Whither Social Market Economy?

Economic Policy Challenges and Lessons from the financial Crisis

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Abstract

The growing interactions of the world economies – one of the main features of globalization – is increasingly alarming, since the aftermath of the financial crises of 2007 to 2009. This paper analyzes the lessons and challenges of Germany's unique model: the 'Social Market Economy'. More and more countries notice that Germany has an interesting alternative due to its distinctive balance between the idea of free and competitive markets combined with social systems and justice. Moreover, the current employment policy without sharply increasing unemployment rates despite of financial crisis, illustrates the potential benefits of the social market economy model. Achieving the goals within the 'Social Market Economy' requests a strong government and a distinct economic framework. However, globalization limits the domestic effectiveness of national policy decisions. We develop some extensions: we take into consideration a so-called threefold sustainability approach – economy, ecology and demography. That triad fits perfectly the historical idea of the 'Social Market Economy' and is a prefect guideline for the future challenges in a globalized world.

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1. Introduction

In recent years and since the onset of the financial crises, concerns have been grown about the negative aspects of globalization and especially financial globalization. The beliefs that free trade and free markets favors only rich countries and rich persons are discussed all around the globe. The current crises showed how volatile capital markets and frozen interbank markets hurt the country's economic growth performance and the citizen's well-being. The 'anti-globalization' movement highlights the social costs of the crises, the loss of local control over economic policy instruments and developments, and the disappearance of jobs. They also criticize the governments for moving too slowly in tackling these concerns. With the current financial crises in mind, we would argue partly rightly (Herzog, 2008a).

But in recent years both sides increasingly realized that the debate should center on how best to manage the process of globalization – at the national and international level – so that the benefits are widely shared and the costs kept to a minimum. There is no question about the challenges ahead and that greater integration and coordination efforts in the world economy. Moreover, by offering a brighter future for all, provides perhaps the surest path to greater global security and world peace. This understanding should attract support for the work needed to address the remaining challenges of globalization. Additionally, it is necessary for the future development and diffusion of the 'Social Market Economy'.

The paper is organized as follows. The next section analyzes the impact of financial globalization and the challenges' of financial market stability. In section 3, we derive policy conclusions to tackle the immense problems of the financial crisis and financial globalization at all. The last section 4, concludes the paper.

2. Financial Globalization and Financial Stability

Financial globalization is just one dimension of the complex process of globalization. Without doubt, this process has changed the economic landscape worldwide in recent decades, and not only the economic landscape. The main changes brought by financial globalization are trends towards intensive cross-border financial and payment flows, greater risk-share of cross-border activities through a broader array of financial instruments, an increasing share of cross-border holdings of assets and an increasing international profile of financial markets, market players and institutions (Lane, Ferretti, 2001). These developments in the global financial system are, to some extent, the source of the current crises due to the lag of regulation and rules. In this sense, we are now ready for a "second wave" of financial globalization – hopefully in a more sustainable manner and a framework embedded in the Social Market Economy.

The well-known driving forces of this process are technological advances in transmission of information, the decreasing cost of communication and the quickening pace of financial innovations – names as ABS CDO, MBS CDO, CDS and so on (Gordon, 2008 and Herzog, 2008b). These developments lead to a gradual shift from the government-dominated system to a market-dominated system. Market-based financing has taken place as the standard tool and hence the banking core business has forced them to search for other opportunities both at home and abroad (Sachverständigenrat, 2007/08).

Undeniable there are several positive effects. For instance, FDI has clear benefits for host countries because it is often associated with transfer of technology as well as financing, and it tends to be more stable than other countries flows. Recent crises have pointed to the need to provide appropriate incentives for capital to stay in a country and not flee at the first sign of trouble. More generally, countries with open capital accounts tended to grow faster in the 1980s and 1990s (WEO, 2001). Some papers found that financial openness – i.e. not financial markets without appropriate rules and oversight over the institutions and financial market – brings significant more stability, efficacy, competition and improved diversification of domestic risks and lower moral hazard (Litan et al. 2001; Mishkin, 2001). Despite several positive effects the current crises illustrated the big negative points.

The trade-off of costs and risks were not accompanied by frequent supervision or regulation. Hence, the trade-off was imbalanced and increased the risks for financial instability. There is a definitive lack of institution-building, a lack in control and no appropriate regulation for some financial innovations. Financial instability implies that due to some shocks the financial markets are not properly performing their standard functions, i.e. effective mediation between creditors and debtors, spreading of risks and efficient allocation of resources over time.

Policy responses: How to preserve financial stability?

The main avenues for coping with the impact of financial globalization on financial stability which have not developed properly in recent decades are:

(A) The departure from the pegged exchange rate regime of the Bretton Woods tradition and the shift to flexible exchange rates;
(B) The problem of global imbalances and the massive development of currency reserves in Asia and particular in China;
(C) The implementation of an extensive system of prudential regulation and supervision as well as a financial product control body;
(D) The proper sequencing of liberalization and institution-building, an issue of particular importance to all economies as the current crises shows.

Each of these approaches has its merits, but also its limits. Their contribution to the preservation of economic and financial stability has proved to be only partial reality and, consequently, the search for further solutions inevitably goes on. In this respect, one issue of reasoning appears to open up for discussion: Should monetary policy also address financial stability?

The ultimate goal of price stability and financial stability are in principle mutually reinforcing. Data show that central banks and their monetary policies have been quite successful in keeping inflation in check in recent decades. A low-inflation environment has been sustained in most national economies, including transition economies and emerging markets. However, the frequent occurrence of financial imbalances, asset and house price bubbles and overt financial, banking and currency crises has proved that low inflation does not guarantee or ensure financial stability. In fact, several financial crises and asset price bubbles have developed in an environment of low and stable inflation. The US economy is the best example.

The ongoing debate on what role financial imbalances and asset prices should play in monetary policymaking can be classified into two opposing approaches. According to the first one, central banks should take into account information from asset price movements and financial imbalances if and insofar as they have an impact on the inflation figures and the goals of monetary policy. This seems to be subject to little disagreement.

The other approach suggest that central banks should respond to imbalances as they build up, even when the (short-term) outlook for inflation and growth does not seem to be affected and remains favorable. The argument is that growing imbalances will have adverse consequences if left unchecked. This will become true if and when these imbalances develop too far and prove to be out of line with fundamentals. The unwinding of such imbalances can be rather costly to the real economy as the current crises show.

Therefore, many international economic institutions and advisory body's including the 'German Council of Economic Experts' an institution that supports the idea of the ‘Social Market Economy’ suggested the implementation of financial stability into the economic regulatory system. The so-called pre-emptive or proactive approach should be used not only to cushion the consequences of financial imbalances, it should be used to decrease ex ante the probability of such imbalances and decreasing their potential magnitude, having a negative impact. Despite some disagreement under experts, even the International Monetary Fund (IMF) and the Bank of International Settlements (BIS) discusses this idea.

Regarding the issues listed from (A) to (D) above, we have an ongoing discussion on the national, the European and the International level – for instance during the last G20 and G7 meetings. The current and past crises illustrate the necessity of new international institutions in the field of financial markets. Each market needs an appropriate regulatory framework – that is the key message of the ‘Social Market Economy’ model. The current national and international regulatory and institutional framework in financial markets is an absolute structural weakness for the current financial system.

According to the Social Market Economy model each free and competitive market needs certain rules of working to be in line with the principles (Abelshauser, 2009). However, due to the international aspects of financial markets all domestic policy solutions are neither possible and in most cases nor appropriate. The key question based on an extended version of the Social Market Economy is: Who controls international financial markets?

The implementation of the ‘Social Market Economy’ on the international level will provide an adequate analytical tool to detect such weaknesses timely with possible solutions. Hence, prior to liberalization of (financial) markets we need sound macroeconomic policies, effective supervisory and new regulatory institutions like the German cartel office in the 1950s. That is the key lessons for policymakers at home and abroad.

Moreover, liberalized financial systems appear to be “inherently procyclical”, as Borio et al. (2001), show. Credit spreads, asset prices, internal bank ratings and loan loss provisions all move procyclically. Keeping this in mind, the regulation applied has also proved to be procyclical in nature, exacerbating cyclical developments in individual economies (Rochet, 2004; Kahn and Santos, 2005; Mitchell, 2000; Boot and Greenbaum, 1993). To correct for this, a more systematic response to the expansionary and contractionary phases of the business cycle has been sought when devising prudential regulation instruments. The current financial turmoil shows the importance and necessity of a macro-prudential regulatory framework that putting more emphasis on the health of financial system as a whole, rather than the state of individual institutions, as was the case in the past.

To contrast these findings with the model of the ‘Social Market Economy’ (SME), we learn that the existing SME model is in the present period not entirely appropriate. Therefore, we need some extension and a further development of the ‘Social Market Economy’ in two directions: Sustainability and International links. In the next section, we develop the new or modern ‘Social Market Economy’ model that is even ready to tackle the globalization challenges.

3. Policy Challenges of the ‘Social Market Economy’

While globalization generally brings benefits, it is also associated with problems which have raised legitimate concerns (Matthes, Langhorst, Herzog, 2008). Apart from cultural, environmental, and political issues, which are not discussed here, the two principal areas of concern are both essential fields in the concept of the ‘Social Market Economy’ too: Firstly, inequality both within and across countries and secondly, stability and volatility in economic and financial markets. In particular, there has not been a narrowing of global income inequalities in recent years. This proves the large number of debates in Germany, in the USA, and many developing countries around the globe. Moreover, in the recent period volatility has increased dramatically as the large number of financial crises and stock market crashes illustrates. In both areas, there is plenty scope for improving government policies and the operation of the international institutions in order to widen the access and acceptance to globalization and in particular the acceptance to the concept of the 'Social Market Economy'.

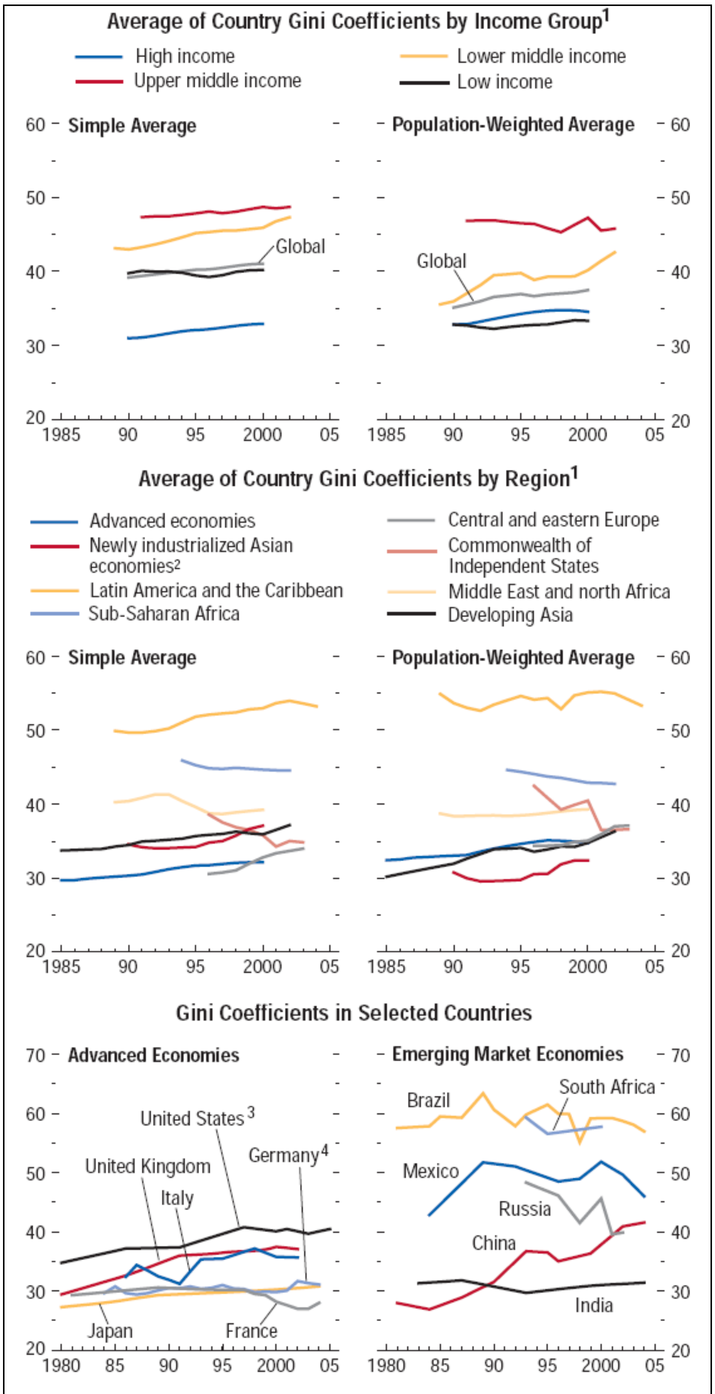
Inequality

Financial globalization has also proceeded at a very fast pace over the precedent two decades. Total cross-border financial assets have more than doubled, from 58 percent of global GDP in 1990 to 131 percent in 2004. The advanced economies continue to be the most financially integrated, but other regions of the world have progressively increased their cross-border asset and liability positions.

However, de jure measures of capital account openness present a mixed picture, with the newly industrialized Asian economies (NIEs) and developing economies showing little evidence of convergence to the more open capital account regimes in advanced economies, which have continued to liberalize further. Notable, the share of FDI in total liabilities has risen across all emerging markets — from 17 percent of their total liabilities in 1990 to 38 percent in 2004 — and far exceeds the share of portfolio equity liabilities, which rose from 2 percent to 11 percent of total liabilities over the same period (WEO 2004). Reduced government borrowing needs have also contributed to changing liability structures, with the share of debt in total liabilities falling across all emerging market and developing country regions. Not surprisingly, the share of international reserves in cross-border assets has also risen, reflecting the accumulation of reserves among many emerging market and developing countries in recent years.

Based on observed movements in Gini coefficients (the most widely used summary measure of inequality), inequality has risen in all but the low-income country aggregates over the past two decades, although there are significant regional and country differences (Figure 1).

Figure 1: Inequality



Sources: Choi (2006); Povcal database; WIDER database; and IMF staff calculations.
[1]Country coverage and years shown are limited to maintain constant country coverage. See Appendix 4.1.
[2]Excludes Hong Kong SAR due to data unavailability.
[3]Trends after 2000 are based on earnings data for full-time, year-round workers.
[4]Trends for pre-1992 are based on data for West Germany.

The channels through which globalization affects inequality are complex: The principal analytical link between trade liberalization and income inequality provided by economic theory is derived from the Stolper-Samuelson theorem: it implies that in a two country two-factor framework, increased trade openness in a developing country where low-skilled labor is abundant would result in an increase in the wages of low-skilled workers and a reduction in the compensation of high-skilled workers, leading to a reduction in income inequality (Stolper and Samuelson, 1941). After tariffs on imports are reduced, the price of the (importable) high skill-intensive product declines and so does the compensation of the scarce high-skilled workers, whereas the price of the (exportable) low skill-intensive good for which the country has relatively abundant factors increases and so does the compensation of low-skilled workers. For an advanced economy in which high-skill factors are relatively abundant, the reverse would hold, with an increase in openness leading to higher inequality.

An important extension of the basic model that weakens the dichotomy between advanced and developing economies in terms of distributional effects is the inclusion of “noncompeting” traded goods, that is, goods that are not produced in a country and are imported only as a result, for example, of very large differences in endowments across countries. Tariff reductions would reduce the prices of these goods — and therefore increase the effective real income of households — without affecting wages and prices of other traded goods. If this noncompeting good is a large share of the consumption basket of poorer segments of society, a drop in the tariff on the noncompeting good would diminish inequality in that country. In general, in both advanced and developing economies, if tariffs are reduced for noncompeting goods that are not produced in a country but are consumed particularly by the poor, it would lead to lower inequality in both advanced and developing economies. The implications of the Stolper-Samuelson theorem, in particular the ameliorating effects of trade liberalization on income inequality in developing countries, have generally not been verified in economy-wide studies.

A particular challenge has been to explain the increase in skill premium between skilled and unskilled labor observed in most developing countries. This has led to a range of alternative approaches, including the introduction of (1) multiple countries where poor countries may also import low skill-intensive goods from other poor countries and rich countries may similarly import high skill-intensive goods from other rich countries; (2) a continuum of goods, implying that what is low skill-intensive in the advanced economy will be relatively high-skill intensive in a less-developed country (Feenstra and Hanson, 1996); and (3) intermediate imported goods used for the skill-intensive product. However, these extensions have themselves presented additional challenges for empirical testing, and none has been consistently established.

This has led to explanations for rising skill premiums based on the notion that technological change is inherently skill biased, attributing the observed increases in inequality (including in advanced economies) to exogenous technology shocks. Any empirical estimation of the overall effects of globalization therefore needs to account explicitly for changes in technology in countries, in addition to standard trade-related variables. An additional important qualification to the implications deriving from the Stolper-Samuelson theorem relates to its assumption that labor and capital are mobile within a country but not internationally. If capital can travel across borders, the implications of the theorem weaken substantially. This channel would appear to be most evident for FDI, which is often directed at high-skill sectors in the host economy. Moreover, what appears to be relatively high skill-intensive inward FDI for a less-developed country may appear to be relatively low skill-intensive outward FDI for the advanced economy. An increase in FDI from advanced economies to developing economies could thus increase the relative demand for skilled labor in both countries, increasing inequality in both the advanced and the developing economy.

The empirical evidence on these channels has provided mixed support for this view, with the impact of FDI seen as either negative, at least in the short run, or inconclusive. In addition to foreign direct investment, there are other important channels through which capital flows across borders, including cross border bank lending, portfolio debt, and equity flows. Within this broader context, some have argued that greater capital account liberalization may increase access to financial resources for the poor, whereas others have suggested that by increasing the likelihood of financial crises, greater financial openness may disproportionately hurt the poor. Some recent research has found that the strength of institutions plays a crucial role: in the context of strong institutions, financial globalization may allow better consumption smoothing and lower volatility for the poor, but where institutions are weak, financial access is biased in favor of those with higher incomes and assets and the increase in finance from tapping global and not just domestic savings may further exacerbate inequality (Prasad, 2007; Claessens and Perotti, 2008).

Thus, the composition of financial flows may matter, and the net impact may also be influenced by other factors, such as the quality of financial sector institutions. In summary, analytical considerations suggest that any empirical analysis of the distributional consequences of globalization must take into account both trade and the various channels through which financial globalization operates, and also account for the separate impact of technological change.

New Policy Response

Governments, with the help of the international institutions, need to address both problems boldly and swiftly. However, the political credibility to change both problem fields is of equal importance because nobody can change these issues easily alone. Moreover, it needs some longer time horizon and a sustainable approach.

The persistence of poverty requires adequate social safety nets to mitigate negative effects on the most disadvantaged and government spending on public education, health, and security, which help to equalize opportunities. Tax competition and the growing debt level, however, limit the scope for governments to raise revenue. Hence, international coordination is necessary not only to tackle the current financial crises, it is even necessary to solve the big problems in a globalized world. Policies aimed at maintaining macroeconomic stability can help moderate the unemployment and wage losses associated with economic contractions, as well as the unfavorable effects of inflation, which has a disproportionally heavy impact on the poor.

Another important step is the further opening by rich countries of their markets to exports from developing countries by reducing tariff and non-tariff barriers and domestic subsidies so that the less developed countries can get the full benefits of the global trading system. Calls in rich countries for environmental and labor standards in developing countries are often presented as being motivated by a concern for limiting the adverse impact of globalization on poor countries. In fact, their effect would be to create barriers to the growth-creating trade that permits poor countries to narrow the gap with the rich countries.

Currently, improvements in the international financial architecture are of highest priority. The ultimate goal is a decreasing likelihood of crises and mitigation of their costs. We need for the financial markets the appropriate regulatory institutions at least at the European level, enhanced early warning systems and improved rating schemes, transparency, and appropriate equity insurance schemes in particular for systemic institutions (Herzog, 2008a).

However, firstly besides finding solutions to problems mentioned above, we need to find ways to implement all these issues effectively. This means keeping in mind that issues formerly seen as national – including financial markets, the environment, labor standards, and economic accountability – are now seen to have international aspects. The ripple effects of actions taken in one country tend to be far greater and to travel faster than ever before. A purely national approach to solving some problems risks merely pushing the problem across the frontier without providing a lasting solution even at the national level. Secondly, we need to ensure that measures are taken to meet internationally agreed explicit targets. Failing to reach the targets should have an immediate impact to politics. Thirdly, we need to revisit the institutions of global governance, to establish mechanisms to implement global sustainable solutions to global problems and to ensure that governments become responsible and more accountable. On economic issues, the countries attach to the open and cooperative multilateral system is reflected in the now virtually universal membership of IMF, World Bank and United Nations. These lessons add up to a weighty agenda for the international and European community.

Globalization holds the promise of enormous benefits for all citizens of the world. To make this promise a reality, however, we must find a way to carefully manage the process. Better attention must be paid to reducing the negative effects and ensuring that the benefits are widely and fairly distributed. The revitalized and extended Germany model of the 'Social Market Economy' is one of the best alternatives to capture the future challenges of globalization even on the international level due to its success during all periods of globalization.

4. Conclusions

In a nutshell, the first step is to strengthen the macro-prudential and financial stability framework in a sustainable way. Indeed, globalization that is managed properly has widespread benefits and is in line with the 'Social Market Economy'. However, politicians must become aware of dramatic global changes – huge financial integration without any regulatory and supervising framework at the international level. Hence, we have to include the new globalized dimension into the concept of the

‘Social Market Economy’ in Germany and Europe. An excellent way to grip the extension of the Social Market Economy model is straightforward: (A) Include economical, ecological and demographical sustainability issues and (B) implement and enforce the rules more internationally (Herzog, 2008b). With these newly designed policies, it can be harnessed to reduce the negative aspects of globalization while at the same time keeping financial markets in check. The alternative, to do nothing wound not solve the current national and international problems and challenges. In fact, it will more likely reduce prosperity, stability with unfavorable effects on both rich and poor alike.

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