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Out With the Old, In With the New

Nearly ten years have passed since the eruption of one of the most dramatic economic and financial crises in decades, with the collapse of Lehman Brothers in September 2008 as one of its most defining moments. This crisis, which fueled fundamental systemic doubts for weeks, not only called into question the ability of banks to function efficiently and the benefits of financial globalisation; it also became a catalytic moment leading to the demise of a model profoundly based on a belief in market efficiency that for at least three decades guided economic policies in many countries, as well as in major institutions like the International Monetary Fund, the OECD and the European Commission.

While market orthodoxy was a more or less clear (and easy) guide to politicians before the crisis – leading to a growing number of free trade arrangements, increasingly sophisticated financial instruments and less regulation of goods and labour markets – this clearly has not been the case since. Deregulation is no longer the reflexive answer to problems in practical policymaking. So far, however, there is no convincing new paradigm to replace the old orthodoxy, which leads to a lot of ad hoc policies. This likely also helps explain the emergence of populist movements which have arisen to fill the paradigmatic vacuum with simplistic, unconvincing and protectionist proposals. Thus, there is an urgent need to come up with better guiding policies using lessons learned from the past decades. The papers in the following Forum are a starting point in this search.

One might argue that there has never been something like a consensus, as economists tend to have differing views on many issues. Despite decades of a seemingly strong belief in free markets, governments still play an essential role when it comes to economic activities. But Michael Jacobs and Laurie Laybourn-Langton find that paradigms throughout history have not necessarily implied that there is a consensus in economic thinking. What is called the “neoliberal” paradigm, for example, brought together very different approaches, ranging from monetarism to supply side economics. Nevertheless, they formed a common paradigm linked through a few guiding principles, like the strong belief in market efficiency as well as fundamental doubts about the efficiency of anything done by governments. As surveys among economists confirm, shifting paradigms are more about the relative, rather than complete, adherence to one kind of thinking. Before the market paradigm took off, the majority of German economists agreed that fiscal policies may have a role in stabilising the business cycle. In 2006, at the peak of economic liberalism, only a small minority of respondents still believed that there was a case for fiscal activism.

In spite of this very relative dominance in academia, there is clear evidence that economic paradigms may gain influence working through different domains, as exemplified by the shift that took place in the late 1970s and early 1980s. This shift was most clearly visible in financial markets, which underwent major deregulations in the US and in the UK under Ronald Reagan and Margaret Thatcher. As Moritz Schularick and Kaspar Zimmermann explain, these reforms were anchored in academia by a deep belief in efficient markets. If markets are efficient, the thinking went, there cannot be enough trade. Fiscal policies increasingly sought to reduce state influence. This also led to a general competition to reduces taxes as much as possible and to an orthodox approach that defined the stability criteria for the European monetary union, as Simon Tilford and Christian Odendahl argue. The rise in income inequality was seen as strengthening the incentives to work. Even in climate policies, the belief in market efficiency dominated, leading to widespread support for (market) trading schemes for carbon emissions that would dictate an optimal price and create disincentives to invest in carbon-intensive industries.

A paradigmatic shift occurring in the 1980s may seem less clear when turning to international trade. Indeed, cross-border exchange had already been liberalised in previous decades, as Sebastian Dullien points out. Still, ever-increasing free trade became one of the main guiding principles contributing to huge growth rates for global trade and the emergence of new players like China.

Huge flaws in this theory have become apparent, however. De facto financial market liberalisation led to an increase in financial crises and a historic debt explosion, as Schularick and Zimmermann argue. The old paradigm's fiscal theories have proven to be risky due to overly simplistic rules that led to pro-cyclical policies. These government policies favoured austerity in difficult times, which made the economic crisis worse while conversely not cutting enough during periods of prosperity. In many countries, governments cut investments, which led to huge infrastructure problems.

Free trade has allowed poorer nations to catch up while also causing extensive problems in richer countries where the China shock devastated entire industrial regions. In the US, people from these regions who most acutely felt the effects of this shock voted overwhelmingly for Donald Trump. Also, the rise in inequality has gone far beyond what orthodox models would have called incentives to work. As Marcel Fratzscher describes, inequality has reached critical levels even in a supposedly more balanced country like Germany.

Even in climate policies, simple market solutions have not worked as expected. As Brigitte Knopf et al. point out, emission trading has not led to steadily rising prices for CO_2 emissions, as was expected, due to the incapacity of market actors to anticipate long-term risks. This shortsightedness resulted in herding behaviour and very low prices.

All of this explains why a paradigm strongly based on the belief in nearly unlimited market efficiency is suddenly less attractive. The question remains whether there are (enough) ideas in each of the critical policy domains that could one day form a new paradigm. This is what all authors provisionally answer by establishing new theories in their various fields. And it turns out that there are new ideas.

New answers seem to be most developed when it comes to financial markets, at least in theory. According to Schularick and Zimmermann, one main objective going forward should be to restrict debt accumulation, especially housing debt. Fratzscher argues that compensating losers is insufficient for reducing inequality; more important is the creation of opportunities through education. One way to cope with the flipsides of trade may be to better anticipate whether opening borders runs the risk of causing major disruptions. Fiscal policies might reconsider how to define an optimal level of public debt. As Xavier Ragot argues, countercyclical deficit rules are crucial. Also, decision makers need to acknowledge that economic shocks generally emerge unexpectedly, and thus escape clauses from binding rules are necessary in such cases. Gustav Horn advocates raising wages in line with productivity, which would help tame current account imbalances. With regard to climate policy, Knopf et al. propose responding to market inefficiencies by publicly guaranteeing minimum (and maximum) carbon prices.

All this is certainly not enough to define a real new economic paradigm that could replace the guiding rule that markets always know better. The measures discussed will not be enough to solve problems like large and continuously increasing inequalities. It nevertheless seems worth the exercise. After the failure of the overly simple market paradigm, the world is now increasingly confronted with people who pretend to have easy answers or who promise to close borders as a reaction to the damages of free trade. There is a risk that the rise of these simplistic answers will end in economic catastrophe. The better option would be to develop new and enhanced solutions to the challenges left behind by decades of adherence to a naively neoliberal paradigm – solutions that will help to create wealth for all again.

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