Macroeconomic Policy Regimes in Western Industrial Countries

Hansjörg Herr and
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Macroeconomic Policy Regimes in Western Industrial Countries

This book analyses how the economic crisis in the 1970s led to the erosion of the regulated type of capitalism that came to be in place after the Second World War, and paved the way to a Neoliberal Globalisation. Deep structural institutional changes especially in the field of financial markets, labour markets and the international economy became the basis for a liberal type of capitalism which included financial markets in a dominant role. The new neoliberal model fundamentally changed the conditions for all macroeconomic policies. In this book, these macroeconomic policy regimes are discussed on a theoretical level.

Macroeconomic Policy Regimes in Western Industrial Countries explains how certain countries have created a more liberal and market-based type of capitalism. The emphasis throughout is on how understanding macroeconomic policies, and the institutional framework in which they operate, is vital to understanding the long-run dynamics of a capitalist economy. The policy regimes that are examined consist of changes in the financial system, monetary policy, fiscal policy, wage policy changes in distribution, and foreign economic policy. The argument emerges that this deregulated type of capitalism is unacceptably unstable and is only preferable to a minority.

Moving on from the finance-driven development of recent decades, the authors take a look at the need for fundamental reforms, including institutional reforms in the areas of national and international financial and labour markets. Case studies from the United States, the United Kingdom, Germany and Japan dating from the 1970s up to today provide the reader with clear examples and analysis of the development in question. This book will be of interest to postgraduates and researchers of economics and political science.

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Foreword

The world economy is still suffering the consequences of the crisis which erupted in the US financial system in 2007 and subsequently spread to all countries. True, the world economy is growing again. But the economic recovery is still too weak and fragile to overcome the damage made in terms of employment losses, growing job precariousness and major business failures. According to ILO's *World of Work Report 2010*, it will take several more years for employment to return to the pre-crisis situation. Importantly, the brunt of the crisis is borne by those groups that had not benefited much from the earlier expansionary period.

Despite the gravity of the situation, much of the policy action to date has focused on addressing the consequences of the crisis – and not its causes. In 2009, major fiscal stimulus plans were launched to boost aggregate demand. As part of these plans, social protection was reinforced in many countries in order to ensure adequate income support to the innocent victims of the economic slump. The measures helped put a floor on the crisis and kick-start economic recovery. Millions of jobs were saved or created as a result. And yet they are now being challenged as policy attention has shifted to reducing fiscal deficits.

This volume provides a comprehensive assessment of the origins of the crisis and, thereby, helps understand the limits in crisis responses so far. It examines in detail the structural weaknesses that led to the crisis, including the growing disconnect between the financial system and the needs of the real economy. Interestingly, the volume goes further and analyses the impact of the financial system on corporate governance, notably as regards the search for ever higher short-term profits. It provides examples where such a short-termism goes against the longer term interest of society and the environment, while also affecting real investment and therefore the economy itself.

The authors also point to the unsustainability of the globalisation process. Export-led growth strategies have led to growing current account imbalances. More generally, globalisation has gone hand-in-hand with a widening of income inequalities without precedent in recent economic history. According to the authors, the view that greater income inequalities were the price to pay for higher economic growth has proved to be a major policy mistake.

Finally, the authors present a set of policies to achieve a New Globalisation which gives prominence to the real economy and emphasises a more balanced growth path. The approach covers an impressive range of policies – macroeconomic, trade, financial markets, taxes and social protection, employment and corporate governance. In this respect, the volume is full of thought-provocative ideas.

In short, this is an impressive piece and a timely contribution to the debate on the post-crisis economic model.

Raymond Torres
Director, International Institute for Labour Studies, ILO

1 Introduction

The years following the Second World War are generally perceived as a period of steady economic development until structural change was adopted in the 1970s and 1980s. Before that break a regulated capitalism had existed, sometimes called the 'Golden Age of Capitalism' or 'Fordism'. The break in the 1970s led to a much more market-based type of capitalism in nearly all western countries and to a specific type of globalisation. What we call 'Neoliberal Globalisation' shaped the world economy and national economies. With regard to economic purposes the key elements of Neoliberal Globalisation involve the liberalisation of national and international financial markets, the liberalisation of national labour markets including reforms in the social safety net, and a change in corporate governance structure following the shareholder principle. These developments increased the power of the financial system and of the agents acting in the financial spheres.

Compared with the 1950s and 1960s, economic development in the 1990s and 2000s became much more unstable and volatile. GDP growth rates declined and unemployment figures increased. A long sequence of currency crises and domestic financial crises developed. The subprime financial crisis, which in 2008/09 triggered the deepest crisis in the world economy after the 1930s, is only the latest example. Moreover, the neoliberal development went along with an increasingly unequal income distribution.

In this book we set out to explain how countries created a more liberal and market-based type of capitalism and how they adjusted to the era of Neoliberal Globalisation, which for most countries was beyond control. We do not analyse in depth the political processes that led to these changes. We rather concentrate on the economic policies that were carried out, and the effects these policies have had. We furthermore focus on policies on the macroeconomic level including the institutional changes that have had significant macroeconomic repercussions. Together with the school of rational expectations, developed mainly in the 1970 and 1980s, and later the New Keynesians, who now dominate economic thinking, the microfoundation of macroeconomics became popular. In these approaches representative households and companies are analysed, and their behaviour is directly transferred to the macroeconomic level as if one single agent represented the whole household sector or the businesses of a country. Our approach is to analyse the macroeconomic level, which gives single households and companies the parameters for their actions. We endorse a macrofoundation of microeconomics.

Macroeconomic policy is traditionally characterised by monetary policy, fiscal policy, wage policy and foreign economic policy as well as their interaction. We support this view. These policies and their interaction are of paramount importance for the development of an economy. However, macroeconomic polices cannot be analysed on a theoretical level that does not take into account the very specific institutional framework of a country. For example, wage policy on a macroeconomic level means a policy that enables the realisation of a certain increase in the level of nominal wages. Obviously, to achieve such an aim wage policy must be very much supported by an adequate institutional framework like strong trade unions and/or strong employers' associations, which in many countries do not exist or are very weak. Referring to monetary policy, it makes a world of a difference if a central bank is equipped with only one policy instrument, the interest rate, or whether it can use capital controls as a second instrument or even direct restrictions on credit expansion as a possible third instrument to achieve its monetary goals.

Institutions can be actively changed by policy actions. Abandoning control over international capital flows, forcing employers to become members of employers' associations or allowing commercial banks to use their own risk models to calculate legal equity requirements are all political decisions with the aim of changing institutions. But institutions can also change beyond the control of policy-makers. The breakdown of the Bretton Woods System in 1973 and the switch to flexible exchange rates between the key currencies in the world was an example of institutional change that could not be influenced, at least not by smaller countries.

Taking everything into account we define a macroeconomic policy regime as the interaction between monetary policy, fiscal policy, wage policy and foreign economic policy within a framework of both, macroeconomic institutions which can be actively changed by policy-makers and become part of economic policy, and institutions which are beyond the control of policy-makers.

To analyse macroeconomic policy regimes we follow a qualitative analysis that considers the many institutional changes that characterise the development of the past decades and that paved the way for the macroeconomic policies. In our opinion econometric tools are not suitable for capturing the deep qualitative changes or the interactions between monetary policy, fiscal policy, wage policy and foreign economic policy, which to a great extent also depend on institutional changes. Keeping in mind what has been mentioned above, we argue that the macroeconomic policy regime is a broad concept in which we attempt to incorporate macroeconomic policies and the relevant institutions as well as their changes – a wide range of factors which can hardly be captured by quantitative econometric analyses that only focus on a very few variables. Consequently, the empirical part of this book rests upon qualitative analyses combined with numerical investigations. By illustrating the use of macroeconomic policies and the country-specific institutional development, case studies will be presented in order to explain the different types of macroeconomic regimes.

A complex analysis of the economic development throughout the 1950s and 1960s and the breakdown of the regulated capitalism of that time period is beyond the scope of this book. Instead, we concentrate on how countries acted and reacted in the era of Neoliberal Globalisation. Considering their role as the engines of the change in the neoliberal era we decided to confine our analysis to the developed western economies. There is a big chance that countries like China, India or Brazil will shape the world, but only in future decades. Given their major importance, we focus on the four biggest countries in the western world as cases: the United States, United Kingdom, Germany and Japan. As the largest country, the United States deeply influences the world's economic development including fundamental institutional changes in all of these countries. President Ronald Reagan who was elected US President in 1980 headed one of the governments who actively and radically changed domestic and international institutions, and gave birth to the Neoliberal Globalisation. Almost equally important in triggering neoliberal development was the United Kingdom. Margaret Thatcher, elected Prime Minister in Great Britain in 1979, introduced policies no less radical than the ones followed by Ronald Reagan. However, the economic size of countries is not the only deciding factor. Following the neoliberal changes very hesitantly at first, Germany and Japan are the latecomers in the neoliberal era. Both countries are characterised by particularly interesting developments. While the German case also highlights the problems of the European Monetary Union, Japan suffered from deflation – a phenomenon thought to be dead after the Great Depression in the 1930s. In addition, we would like to stress that our approach can serve as a blueprint for analyses of other countries, such as Italy, France or the Scandinavian countries, and even developing countries. The countries we have chosen can therefore be considered exemplary despite their respective country-specific conditions.

The structure of the book is straightforward. First, we analyse the macroeconomic policy regime in detail to clarify our theoretical approach. Then the case studies are presented. We finish with the outline of a reform strategy with the aim to overcome the Neoliberal Globalisation.

A German version of this book was published in 2006 (Heine *et al*. 2006). Therefore we would especially like to thank Michael Heine and Cornelia Kaiser who could not join the publication of the English version. We are indebted to the Hans Böckler Foundation and especially Frank Gerlach for their financial support for the German publication, as well as the Berlin School of Economics and Law where we work. Last but not least, we thank Peter Bofinger, Trevor Evans, Eckhard Hein, Ulrich Fritsche, Arne Heise, Dierk Hirschel, Jürgen Kromphardt, Jan Priewe, Wolfgang Scheremet, Dieter Scholz, Achim Truger, Rudolf Welzmüller, as well as Florian Zinsmeister who gave their invaluable contributions to the development of this project. Most of them were members of the Academic Advisory Board of the project, which led to the German publication. As research projects are never identical, this English publication is now substantially different

from the German original. In the meantime, the subprime financial crisis and its effect on the world economy have improved the understanding of Neoliberal Globalisation and led to different judgements on policies. For providing data research for the English publication we are grateful to Marco Scheufel, Bea Ruoff and Stefanie Marie Scholz.

2 Macroeconomic policy regimes and their assessment

This chapter begins with a more detailed description of a macroeconomic policy regime concept. In the first section we analyse the general characteristics of a macroeconomic policy regime. In the second section the different elements of macroeconomic policy regime are examined individually. Finally, the last section deals with the typical theoretical constellations of a macroeconomic policy regime.

2.1 The general characteristics of a macroeconomic policy regime

2.1.1 'Ordnungspolitik' and process policy

The macroeconomic policy regime concept stands for the recognition that macroeconomic policies and the institutional framework in which they operate play a paramount role in understanding the short-run, and much more importantly, the long-run dynamics of a capitalist economy. The macroeconomic policies that will be examined here consist of monetary policy, fiscal policy, wage policy and foreign economic policy. Economic development of a country cannot be understood by analysing one policy area in an economy exclusively. For example, the economic development in the US, Japan or in Germany during the 1990s cannot be explained by a specific monetary policy alone. Rather, it is the interaction of the different elements of the policy regime that is important to explain economic development. Essentially, the outcome of a macroeconomic policy regime is more than the sum of its individual parts. For example, wage policy is of vital importance for monetary policy in a way that excessively high wage increases over productivity gains pose inflationary dangers to the economy and will trigger restrictive monetary policy. On the other hand, the case of Japan shows that nominal wage cuts reduce unit labour costs and thus cause a deflationary development, making monetary policy less successful in controlling price development. The idea of the importance of a policy mix is not spectacular in itself. However, different economic paradigms stimulate the emergence of different opinions about a good or a bad macroeconomic policy regime.[1] It is therefore essential in this study to define in more detail what we understand by macroeconomic policy regime.

Macroeconomic policies and their effects are not entirely independent of institutions. In fact, institutions can set the basis for and/or limit the policy mix of a macroeconomic policy regime. An illustration: in countries where labour market institutions (employment protection, unemployment benefits, coordination of collective bargaining, etc.) are sufficiently developed and where trade unions and employers' associations are strong and internalise the macroeconomic effects of their action, a macroeconomic wage policy is potentially possible. In the opposite case, the lack of agents who could carry out such a policy renders macroeconomic wage policy impossible; we can only talk of wage development. To offer another example: if asset markets are strictly controlled and separated from the commercial banking system, asset price inflations and deflations do not fundamentally disturb monetary policy. Macroeconomic policies depend on the institutional framework in which they are executed. Without understanding institutions that shape macroeconomic policies, the economic development of a country is difficult to understand.

Institutions are not fixed; they can change, while politics cannot easily shape all institutions. However, there is an important area of politics that changes institutions intentionally. It is a German tradition to label such a policy Ordnungspolitik.[2] We define Ordnungspolitik as a policy to change institutions with the explicit aim to influence the behaviour of (macroeconomic) agents and create certain economic results. These policies also provide the framework in which macroeconomic policies operate. For instance, making a central bank independent of direct government interventions may aim at gearing the monetary policy exclusively towards price level stability; changing laws which weaken trade unions may strive to create wage moderation; a law to enforce balanced public budgets may be proposed to prevent increasing public indebtedness.

However, policies to change institutions may have effects that are not intended. Institutions may also be a subject of change without a government's interference and beyond its control. For example, the collapse of the Bretton Woods System and the introduction of flexible exchange rates were beyond the control of many governments and at the same time fundamentally changed the framework for economic policy.

Thus, we make a distinction between policies that change institutions (Ordnungspolitik) and process policies. The latter cover the traditional macroeconomic policies that strive to influence macroeconomic variables like GDP growth, inflation rates or exchange rates. Of key importance is monetary policy, which is the most direct process policy. An increase or decrease of the refinancing rate dictated by the central bank influences GDP growth and/or the price level. No less significant is fiscal policy as a process policy. An active expansionary fiscal policy, for example, targets an increase in GDP growth. As explained above, wage policy is possible in some countries, whereas in other countries institutions for wage policy are missing. Foreign economic policy can also become an important process policy. It depends on the exchange rate system and the embeddedness of a country in the world market whether the exchange rate can be used as a policy instrument or not. If possible, a country can use the exchange rate to foster export-driven growth. The stabilisation of the exchange rate can also be used to give the domestic price level an anchor and to fight against inflationary processes. From the long list of asset market bubbles and financial crises in developing and developed countries – for example the asset price deflation in Japan in the early 1990s, the worldwide stock market crisis after the end of the dot-com bubble in 2000–2001, or the subprime crisis in the United States after 2007 – it becomes clear that the financial system has many important macroeconomic dimensions that influence process policies deeply. Therefore, the financial system is an important part of a macroeconomic policy regime.

If we take the institutional dimension and process policies into account we arrive at the following five elements of a macroeconomic policy regime (see Figure 2.1): monetary policy, fiscal policy, wage policy, foreign economic policy and the financial system. The monetary, fiscal and foreign economic policies of a country always involve institutional dimension and process policies. Wage development always has an institutional dimension. However, whether wage policy is possible depends on the specific situation of a country. Finally, the structure of the financial system thus far only has an institutional dimension. Usually, each element of an economic policy regime influences all other elements of the regime.

In this book we first describe and analyse the different macroeconomic policies in a country, including their interaction. Theoretically and empirically we find successful and unsuccessful types of policy mix leading to positive and negative economic results. A simple measure of a positive performance of a country is high GDP growth combined with low unemployment. We are

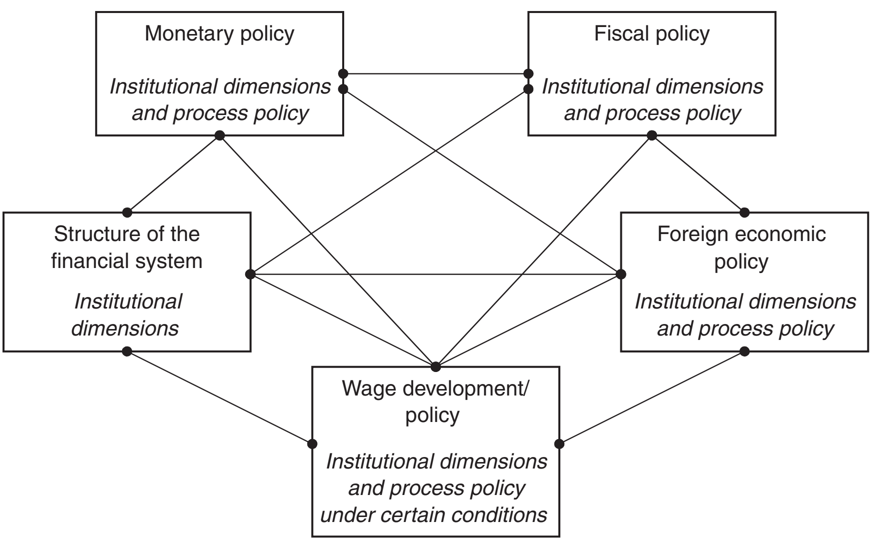

Figure 2.1 Elements of a macroeconomic policy regime (source: authors' illustration).

certainly aware of the fact that GDP and even GDP per capita is not a perfect welfare measure as it ignores especially ecological effects and income distribution. However, the elites in all of the countries we analyse were and are still attempting to achieve high sustainable growth and higher employment through GDP growth. We look to see how the different countries have managed to control the capitalist process in their economies to achieve these results.

We do not argue for permanent high growth for developed countries as a target as such. Instead, we believe that in the long run industrial countries should use their increasing productivity for shorter working hours and not for higher output (Keynes 1930a). But we also hope to contribute to an understanding of how to control and how to manage a capitalist economy. The better this is understood, the higher the chances will be of avoiding crises and also of following a conscious policy for full employment even without growth.

Economies are characterised by uncertainties. This means that not all future events are known and even for known events it is difficult to find probabilities. With such an approach there are no models available that can fully explain expectations. There are no axiomatic foundations to determine expectations and there is also no sound psychological model to solve the problem. The only solution is to assume that expectations are given for the economy exogenously. The other 'solution', i.e. following rational expectations and assuming that expectations are identical with the equilibrium outcome of the model and in this way disappear as independent variables, lacks plausibility.[3] This argument requires further explanation: it does not mean that economists cannot say anything about expectations. The point is that expectations also depend on historical time and place and cannot be discussed without taking into account the institutional, social and political constellation in countries and in the world economy. Expectations depend on factors like 'conventional judgement' or 'animal spirits', as Keynes (1936, 1937) emphasised, and are not anchored in economic fundamentals given by objective factors. 'Soft' categories like conventional judgement capture the idea of economic agents having to act in a world with an uncertain future. In such an environment institutions that reduce uncertainty (Kregel 1980) or tradition and convention become important. Expectations also depend on factors other than ones of economic nature. In this sense expectations are one of the channels between the economic subsystem and the rest of the social system. Hence, conditions in the social environment, expectations, institutions, political factors, as well as economic policies, become relevant to the understanding of economic development. Expectations are not stable. It is likely that expectations can change quickly and violently. The expression 'conventional judgement' also implies that normally economic agents change their expectations in the same direction, so that general shifts in conventional judgment are typical.[4]

Economic development is also not independent of history (Hicks 1979). If economic agents believe in different fundamentals, mere chance may decide which fundamental will become dominant. This also implies that development is path dependent. George Akerlof and Robert Shiller (2008: 12) give a nice example. After Hurricane Katrina in 2005 destroyed large parts of New Orleans it was questionable as to whether New Orleans would be rebuilt or not. If the opinion prevailed that many people would rebuild their homes in New Orleans, it would be rebuilt. If, on the other hand, it were a common belief that many people would not go back to New Orleans, it would not be rebuilt, as nobody would like to live without neighbours or shops. In such cases we can speak of a self-fulfilling prophecy, an expression coined by the sociologist Robert Merton (1949). The economy is full of such phenomena. Shocks like a financial crisis can change the long-run development path of an economy. Expressed in a formal way, various equilibria can come into being, including undesirable ones (New Orleans is not rebuild, long-term stagnation, etc.). Market forces do not necessarily have to tend towards equilibrium. Markets can create processes that bring the economy into a more and more fragile and unstable constellation. We use equilibrium as an analytical tool. However, we do not assume that markets by default tend towards equilibrium. Instead, we assume that stabilising institutions and adequate process policies are needed to prevent a market economy from suffering from permanent instability.

Under the conditions of uncertainty and unanchored expectations economic fluctuations do not follow any long-term trend that can be set objectively. Trends arise solely as a statistical result of the previous development. Thus, we reject ideas of fundamental factors that determine long-term growth and a business cycle moving around this long-term trend without changing it. We consider growth models on the basis of production functions such as those in the tradition of Robert Solow not very helpful in explaining economic developments.[5] Rather, we assume a sequence economy with a succession of phases (Hahn 1981). The respective phases depend on the corresponding specific historical constellation including the macroeconomic policy regime of a country.

A macroeconomic policy regime possesses certain durability because the relevant institutions, traditions and macroeconomic policy strategies of a country do not normally change 'overnight'. Thus, they affect the medium-term, or, if they are stable over a long period, the long-term prospects of a national economy. Therefore, an economic policy regime generally consists of a number of sequences and is usually longer than a business cycle.

Since an economic policy regime is embedded in various specific institutional frameworks and based on strategies followed by economic agents and policymakers with certain inertia, it cannot, as mentioned above, be solely created by economic policies. Also, positive economic policy regimes can arise without resulting from coordinated or deliberate policies. They simply reflect luck. Equally, in almost all cases a negative economic policy regime is not a planned outcome.

Our approach implies that there are different types of capitalism depending on the institutions in place and the economic policies followed. Of course, certain types of macroeconomic policies are only possible if a certain type of capitalism exists. If, for example, international capital flows are regulated, the banking system is state-owned and the interest rates of the banking system are dictated by the central bank, different policy options are possible than in a country with an unregulated domestic financial market and full integration into the international capital market. However, given certain institutions there is room to choose between different macroeconomic policy mixes.

Analysing institutions and policies that change them and process policies is not very common. In many regime analyses the emphasis lies on institutions as building blocks of regimes (see for example Hall and Soskice 2001). Process policies and the analysis of a policy mix to influence macroeconomic variables are usually excluded in institutional economics. Or, there are analyses of a macroeconomic policy mix, but the institutional changes and backgrounds are not made as clear as necessary.

2.1.2 Rational expectations and efficient financial market hypothesis

The dominant schools of thought in today's economic theories are to a certain extent all based on the neoclassical paradigm (the new classical model, the New Consensus macroeconomics).[6] The neoclassical paradigm is guided by the idea that the economy is a kind of machine which, as long it is not disturbed by misled policies, works properly and leads to welfare gains for all. Models used in this approach are methodologically based on the classical Newtonian physics. This is because the founders of the neoclassical school were strongly influenced by Isaac Newton in forming their theories. The essence of this methodical approach has remained unchanged to this day. The models developed in the neoclassical tradition are thus independent of the historical situation of a country. Differences in national institutions, unique national or regional features, traditions or historical situations do not play a significant role here. Even economic policy is unimportant or of secondary importance for the long-term economic development of a country.

This viewpoint was most radically emphasised in the new classical model with its basic assumption of 'rational expectations' (see for example Muth 1961; Lucas 1973 and 1981; Barro 1974 or Sargent 1979). John Muth (1961: 316), the father of rational expectations, gave the definition: 'I would like to suggest that expectations, since they are informed predictions of future events, are essentially the same as the predictions of the relevant economic theory.' We have to savour this. It means that expectations disappear as independent variables from economic models as economic agents expect the equilibrium outcome of the economic model. For the model builder rational expectations are of great help. The proponents of this theory can build their models without being disturbed by such nasty problems as time and expectations. Economic models capture fundamentals and it is simply assumed that economic agents expect these fundamentals. In this way, expectations are made endogenous and at the same time removed as independent factors in explaining economic development.

Later Muth's model of rational expectations was made more complicated without changing its substance. It was argued, for example, that there is no perfect foresight and economic agents only in a probabilistic sense are able to predict future variables. However, the probabilities that are important for economic models are assumed to be objective probabilities. As probabilities of future events simply do not exist, past probabilities were used under the assumption that in a probabilistic sense developments in the future are identical with developments in the past – a perfect Newtonian world (Davidson 1991).

Different versions of rational expectations exist which also became the assumption behind the efficient financial market hypothesis (Fama 1970). First, it can be assumed that all economic agents have subjective probabilities and that these probabilities are all identical with the objective probabilities. In this case the subjective-probability distribution of economic actors is identical with the true objective-probability distribution of the economic system. Second, it can be accepted that some agents have wrong expectations. However, wrong expectations have normal distribution and cancel out. Third, it can even be assumed that wrong expectations are biased and do not have normal distribution. In this case the arbitrage processes of informed economic agents will realise the equilibrium and lead to the same result as if all economic agents had subjective probabilities identical to the objective probability. In any case, expectations of economic agents do not disturb the equilibrium given by the fundamentals of the economic model.

The twin of rational expectations is the microfoundation of macroeconomics. Microfoundation simply means that the rational optimisation of a representative agent, a household, a firm or a worker is analysed; the outcome of the optimisation is then set to be identical with the macroeconomic behaviour of all households, all firms or all workers.

This kind of model creation does not seem to be very plausible to us since there is no way in which all economic agents will attach credibility to the same economic model, nor, moreover, can their expectations be established on the basis of objective probabilities. Even experts in economics do not base their arguments on the same model and give different predictions about future economic development. The microfoundation of macroeconomics ignores one of the basic outcomes of macroeconomic thinking: the phenomenon that rational microeconomic behaviour of individuals can lead to suboptimal and even disastrous macroeconomic results. And there are plenty of examples to show that rational individual behaviour can lead to bad macroeconomic results (Shiller 1978; Palley 1996: 87ff.).

Neoclassical models and approaches in their tradition tend to stress the role of flexible and liberalised markets, good incentive structures, optimal allocation and innovation-friendly economic policy for economic development. Macroeconomic policies are considered to be of secondary importance. Macroeconomic polices should not disturb the microeconomic process of optimal allocation – this is the best macroeconomic policy can do. We are sceptical about such arguments. This is because improving allocation does not automatically lead to economic dynamics. If an economy is characterised by a lack of demand, a better allocation and even a jump in productivity will not increase GDP growth and employment – in fact, unemployment can be the result. Thus, a policy of allocation improvement and productivity increases leads to a dead-end when the macroeconomic constellation does not provide a sufficient increase in demand and output. This of course is not an argument against improving allocation and productivity. But there is no way around the recognition that without active and good macroeconomic policies, microeconomic improvements will become meagre in the end. And it also should be seen that high investment stimulates productivity as new technologies are nearly always incorporated in new investment goods.

Our rejection of 'Say's law', which assumes that the supply side of the economy determines output and creates sufficient aggregate demand, is reflected in this conclusion. The neoclassical postulate that there is a market between current savings and current net investment and that the interest-rate mechanism always channels all ex-ante savings into investment does not hold (Heine and Herr 2003). Output in most historical constellations, i.e. all constellations with unused capacities and unemployment, depends on aggregate goods demand and is not restricted by supply factors. If Say's law does not hold true, the neoclassical (and classical) dichotomy of the economy between a monetary sphere and a real sphere is not sustainable. We assume that money or monetary policy and economic policy in general are not neutral in the short, or in the long term.

New Keynesian economics, which has gained dominance in recent years at the expense of new classical thinking, assumed the concept of rational expectations and the microfoundation of economics. The difference between New Keynesians and new classical economists is that the former find imperfections on the microlevel, which disturb the economy. Such imperfections are based on rational behaviour and optimisation and, in this spirit, are part of markets. Such examples are: If menu costs exist to change price lists, prices may become sticky for some time and disturb the economy. If firms try to prevent shirking, they pay higher real wages than market wages to motivate employees or expose them to the risk of losing well paid jobs. If all companies follow such a strategy, the real wage level is above the equilibrium level and unemployment can result (efficiency wage theory). Given such imperfections, macroeconomic policy becomes important in the realisation of high employment – this is the important difference from the new classical model (Mankiw and Romer 1991). However, the New Keynesian model is completely different from the approach followed in this book.

In the following sections we analyse the different elements of the economic policy regime in detail. Our departure point is the financial system.

2.2 Financial system

2.2.1 Prototypes of financial systems

Financial systems can be regulated and function in completely different ways. We will present two prototypes.