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## Article

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## **‘The trading behaviour in financial markets and the impacts on the real economy became the theme of my life’**



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Interview with Stephan Schulmeister

Stephan Schulmeister was a senior researcher at the Austrian Institute of Economic Research (WIFO) from 1972 until his retirement in 2012, and a lecturer at the University of Vienna and at the Vienna University of Economics and Business. He has been a vocal critic of neoliberal economics in the German-speaking countries and has provided profound analyses of the role of financial markets for the real economy. His latest book, *Der Weg zur Prosperität (The Road to Prosperity)* won the Bruno Kreisky prize 2018 in Austria and the prize of the German Keynes Society in 2020.

*How did your academic career as an economist start? Were there any heterodox influences?*

First of all, I would say I didn't make any academic career. I mean, I have been working in an empirical institute with little connection to universities. Initially, I was not even interested in economics at all. I was interested in German literature, philosophy of whatever, and it was mainly due to the '68 movement that I got interested in economics. Why? Because I'm from the family of a very conservative but very famous Austrian journalist. He was the editor-in-chief of the most influential Austrian conservative newspaper and of course, when I was 15 or 16, I admired him. Also what influenced me very much was that we had in our place in 1956 a Hungarian refugee who lived with us after the uprising. And so, I was an anti-communist and became a student representative at the Vienna University for a conservative student party. In November 1967, we travelled to Berlin to learn how to fight Rudi Dutschke, because he for me was really the devil. But this visit I will never forget, because this guy produced so many doubts in me. The way he was speaking was very modest and clear – a little bit like a priest. That was the beginning of a long journey of producing more and more doubts.

Then I came to economics because I thought you need to understand the basics, the basis – superstructure – of the story, in Marxian terms. I had studied law and I also started economics. But I never did a doctoral degree. I just got the 'Magister' [Master] and I wanted to become independent – to leave my parents' house, of course. So I was looking for a job. At that time, this was extremely easy. Once, the director of the Austrian National Bank, Heinz Kienzl, told me, 'You should go to the WIFO [the Austrian Institute for Economic Research], because there you will learn empirical economics. You will learn statistics and you can leave after two or three years if you're not so interested in that'. So I applied at the WIFO for a job. Unfortunately, they offered me only one job in tourism research. I was a bit disappointed. But I said, okay, why not tourism? And I was a

tourist researcher for eight years and I liked it, since tourism was fascinating because of the interdisciplinary nature of the problem. But then I became more and more involved in the financial issues.

*When you studied economics, was there any Austrian economist (Austrian by nation not by school) who impressed you?*

I only attended lectures by Erich Streissler, whom I liked. Later on, I almost fell in love with Kurt Rothschild. I saw Rothschild every week. Rothschild also liked me, even though he knew my father, with whom he had some controversial TV discussions. I liked Rothschild's irony, but we never openly spoke about our relationship. I was really touched, because at his 90th birthday, the President of the Republic, Heinz Fischer, gave a lunch for Rothschild, and the only person invited besides Professor Nowotny was me.

*When did you get in contact with Rothschild?*

He was at the WIFO once a week, because he was a consultant there. So always on Monday he showed up at the WIFO. This was the time when I got interested in the trading behaviour in financial markets and the impacts on the real economy, which became the theme of my life.

*When did you get interested in this topic?*

Well, it started practically when I started to work at WIFO, because in 1973 we had the first oil price shock causing the first post-World War II recession. I conceived the oil-price shock as a reaction of OPEC to the preceding dollar depreciation, only triggered but not caused by the Yom Kippur war. As long as the dollar is stable, oil-producing countries do not have economic incentives to sharply raise prices. The dollar depreciation was related to the liberalisation of financial markets in general, and I felt confirmed very much by the repetition of this process, because between 1976 and 1979, we had the second dollar depreciation, again by roughly 25 per cent, which was followed by the second oil-price shock. This second shock caused a completely different reaction on behalf of the central banks: high interest-rate policy. This policy caused a reversal in the dollar exchange rate (triggered by the election of Ronald Reagan as US president in 1980), the dollar appreciated like never before, and in 1982, a continent got bankrupted: Latin America.

At that moment, I saw the relationship between financial speculation in foreign-exchange markets and millions of people suffering from a horrible crisis. I think this was the most important emotional event also: I started to try to better understand what people are doing in the trading rooms. But it was not until 1986 when fortunately Egon Matzner invited me to spend a sabbatical of six months at the WZB Social Science Center Berlin. I had a three-metre-long chart of the daily DM/dollar exchange rates since 1971 fixed on a wall in my office, and for days I was just looking at this curve. Which type of human behaviour might be behind these kinds of movements? Later on, I took on even the jargon of traders, bull markets, bear markets, because there's something into it. They are not crazy people. But I was unable to find a general explanation besides that I saw this trending behaviour, which couldn't be a random process. I went to Frankfurt to observe and interview foreign-exchange traders, which changed my life again. Because what I experienced were open-minded people who showed me the computer signals, the computer-generated buy and sell signals. I asked: What is the information base? How do you derive these signals? Just past prices? This cannot not be, because then the financial market would not even be weakly efficient according to Fama's (1970) definition.

So, for the next 25 years, I did a lot about technical trading systems, because at that time, in the mid 1980s, the practice of 'technical analysis' was absolutely unknown in empirical economics. The trading rules or trading systems were very trivial at that time. They operated with moving averages, the first differences and so on, but those were not empirically analysed. So I did my first paper on that, which was published by the *Banca Nazionale del Lavoro Quarterly Review* (Schulmeister 1988), but did not get any reaction. Then came the invasion of Saddam Hussein in Kuwait, and ENI, the Italian oil company, was interested in an analysis of why the oil price did not fall once it was clear that the supply of Saudi Arabia would compensate for the lack of oil from Iraq and Kuwait. So I had the chance to go to New York and it was the first and the last time when I could get into Goldman Sachs and on the trading floor at the World Trade Center at the 33rd floor, where at that time crude-oil derivatives were traded. I could observe people. So before behavioural finance, I was fascinated by this interaction of emotions and contagious effects of people. At that time trading was done on the floor through open outcry, I saw the 50 people shouting, they had their earphones and got instructions from people somewhere else who were sitting before their screens and trying to apply these trading systems.

In the early 1990s I started to think: How could I build a theory, some kind of generalisation of all my observations, of what is going on in financial markets? If I want to make profits through real investments as an entrepreneur, it is so completely different from trying to make profits in the financial world. So, I started to think that there might be two different types of capitalism, depending on the incentive conditions for striving for profits. It makes a difference whether it is focused on the real economy (causing an upswing) or on the financial economy (causing a decline). So this is the basis. I was looking at the world with this differentiation.

*How does this relate to the work of the great thinker in economics?*

My guru in economics is not John Maynard Keynes but Adam Smith; he is the greatest for me, really. But I have thought so only since I retired, and it was in particular his first book, *The Theory of Moral Sentiments* (Smith 1759), which has such fantastic observations about the interaction of people, for example, when Adam Smith describes that any entrepreneur is dependent on his ability of looking at things from the perspective of partners and taking their interests into account. But in financial markets, for example, exactly the opposite logic prevails: the more my partner loses, the more I win. You just have to be smart in this world and morality doesn't play any role.

Then I came across an economic historian, Giovanni Arrighi, and his work on the issue (Arrighi 1994). The basic idea of Arrighi, coming from a completely different starting point, was in practical terms very much the same as my idea: that we always find an upward movement over several decades where the hegemonic country, which possesses the most relevant technology of the time, gets richer and richer through investments in the real economy ('real accumulation'), and, because it gets richer – completely endogenously – it tries to make even more out of it through financial investments ('high finance'). But by doing so, it fosters its successor, because it provides credit to him. For example, the Republic of Genoa was the first hegemon in the sixteenth/early seventeenth century, and whom did they finance? The Dutch Republics. The Dutch Republics were then the economic hegemon, and whom did they finance, 100 years later after this? England. And England became the hegemon over the nineteenth century, and got into finance by the end of the nineteenth century. Whom to finance? The United States. The US became the hegemon, and whom did they finance, when they got into this Wall

Street culture? China. The global financial crisis of 2008 can thus be seen as the beginning of a new phase of the long cycle.

But I'm now sceptical whether I can apply the model for the coming decades, because we now have a kind of central-bank finance capitalism. In March 2020, everybody was expecting a so-called correction and a long-run bear market. It started when the corona crisis broke out and we had the strongest decline of stock-market prices ever within three weeks. Then the central banks intervened in an unprecedented manner, turning a stock price decline of 35 percent into a rise of roughly 80 per cent. As a consequence, we got back in a general bullish sentiment: all asset prices went up, including house, commodities and cryptocurrency prices. As central banks can in principle 'abort' any bear market, it is hard to tell where permanently producing 'fictitious capital' might lead.

This most 'advanced' form of finance capitalism also has some serious consequences for pricing CO<sub>2</sub> emissions. Almost exploding fossil energy prices raise profits of producer countries and make it more difficult for consumer countries to raise carbon emission prices in an orderly manner, for example, through CO<sub>2</sub> taxes.

*If we now come to the policy implications: You have published a very important book recently (Schulmeister 2018). It won two prizes. What are the main messages?*

The main message is clear. We need some kind of change towards a real capitalist system, which at the same time addresses the core problem of our time: the climate crisis. I still think that it is tremendously important for a successful economic and social development that you can integrate two poles: competition–cooperation; individualism–collective consciousness; solidarity or compassion–egoism (if you want such).

The concrete prescriptions for economic policy would be that we have to go back to the neglected Keynes. One reason why neoliberalism was so successful was simply that there were two messages of Keynes in a political sense. The first was the role of the government in economic affairs. That was accepted. But the second was to strictly restrict all kinds of financial speculation – the 'euthanasia of the rentiers'. And this part was never finalised by Keynes (and never accepted by most of his followers). So the fascinating chapter 12 is isolated within *The General Theory* (Keynes 1936). Bull and bear markets mean nothing else than tremendous changes in the valuation of already existing assets. This phenomenon has not been integrated into Keynesian theory. Why? Because to my mind post-Keynesians also did not deal in a concrete way with financial markets and even the concept of financialisation is vague. Whereas in my theory it is not vague. It shows why financial markets can, in principle, never work because emotions necessarily cause wide swings of stock prices, exchange rates and commodity prices – all of which are extremely important for the real economy.

As regards the climate crisis, for example, the prescription would be to simply fix a rising price path of fossil energy by skimming off the difference to prevailing world market prices through a flexible energy tax. By contrast, neither carbon taxes nor emission trading systems can establish the reliable expectation that emitting carbon will never become cheaper again. Over the last 30 years we had three periods when the price of fuels fell by 30 per cent. Under these conditions, the profitability of investments in reducing carbon emissions remains completely uncertain. So my idea is simple: to fix the price paths through a flexible tax.

Next would be regulation of trading in financial markets. You could move to electronic auctions, for example, every three hours. It would even be completely in line with neoclassical theory. But it would change the world completely, because you deprive the algorithmic trading systems of their food, the high-frequency data.

Generally, it is absolutely clear that economics is too much focused on private goods, and we need now to focus much more on common goods. The whole theory of economics is turned upside down, if we deal with common goods.

*In your view, regulation, or re-regulating the financial sector, would do the trick plus an increase in public activity, the public sector, public investments, public spending, etc.?*

Very much... We have two big problems. I'm very much also influenced by the New Deal. I studied a lot about Roosevelt and also his personality, and I am very impressed by his life and his attitude. He said: I systematically start from the problems. Where are the problems? High youth unemployment, farmers with high debt, and so on. The New Deal was just a puzzle of different measures, you know, addressing the different problems, and this attitude I would have today. I would say: what are the problems in our society? It is, of course, poor people. It is, of course, the education of people with a migration background. It is, of course, the environment. It is not too difficult to identify the problems. And, in the second step, to design measures. That shouldn't be so difficult, in my mind. As I generally have a great preference for concrete thinking.

*As an example, you are one of the main proponents in Austria, maybe in Europe, in favour of a general financial transaction tax.*

That would be one example, but I prefer in the meantime these electronic auctions which would tremendously reduce transactions volumes. However, we would still need a financial transactions tax as a complement to make speculation outside the EU more costly, for example if Deutsche Bank transferred its speculative business to London. But it would no longer be that important. By the way, the transaction tax is seemingly the only success I had. Because it was by coincidence that I published this study in February of 2008 (Schulmeister et al. 2008), so after the global financial crisis it got some attention. I was very often invited by the European Commission. I had tremendous fights there. But there was a German economist, educated as a lawyer like me, Manfred Bergman, and he pushed this so much that we could really turn the European Commission by 180 degrees. They were really in favour and it was only the financial lobby campaign in 2013 which killed the project for the moment.

*Your proposal for the financial transaction tax was while you were still based at the WIFO. How was this taken at the WIFO and what was your role then in the WIFO institute?*

This helped me a lot because I became over the years more and more of an outsider at the WIFO, and if I had been an economist in Germany, they would have kicked me out, I'm sure. I was fighting against neoliberal policy all the years. But the public popularity of the financial transactions tax helped me a lot. I could even present it at the European Commission and at the United Nations, and the WIFO also got a little bit of a reputation, which was a second good thing. I mean, the Austrian National Bank always funded my studies – most of my studies. So this made it easier for me to continue my research, because normally doing research on algorithmic trading systems in financial markets is very specific.

*Currently, we are facing severe challenges – you have mentioned the ecological challenge, inequality, etc. But we still have this dominance of orthodox, neoclassical, neoliberal, whatever, economics at universities and maybe also in the main research institutes, etc. How can this be overcome? What are your recommendations for the younger generation?*

Yes, that will be the biggest problem. You need, as I often call it, a navigation map. You need a theory which is constructive in such a way that it addresses the concrete problems

in reality, a theory in which the complexity can be reduced in such a way that it is usable for politicians. So this was what Keynes's theory did. Of course, the following neoclassical synthesis was theoretically a catastrophe, but as far as economic policy is concerned, it was a practical thing, you know, and it worked. Policy also followed Keynes by regulating financial markets, whereas Keynesians in academia did not really take seriously the advice of Keynes about the 'euthanasia of the rentiers'. But the politicians at that time said, okay, let's have fixed exchange rates and all that. And it is no coincidence that the counter-attack of the neoliberals focused very much on liberalising the financial markets.

For the present it means we need some kind of concrete theory which addresses the main issues, but at the same time can be translated into everyday language. With my book (Schulmeister 2018), I made an attempt to contribute to that, but it did not have such a big impact. I have for example many ideas in this book, which are extremely theoretical, concerning the essence of money, concerning the production function. But since I made the – overly ambitious - attempt to develop a theoretical framework, which at the same time is interesting for theoreticians as well as for practical people, it was simply too much.

*So, your recommendation is that we should do our work in order to explain the real world and make it accessible to politicians, social movements, etc.?*

Like economic development, the production of economic theories should be conceived of as a process with an open end. Only theories which address the most oppressing problems of our time and which sketch possible solutions can serve as a basis for useful navigation maps.

*Many thanks for this interview.*

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