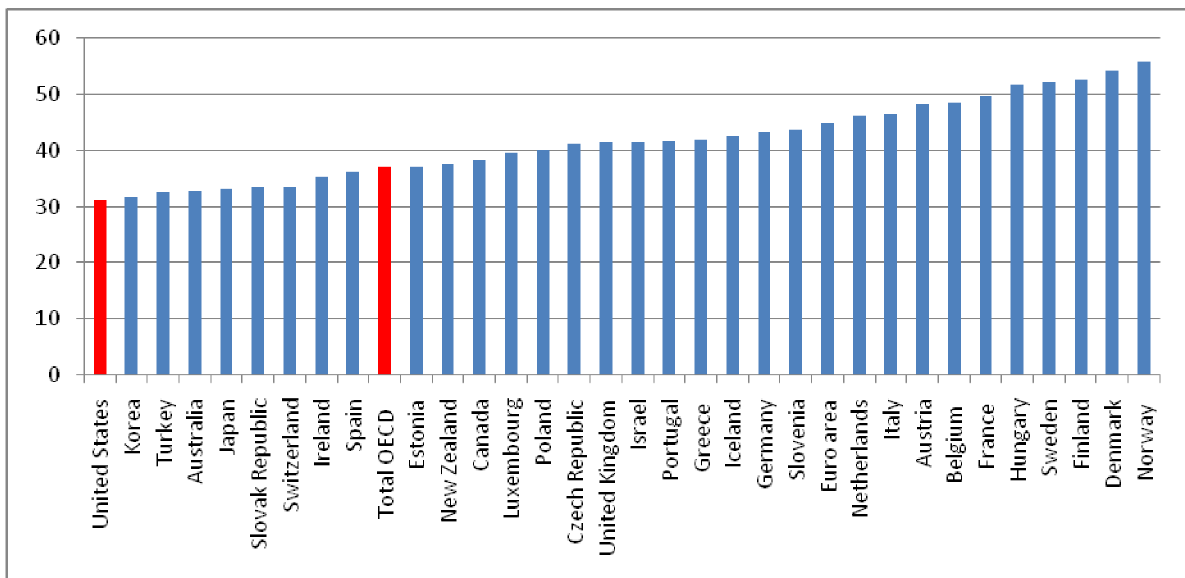
Chart 1: Government expenditures in % of GDP (2011)



Source: OECD, Economic Outlook

The budget problem of the United States is related to the revenue side, which amounts to a mere 31.2 % of GDP, which is some six percentage points less than the average for the advanced economies (Chart 2).

Chart 2: Government revenues in % of GDP (2011)



Source: OECD, Economic Outlook

Hence the logical route to achieving stable public finances in the United States would be to raise taxes. But since that is politically taboo in the USA, fiscal consolidation can only be achieved by cutting expenditure. The already very lean US state is thus being slimmed down further, with the consequence that even less money will be available for education, infrastructure and social equalisation. The precept that spending cuts are always better than higher taxes is also a hallmark of the IMF's programmes for the euro area's ailing member countries. Consequently, government expenditure is being pruned in areas such as infrastructure investment which is crucial in the medium term for enhancing these countries' competitiveness.

6. The flawed discussion on the reform of the international monetary system

The current debate on the reform of the international monetary system provides another example for wrong lessons from the crisis. It is relatively easy to diagnose that the current international exchange rate system has little in common with the textbook world of flexible exchange rates which is characterized by exchange rate developments that are determined by macroeconomic fundamentals and a complete absence of foreign exchange market interventions.

- It is widely accepted in the literature that bilateral nominal exchange rates cannot be explained satisfactorily with any kind of macroeconomic fundamentals. Obstfeld and Rogoff (2000) speak of a "purchasing power puzzle" and a more general "**disconnect puzzle**" as one of the six major puzzles in international economics. The first puzzle "highlights just how weak the connection is between exchange rates and national price levels" (Obstfeld and Rogoff 2000, p. 373). The second puzzle "alludes broadly to the exceedingly weak relationship (except, perhaps in the longer run) between the exchange rate and virtually any macroeconomic aggregates" (Obstfeld and Rogoff 2000, p. 373). As far as the UIP relation is concerned, Froot and Thaler (1990) identified the anomaly of a "forward premium puzzle" which means that contrary to UIP, currencies with a positive interest rate difference are appreciating instead of depreciating.
- In addition, **the laissez-faire approach** of the system of flexible exchange rates has allowed many countries to follow trade-oriented exchange rate policies. All recent studies agree that the strong increase in foreign exchange reserves reflects not only precautionary motives but mainly exchange rate policies that are driven by protectionist motives. As the US-Dollar is used as the pivot for these policies it is not surprising that this currency still enjoys an "exorbitant privilege".

Given the evident failure of the market-based paradigm of flexible exchange rates one would expect that the reform debate is mainly focused on proposals for a better management and surveillance of exchange rate polices. Again, just the opposite is happening. Most proposals for a reform of the IMS have devoted their attention to the topic of **international reserves**. Thus, they discuss ways

- to reduce the still dominant role of the US-dollar as an international reserve currency, the so-called "exorbitant privilege",
- to enhance the use of the renminbi as an international currency above its inclusion in the Special Drawing Rights basket, and
- to boost the global role of the SDR through bigger new issues and a bigger role in IMF lending.

The priority that is given to the topic of international reserves in the current reform debate shows that most economists regard a reform of the system of global reserves as more urgent than a reform of the global exchange rate system. In fact, there is very little fundamental criticism of working of the system of flexible exchange rates, especially its lack of multilateral rules and the strong influence it assigns to financial markets in the determination of exchange rates. On the contrary, e.g. Bénassy-Quéré and Pisani-Ferri (2011, p. 39) regard the "move towards greater flexibility of the exchange rates of the main currencies" as an intermediate priority and Dorrucci and McKay (2011, p. 7) argue that "more market-driven developments could also help to change the incentives for policy-makers".

With a clear diagnosis of the flaws of the current international monetary system, a completely different approach would be adopted. It would start with the question of how to manage exchange rates in a way that they are compatible with macroeconomic fundamentals. In my view the most promising strategy consists of bilateral exchange rate paths that are determined by short-term interest rate differences as it is postulated by the theory of uncovered interest rate parity (UIP) (Bofinger and Wollmershäuser 2003). Such a **strategy of managed floating** would prevent above all destabilizing carry-trade processes. It would require exchange rate interventions but as the example of the Slovenian exchange rate policies in the years 1999 to 2004 has shown it can even be implemented unilaterally. The European Monetary System (1979-1999) is an example for a successful de facto managed floating system.

7. The market is dead, long live the market

Consequently, the outcome of the financial and economic crisis could be construed as rewarding the markets for their failure. Admittedly, that is a slight exaggeration as attempts have indeed been made here and there to subject the financial markets to a greater degree of control. For example, the new prudential standards known as Basel III oblige banks to build up much more robust risk buffers in the coming years in the form of far higher capital cushions. But in this context, too, there is appears to be a lack of willingness to tackle the roots of the problems. There are, for instance, still no rules for effectively addressing the **too-big-to-fail** problem. This leaves countries exposed to the risk of having to bail out major banks again in the future since they are so big that their collapse could endanger the stability of the entire financial system.

The **paradoxical triumph of the market** is hard to explain. Perhaps it can be put down to the fact that, nowadays, the principle of egotism that underlies the market enjoys greater resonance throughout society than the principles of collectivism and solidarity that are the bedrock of the state. Be that as it may, the proponents of neo-liberal market ideology should not laugh too soon as their surprising success could easily turn out in the medium and longer term to be a Pyrrhic victory.

- If **Germany** continues to entrust the bulk of its national savings to the international financial system and to invest too little in its own education system and infrastructure, the consequence in 10 to 15 years time could well be the double burden of an ageing population and an ailing economy.
- If the member states of the euro area continue to leave the fate of **monetary union** to the vagaries of the financial markets and do not instead mobilise all their resources in order to offer effective support to countries fighting for their economic survival, the euro will break up. While some people might relish this prospect, it should be remembered, looking back at the D-Mark's

track record, that its periodic appreciations repeatedly deprived the German economy of its competitive advantage.

- If the political decision makers cannot summon up the courage to devolve real prudential power in the field of **banking supervision** to the European level, supervisors will continue to chase their tails as the financial markets keep several moves ahead. The next crisis will then be inevitable, except that next time, given the high sovereign debt levels, there would be little scope for extensive government rescue programmes.

Finally, if the United States increasingly erodes its capital base and China, with its state-led economy, becomes the world's dominant economic power, the pendulum could swing so far in the opposite direction that, in the end, the role of government could cast an excessive shadow over both the economy and society in general.

As gratifying as the global economy's rapid recovery after the crisis is, it should therefore be borne in mind that both Europe and the world economy in general are treading a very fine line. Future prosperity hinges on maintaining the right balance between government and market involvement. Too much market is equally as dangerous as too much government.

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