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In search of a new balance between state and market[*]

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Ladies and Gentlemen,

It is a great pleasure to welcome you to Deutsche Bank's offices here in Berlin. We are delighted to be hosting this Conference. Given the list of distinguished guests – above all from academia – there could be hardly a better forum to discuss "post-crisis economic policies"!

It's clear to me that the financial and economic crisis will, in retrospect, be regarded as one of the transformational periods in human history. But while this crisis, however severe it still looks today, will eventually pass, questions about the future shape of our economic systems will remain.

These questions are not so much about the end of capitalism – as perceived or even desired by some – but rather about the different ways in which capitalism is understood in different countries around the globe. What we are witnessing right now is – if I may put it like this – an inverse revival of the 1980s debate on the role of state and market.

In the days of Thatcherism and Reaganomics, Ronald Reagan used to joke: "The nine most terrifying words in the English language are: I'm from the government and I'm here to help!"

Now that governments have spent trillions of dollars, euros and pounds on stabilizing the financial markets and the economy in general, these words seem far from terrifying for a growing number of people.

In fact, faith in the capability of the market mechanism has been dented, while trust in the power of government and regulation is increasing. After decades of consensus that the state should limit itself to setting the right framework conditions, and otherwise leave private- sector representatives to do the job, the state is now widely seen again as a beneficial force in its own right, one that should play an active role in the economy.

The pendulum swinging between the poles of state and market influence – which probably reached its widest amplitude at the beginning of this millennium – has started to swing back towards interventionist policies. And this is happening despite the fact that the crisis has not produced any clear indication of the superiority of the state (or the market).

On the contrary, government failure in the shape of inadequate financial regulation and deficient financial supervision no doubt contributed significantly to the crisis. The heavy intervention of the U.S. government in the American housing market is probably the most pertinent example.

The change in the ideological climate goes beyond the issue of the appropriate role of the state in the economy. More fundamentally, it reflects the disposition of the population at large. This is important because, ultimately, in a democratic society, it is the views of the majority of the electorate that determine the shape of our societies.

Today, there are signs that preferences may shift away from the creation of wealth towards equality, for instance. Catchwords such as "taxing the rich" and "restrictions on managerial freedom" are precursors of that debate. In a similar vein, stability may in the future be favoured over innovation.

I sense a growing willingness to forego the benefits of innovation – not only but primarily financial innovation – in exchange for a market environment that has a slower pace of change, which is assumed to be more controllable. I'm afraid these shifts will not only have a bearing on the future growth rate of the economy but also, were they to become a long-term reality, bring a number of other dangers with them. Let me mention just three:

The first danger is that the state would be at severe risk of overextending itself. The fiscal balances of the G20 economies will dramatically deteriorate as a result of the crisis. Budget deficits in the U.S. and the UK look set to soar to double-digit figures.

Certainly, deficits will improve somewhat in response to the recovery and the withdrawal of support measures. But not all measures are temporary or economically reasonable. Most governments have seized the opportunity and used their stimulus packages to serve vested interests or social purposes as well.

The accumulated debt will constitute a lasting burden on public finances, one that will also weigh on the next generations. Or to put it in a seasonal context: Christmas is a time when children tell Santa Claus what they want and adults pay for it. With budget deficits, adults tell the government what they want and their children pay for it!

Moreover, we must remember that budgets were already under stress before the crisis, and that governments' balances do not reflect all aspects of reality. In Germany, for example, overall debt jumps from the current 65% of GDP to 250% when pension liabilities are included. Also, interest payments account for an ever larger share in budgets – and will continue to do so once interest rates start to rise again, as, inevitably, they will at some stage.

All this makes it even more urgent to rein in excessive deficits. Consequently, we need to see strong political commitment and credible plans in place for a gradual fiscal correction in order to reassure the public.

Otherwise there is a distinct risk that at some point sovereign yields will rise markedly – with negative implications for the economy and politics. A recent FT headline captured all the concerns about financing public debt around the world in the provocative question: "Will sovereign debt be the new subprime?"

The second danger is that governments will continue to be faced with tough choices as to which firms to save and which to allow to fail. A line will have to be drawn between emergency measures that are necessary to prevent our economies from collapsing and normal circumstances in which the full force of market mechanisms applies.

As we have seen in many cases in the recent past, this is a difficult call to make – all the more so during such a crisis. Also, the instinct of governments seems to be to revert to the idea of protecting national champions or reasserting national sovereignty in some sectors. But instinct is not necessarily a sound basis for decision- making. And in times of globalization, drawing a line between "national" and "foreign" is neither appropriate nor really possible anymore. The case of

GM/Opel is just one prominent example that shows how difficult it is for governments to find a way to adequately cope with the needs of transnational corporates and at the same time to meet domestic expectations.

However, in order to preserve the state's ability to act and to avoid competitive distortions between and within industries, we would probably be well advised to establish a set of criteria that is as objective as possible to guide the future decision-making process.
As a matter of principle, companies that already had difficulties prior to the crisis should not be eligible. Also, aid must be limited, lest firms become addicted to it. Governments in Europe can look to the political umbrella of the EU with its competition and state aid code, which so far has helped to steer government intervention in the course of the crisis.

Governments should also be aware of the long-term costs: large-scale state interference in market processes will produce its own set of corporate winners and losers. Structural change may well be delayed, depriving us of the chances offered by the crisis to build a more competitive and dynamic industry. Such a backward- looking approach would accelerate the relative decline of mature economies in the global economic power league which we have observed over the last few years.

The third danger involved in the state's assuming a greater role in the economy, in my opinion, is that a shift towards politics entails a shift towards the national, away from the global. This, in turn, paves the way for various forms of protectionism.

We can already observe this in the financial industry, where increased ownership by the state has led to a distinct danger of re-nationalization and re-fragmentation of financial markets. Many financial institutions that received funds from the government have concentrated on their respective home markets and scaled back their activities abroad. While this may be sensible in some regards, it is nonetheless a development that we should keep an eye on.
Similarly, there is a risk that new regulation may, either as a deliberate result or as an unintended side effect, lead to a re-nationalization of markets.

It is understandable that governments, chastened by the experience of the crisis, seek solace in the presumed safety of national markets. But this is illusory: the only way to increase the resilience of financial markets and to make sure that a repetition of this kind of crisis becomes less likely is to build a regulatory framework that is commensurate with integrated markets.

We need global, or at least European, rules and we need strong institutional structures to enforce these rules – a situation not necessarily limited to the financial markets.

Ladies and Gentlemen, I am convinced that the "search for a new balance between state and market" and the design of sensible post-crisis economic policies will occupy us – be it in academia, politics or business – for quite some time. There is no clear-cut blueprint to draw on, since different models for market economies – not to mention the competing model of state capitalism in some emerging markets – coexisted even before the crisis. Notwithstanding the general rule that market economies perform better over the long term, the empirical evidence on the superiority of different models of capitalism is, unfortunately, far from clear.

What is clear in my view, however, is that we have to resist the temptation to believe that a meddling, paternalistic state is the way out of the crisis and into the future. Not only business but also society at large would lose out if we were to move in that direction. Or as a famous politician once said: "A government big enough to give you everything you want is strong enough to take everything you have!"

Thus, in dealing with the fundamental questions that present themselves in the aftermath of the crisis, we need to remind ourselves of **two** things:

- **First**, Capitalism – or to use a less ideological term: the *market economy* – is the foundation of our economic prosperity.
- **Second**, Capitalism is also the best guarantee for individual freedom.

Thank you for your attention.