

Post Crisis Lessons: Changing Macroeconomics and Morals⁺

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Abstract

This paper will argue that the American economy, in the longer run (within a matter of years), it will somehow convert the revealed moral weaknesses to its advantage. America has a long record of learning from its excesses to improve the working of its particular brand of capitalism, dating back to the imposition of antitrust controls on the robber barons in the late 1800s and the enhancement of investor protection after the 1929 crash. The American economy has experienced market imperfections of all kinds but it almost always has found, true, not perfect, but fairly reliable regulatory answers and has managed to adapt to change, (e. g. Dodd-Frank Act on financial stability). The U.S. has many times pioneered in the elaboration of both theoretical and policy oriented solutions for conflicts between markets and government to increase economic welfare (Bernanke, 2008, p. 425). There is no single reason why it should not turn the latest financial calamities and the sharply eroded morals to its advantage. At the same time, to regain confidence in capitalism as a global system, global efforts are indispensable. To identify some of the global economic conflicts and the need for changing both mainstream macroeconomics and morals, we seek and provide some intuitive answers to global systemic questions.

Keywords: Open economies, US Economy, Global financial imbalances, Banking regulations

JEL: E32, G01, H12

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Introduction

The credit crisis was certainly not one of those “forecastable” events. If we ask why economists failed to predict the credit crisis, we should also ask why political scientists failed to predict the recent Arab Spring, or a terrorist event like 9/11, or why seismologists cannot predict earthquakes.

Raghuram Rajan

Will the United States stay the main engine of world economic growth for quite some time to come, or at least in the current decade? Will and should the United States, as the single largest open economy of the world, be in some way responsible for the provision of global economic stability as a valuable public good?

⁺ This is an updated and revised version of an earlier, version of my paper *Post crisis lessons: are they all ne ?* which was published in *Society and Economy*, Vol. 14, 4, 2011. Some of the points and the conclusion have been redrafted reflecting the discussion held in the International Competitiveness Section of the Chinese-European Cooperation for Long-term Sustainability, Nov. 10-11, 2011 BCU, Budapest. The author is thankful to all discussants. All remaining errors are his.

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Was the recent crisis predictable? These are the main questions addressed in this paper, all of which are answered in a new global context, and the responses are based on some known principles of international economics and economic history.

The American economy, the European Union and with it Capitalism in general, have had serious troubles lately. Not, with luck, as serious, as in 1929, when a stock market crash on Wall Street set off the global Great Depression, but serious, nonetheless. In a longer perspective, 2001-2011 might come to be seen as the 10 years -when after two decades of mostly unbroken progress- capitalism gave way to something more ambiguous and uncertain. U.S. corporate governance, capitalism American style has received a lot of criticism. But, after all, we believe, it is human behavior that can be blamed for the troubles and not capitalism in general. In this sense, the above-cited words of Fed chairman, Alan Greenspan most properly encapsulate the story of the recent evaporation of enormous amounts of wealth. The decade of 2001-2011 were the first, perhaps since the start of America's great equity bull market in 1982, when the U. S. and the world became significantly less wealthy.¹

The capitalist system, the American economy and the international financial markets in general, however, have proved surprisingly robust in the face of recent crises. They have shown their muscles and also their willingness to adapt to change. But, if they are to keep their strength, there should be some systemic changes and indeed global efforts are to be made.² After the severe blows dealt to the trust and values of American capitalism, one wonders whether the U.S. economy will preserve its dominant world economic position, and whether it will stay an attractive place to invest. In many countries, experience calls the American model and its morals into question in any case.

This paper will argue that the American economy could and will absorb the recent shocks, and that in the longer run (within a matter of years), it will somehow convert the revealed weaknesses to its advantage. America has a long record of learning from its excesses to improve the working of its particular brand of capitalism, dating back to the imposition of antitrust controls on the robber barons in the late 1800s and the enhancement of investor protection after the 1929 crash. The American economy has experienced market imperfections of all kinds but it almost always has found, true, not perfect, but fairly reliable regulatory answers and has managed to adapt to change, it has tightened up banking standards and on morals (e. g. Dodd-Frank Act on financial stability). The U.S. has many times pioneered in the elaboration of both theoretical and policy oriented solutions for conflicts between markets and government to increase economic welfare (Bernanke, 2008, p. 425). There is no single reason why it should not turn the latest financial calamities to its advantage. At the same time, to regain confidence in capitalism's mechanisms and in its underlying morals as a global system, global efforts are indispensable. To identify some of the global economic conflicts that have a lot to do with U.S. markets in particular, we shall seek answers to the following questions.

In a systemic perspective, what are the primary transmitters of global competitiveness with the proper coordination mechanism? What are the systemic impacts of the U.S. economy on world markets? Will the United States stay the main engine of world economic growth for quite some time to come, or at least in the current decade? Will and should the United States, as the single largest open economy of the world, be in some way responsible for the provision of global economic stability as a valuable public good? We offer affirmative answers to these questions.

¹ Total global marketable wealth-that is, all assets traded in the financial markets, such as shares and bonds, fell by almost 40% over the last ten years, according to a study by the Boston Consulting Group. The number of households with at least \$250,000 of marketable wealth dropped from 39 million to 37 million. (www://quote.Bloomberg.com/newsarchive). For a more detailed analysis of the changing wealth positions of different countries and world economic regions as reported by World Wealth Report, 1.6 trillion (1600 billion worth of financial assets evaporated only in the US markets alone).

² The most awful shock of 2001 was the terrorist attack on September 11th. The financial system stood up to it remarkably well. A lot of credit was due to the central banks and to the IMF itself, the pledge made by Hörst Köhler, IMF chairman of the Board, right after the disaster „*There is commitment to ensuring that this tragedy will not be compounded by disruption to the global economy, our central banks will provide liquidity to ensure that financial markets operate in an orderly fashion*” has entirely been lived up to (IMF Survey, Vol. 30. No.18, September 17. 2001. p.1). Moreover, both the American economy and, more broadly, the world economy have rebounded much more strongly than anybody dared hope. Yet the attacks proved that even where capitalism is well established, it is increasingly vulnerable to those who hate it. No amount of success in the current war on terrorism will eliminate this hideous new risk, which is impossible to quantify. 7 years later, John Lipsky remarked in his speech at John Hopkins University, Towards a Post Crisis Economy, re-emphasized the same principle saying “*these reforms can only be successful if they rest on the principles of free markets* “ www.imf.org /external/speeches/2008/111708.htm

1. Key Macro Economic Principles

A./ The underlying framework of analysis in the paper relies on some standard propositions of open macroeconomics. Krugman-Obstfeld (2000, 2003, pp. 344-377) However, in our discussion we shall use these propositions as basic principles that may be subject to varying interpretations as function of a changing domestic and global environment. We consider both individuals (consumers and investors), firms and government as economic agents who are ready to learn from past and recent experience, ones who are willing to change their behavior as circumstances change. In this perspective, we believe in the “evolution“ of both economic principles, describing relevant economic behavior, and in the adoptive learning capacity of economic agents. Thus, we do not subscribe to the idea that fixed, atemporal laws are capable of precisely capturing and forecasting future (or expected) patterns of economic behavior.

B./ We hasten to add, nonetheless, that the indispensable virtues of model-based, rigorous analysis in advancing economic theory are to be fully recognized by the author. In addition, we acknowledge that the significance of the requirement for the appropriate quantification of the outcome of economic events, and more importantly, the need to develop the capacity to forecast events, with a reasonable margin of error, cannot be overestimated. But it may not be overlooked that, to a large degree, the outcome of many fundamental economic decisions, whether individual-, firm- or government-related are based on people’s beliefs and expectations about the future. This is especially the case on the global asset markets and on foreign exchange markets that move tremendous amounts of money with a lot of lagged real effects. On these markets, people are playing against people (and central banks) that value assets on the basis of their feelings about the future. In our age, flooded with information, these feelings, at best, are largely unstable.³ Thus, trying to understand human behavior – which, is always subject to change as circumstances change, and incorporate that into economic analysis, is perhaps a genuine and valuable effort.

C./ It is an important point of departure that the U.S. economy, against the rest of the world, is still very large and the dollar continues to be the most important currency in international financial markets. Therefore U.S. policies are markedly more important - save the common policies of the euro-zone, EU-17, and EU-27 - than any other country for the evolution of the world economy. Because the U.S. economy has become more open, the foreign repercussions of U.S. policies are significant today not only for their impact on other economies but also for their influence at home. Because the other leading OECD economies have become substantially larger, and the EU-27 especially has graduated to be on a par in every sense of economic potential (output and resources in general), their policies effect the U.S. economy and the whole world economy more strongly than any time earlier.

D./ Under these circumstances, the U.S. policy makers must pay more attention to the international situation for national as well for global reasons. Furthermore, the governments of the other major industrialized nations must be viewed as a small group of economic actors whose decisions are truly interdependent and important jointly for the world economy. Thus, sub-optimal policy choices are likely to emerge in this sort of situation, and all countries can be hurt. In other words, the situation calls for policy coordination and for international supervision.⁴ In this sense, global mistakes can be worse than national mistakes.

E./ Governments engage in frequent consultations, exchanging information about national policies and comparing economic forecasts, and these routine activities can and do lead to better policies by reducing uncertainty domestically and globally. In this sense, improving the global economic outlook can be considered as a public good that offers global benefits. This reasoning would follow the analogy of the public good concept of the international financial stability, a concept fully recognized by now. In light of the recent global concerns, both in terms of global growth patterns and in regard to increasing uncertainty on international financial markets, this line of reasoning should get more attention. Keeping these global

³ This, of course, is not a new dilemma on asset (especially on stock) markets, but the IT revolution has brought about new dimensions and twists to reckon with.

⁴ In principle, one should add, coordination can also have perverse effects, when it is conducted under great uncertainty about future outlook. Why is small-group behavior likely to produce sub-optimal policy outcomes? Suppose there has been a worldwide recession. No single country may be able to recover on its own by expanding its money supply or taking other measures to stimulate demand. It runs the risk of getting ahead of the rest and facing a balance of payment deficit or seeing its currency depreciate if has a floating rate. An increase in domestic demand will raise its imports, and it can experience a capital outflow, too, especially if the increase in demand is engineered by monetary policy. When governments act jointly, by contrast, they may be able to avoid unsatisfactory outcomes. If each government agrees to generate some homegrown demand, by proper policy measures, each can hope to benefit from the other’s efforts, and can all count more firmly on complete recovery.

concerns in mind, we shall review some of the impacts that the U.S. economy has generated by its domestic economic events and has channeled them through its global links to world markets. The paper will be structured as follows.

First, as part of the introduction, we shall review the markedly changed world economic environment and its outcomes on the U.S. roles in the international division of labor. In section 1, we shall examine the changing international economic environment and the worsening debt position of the U.S. economy. Then, in section 2, we shall discuss some reborn concerns of the business cycles and the responses to it. In section 3, we shall survey some recent developments of financial market regulation which were generated in the U.S. economy but have rapidly spread to global financial markets, too. Section 4 provides a summary and a final conclusion.

1.1 A New Global Economic Environment

Classical and neo-classical trade theories have established benchmark values in economic thinking and they must have their respective chapters in all economics textbooks.⁵ However, they are increasingly irrelevant to the analysis of businesses in the countries currently at the core of the world economy: the United States, Japan, the nations of Western Europe, and, to an increasing extent, the most successful East Asian countries. Within this advanced and highly integrated “core” world economy, differences among corporations are becoming more important than aggregate differences among countries.⁶ Furthermore, the increasing capacity of even small companies and countries to operate in a global perspective makes the old analytical frameworks often obsolete (Csaba (2005, 2009)).

Not only are the “core nations” more homogeneous than before in terms of living standards, lifestyles, and economic organization, but their factors of production tend to move more rapidly in search of higher returns. Natural resources have lost much of their previous role in national specialization Rodrik (2007), (Bhagwati, 2004. pp. 128-130), as advanced, knowledge-intensive societies move rapidly into the age of artificial materials and genetic engineering (Nováky, 1999). Capital moves around the world in massive amounts at the speed of light, increasingly, corporations raise capital simultaneously in several major markets. Labor skills in these advanced countries no longer can be considered fundamentally different; modern and ongoing training has become a key dimension of many joint ventures between international corporations. Technology and “know-how” are also rapidly becoming a global pool. Trends in protection of intellectual property and export controls clearly have less impact than the massive development of the means to communicate, duplicate, store, and reproduce information.⁷

Against this background, the ability of corporations of all sizes to use these globally available factors of production is a far bigger factor in international competitiveness than broad macroeconomic differences among countries. In effect, the traditional world economy in which products are exported has been replaced by one in which value is added in several different countries and the notion of national competitiveness has gone through a dramatic change Rodrik (2007), Bhagwati (2004), Krugman (1994).

At the moment, the United States has some peculiar but significant competitive advantages. For one thing, individualism and entrepreneurship-characteristics that are deeply ingrained in the American spirit- are increasingly a source of competitive advantage, as the creation of value becomes more knowledge-intensive. When inventiveness and entrepreneurship are combined with abundant risk capital, superior R&D efforts and budgets, and with an inflow of foreign brainpower, it is not surprising that since the mid-1980s, U.S. companies - from Boston to Austin, Silicon Alley to Silicon Valley - dominate world markets in software, biotechnology, internet-related business, microprocessors, aerospace, and entertainment.⁸ Also, U.S. firms are moving rapidly forward to construct an information superhighway and related multimedia technology, where as their European and Japanese rivals face continued regulatory and bureaucratic roadblocks. The American economy provides ample opportunities for profitable investments. Little wonder that throughout

⁵ The pioneering works of Prof. Mátyás have provided a solid guarantee to this early in the Hungarian literature (Mátyás, 1973, 1992, 1996)

⁶ For countries of the semi-periphery with respect to current global trends, there are a lot of new developments to account for, and renewed distinctions to be made, for a recent work surveying these developments, see Rodrik (2007), Kozma (2002).

⁷ These new tendencies that give new opportunities to trade have been recognized and surveyed for large, as well as for small countries, early on, Kádár (1979), Csaba (1984), Simai (1994), Csaba (1994, 2005, 2009), Szentes (1999), Török (1999), in the Hungarian literature, too.

⁸ For empirical evidence explaining the early breakthrough of U.S. High-tech industries in an imperfect competition framework by some new factors of competitiveness, see Magas (1992).

the last two decades the U.S. economy has been receiving continuous and large doses of foreign (investment) capital. Foreigners like to invest in the U.S. But there are some other, maybe, less obvious reasons that explain why the American investors' money gets external support. Of course, the excellent opportunities, the big attraction of returns far exceeding normal profits have, at times, lead to excesses, to misuse of funds, as well to outright frauds. We have been hearing lately more of the latter in connection with the revealed questionable ethics of some large firms of the élite corporate America. Yet, we shall argue that the strength and the attractiveness of U.S. markets will, very likely, remain (even with the largely uncertain global outcomes of the ongoing war against Afghanistan).

The two prime transmitters of competitive forces in the global economy are the multinational corporations and the international capital markets. What differentiates the multinational enterprise from other firms engaged in international business is the globally coordinated allocation of resources by a single centralized management. Multinational corporations make decisions about market-entry strategy; ownership of foreign operations; and production, marketing, and financial activities with an eye to what is best for the corporation as a whole. The true multinational corporation emphasizes group performance rather than the simple aggregated performance of its individual parts. In this sense, the multinational companies can set standards globally for the efficiency targets of the leading firms in the industry. The growing irrelevance of borders for corporations will, at the same time, force policymakers to rethink old approaches to regulation. For example, corporate mergers that once would have been barred as anti-competitive might make sense if the true measure of a company's market share is global rather than national. In general, the multinational firm is efficient and mostly successful in allocating resources with well defined global goals. One cannot argue that national economies and their governments can claim to have such goals. On the contrary, their coordination and resource allocation efforts are serving purely domestic needs.

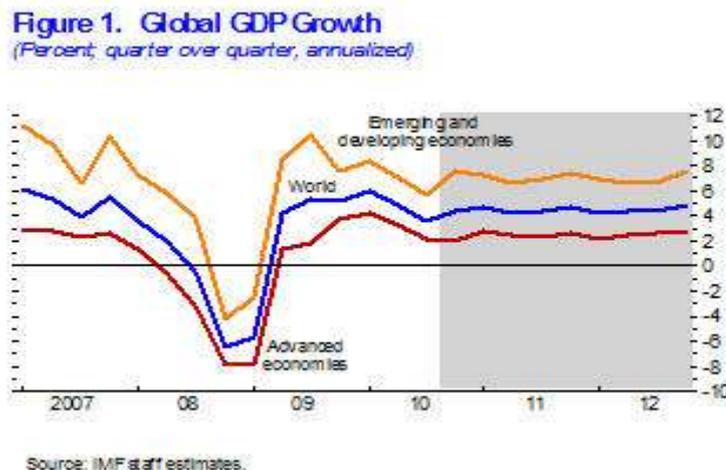
In the Hungarian literature it has been also known and extensively analyzed for quite some time, Kádár (1979), Inotai (1989), Lőrincné Istvánffy-Lantos (1993), Palánkai (1999), that global economic forces and international economic integration also reduce the freedom of governments and central banks to determine their own economic policy. At the same time, globalization and integration do enlarge the room for companies to foreign investments and multinational operations in general. Yet, the desire for making national economic policy choices does remain. If a government tries to raise tax rates on business, for example, it is increasingly easy for business to shift production abroad. Similarly, nations that fail to invest in their physical and intellectual infrastructure (roads, bridges, R&D, education) will likely lose entrepreneurs and jobs to nations that do invest. Capital - both financial and intellectual - will go where it is wanted and stay where it is well treated. In short, economic integration and the free flow of capital are forcing governments, as well as companies, to compete. Through sending the right price signals international financial markets are becoming good, yet not perfect, mediators to investors worldwide to vote with their moneys - and let them invest in economies and companies that perform best globally.

As markets become more efficient, they are quicker to reward sound economic policy-and swifter to punish the profligate. Their judgments are harsh and cannot easily be appealed. True, as markets become more global and there is enhanced mobility of the factors of production, knowledge and information, unseen types of market imperfections emerge, and with that new dilemmas are created for regulators, both domestic and international. The global financial markets for instance have been especially innovative in creating new complexities and risks that were tough matches to both under-informed investors and regulators, domestic and international alike. The American securities markets, along with the tightly knit international capital markets have produced a good deal of crises in the last two decades but none of them led to globally dire consequences or - as of yet - to a global recession. That it has not happened, both the self-regulatory mechanisms of markets and the swift and astute, yet mostly coordinated actions of financial-market regulators can be credited. For good market performance -among other things- we need efficient markets, good rules, and, of course, determined; yet not over-ambitious regulators that have a powerful bite, nonetheless. Between crisis and resolution, however, is always uncharted territory, with the ever-present potential of panic feeding on itself and spreading from one nation to another, leading to global instability and recession. What we can say about markets, however, is that they are, to a large extent, self-correcting; unlike many governments, when investors spot problems, their instinct is to withdraw funds, not add more. At the same time, if a nation's economic fundamentals are basically sound, investors will eventually recognize that and their capital will return. As a general rule, however governments and regulators learn, too. True, they learn slowly, but they do learn. At least, that is the impression one gets from the American experience of interactions between markets and government of the last two decades. Overall, the strength of the American economy in building wealth, individual and corporate, the resilience of its financial system and the attractiveness of its domestic markets, at least in the eye of foreign investors can be accredited, in no small

measure to the not flawless but flexible and mostly proper economic policy actions taken. One must add, that the satisfactory interactions between markets and government in the last twenty years or so, can be, perhaps to a large extent, credited to the quality of the American graduate economics education.⁹ This strength was reflected in measurable terms: the strong, one could say markedly superior performance of the U.S. markets stands out for the 1970-2011 period, when measured by GDP and employment growth terms and compared to the European region, now known as the EU-27 (EU-15 earlier), as was reported by the World Economic Report (WER 2011).

The future global growth patterns, however will be determined more by the strength of the demand factors of the emerging markets, and that shift will be reflected in the expected patterns of the advanced economies, too (see Figure 1 below).

Figure 1. Global GDP Growth



Note: forecasts are IMF staff estimates

1.2. Debt History of the U. S. - Where it All Began¹⁰

The U.S. economy is still by far the largest capital importer of the world economy. Even in the bad year of 2001, which was overshadowed by the September 11th terrorist attack, when foreign direct investment (FDI), fell by 51% to around USD 735 billion, (the biggest decline for over 30 years),¹¹ it remained the largest importer of foreign funds. After 2008-2010 crisis and despite the sudden waning of the cross-border merger frenzy, America still remained the largest recipient of FDI with inflows of USD 124 billion. The reasons why the United States prides itself as the number one importer of foreign capital are not self-evident. In this section, we shall elaborate at some length on the meaning of international wealth.

The United States ran trade deficits from early Colonial times to just before World War I, as Europeans sent investment capital to develop the continent. During its 300 years as a debtor nation - a net importer of capital - the United States progressed from the status of a minor colony to the world's strongest power. In 1987, the United States became a net international debtor, reverting to the position it was in at the start of the 20th century. By the end of 2010, U.S. net international wealth was -\$2.8 trillion. Does this huge amount of negative international wealth mean that overall the U.S. is using its world economic relations to attract funds to build its domestic wealth? To some extent, yes. But a large part of it goes to current consumption and some of it disappears due to exchange rate fluctuations.

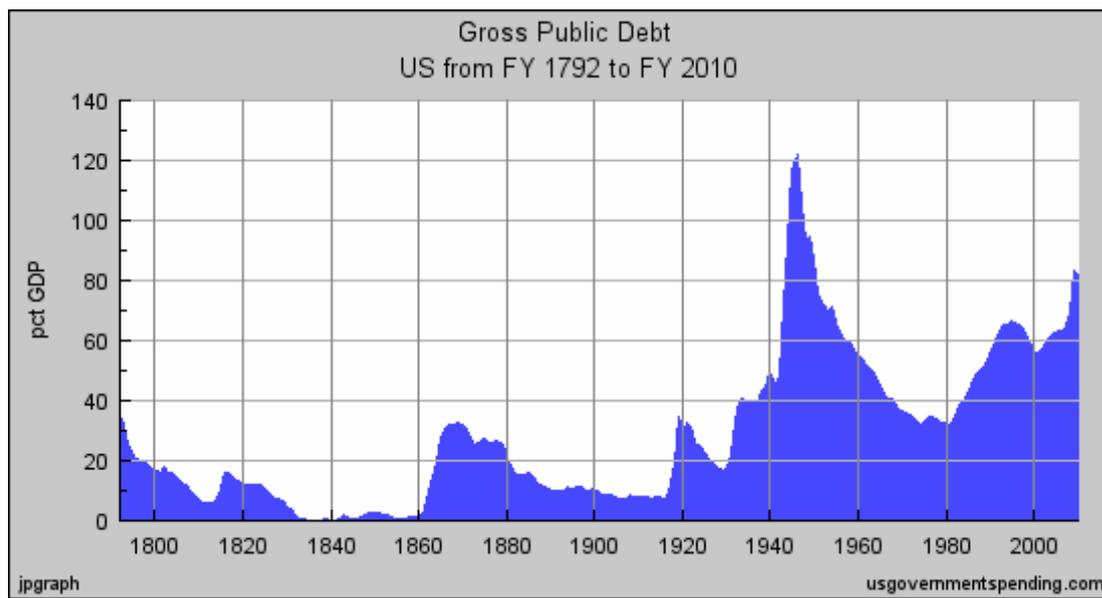
The US government was heavily borrowing from the rest of the world over the last two centuries as it is depicted by Figure 2.

⁹ This assumption is rarely made in economic analysis, yet we think it is important.

¹⁰ In this section, I extend and refine the analysis that I have given in my recent work, "Növekedés és nemzetközi forrásbevonás a világgazdaságban 1980-2000", In: Magas (2002), pp. 159-178.

¹¹ According to the World Investment Report, quoted by The Economist, „The World this week”, Electronic newsletter, 14-20 September 2002.

Figure 2. Gross Public Debt of the U.S. in % of GDP (1792-2010)



Source: St. Louis Fed.Com

How can a long-term indebtedness be maintained for a large open economy?

We begin the argument by a basic theoretical proposition:

An economy cannot have excess demands in all its markets. If there are excess in demands in some markets, there must be excess supplies to other markets. In an economy with markets for goods, market for securities and market for money this general equilibrium proposition asserts that

$$\text{Excess demand for goods} + \text{excess demand for securities} + \text{excess demand for money} = 0$$

This identity can be rewritten as:

$$\text{Excess demand for goods} + \text{excess demand for securities} = \text{excess supply of money}$$

In an open economy, this can be identified as the monetary approach to the balance of payments, which can be traced back to David Hume, who argued that that surpluses and deficits are self-correcting, because of their effects of the money supply. The modern version is an application of the Walras's law, which says that excess demands and supply must sum to zero. Applied to an open economy, it says that a country with a balance of payment deficit can be regarded as having excess demands in goods and bond markets taken together, and must have excess supply in its money market. It "exports" its excess supply of money to satisfy its excess demand for goods and bonds.¹² The monetary models of the balance of payments have been used to explain the behavior of flexible exchange rates. The monetary logic is still very appealing but empirical tests though have not been able to support it adequately to this day. Fisher (2001).¹³

Our main question in this regard is whether Japan and Europe, the main sources of foreign funds flowing to the U.S. will and/or should stay as high-savers and net international investors into the U.S., or rather, this cast among the leading industrial powers is expected to change in the foreseeable future. It will be argued

¹² For a detailed discussion of the merits and of the limits of the monetary approach, see Kenen (1988) pp. 353-371 and Száz (1991) pp. 48-84, Szentés (1999) pp. 281-426, Magas (2002) pp. 139-148.

¹³ Monetary models of the balance of payments use very strict assumptions which are hard to meet in the real world. These are: (1) There are no rigidities in the factor markets. (2) There is perfect capital mobility, so domestic interest rates are tied strongly to foreign rates. (3) Domestic and foreign prices are held together by purchasing power parity, PPP, so the domestic price level is fixed when the exchange rate is pegged. The PPP plays a central role, and there are strong reasons for doubting its validity. The PPP doctrine cannot be derived from the law of one price, which holds only across markets for a single good. It can be derived from the supposition that money is neutral, but this means that it applies to the long run and only with regard to monetary shocks. PPP should not be used to predict actual exchange rate behavior, even as crude rule of thumb.

that the for a more even future growth prospect for the world economy, the present international division of lenders and borrowers is largely unbalanced and thus is likely to change. To provide some support to this statement we shall rely on a standard open economy framework.

The standard open-macroeconomic framework, (Krugman-Obstfeld, 2000, 2003, pp. 344-377), applies a set of accounting identities that link domestic spending, savings, and consumption and investment behavior to the capital account and current account balances. By these national accounting identities, one can identify the nature of the links between the U.S. and world economies. This will follow next.

Let U.S. start with the observation that U.S. national income (or national product) Y is either spent on consumption C , or is saved, S .

$$Y_I = C + S \quad (1.)$$

Similarly, national expenditure (the total amount that the U.S. economy spends on goods and services, can be divided into spending on consumption and on investment. This relationship provides the second identity:

$$Y_s = C + I \quad (2.)$$

Subtracting (2) from (1), that is National income – National spending, yields a new identity:

$$Y_I - Y_s = S - I \quad (3.)$$

If the U.S. economy spends more than it produces, it will invest domestically more than it saves and have a net capital inflow. The U.S. has long been known a low saver and a high capital-importing country.

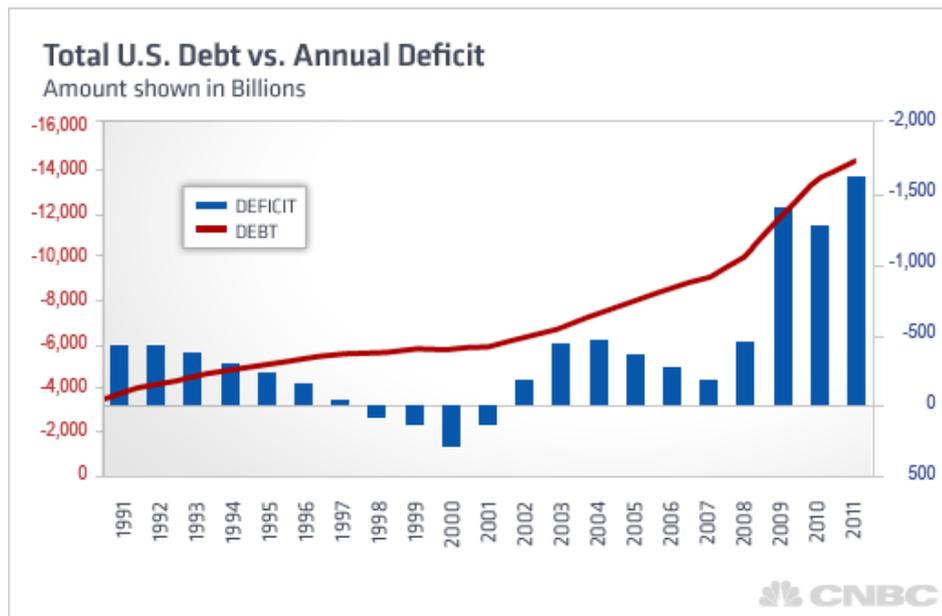
Beginning again with national product, let us subtract from it spending on domestic goods and services. The remaining goods and services must equal exports. Similarly, if we subtract spending on domestic goods and services from total expenditures, the remaining spending must be on imports. Combining these two identities leads to another national income identity:

National income-National spending = Exports-Imports

$$Y_I - Y_s = X - M \quad (4.)$$

Figure 3 illustrates the lasting borrowing needs of the United States for the 1991-2011 period:

Figure 3. U.S. Debt and Annual Deficit (Bill USD) 1991-2011



Source: U.S. Dept. of Commerce, CNBC

Equation (4.) says, that a current-account surplus arises when national output exceeds domestic expenditures; similarly, a current-account deficit due to domestic expenditures exceeding domestic output.

Moreover, when Equation (4.) is combined with Equation (3.), we have a new identity:

Savings-Investment = Exports-Imports

$$S - I = X - M \quad (5.)$$

According to Equation (5.), if a nation's savings exceed its domestic investment, that nation will run a current account surplus.¹⁴ A nation such as the United States, which saves less than it invests, must run a current-account deficit. Noting that savings minus domestic investment equals net foreign investment, we have the following identity:

Net foreign investment (NFI) = Exports - Imports

$$NFI = X - M \quad (6.)$$

Equation (6.) says that the balance on the current account must equal the net capital outflow.

These accounting identities also suggest that a current-account surplus is not necessarily a sign of economic vigor, nor is a current-account deficit necessarily a sign of weakness or a lack of competitiveness. But there are some important points to be considered in this context. Indeed, economically healthy nations that provide good investment opportunities tend to run trade deficits because this is the only way to run a capital account surplus. The U.S. ran surpluses while the infamous Smoot-Hawley tariff helped sink the world into depression. Similarly, during the 1980. In addition, nations that grow rapidly will import more goods and services; at the same time those weak economies will slow down or reduce their imports because imports are positively related to income (in the short run import propensities do not change). As a result, the faster a nation grows relative to the other economies, the larger its current-account deficit (or smaller its surplus). Conversely, slower-growing nations will have smaller current-account deficits (or larger surpluses). Hence, current-account deficits may reflect strong economic growth or a low level of savings, and current-account surpluses can signify a high level of savings or a slow rate of growth. Because current-account deficits are financed by capital inflows, the cumulative effect of these deficits is to increase net foreign claims against the deficit nation reduce that nation's net international wealth. Similarly, nations that consistently run current-account surpluses increase their net international wealth, where net international wealth is just the difference between a nation's investment abroad and a foreign investment domestically. Sooner or later, deficit countries like the United States become net international debtors, and surplus countries like Japan or Germany and the entire euro area become net creditors.

National spending can be divided into household spending plus private investment plus government spending. Household spending, in turn, equals national income less the sum of private savings and taxes. Combining these terms yields the following identity.

$$Y_s = C + I + G =$$

$$Y_s = Y_i - S - T + I + G \quad (7.)$$

Rearranging Equation (7.) yields a new expression for excess national spending, after rearranging

$$Y_s - Y_i = I - S + G - T \quad (8.)$$

Where the government budget deficit equals government spending minus taxes. Equation (8.) says that excess national spending is composed of two parts; the excess of private domestic investment over private savings and the total government (federal, state, and local deficit). Because national spending minus national product equals the net capital inflow, Equation (8.) also says that the nation's excess spending equals its net borrowing from abroad.

Rearranging and combining Equations (4.) and (8.) provides the last important national accounting identity:

¹⁴ This equation explains the Japanese current-account surplus: the Japanese have an extremely high savings rate, both in absolute terms and relative to their investment rate.

Current-account balance CA = Private savings surplus + Government budget deficit

$$CA = (S - I) + (T - G) \quad (9.)$$

Equation (9.) reveals that the nation's current-account balance is identically equal to its private savings minus investment balance and the government budget deficit. According to this expression, a nation running a current-account deficit is not saving enough to finance its private investment and government budget deficit. Conversely, a nation running a current-account surplus is saving more than is needed to finance its private investment and government deficit. The important implication is that steps taken to correct the current-account deficit can be effective only if they also change private savings, private investment, and/or the government deficit. Policies or events that fail to affect both sides of the relationship shown in equation (9.) will not alter the current-account deficit.

In the current world economic environment, in which growth in the developed countries has been sluggish and in some countries seriously depressed, there is a valid concern, though, on the merits of incessant and massive capital import and current account deficits. The large world economic imbalance of current accounts should be a matter of concern even for a country as large and attractive a place to invest as the United States, whose national legal tender happens to be the leading reserve currency for the world economy. With the wild fluctuations of currency values and the largely unpredictable nature of foreign exchange rates and with the emergence of more and more derivative products spreading risks among many international participants, (banks, investment banks, brokerage houses insurance companies, pension funds, etc.) there is a point where "internationally composed" risks cannot be properly "decomposed", measured and managed either by holders of these products, or by the financial regulators.¹⁵ Thus the idea of building (and buying assets) wealth internationally becomes somewhat blurred.

True, the trust of foreign investors in the U.S. economy has been largely unbroken even after repeated years of dismal stock market performance and the calamities of September 11. But there is lot of discussion about international payments imbalances and unsustainable patterns of world economic growth, due to the actual current account deficit profile of the developed countries. Kenneth Rogoff, former chief economist of the IMF, voiced this concern.¹⁶ He argued that the present constellation of global current account imbalances – with the U.S. in deficit and Europe and Japan in surplus, – is clearly unsustainable in the long run. The inevitable adjustment in the current account imbalances and exchange rates will be much more severe when it ultimately comes. We hasten to emphasize the significance of this argument to our analysis.

Considering that a net current account deficit represents inter-temporal trade, with the deficit nation importing more goods and services for current use and promising to repay net exports of goods and services in the future, one question must be answered. For how long can this traditional cast last, where the U.S. economy is a debtor, Japan and Europe are the creditors? It can be reasoned that for a more even and sustainable growth-pattern the world economy could surely benefit from a higher U.S. savings rate and from a higher Japanese and euro area consumption. The best thing for the global economy would be for Europe and Japan to achieve a sustained increase in growth allowing private savings in the U.S. to rise to more normal levels without a cutback in global demand. Coordinated action in this regard would surely help global growth. National goals should be also adjusted to some commonly agreed on global growth needs.

Nonetheless, for the IMF, and for prof. Rogoff, when compared to Europe and Japan, the U.S market mechanisms can be looked at as still markedly positive examples. They believe that as long as continental Europe fails to accelerate labor market reform and Japan hesitates in decisively ending deflation and addressing the need for restructuring its banking sector, the world is going to continue to look to the U.S. as the main engine of growth.

In an extensive World Economic Outlook study for 2010, the IMF has documented that the increase in business cycle correlation across the largest countries of OECD is roughly 55 per cent. This is significantly less than the correlation of business cycles across the states within the U.S. So there is a lot of room for the closing up of growth cycles and for macro policy coordination, with further integration of OECD markets.

Viewing Europe from the outside, *"reforms to facilitate EMU members ability to adjust to shocks and cope with secular change has been rather slow. Employment rates remain far below those in the US. This is*

¹⁵ For a formal interpretation of this question see Magas (2001).

¹⁶ See the seminal article in the Wall Street Journal: "Professor Joseph Stiglitz and Kenneth Rogoff offer starkly different views on hopes and risks for the world economy." WSJ Oct. 18-20, 2002 R8. The dilemma has as one which is almost unchanged, and has firmly reappeared in the 2008-2011 crisis years.

by far the strongest reason why per capita income is much higher in the U.S. than in Europe. High tax burdens, generous unemployment benefits, high minimum wages and huge costs of layoffs are among the reasons why employment is relatively low in Europe." (WSJ. 2009, Oct. 18-20. R8.)

This line of the Rogoff logic that contrasts European and American labor market efficiency is spelled out with respect to the different growth prospects of the two regions and has been firmly argued earlier by Solow (2000), too. The current European system of adjustment mechanisms is just too rigid and insufficiently adept at dealing with the environment of constant change we see in the current world economic environment. Without a clear plan for medium term budget consolidation in some of the largest countries of EMU, growth prospects remain modest. Growth will only come if Europe successfully confronts its broader structural problems. These are very strong confirmations from two top-notch economists to help us believe that the bulk of future global growth is not going to come but mainly from the future wealth - and especially the large banks - in the high-saver countries of the world economy.

But beside the large international payments imbalances between high- and low-saver countries, there are some other new global concerns departing from the U.S. economy, namely the rebirth of the business cycle concerns. We shall discuss that next.

2. Can we Read Business Cycles?

If in the coming years we shall always be looking for consumption to pick up in the U.S. and for financing from elsewhere, we may have a global business cycle problem at our hands. Cyclical patterns and their smoothing by government action are a reborn concern in the American economy itself.¹⁷ It appears, though, as if the views about governments' ability to tame the business cycle have themselves moved in cycles. In the 1950s and 1960s, it was widely believed that Keynesian demand-management policies could stabilise economies: a properly measured increase or decrease in government spending was all that was needed to reach the desired level of output. But the stagflation of the 1970s produced a new economic consensus that governments were powerless to do anything except restrain inflation. By the 1990s the business cycle returned.¹⁸ The American mainstream economic opinion has reflected this and had traditionally had the anti-cyclical stance of government spending. So, there is some evidence of learning from past experience.

The current dilemma is that three strongest economic regions of the global economy are growing at distinctly different rates and all are looking for increasing foreign demand. America's mild recession in the years 2001 followed its longest unbroken expansion in history. The euro area, until 2008 was in its ninth year of growth, it has escaped outright recession, but has seen a sharp slowdown. In contrast, Japan's economy has suffered three recessions since its own bubble burst at the beginning of the 1990s. In Europe, where inflation is not the problem but unemployment is. France has made it clear that it wants the Growth and Stability Pact redefined, so it can have a more expansionary fiscal policy. Stiglitz (2002), for instance, thinks that Europe has adopted a policy, which is pro-cyclical, which flies in the face of what it should be doing. It should be anti-cyclical (do not cut your government spending in a recession).¹⁹ Japan is indeed a great concern, too, with respect to global growth prospects. Japan needs a determined effort to clean up its banking sector, encourage needed corporate restructuring, and rein in ballooning fiscal deficits over the medium term. It

¹⁷ Cyclical behavior of the American economy was a more pronounced concern in the 1970s and in the 1980s, (Erdős T. (1976), Magas (1987).

¹⁸ The U.S. economy had three recessions between 1974 and 1982. However, since then, it has enjoyed two long booms, in the 1980s and again in the 1990s, interrupted only briefly by a mild downturn, leading many to believe that recessions were a thing of the past. For more on this issue see *The Economist*, Jan 4th 2003.

¹⁹ He argued that "Europe thought it could weather the storm on its own, but they have had their hands tied by the 1997 Stability and Growth Pact that codified the euro areas' fiscal rules. Unlike in the U.S. they have a monetary authority that is not supposed to look at employment and growth. The Stability and Growth Pact is somewhat similar to the balanced budget amendment, which the U.S. rejected on the grounds that it would be disastrous to have your hands tied in a way that makes you unable to respond to a downturn." *WSJ*, Oct. 18-20. R8. But the stability and growth pact in Europe is to be taken seriously. The European Commission issued warnings to those big EU member states, Germany, France and Italy for their excessive budget deficits. The harshest criticism was aimed at Germany, which is likely to breach the pact's ceiling for deficits of 3 % of GDP both in 2002 and 2003. This implies that strong, nationally determined choices do remain. For a detailed analysis of this conflict, see the article "Breaking the Pact" *The Economist*, Jan 4th 2003. The current, 2011 November situation is alarmingly similar where the what was at stake was the breakup of the Eurozone (see more on this *WSJ*. Nov. 2011 Nov 13.)

should act decisively to end deflation. So far, Japan has tried a gradualist, “muddling through” approach. Far more ambitious and sweeping reforms are needed. To some extent Japan is wrestling with the crisis of the Japanese corporate model of a kind. The traditional sources of growth, as accounted for by Móczár (1987), have not been fully exhausted, they are just being suppressed by a deep and unusually stubborn deflationary cycle.

Figure 4. Business Cycle in the OECD Countries 1990-2010

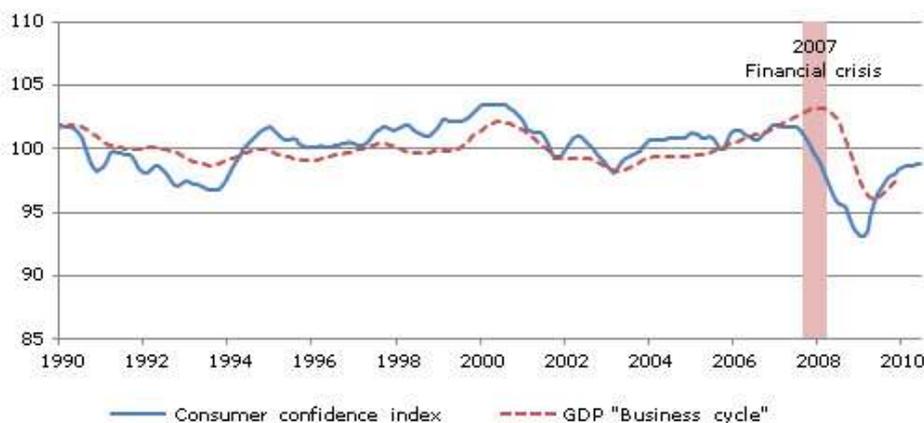
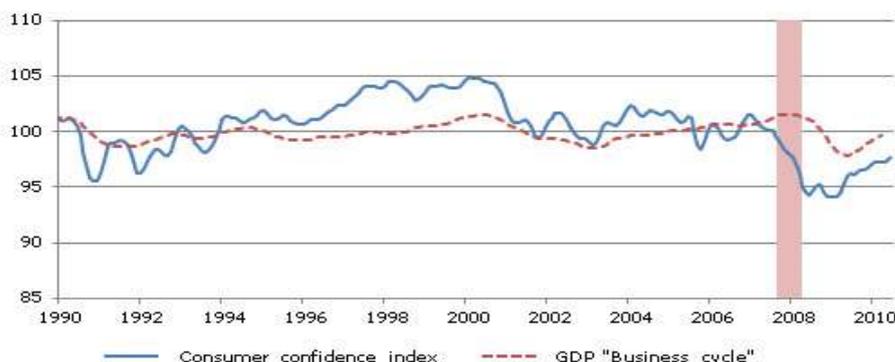


Figure 5. Business Cycle in the US Economy 1990-2010



Source of Figure 4. & 5.: OECD Economic Data Bank

In relation to the steep economic downturn in the U.S. and in world markets in general, one question is often asked: Do Central bankers monitor inflation and cycle-related wealth effects together?

In the U.S., the Fed does take asset prices into account in its policymaking, but only in so far as changes in them are transmitted to demand in the economy and thus potentially affect the rate of inflation. The likely transmission mechanism is the “wealth effect”. As share prices rise, people feel better off and spend more; as they fall, people feel poorer and spend less, reducing inflationary pressure. In practice, the FED has seemed to act on the wealth effect only after share prices have fallen. For instance, when prices tumbled after the collapse of LTCM, (The Long Term Capital Management Hedge Fund), the Fed cut interest rates sharply, and shares started to recover at once. Given that a central bank could never be 100% sure at the time that there is a bubble, would it be justified in trying to burst it if it were 80% sure, or 40%? This is a difficult question, and not just because raising interest rates would be unpopular; if it were raising rates to control inflation, it would willingly bear that burden for the sake of the economy. Keeping inflation under control does not challenge people's judgments; by maintaining the real value of the currency, it actually helps them to be confident that a price means what it appears to. By contrast, asset prices reflect the free judgments about value made by millions of people who have backed those judgments with their own money. Over the past decade investors, firms and consumers worldwide put far too much faith in the power of information technology, globalisation, financial liberalisation and monetary policy to reduce volatility and risk. It did not

pay off. ICT, information communication technology, the very sector that was supposed to smooth out the business cycle through better inventory control, has ended up intensifying the current downturn. In principle, globalisation can help to stabilise economies if they are at different stages of the cycle, as was suggested by Obstfeld (1998), Pugel-Lindert (2002, pp. 552-554), but the very forces of global integration are likely to synchronise economic cycles more closely, so that downturns in different countries are more likely to reinforce one another. Financial liberalisation is supposed to help households to borrow in bad times and so smooth out consumption, but again it has trade-offs: it also makes it easier for firms and households to take on too much debt during booms, which may exacerbate subsequent downturns. This is what happened in the first half of the 1990s in Japan²⁰.

In the United States, Alan Greenspan is widely considered a highly successful chairman of the Federal Reserve, but the belief that he has special powers to eliminate the cycle is probably naive. In July 2001, Mr. Greenspan himself said in testimony to Congress:

“Can fiscal and monetary policy acting at their optimum eliminate the business cycle? The answer, in my judgement, is no, because there is no tool to change human nature. Too often people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the build-up or cessation of speculative excesses.” (As quoted by Reuters news service)

Indeed, speculative excesses in asset prices and credit flows might occur more frequently in the future, thanks to the combined effects of financial liberalisation and a monetary-policy framework that concentrates on inflation but places no direct constraint on credit growth and wealth effects.

*“It's only when the tide goes out that you can see who's swimming naked.”*²¹ A witty and realistic description of what was happening in the American economy lately. The stock market boom in the late 1990s masked excessive borrowing by firms and households, “irrational exuberance”, - the expression of Alan Greenspan - and infectious greed is being shockingly exposed. Share prices have suffered their steepest slide since the 1930s. Yet, this was not a normal business cycle, but the end of the biggest stock market boom in America's history. Never before have shares become so overvalued. Between 1997-2001 share prices of the S&P 500 index reflected 30-50% more reported profits than the national accounts profits registered at year end by official GDP statistics.²² Never before have so many people owned shares. And never before has every part of the economy invested (indeed, over-invested) in a new technology.

In short, it appears that the business cycle is still alive, but it does appear to have become more subdued. During the past 20 years, the American economy has been in recession less than 10% of the time. In the 90 years before the Second World War, it was in recession 40% of the time. In most other economies, too, expansions have got longer and recessions shorter and shallower. The exception is Japan, which in the past decade has suffered the deepest slump in any rich economy since the 1930s.

The revolt against Keynesian policies since the 1970s was based on the belief that government intervention is inefficient and it may destabilise the economy. However, America's recent experience has shown that the private sector is quite capable of destabilising things without government help. The most recent bubble was not confined to the stock market: instead, the whole economy became distorted. Firms over-borrowed and over-invested on unrealistic expectations about future profits and the belief that the business cycle was dead. Consumers ran up huge debts and saved too little, believing that an ever rising stock market would boost their wealth. The boom became self-reinforcing as rising profit expectations pushed up share prices, which increased investment and consumer spending. Higher investment and the then still strong dollar helped to hold down inflation and hence interest rates, fuelling faster growth and higher share prices. That virtuous circle has turned vicious and did tremendous damage: since March 2007 until December of 2009, the Dow Jones Industrials Stock Index has fallen by more than 49%, some \$7 trillion has been wiped off the value of American shares, equivalent to two-thirds of annual GDP!²³ In addition, global growth is still very cyclical.

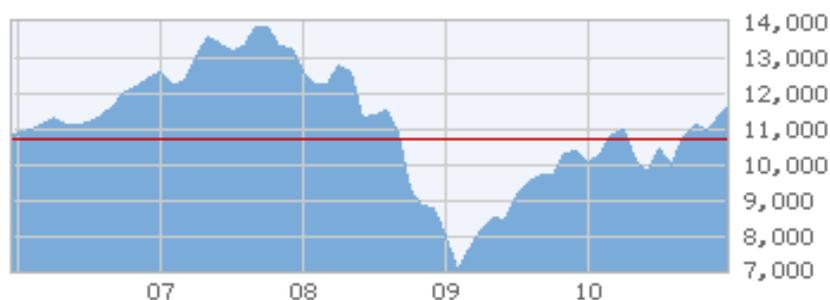
²⁰ For a detailed description of the Japanese growth problem related to over-borrowing in the first of half of the 1990s, see Magas (2002) pp. 403-410.

²¹ This sarcastic remark can be often heard in the American financial community. The phrase is said to have been used first by Warren Buffett, one of Wall street's best-known investors.

²² Source: Dresdner-Wasserstein; Thomson Datastream 14 Dec. 2004

²³ As reported by Goldman Sachs, U.S. Weekly Analyst, March 24, 2011-, quoted by Thomson Datastream

Figure 6. Performance of DOW Jones Stock Index 2077-2011



Source: Bloomberg.com

If labour productivity remains strong, it should help firms to restore profits as well as ensure robust long-term growth. The slide in the stock market, then, may only reflect a crisis of confidence in corporate governance and accounting fraud, not deep-seated economic problems. It is true that until 2010 America has benefited from faster productivity growth since the mid-1990s (although the rise is less than once thought).²⁴ But, as with all previous technological revolutions, from railways to electricity to cars, excess capacity and increased competition, in the long run, are ensuring that most of the benefits of higher productivity go to consumers and workers, in the shape of lower prices and higher real wages, rather than into profits. This is the highly desired outcome of any well-performing capitalism. Equity returns are therefore likely to be a lot lower over the next decade than the preceding one. As a result, households will need to save much more towards their pensions, which - other factors being unchanged - will drag down growth somewhat. But even then, it's very likely, for the U.S. economy to recover and gather sustainable momentum with the recent fiscal and monetary stimulus, there is no other safe way out for long term growth but increasing domestic savings and rely less on foreign funds.

To sum it all up, we conclude that after decades of declining economic volatility in developed economies, the business cycle may become more volatile again over the coming years mainly as a function of the changing fortunes of asset markets and with it the volatile wealth position of American savers and consumers. In addition, the IT revolution and globalization apparently have not deleted the business cycle.

3. Regulation of Motives or Morals?

Many think that a single regulator along FSA lines would be good for America's capital markets for its mechanisms and for its morals. Serious doubts remain. The Dodd-Frank Financial Act has reformed the entire system for the satisfaction of almost all players, true the product is lengthy, it is incorporated into twenty five hundred pages of new legislation.

So far America's cumbersome regulatory system does not seem to have retarded the development of its markets, but in the long run it may prove costly, particularly if-and it is a big if-the European Union succeeds in fully integrating its capital markets and introducing appropriate regulation. America has long boasted of having the most efficient capital markets in the world, and to date that has broadly been true. But its unwieldy system of multiple regulators could become a competitive disadvantage should Europe develop a better, less costly regulatory mousetrap. Indeed, it is possible that pressure from the EU will help to consolidate American regulation. Under a forthcoming EU directive, any financial conglomerate operating within the Union will have to choose a main EU regulator who will be responsible for global supervision of the firm. In practice, the European regulator for the big American firms, such as Goldman and Citi, will probably delegate by requiring the firm to nominate one of the American regulators as its „co-ordinating regulator”, which would become a de facto single national regulator for the firm.

Global regulation of morals and that of motives is clearly another matter. Even if the infrastructure for effective global regulation were in place, huge challenges would remain. Some are of an intellectual sort. „How much failure should a regulatory system allow?”, e.g. it should be more than zero, and less than would cause system-wide collapse. It may be a tribute to American regulation that Enron was actually allowed to go

²⁴ The first two waves of the computer age starting in the early 1980s for some very special reasons - and to a large extent paradoxically - did not bring the long expected productivity gains for the American economy. For a detailed discussion of the probable causes of lagging productivity growth in the first half of the 1990s, see Magas (2002) pp. 392-403.

bust, and luckily this does not appear to have had system-wide consequences. Some countries might have tried to organise a rescue; indeed, even the Fed has a reputation for keeping alive firms that should have been allowed to die. Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. Many worry that regulators and financial firms alike are better at judging the relative riskiness of different instruments, institutions and counterparties than the total risk in the system. The worries became more than evident after the Lehman events.

Basel 3, a more sophisticated version of risk-based capital rules, is now in the pipeline. It is meant to apply not only to big banks but to all banks worldwide, and to all investment firms in the EU. There is also talk of an insurance Basel 3 before long. But Basel 3 has met with considerable opposition, partly because it is too complicated, partly because some countries disagree over how much capital should be set aside against some sorts of loans. Germany wants a lower capital requirement for loans to small businesses, for example, because bank loans are their traditional source of funding. The launch of the new regime, originally scheduled for 2013, has already been delayed until 2014, and even that may prove to be optimistic. Meanwhile, the banks are operating with a capital regime that does not work as intended, but may be lulling regulators into a false sense of security.

In determining regulatory capital, Basel 3 would give an even more important role to credit-rating agencies such as Moody's and Standard & Poor's. How good their ratings are is the subject of much debate. As an alternative, banks will be encouraged to use their own in-house credit ratings. But regulators still mistrust the use of quantitative credit-risk models to set regulatory capital. They need better techniques and better data, especially in Europe.

Many big banks already use quantitative models to assess how much capital they need to set aside against portfolios of marketable securities. These „value at risk” (VAR) models typically measure the most the firm could lose in a day, judging by past performance, but they tend to underestimate the frequency with which really bad days occur. There have been half a dozen „perfect storms” in the market in the past decade, during which VAR calculations proved useless in predicting losses. Stress-testing portfolios against imaginary perfect storms remedies some of the weaknesses. But modelling credit risk in this way is much harder, not least because data about past credit performance are scarce.

Another market-based system of regulation has also received some attention. If banks issue short-term subordinated debt that is traded every day and has to be refinanced regularly, and can stay in business only as long as the debt is refinanced, then the market will in effect regulate the bank. Lenders will not finance a bank they think is in risk of default. Alas, the only country to have tried it so far has been Argentina, where the government's fleecing of the banking system after its debt default rather spoilt the plot. The recent unmet claims of US hedge funds on 2001 debts gibe headaches to both Argentine authorities and to and US regulators

Regulators are only too aware that the sheer complexity of the financial system imposes practical limitations on what they can do. Increasingly, they are having to rely on the private sector to assist them in their regulatory task. They simply do not have the capacity to find out what risks are being taken inside a large international bank unless it tells them.

The new global dilemma, and with it the real danger, that the risk originally taken on by the capital markets will eventually find its way back into the banking system.

Given the serious political difficulties, the idea of a single global regulator is not on any serious agenda. That may be just as well: competition among regulators has some benefits. What is on the agenda, at least of the regulators in countries open to international capital, is to ensure that good information is available about the state of global markets and about financial firms' global operations. The FSA, for example, is able to regulate only Citigroup's British activities, but it will have a much better chance of doing it well if it knows enough about the health of the firm worldwide²⁵ Information is already flowing more freely between different national regulators. Multinational institutions such as the International Monetary Fund, the Bank for International Settlements and the Financial Stability Forum all play a useful part in this, but it is bilateral communication between national regulators that matters most, and the global financial system is nowhere near as transparent to national regulators as it should be (Magas, 2000b, 2009).²⁶

²⁵ In some respects, however, an inefficient regulatory system suits powerful financial firms. In the United States The Glass-Steagall laws, which kept banks, investment banks and insurers separate, survived a dozen attempts in Congress to scrap them -until 1998, when Travelers, an insurer, merged with Citibank, (which immediately ended its expensive lobbying against abolition). They went soon after.

²⁶ One reason is that no global consensus exists on what exactly should be regulated. for instance, in Britain re-insurers are regulated by the FSA, but in their home markets only, Munich Re and Swiss Re, the world's largest reinsurance

Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. The problem has been brought to the fore by the technology bubble, and the fear of a wider American equity bubble. Do regulators know when a bubble has formed and the financial system is becoming dangerously unbalanced? Probably not, with enough certainty to base policy on. What is clearer is that aggregate risk changes and flows with the economic cycle. Credit officers tend to lend too much in good times, heating up the economy, and then cut back too much in a downturn, making things worse. One way to get around this would be to require banks to set aside higher amounts of capital during economic booms than during recessions, to make risk-taking less pro-cyclical.²⁷ If this was internationally required, it would be all the better. Initiatives in this regard should come from the regulators of the largest key players of the American markets.

This is not a new development by any measure.

4. Summary and Conclusion

A./ The two prime transmitters of competitive forces in the global economy are the multinational corporations and the international capital markets. They both show revealed systemic behavior with well-defined goals and measurable efficiency. For good global market performance, however, - among other things - we need efficient markets (with respect to information processing), good rules, and, of course, determined, yet not over-ambitious regulators that have a powerful bite. In a global economic framework, however, as of yet, we do not seem to have any of these requirements met. National government choices, as well as multinational company and individual international investment decisions do remain largely within their “own” perceived boundaries, and without regard to any “globally defined” or desired goals. This present dichotomy of determining international economic events by large-country (e.g. USA, EU-27, Japan) preferences, but in fact domestic macro needs, and by firm-level multinational company preferences, is not likely to change soon. At the same time, there is increasing need to act and manage markets globally, and, as consequence there is a need to be ready to coordinate national policy actions, regulate multinational company behavior and agree on some commonly shared safety rules of international financial markets. These global coordination efforts can be looked at as contributions to the provision of global economic stability, which is a valuable public good.

B./ As a general rule, competing firms, domestic and international alike, do learn from their past mistakes and constantly adapt to change. We have reasoned that governments and regulators learn, too. True, they learn slowly, but they do learn. In this perspective, there is an evolution of concepts and proper policy actions as a function of a constantly changing global economic environment. Although the macro economy is not self-correcting, it has a learning capacity. At least, that is the impression one gets from the American experience of interactions between markets and government of the last two decades. In the American economy, overall, we argued that despite the recent dramatic weakness of the stock market, and despite the corporate scandals, the resilience of its financial system and the attractiveness of its domestic markets in the eye of foreign investors has not diminished dramatically. This surprising loyalty can be accredited in no small measure to the mostly proper economic policy measures taken, or, - if you like - to the trusted values of the American market mechanisms in general.

companies, are mostly unregulated. Non-financial firms with big financial operations do not fit comfortably into the current regulatory framework anywhere. Enron, which has been plausibly described as an investment bank or hedge fund with an energy business on the side, was not regulated in America. In Britain, the firm itself was not regulated, but its financial subsidiaries were monitored by the FSA. There are big question marks over who regulates the growing number of firms now transforming themselves into financial behemoths, modeled on GE with its huge GE Capital operation. Hedge funds and other highly leveraged institutions are regulated lightly in most countries, and not at all in America.

²⁷ How much capital financial firms should set aside against risks going wrong is the trickiest decision international regulators have to make. Since 1988, big banks have been abiding by the Basel capital regime, which links the amount of capital they have to hold in reserve to the overall risk of the loans they make. Basel-2, a more sophisticated version of risk-based capital rules, is now under way. It is meant to apply not only to big banks but to all banks worldwide, and to all investment firms in the EU. There is also talk of an insurance Basel before long. But Basel-3 has met with considerable opposition, partly because it is too complicated, partly because some countries disagree over how much capital should be set aside against some sorts of loans. Germany wants a lower capital requirement for loans to small businesses, for example, because bank loans are their traditional source of funding.

C./ Based on the international debt history of the U.S. economy, we suggested that for a more even and sustainable future growth-pattern for the world economy, a higher U.S. savings rate and a higher Japanese and euro-area consumption rate would be beneficial. This is by no means a novelty, but it can be considered as a very pressing global issue to be (re)addressed soon.

D./ Neither the IT revolution nor globalization have managed to delete, let alone iron out unwanted recessionary business cycles. In addition, we argued that central banks should constantly monitor the wealth effects too, not just inflation. This has been a recent lesson to be (re) learned. Thus, we stressed that the useful elements of anti-cyclical government interference should be kept. What is more, on-going intergovernmental efforts are needed to sustain global demand.

E./ Recent capital market developments have confirmed that there is also a need to overseeing the global impacts of international capital movements. The need for some globally co-ordinated supervision of international capital mobility is warranted if it is to match the accelerated intra-company cross border flows of funds with some regulation, to prevent the hiding of unwanted risk internationally. The trouble with today's global pool of capital is that regulators may be out of their "depth", i.e. jurisdiction. In this sense, there is an obvious need for some kind of global regulation that increases global safety standards of managing risks that are being spread over numerous international participants. Unlike domestic capital markets, global markets have no desire and means to self-police, not to mention a strong formal supervision.

But certain things do not change, as it was put by former FED chairman Alan Greenspan(2003) in one of his famous statements:

"...there is no tool to change human nature. Too often people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the build-up or cessation of speculative excesses."

When exactly the build-up collapses, well that is very hard to tell and forecast, so the Rajan (2010) statement sounds as a realistic tune:

"The credit crisis was certainly not one of those "forecastable" events. If we ask why economists failed to predict the credit crisis, we should also ask why political scientists failed to predict the recent Arab Spring, or a terrorist event like 9/11, or why seismologists cannot predict earthquakes."

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István Magas: *Post Crisis Lessons: Changing Macroeconomics and Morals. Délkelet Európa – South-East Europe International Relations Quarterly*, Vol. 3. No.3. (Fall 2012) 18 p.

Thank you for your kind collaboration. *Editor-in-Chief*