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Economic policy after the crash

*Herbert Walther**

Introduction

The worldwide financial crisis, which started in the autumn 2007 at the climax of a bursting asset price bubble in the US, is still alive and with us, in spite of the tremendous, undoubtedly Keynesian and far reaching efforts of central banks and governments to mitigate its horrifying impact. Now, in the year 2009, heavy aftershocks are shattering the real economy throughout the world inducing the deepest recession in post-war history.

Shrinking world trade, shrinking industrial output, rising unemployment, exploding fiscal deficits and accumulating public debts, which will reach historically extraordinary high levels in many countries, are the immediate frightening effects. Some countries have already entered a dark mixture of classical, nineteenth century deflationary cumulative process (like Ireland and the Baltic Countries), falling (public and private sector) wages, and pro-cyclical fiscal policies. Some are free riding on other countries' efforts to stabilize the economy (like Switzerland, which has devaluated its currency in spite of a huge current account surplus). Protectionism, open and disguised, is on the rise.

The larger countries are still struggling bravely within the limits of traditional expansive Keynesian demand management, leaning against the wind, while their politicians are praying that the combined efforts of central bank policies, the inventory cycle, and autonomous forces (re-investment, technological innovation) will do the job of saving the world.

Meanwhile, the financial centers of the world are still in a predominantly desperate mood, trapped in a slow deleveraging process. Given the unprecedented overshooting of housing and share prices in the US (but also in the UK, Ireland and Spain) during the past decades the chances are high that the enforced deleveraging and the related deflationary tendencies might last for some years to come. As is always the case in periods of crises, expectations are not unanimously pessimistic, however. A tiny, but not negligible, part of the financial community is less pessimistic (or at least pretends to be so). This minority seems to be betting that a new financial bubble will extinct the memories of the present nightmare (as it happened in the past, e.g. after the bursting of the ›New Economy‹ bubble). Hopes of reanimating the golden age of billion dollar bonuses for financial top managers as soon as possible are lingering behind.

This is the present uncertain state of affairs. What will happen in the next few years? Possible outcomes range from catastrophic scenarios (with mass unemployment up to record high two digit levels) in many countries to a sharp and strong revival within a few months. Unfortunately, at the time of writing this article (June 2009), the first option does look

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rather more realistic. However, given the exceptional conditions of the financial crisis, one has to be aware that pessimistic forecasts might become true due to their self-fulfilling character only.¹

The responsibility of the economists

As the economic disaster is evolving, one cannot avoid asking some critical questions with respect to the overall responsibility of the economics profession as a whole. Economists prefer to see themselves as neutral scientists working in the spirit of natural sciences, developing theories and testing specified hypothesis empirically, adding to our knowledge of the behavior of an underlying objective economic reality. Economists as a rule do not see themselves as being part of the social system, inevitably sharing and promoting certain ideological prejudices and biases.

If one looks somewhat disillusioned at the development of economic science during the last 40 years, such a view seems to be at odds with reality. Since the early seventies a new generation of economists, sharing no personal memories of the Great Depression, shifted from a perception of markets as being inherently unstable, in need for public regulation, outside control and guidance, to the perception that competitive markets are reasonably efficient and stable. Even the labor market, which developed institutions around indivisibilities of labor, non-convexities of technology, and other sources of market failure (like imperfect information and high mobility costs), was seen in a very different light – portrayed ›as if‹ it could be analyzed as a perfectly competitive market. One line of research, originally developed by Milton Friedman and Edmund Phelps in the late sixties, led to the strange explanation of unemployment as the voluntary outcome of equilibrium caused by temporary misperceptions of relative price signals (distorting the – otherwise – efficient intertemporal substitution of the labor supply). The ›Great Depression‹ became caricaturized as the ›Great Vacation‹.

Another line of research, sharing in principle the same fundamental belief in the (long-run) efficiency and stability of perfectly competitive markets, tried to be somewhat more realistic. Minor, seemingly natural ›frictions‹ were integrated (like monopolistic competition, ›menu costs‹ for price changes, transaction costs etc.) into the dynamic stochastic general equilibrium (DSGE) model. Such nominal and real rigidities seemed to be sufficient to generate Keynesian effects, portrayed as short-run, temporary, but essentially self-correcting deviations from the dynamic path of long-term equilibrium. The school of ›New Keynesian Economics‹ became the basis for many discussions about labor market reforms in the eighties and nineties and in numerous OECD reports. ›Inflexibilities‹ of the labor mar-

1 Official institutions and other interest groups (financial market actors in particular) are very well aware of that possibility. Therefore, they are continuously engaging in a strategic game, properly called the ›management of expectations‹. As the public becomes aware of these strategies, the credibility gap of – official and private – forecasts is now probably larger than at any time before.

ket (downward rigidity of real wages) were seen as the principal barriers preventing entry into the promised paradise of full employment and efficient equilibrium.

As Axel Leijonhufvud (2008) recently argued, this line of development was not Keynesian at all, actually building on earlier, classical ideas, according to which the main causes of unemployment are ›rigid‹ prices and wages. Given the high volatility of prices in the financial markets, this specific school tended to look at the financial markets as *the* benchmark model of flexibility and efficiency. It did not seem necessary to analyze such a market for possible causes of malfunctioning as carefully as the labor market.

The strictly regulated banking sector – a political heritage of the Great Depression – was one of the earliest experimental settings for deregulation in the US (e.g. 1980 and 1982, see Cornett/Tehrani 1990). It became also the first victim of these policies. Allowing S&L associations to offer a broader spectrum of savings accounts and to step into riskier lending activities was an attempt to help the industry ›to grow out of problems‹, which were attributed by economists to ›overregulation‹. As is well known, the results of deregulation were radically different from what was expected: Leaving costs of approximately 140 billion \$ to the US taxpayer, the S&L crisis of the late eighties was comparatively cheap (and locally limited) by today's standards, however.

It is interesting that the financial crisis at that time stopped to become a nationwide banking crisis only because of the strict ›departmentalization‹ of the US banking system, viewed at that time as a terrible source of inefficiency by most economists. However, ›departmentalization‹ immunized other branches from the problems of the S&L associations and prevented the outbreak of a nationwide or even global financial crises.

Which conclusions did the advocates of liberalization draw from this early disaster? Similar to Soviet style ideologists, who – in search for the reasons of the dismal performance of their own economic system – always blamed the imperfect implementation of socialistic principles, economists argued that *partial* deregulation was the prime failure. Consequently, further steps of liberalizing were undertaken, transforming banks in general into a universal banking system, which got the chance to engage in a much broader spectrum of activities. During the nineties, even the remaining bonds were broken. The ›origin and distribute‹ model became the new mantra of efficient portfolio selection. Securitized debts, used at the next stage as collaterals to build up further layers of leverage, and widespread outsourcing of banking activities into ›special purpose vehicles‹ followed. Akin to historical experiences in the nineteenth century, a (shadow) banking system developed – intimately connected by sensitive complementarities at the international level – without being (officially) backed by a lender of last resort.

The outspoken preference for deregulation and liberalization was partly a natural reaction in response to the over-confidence of earlier generations into the state as a pure ›benevolent‹ actor. The process became very soon captured by hard-core right-wing ideologists, however, which tried to denounce state agencies and politicians as purely self-interested, motivated solely by the desire to extend the bureaucratic monopolistic ›exploitation of tax payers‹ (Buchanan and Co.). During the eighties, economists of that school became the chief ideologists of liberalization, deregulation and anti-welfare state policies in many coun-

tries. Not any single institution of the welfare state (unemployment insurance, job protection, pay-as-you-go pension system, minimum wages, unions etc.) remained untouched by the penetrating criticism of free market ideologists.²

Finally, governments all over the world, even social democratic ones in ›old Europe‹, implemented reforms to make the labor markets more ›flexible‹, which turned out to be just a code for shifting bargaining power in notoriously imperfect markets to the employers' side. In a similar spirit, one tried to open up and ›modernize‹ the capital markets. In each case, the implicit utopia was the perfectly competitive market model, albeit in reality it turned out to be just an imperfect imitation of the Anglo-Saxon institutional set-up. One of the key-elements of Anglo-Saxon governance structures, the stock-option-based model of managerial compensation, which originally developed as an academic exercise in ›principle-agent‹ theory, became a widely approved method of ›disciplining‹ managers (i.e. aligning their private economic interests with those of the shareholders). Numerous scientific papers defended those models of remuneration as an efficient method of furthering socially productive risk-taking.

The chorus of anti-welfare state ideologists became gradually hysterical during the golden area of US/UK ›financial capitalism‹ from the early eighties up to 2006, where nearly everything seemed to work out extraordinary well. The remarkable increases of employment, productivity, and real GDP per capita in the US during that period (supported by the Boskin Commission's statistical work) seemed to convince even the skeptical leaders of social democracy in Europe that some ingredients of the laissez-faire model might be useful to overcome the sluggish growth / high unemployment scenarios in European welfare states. Few seemed to take notice of the dark side of the seemingly endless US boom:

- the growing inequality of income and wealth;
- the exploding ratio of bank credits to GDP;
- the immense current account deficit, refinanced by the export-led growth addicted China;
- excessive increases of the real share prices (according to the S&P 500, beginning as early as 1995);
- the emerging housing price bubble³ (since 2003).

² For a detailed methodological and empirical criticism of OECD studies (1997 and 1999) see Howell et al. (2007). See also St. Paul (2004), who summarizes neatly the orthodox view.

³ It is interesting to compare a statement made by Ben Bernanke (an eminent economist who just had been nominated as chairman of the Federal Reserve) at the 27th of October, 2005 (»Ben Bernanke does not think the national housing boom is a bubble that is about to burst.«, in: The Washington Post, October 27, 2005) with the contrary conclusions drawn at May 2005 by two natural scientists – Zhou/Sornett 2005: »We analyze the quarterly average of sales prices of new houses in the US as a whole. [...] We find that 22 states [...] exhibit clear-cut signatures of a fast growing bubble.« The two natural scientists developed a theory (very Keynesian in spirit), based on »the existence of positive feed-backs in stock markets as well as in the economy.« While their theory is based on ›ad hoc‹ behavioral assumptions from the viewpoint of neo-Classical economics, they were (by the moderate standards of economic forecasts) perfectly right and Ben Bernanke was – completely - wrong. The

Why did the great majority of US economists ignore the red lights flashing at the US financial markets at least since the early nineties, indicating the building-up of a share price bubble, followed since 2003 by a dangerous house price bubble? Economists ignored⁴ the destabilizing effects on exchange rates, asset prices and current accounts of the profitable carry trades performed by highly-leveraged US investment banks, which used cheap Yen credits during the nineties to buy US stocks and – in the end – trillion dollar baskets of toxic assets. At the same time, eagerly to imitate their successful US competitors in some of the same lines of business, European banks tried to oversell foreign currency credits to the new markets in Eastern Europe and elsewhere, absorbing simultaneously toxic assets from abroad.

One reason for ignoring systemic risks was overconfidence in the power of financial innovation: As banks felt increasingly uneasy and credit risks shed more and more shadows on balance sheets, they developed an immense appetite for credit default swaps, securitization of debts, and all types of seemingly clever risk diversification strategies. Extraordinary transaction fees made that development enormously attractive for investment banks and even for those who did not understand the complex nature of the contracts behind. Unfortunately, in the end those who bought insurance were not aware that risks entered the banking system from the backside again. It became clear that the main owners of special purpose vehicles (and the main creditors of investment banks) were – the same banks, which tried to get rid of them. Risk diversification became in effect risk concentration, as some institutions specialized heavily in those transactions.

Why did notable economists (like Larry Summers, still in charge as one of US President Obama's economic advisers) support destabilizing reforms (like those of the Cox Commission of 2004, raising legitimate leverage ratios for broker-dealers from 12:1 – as in the case of Merrill Lynch – to as high as 40:1)? The proponents defended this step as a defensive reaction against a similar move in the EU, which passed a rule allowing the SEC's European counterpart to manage the risk of both broker-dealers and their investment banking holding companies, implying also consolidation of balances and higher risk-taking levels. This example shows how the financial industry had been extremely successful as a political lobby group on both sides of the Atlantic. Many decision makers in crucial positions had close links to the financial industry (like the former US Secretaries of the Treasury Henry Paulson and Robert Rubin). In Germany, during the era of the social democratic finance minister Hans Eichel, experts from the *Bundesverband Deutscher Banken* (*Federal Association of German Banks*) were even actively involved in writing the detailed legal code of the *Kapitalmarktmodernisierungsgesetz* (*German Investment Modernization Act 2004*).

The golden age of US financial capitalism provided the stage for a worldwide process of competitive deregulation, as more and more countries tried to imitate this successful model. The financial sector grew and became a powerful economic political actor of its

reason behind might be that natural scientists had not been brainwashed before by general equilibrium theory and the dogmatic belief in perfectly rational agents and efficient markets.

⁴ The notable exception was Paul Krugman, who repeatedly warned about the dramatic imbalances – but he was primarily afraid of a dollar crash, not of a banking crisis.

own, supported by the (financial) media, which stigmatized all governments, which dared to set even minor acts of resistance against the prescriptions of Wallstreet's medicine. After the ›Big Bang‹ -reforms in London's financial city in 1986 and similar steps in the US, the booming capital markets in the US and the UK confirmed the view that these countries had detected a magic formula of generating wealth by becoming the centers of the most profitable service industry of the world. Many countries were increasingly envious, some tried to imitate (like Iceland ...). Now, the ›successes‹ and the associated hubris has to be judged against the dark background of the disastrous financial crises 2007 – 2010, which eliminated gains in GDP of nearly a decade of growth and still has the potential of creating enormous indirect political repercussions.

Economists as ›bubble makers‹: The OECD/IMF design for pension reforms

One underlying and widely ignored economic-political cause for the development of a bubble economy and for the supportive policies was the (legitimate!) concern of US governments that the US system of dominantly capital-funded pensions is at risk to go bankrupt or might be unsustainable at least, when the baby boomer generation starts to retire in larger cohorts beginning in 2010. Because the US pension funds will have to reduce their net demand for illiquid assets to pay-off pensions, a ›melting down‹ on US asset markets was an imminent threat. Consequently, US-dominated international institutions, like the OECD and the IMF, started an aggressive campaign against pay-as-you-go systems to convince stubborn and welfare-addicted European politicians to build up at least partially funded systems for their own aging populations, or, to put it differently, to enter (by way of diversifying their portfolios) the US Ponzi game of pensions at a later stage.

The campaign in favor of funded systems was a tremendous ›success‹ – from the Netherlands to Sweden, from Germany to Spain, from Poland to Slovakia many countries started to build up simultaneously a funded system during the last 20 years. A pre-condition for such policies was to convince the younger generation that the pay-as-you-go system will not be sustainable for demographic reasons. The consequences are now clear to anyone – European pension funds, by building up considerable amounts of virtual wealth during the last 20 years and by ›diversifying‹ risks via investing at least partially also in the booming US market, actually helped to blow up the financial bubbles in the US. Now, they have already lost – on average – probably 20 percent to 30 percent of their asset values, a huge implicit subsidy, indeed, for the dysfunctional Anglo-Saxon pension fund capitalism.

This might only be the beginning of further losses, as the inability of the funded system in the US (and worldwide) to cope with the demographic time bomb becomes more and more a structural source of asset price risk for the next decade after 2010. Nevertheless, in its latest (2009) report, *Pensions at a Glance*, the OECD again points to the »necessity« of strengthening funded pensions at the expense of pay-as-you-go – in spite of the demonstrated volatility of the financial market and the demographic challenges for funded systems in all industrialized countries:

»Confidence in private pensions is at an all-time low. In a number of countries, there have been calls to move away from mixed pension systems back to an exclusive reliance on public pay-as-you-go-schemes. [...] This is the wrong way to go. [...] To prevent a backlash and the reversal of past reforms, it will be important to restore people's faith in private pension savings.« (OECD 2009: 9)

Using data covering the last 25 years up to 2006 for the G7 countries plus Sweden, the OECD also continues to project for the next decades median real rates of returns of 7.3 percent over a span of 45 years for mixed portfolios (50 percent equities / 50 percent government bonds) held in pension funds. These calculations assume real returns for equities of 8.9 percent and of 5.2 percent for bonds. The OECD admits – rather casually – that 2.3 percentage points, or nearly one third of the mixed portfolio return, gets lost for the retirees due to »administrative expenses«, »transaction costs« etc., reducing the median return to five percent.⁵ Unfortunately, these projections are still heavily biased – upwards, of course:

The OECD's calculations ignore that the period from 1981 to 2006 was a historically exceptional period in all countries (starting from a deep recession, ending with a boom year just before the outbreak of the financial crisis!). Secondly, during that period many factors contributed to higher than average capital returns (liberalizing capital markets under Reagan/Thatcher, favorable tax policies, falling wage shares, globalization and outsourcing etc.); factors, which worked in addition to the already mentioned structural shift of portfolio preferences towards more risky assets due to the baby boomer generation. It is logically impossible that these long-term, extraordinary stimulating factors are sustainable *ad infinitum*.

Let us compare these excessively optimistic assumptions with the actual long-term real equity and bond returns in the US after the Second World War: 6.0 percent for equities and 1.8 percent for long-term government bonds (Bradford DeLong/Magin 2009: 4). If one uses these figures for similar projections (ignoring the threats of climate change, demographic risks etc.) and if one assumes that the »administrative expenses« reduce the mean rate of return by 2.3 percentage points (in line with the above OECD assumptions), one gets a net return of approximately 1.7 percent. In effect, the »equity premium« covers the administrative costs of the funded system! If workers pay ten percent of wages into such a system, after 45 years the income replacement rate would be approximately 15 percent of working income – the OECD promises nearly 50 percent. The 15 percent income replacement rates are median values, however – and that means that income replacement can be even much lower.

One of the most famous and active propagandists of funded systems was the economist Laurence Kotlikoff who acted as an influential consultant to the IMF and many governments worldwide. Recently Kotlikoff (2008) wrote a cynical (but very realistic) satire on the political and economic vulnerability of funded systems. Nevertheless, the conclusions he draws are again in line with the orthodox ideology, implying not less, but more of the same recipe: Following Bradford DeLong and Magin (2009), he argues in favor of elimi-

⁵ This compares to administrative costs in a pay-as-you-go system of much less than 0.5 percent.

nating social security pensions in the US altogether (!) and of building up a passively managed and worldwide investing Exchange-Traded-Index-fund.⁶

Economic policy after the crash

What will and/or ought to be the economic policy after the crash? The answers to both questions are very different. First, let us try to discuss the most probable economic scenarios in the near future, depending also upon the reactions of the political system. Then we will shift to the issue what, perhaps, ought to be done.

The immediate cost of the financial crisis, already with us, is a tremendous waste of human resources, called unemployment, raising social unrest in many countries. In addition, due to the unavoidable losses in tax revenues and the rise in expenditures for unemployment benefits, public deficits and debt ratios are surging. Given the dimension of the crisis, even relying exclusively on automatic fiscal stabilizers will drive the ratio of public debts to GDP in many countries near to or above the 100 percent level. Without doubt, the main problem during and after this crash will be how governments manage these financial constraints preserving economic and social stability; and how they can avoid a terrible trap of a dynamic downward spiral of lower credit-worthiness, higher interest rates, and deflationary budgetary policies; a downward trap which is already visible in the Baltic States or in Ireland. In the Euro zone, a rising share of countries is already violating the Maastricht criteria, leading to the obligatory deficit procedures, which seem to be somewhat misplaced, to say the least, given the present economic background.

To be sure, there is a real risk involved related to higher government indebtedness, which devoted Keynesians are rarely ready to admit. In particular, old-fashioned 'hydraulic' Keynesian economists were not willing to accept that the concerns of financial market actors with regard to the future development of public debts might become a vigorous independent source of instability. Nor does Keynesian theory provide convincing recipes how to deal with such destabilizing forces.

In this respect, California provides an interesting 'role model' for the Euro zone: California seems to be unable to raise taxes for political reasons and probably tries to bet on a bailout by the Federal US-government. Regardless whether such a bailout will happen or not, financial markets will be shocked by any outcome, making it more difficult for California and the US government to finance future deficits. In the Euro zone, similar prob-

6 Ironically, at the height of the bubble (April 2007) a draft of an article by two eminent financial economists teaching in Berkeley was published the first time online. The authors argued that investors are too risk-averse, basically too stupid, holding too many bonds and not enough equities: »We are driven to the belief that there is a strong case for revisiting issues of financial institution design in order to give the market a push toward equities. Economists need to think about institutions that would make long-run buy-and-hold bets on equities easier and widespread. Mandatory (!) personal retirement or savings accounts with default investments in equity index funds? Automatically investment of tax refunds into diversified equity fund in personal savings accounts? Investing the Social Security Trust Fund in equities?« (Bradford DeLong/Magin 2009: 31)

lems might arise if the present crisis goes on for long. Contrary to the US, European governments cannot seriously hope to get any bailout or any direct support by the European Central Bank (ECB). It is obvious that European institutions are not strong enough to overcome any emerging sovereign debt crisis solely by mutual solidarity. By implication, even Euro zone members have to rely on the IMF and its harsh recipes, which, by default, will be of the classical deflationary and brutal style.

Even a firm believer in Keynesian economics has to admit that the implicit and explicit ideological prejudices shared by the financial market actors are already acting as a psychological barrier against ›too‹ forceful anti-cyclical policies. In sharp contrast to the real problem of actual deflationary tendencies, since March 2009 monetarist reasoning is raising its voice again, pointing to the extraordinary expansion of the monetary base by the Federal Reserve and the ECB as a potential inflationary threat. Closely linked to this threat are the apocalyptic warnings related to the rising sovereign solvency risks and the deeply rooted fears, nurtured by the ›public choice‹ school of thought that governments will – more or less by necessity – try to solve their debt problem in the future by raising the rate of inflation. These warnings do serve also as an early threat to all governments (but in particular to the US government) that anyone who attacks the disastrous business model of rating agencies or who might try to commit the sin of ›excessive regulation‹ might risk an immediate rebuttal via lower credit ratings.

To an outside observer of the current macroeconomic situation, fears of rising inflation might look as bizarre, as if someone burning alive is asking for an umbrella to protect herself against firewater. However, those who are excessively inflation-averse (and government debt-averse) are not the same as the unemployed, who are the real victims of the crisis. Somewhat hypocritically, the anti-inflation hawks like to express their deep concerns about the tax burdens on future generations from inherited public debts. The same people are silent about the flows of interest revenues flowing from inherited government bonds to the future generation of heirs!

Fighting against this inequity *within* the future generation is easy, at least in principle. In countries where debts are mostly internal, as is in Western Europe generally (and in Germany in particular) the case, taxes on inherited wealth and/or taxes on capital income could be raised up to the same level as for workers income (in the US, with its huge external indebtedness, the advantages of devaluating its currency are much higher). Such a step requires, of course, that Euro zone countries defend their tax base with strong and credible measures against hypocritical ›tax thieves‹, like Switzerland, Luxembourg etc.

Unfortunately, those who raise their voices in defending future generations against irresponsible burdens of government debts are regularly the same as those who argue against any policies of fighting rising inequity (now and ex post) via higher taxes on inheritance or capital income. They are also silent about the fact that unemployment within the present young generation is the most unacceptable inequity – representing also a tremendous burden for future generations, due to its well-known long-term effects on human capital formation and fertility (the Great Depression during the thirties is still visible in demographical cohorts of that time).

As is always the case, the distribution of power in the political process is decisive which interests will get more weight in determining the unavoidable burden sharing after the crash. Given the obvious dependence of governments from the sympathy, the good will, and the expectations of the international financial community and given the mounting public debts, which increase this dependency further, hopes that any real, substantial, and harsh reforms, necessary to stop the fatal excess volatility of the international financial system, will be politically feasible, look rather illusory.

What will be done?

Governments are deeply concerned not to violate the ›vital interests‹ of financial markets. The rhetoric at international meetings, the enragement about greedy managers and so on, is for the showcase only. No strong actions to limit the playgrounds for financial innovations, shadow banks, and speculative activities can be expected in the near future. As long as unemployment does not get higher than expected in the worst scenarios, governments will prefer to help the financial sector to grow out of its problems, delivering the final bill to the taxpayer. After the crisis, and given the mounting burden of debt, tremendous costs for the taxpayers have to be expected and – as a consequence – a further trimming of the welfare state. Ironically, one particular victim of these policies will be the stability of the pay-as-you-go pension system.

The mouthpiece of financial capitalism, the newspaper *The Economist* (2009: 13), but also the OECD in its recent *Pensions at a Glance* (2009) study, are already pointing towards the necessity of further fundamental reforms of the pension systems (and, of course, the labor market institutions in Germany and other European ›welfare states‹). From their particular viewpoint, the long-run political advantages of such reforms – for the hidden agenda they promote – are twofold. Firstly, only the highest (e.g. public) pensions can be lowered without enormous political repercussions, as relatively ›privileged‹ pensioners will get less political support from the public and in the media. Secondly, fearful future pensioners with higher working income will be more willing to step up their private pension plans. While these attempts to build up a significant funded pension system will be frustrated in any case at the aggregate level in the far future, at least the financial sector gets some further implicit subsidies now. By lowering the (pay-as-you-go system) pensions for the well-to-do retirees, these subjects will (probably) dissave. The latter process helps to restructure balances, as the simultaneous deleveraging of (non-) financial corporations and the consolidation of budget deficits requires by logical necessity a reduction of private household savings (leaving any ›beggar-my-neighbor-policies‹ via net exports aside). If the recession becomes a long-lasting depression with debt deflation, even the stock of outstanding aggregate household savings will have to fall. While the unemployed cannot avoid dissaving, lowering the entitlements for the better off retirees forces them to dissave. The former group will be the main victims *during* the crisis, and the latter group will be the main victims *after* the crisis. Ironically, the increasing reliance of employees on private savings for old age will induce rather more than less political support for the interests of shareholders in the long term,

while in the short run political resistance against any attempt to push them into this direction will be strong, of course.

Can we expect some substantial reforms of the rules of the game in the financial sector? Until now, we hear much cheap talk about more transparency and better control of 'systemic risks'. While transparency is nice (albeit depending upon the incentive compatibility of reporting honestly), and good – supranational – governance makes always sense (who is responsible, what are the sanctions for detected misbehavior?), the most fundamental question is the following one: How can we implement or strengthen forceful negative feedbacks which stabilize the asset markets endogenously in times of boom and depression?

What ought to be done?

During the era of the former Federal Reserve Chairman Alan Greenspan it became evident that classical monetary policy (the 'Taylor rule') is not sufficient to stabilize the real economy and the financial sector simultaneously. It would be a wrong and dangerous conclusion, however, to subordinate monetary policy to the needs of preventing bubbles, ignoring the stability implications for the real economy, as the financial lobbyist are suggesting. The main conclusion must be that monetary policy needs additional instruments, in particular automatic monetary and fiscal stabilizers. As the past has shown, one cannot rely on discretionary fiscal instruments. Albeit available as an option, discretionary fiscal policies were not politically feasible during the bubble area – neither in the US, nor in Spain, nor in Ireland. Actually, discretionary policies helped to intensify and prolong the bubble.

The serious problem of systemic risk needs to be addressed more directly, by strengthening the role of negative, automatic feedbacks during the cycle (see below), rather than by adapting static rules of raising minimum capital requirements to prevent pure idiosyncratic risks, or to rely on ad hoc interventions of benevolent governments. To be sure, higher minimum capital requirements will be useful to reduce the incidence and the intensity of future systemic crises, but they are not sufficient. Given the complexity of the financial sector, there are severe trade-offs involved between short-run costs and long-run benefits of all types of financial reforms. For instance, raising minimum capital requirements and/or liquidity reserves as banks are already struggling to raise their capital basis and their liquidity reserves might make a crisis even worse.

Therefore, monetary authorities and governments need new instruments. Three important extensions of the set of instruments might be the following ones:

1. Similar to regulations, which already existed in the past in Austria and some other countries, central banks should get the right to fix upper limits of the growth of credit at the level of individual banks and for specific types of credits (mortgages and foreign currency credits).
2. Governments should be brave enough to split up very large banks into smaller banks. No single bank's balance should be allowed to be larger than 20 percent of the GDP of its home country. The latter limit is not defined by national borders, but by the rel-

evant regulatory framework and the lender of last resort (note that the Swiss UBS, but also other Swiss banks do not fulfill this criterion at all), nor is this the case for many others banks in smaller countries outside of the US or the EU. The reason for such a strict limitation of the maximum size of individual banks is simple: As Iceland has demonstrated convincingly, even the 'lender of last resort' function of central banks does depend for its credibility and viability upon the taxable resource base (the GDP) behind. An indirect and very positive effect of such regulations would be the elimination of offshore bank centers.

3. According to the concept of a comprehensive income tax, capital gains should be taxed like income at the source with the highest progressive income tax rate, but depending upon the length of the period of ownership. Short-run trend followers ('chartists'), probably the most important source of volatility⁷, should be punished in two ways: (1) by applying the highest marginal income tax on capital gains for financial assets bought and sold within three years, (2) by eliminating the possibility of offsetting capital losses during the same holding period. For assets sold after three years, the capital gains tax rate can be much lower and loss deduction more generous. Tax rates and loss deduction can be lowered (raised) gradually dependent upon the length of the holding period, avoiding possibly destabilizing 'calendar effects'. Note that capital gains taxes with full loss deduction might increase risk taking.⁸ Because such a capital gains tax has the potential to increase the volatility of public deficits and surpluses significantly, independent central banks should get the power to 'sterilize' during the upswing at least part of the revenues from such a capital gains tax. On the other hand, they could support expansionary fiscal policies of the governments by dissolving collected reserves from the past.
4. The incentives for the rating agencies should further truthful reporting. That agencies profit from successful sales of the very same financial products they should critically evaluate is absurd, to say the least. This, however, is the case when the same institutions emitting products are paying the agencies for their testimonials. In addition, there will always be a natural tendency of 'upgrading' doubtful financial products, because it is always much more tedious (and costly) to justify a negative expertise. Therefore, a public rating agency for rating agencies must observe, analyze, and compare the accuracy, consistency, and long-run performance of individual rating agencies.

⁷ To be sure, short-run speculators can also stabilize the markets if long-term price expectations are anchored around some fundamental natural and economic forces. In complex financial markets, where expectations are always heterogeneous, short-run, fuzzy information gets probably too much weight in decision making. To prevent notorious overreaction (and the possibility to exploit this tendency), policy should strengthen 'patience' ('wait and see attitudes') at the part of the investors and orientation relative to structural, long-term information.

⁸ See Atkinson/Stiglitz (1980).

Final remarks

In spite of the relevance of ›Keynesian Theory‹ for understanding the main elements of the present crisis, and in spite of the surprising revival of some pragmatic Keynesian policies, the powerful political basis of that theory – the spirit of organized solidarity of employees – has been in decline for the past 40 years. Nothing has changed to the better in that respect, quite to the contrary. The absence and/or weakness of countervailing political power means that rising unemployment will set under pressure all kinds of protective labor market institutions, even without any further ›labor market reforms‹ so obstinately propagated by the OECD and the IMF. If the crisis will be short, the upswing will revive the orthodox belief in the vitality of capitalism very quickly, bringing classical economists back to their inherited place as secular priests of market fundamentalism. The Keynesian lessons will fall into neglect, as future commentators are prone to point to inherited public debts without even mentioning why these debts emerged in the first place. It is not difficult to make a political point prediction: The trimming of the welfare state will continue in an even more radical and aggressive way than in the past. As the financial sector grows out of its troubles (Goldman Sachs ahead), the great ›pay-as-you-go‹ pension rip-off (© by *The Economist*) will start driving more and more better-off employees in the arms of a fundamentally unstable and – for demographic reasons – basically bankrupt ›funded system‹. If the crisis is lasting longer, the political fallout will be much more dramatic and it is impossible to say what the future will bring.

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The Research Network Macroeconomics and Macroeconomic Policies (FMM)¹ – Past, present and future

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Introduction

The Research Network Macroeconomics and Macroeconomic Policies (FMM) has existed since 1996 as a platform for analysis, research and discussion of macroeconomic issues. It is primarily based in Germany, Austria and Switzerland, but it has established close links to similar networks in other countries, particular in Europe. Since its start the FMM has been concerned with promoting the revival and development of macroeconomic approaches, which have tended to be marginalised, especially in Germany, as a result of the dominance of neoclassical, monetarist and supply-side approaches since the 1970s. According to its latest research programme (FMM 2008), the Research Network aims to be both a platform for discussions about economic theory as well as a forum for economic policy debates:

»Macroeconomic theory is seen as the basis for policies which aim at high employment, environmentally sustainable growth, price stability, reduced inequality, and the elimination of poverty.« (FMM 2008: 1)

Organisationally, the Research Network is based at the Macroeconomic Policy Institute (IMK) at Hans Boeckler Foundation, and it is funded by the Hans Boeckler Foundation of the German Trade Union Federation (DGB). The FMM is politically independent. Its activities are directed by a coordinating committee, which has been appointed in accordance with the IMK. Since 1996, the main activities of the FMM have been organising annual conferences, publishing the conference proceedings, and organising working groups and summer schools in order to support young economists. The coordinating committee

¹ FMM stands for: Forschungsnetzwerk Makroökonomie und Makropolitik.

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