

# Keeping the Economy in the Neo-Schumpeterian Corridor\*

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We have been speaking about many subjects today which are of highest current interest and which make these days appear to be so special and unique, only comparable to the period at the end of the Twenties and the beginning of the Thirties of the last century. Back then, however, there was more or less only one real problem for society and politics, namely the economic crisis which began to spread in a dramatic way to become a worldwide crisis of nations and cultures. Today, we have to consider other developments which will significantly influence and limit our lives and our future besides the consequences of the economic crisis. The climate change and the ecological effects which will apparently derive from it for us and the next generations are an enormous source of danger opening up in a parallel way to the economic crisis. Questions concerning the exploitation and the use of energy and the sustainable management of our natural resources shape another field of concern of growing significance for the existence and the form of our life on this planet Earth. The same is true for the threatening developments stemming from an aging population in societies in highly developed economies which we cannot afford to lose sight of in times when almost all crisis comments focus on the financial and economic sector. Therefore, I am proud and happy that we have also taken those incredibly relevant topics into account during this conference both in the program and in the presentation and discussion of the problems with the due time and energy as well as the high expertise and competence of the participants. I will return to Augsburg with many new ideas and stimuli and am very thankful to the organizers and the participants.

At the closure of this conference let me shortly address the looming global economic crisis and present some thoughts which may have also been

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pronounced in previous speeches today. For this crisis does not only carry risks and dangers with it, it also offers the great opportunity to link economic policy to other goals such as a sustainable climate and environmental policy. The slogan should be to make economic policy not at the expense of climate and environmental concerns, but to understand economic policy also as a kind of climate policy. The next wave of innovation in the world will certainly be based on climate aware and resource protecting technologies.

But, if you permit, I will now focus my presentation, as I said, on the present economic and financial problems and will link it to a school of thought which can be best illustrated by the name of the great economist Joseph A. Schumpeter.

A first postulate, which I would like to propose, is:

The current crisis can be characterized as a typically **Schumpeterian** crisis. In any case, it is not a malicious development in the Keynesian sense, which would be based on price and allocation processes related to and determined by rigidities in a market economy or on a mismatch of aggregate supply and aggregate demand. Furthermore, I cannot recognize any classical or neo-classical market failures as triggers: failures such as the supply of public services or market imperfections connected with misleading competition. No, the current crisis is hardly reducible to endogenous errors or shortcomings of such kind in the market economy or the capitalistic system. It is much more the result and product of an excessive and exaggerated success of this system. One of the first economists who recognized this correlation was Joseph Schumpeter. His interpretation shows a strong opposition to the common, Anglo-Saxon influenced neoclassical approach of economics. According to Schumpeter, the capitalistic system is defined in its dynamics and its development in a prominent way by forces largely ignored in the neoclassical theory. This includes creative entrepreneurs and bankers ready to assume risks, whose actions are future-oriented and aimed at replacing old forms of doing business by creating new ones that means by “creative destruction”.

Thus defined, capitalism becomes a system which is to a high degree linked to uncertainty and insecurity both in a positive and negative sense. Basically, everything can and will happen if the system is allowed to develop freely. It is

capable of generating the most impressive performances and also of causing most painful collapses. It is, therefore, not a system of balance and harmony as the neoclassic supposes, but one which flutters between possible extremes of the highest success and the most deplorable decay. This is true for companies as well as regions, nations and global economic areas. Basically, it oscillates in a Schumpeterian cycle of “Boom and Bust”.

It is this cyclical up and down which also holds much of the responsibility for the crisis we currently suffer. The true base of today’s global financial crisis lies in the USA and in the enormous economic boom, starting about twenty years ago and which was spurred by the coincidence of several economic factors that may be called Schumpeterian: the innovative key or general purpose base technology in the IT-sector which spread like wildfire; the readiness of creative entrepreneurs and the availability of sufficient risk capital that could be used to finance a future oriented extraordinarily strong expansion. Besides, governments provided the necessary framework by choosing a policy of low taxes and deregulation of economic processes. This expansion period proved to be so tremendously successful that it burst – not only in the IT-sector – all scales of evaluation of companies and it carried with it many other economic sectors to unseen heights.

Around the year 2000, the boom stumbled over its own hubris and the limitless optimism of the involved actors. But the central banks also held their share of responsibility. They suddenly focused on a tight monetary policy by raising the interest rates in order to fight a perceived inflation in consumer markets. In the run-up to the emerging crisis, however, they had carelessly ignored the inflation in assets that had been developing in the stock markets. However, it is this inflation in assets which is in a Schumpeterian context an essential cause for distortion and crises. The eventual burst of the inflated bubble preceded the deep slump of the New Economy and the Dot-Net-World.

The central banks had no other option but to react almost in panic, this time by lowering interest rates and therefore by adding even more new liquidity into the economic circular flow. The new money searched for new fields of investment and this is the point, where we find the shift from the firm sector to the households’ real estate sector. Here, the same unregulated

interdependence of greed, short-term focus and exaggerated optimism surfaced. A new, incredibly large bubble formed, which is about to burst on a worldwide scale with a more and more audible noise. The central banks were part of the trigger of this outpouring due to their policy of rapid increases in the interest rate designed to tame the enormous volumes of liquidity. This culminated in a shambles, a global financial and economic crisis, which should consequently rather be called a “Schumpeterian crisis.

So, what can we do in such a crisis? Which tasks are reserved for the market and which ones are bound to the government as a knight in shining armor?

Well, I think Schumpeter would take the easy way out of this argument. He would probably reason that we should leave the capitalistic system alone. There are enough self-healing forces within it that will make sure that after a certain period of global downturn, we would return to a phase of common growth; meaning that it would start a development which will once again lead through a powerful, maybe technological incitation from a bust towards a boom situation. But, can and may we consider this option justifiable in economic or political terms after we have made the terrible experiences during the world economic crisis and in the subsequent years, in the devastating consequences of the Second World War? No, the political dangers that would arise were by far too unforeseeable and dramatic that such a strategy could not be tested under any circumstances because of consequences such as an increasing nationalism, social riots and possibly even wars. Therefore, the crisis needs the government and its policies.

To this fundamental insight, I would like to add a second postulate, which focuses in a critical way on the intensity and efficiency of governmental action.

Due to the neoliberal, neoclassical state of mind of the important makers and shakers in academia and politics, who consider the government to be a sort of repair garage of last resort, the people in charge are skating on thin ice and risk overreacting. They think that they have recognized some defaults in the market system and are trying to eliminate them by strong public involvement. Apparently, this provides the government with a role and responsibility that exceeds by far every so far accepted dimension. The currently discussed inventory of possible measures represents exhaustively the whole spectrum of

public activity: intervention, regulation, control, and nationalization are the most frequently cited terms when it comes to using governmental help to cope with both the financial crisis and the developing economic crisis. This can be an extremely risky attitude, especially when it leads to a policy of partial “piecemeal engineering” and when the overall context that characterizes modern economies in the era of the knowledge societies is not respected.

It does not seem controversial that successful capitalistic economies cannot exist without a certain amount of regulation if we want them to generate an economic development which is sustainable and less erratic than the unregulated invisible hand could achieve. The government as a political actor can, and should, of course, make a contribution so that ups and downs in the development process of an economy are more moderate and steady and that a smoother evolution can be attained. In this context, I propose a concept as an analytical framework which we have introduced earlier as the “Neo-Schumpeterian Corridor”.

Such a corridor is designed in a future oriented way and represents an open space for development which runs acute-angled between two axes representing time and economic success and in which the innovation and firm driven dynamics of modern economies can be modeled. Within this corridor, economic entities, companies as well as economies, can move freely and can choose a success-based and promising position dependent on their specific preconditions. In this sense, the corridor also serves as an outline for possible developments that political actors have to respect as well.

Without doubt, the essential asset of this concept is its future oriented focus. It is of utmost importance for the long-term stability of the economic system that its progress is neither too large nor too small. Too little growth cannot establish an advancing dynamics, and the standard of living in an economic area would have to suffer. The increase in investments would be insufficient both in the private and the public sector as well as with respect to physical, human, intellectual and social capital. The people will then adopt a negative view on the future development and, therefore, oppose and block the creative access to innovations and risk propensity. These two elements, however, sum up the driving forces of development in a capitalistic economy. At the end of a period

of insufficient growth, the living conditions will inevitably decline on a relative basis. The relative recession may even be aggravated, if other regions, nations or economies achieve a higher growth and standard of living.

The same is true for the case of an economy that is too successful and attains growth rates far above average, rates which may be neither sustained nor stabilized. This success may very well create the positive and optimistic basic attitude in the economic agents necessary for future-oriented operations. But, rapid growth is also always linked to an accelerated process of change in the structures of an economy. There are sectors which are readily expanding and others that do not grow as dynamically and so cannot keep up with the fast pace of development pushed upon them by the fast growing domains. The real development in such an economic system will then be determined by two velocities. The forces that impose and can bear the high speed will be found in the innovative and strongly growing sectors and companies, while the sluggish variables fall into the sectors of low growth. As long as the latter serve as a natural brake for an exuberant economic dynamics, the economy will continue to position itself within the corridor and quite possibly even at its upper boundary. From a theoretical point of view, this is the best and economically the most successful situation for an economy. Admittedly, this case will empirically only occur in the rarest cases for a longer period of time.

For the structural conflict between the fast and the slowly developing industries in an economy can – even if it was limited to the real sector and therefore seems to follow the Schumpeterian ideal of “creative destruction” – lead to the complete breakdown of the entire system, because the inert sectors can no longer support the high pace of growth of the dynamic industries. This may happen when, for example, the infrastructure, the training of employees or the adaptation to customers’ wants or suppliers’ conditions cannot be altered and harmonized rapidly enough and will then work as a scotch block for all sectors.

Still, this case may also be seen as an exception, just as the “natural” adjustment of dynamic and retarding forces in an economy or an economic region. Empirical findings and the history of economics show that, in general, two spheres of action are responsible for the determination of the state and

the position – within the corridor, the overheating or the stagnating zone – of an economic body. The causal factors are in the real sector on the first part and to a large degree in the financial sector of an economy on the succeeding part.

Though, dynamic industries, such as the IT-sector in the 90s, will incite the attention and the interest of all those economic actors who desire to participate in the boom in fast growing domains as financial investors and who will want to also enjoy the high returns achievable. The technology driven expansion in the dynamic part of the industrial sector will then be spurred and artificially inflated in the asset part of the financial sector and might even be triggered to a boom by the greed and short-term focus of the financial investors.

It is this finance-based overheating that can topple the whole economy into a severe crisis. This will always happen when we observe a situation where the market is full of fear of inflation and where the monetary policy is quickly shifted from an expansion to a contraction strategy. Just as we can see in the examples of Japan and the USA, this will lead in most cases to a panicking reaction of private investors in the financial markets. They suddenly see their return opportunities going down the drain and try to save all they can. Financial bubbles that had been built up in the time leading to this point will burst and in its wake will tear down the industrial part of the economy. The more important and faster a technology induced expansion develops into a financial boom and the more interconnected an economy is in the global economic sphere, the more global and dramatic the consequences and crises will appear.

The only sensible path for a future-integrated, continuous and sustainable development of an economy or of an economic system is, in my opinion, a political strategy of having monitored, moderate overall growth with a corresponding rate of development. Only then all structures, both in the real and the financial sectors, can advance within the Neo- Schumpeterian Corridor in a “healthy”, co-evolutionary way. So it is the government and the central banks that bear the responsibility to generate an almost natural balancing between “Fast” and “Slow”, between “Dynamics” and “Statics”, between “New” and “Old”. The fast growing industries must have the possibility to expand without risking having their dynamics devitalized by the more sluggish

sectors. On the other hand, the latter are supposed to form a natural brake that prevent the development of an excessive dynamics, both in the industrial and in the financial sector. It is the responsibility of the public sector to provide for a framework which is designed in a way that hardships in the present - such as can arise in regular cyclical recessions – can be shouldered and that successful developments in the future are stimulated. An economic system can achieve such a secure long-term strategy which minimizes the risks of a boom as well as those of a drastic crisis exclusively only, if it moves within the Neo-Schumpeterian Corridor, if possible at its upper end.

The idea of such a corridor however presupposes that the political sphere can actively decide on the framework and take the appropriate measures that can effectively and timely tame and dominate those forces in a capitalistic system which continuously try to go through the roof and risk exiting the corridor towards an excessive growth path. On the other hand, politicians have to make sure that an economy will not fall out of the corridor, and that it will not have to cope with economic stagnation. Probably the greatest challenge for academia and politics in the next years will be to bring this Neo-Schumpeterian Corridor to life by providing the economic and political content of implementing the right strategy.

As substantial as this challenge may be, there are a few rough and avoidable mistakes in politics which we can already point to today. The political framework should by all means not be limited to singular, not deeply thought through, reactive measures such as are discussed right now in Europe and worldwide for the financial sector, such as for instance transparency, surveillance, control or nationalization in the banking sector. The focus should be much more on the dynamic overall performance of a modern, capitalistic economy which is on the brink of transforming from an industrial into a knowledge-based society. This evolution is driven by the three most important pillars of its economic and social regime, which are the sectors of the real economy, the financial sector and the public sector. All three have to serve the future design of society and economy and assume a corresponding role.

In such a concept, the task of the real economy will be to foster at all times through innovation and parallel investments the knowledge-oriented progress



and the resulting wealth of a country or a region. To accomplish this task, it needs certain freedoms and the active support of the government, for example, through a growth and progress oriented tax system on the revenue side of the public budget or investments in education and research on its expenditure side.

The financial economy has an even closer, almost symbiotic relationship with the real economy. Its task is not – as it just happened – a short-term decoupling from the real economy spurred by speculation, but quite the opposite, the medium- and long-term oriented sustainable financial accompaniment and encouragement of innovative and successful companies and sectors.

The governmental and political responsibility lies, as we just mentioned, in the monitoring of the future-oriented, long-term symbiosis of the real and the financial economies as well as their co-evolutionary development. This includes a two-sided counter-cyclical strategy, on the one hand the tasks of avoiding trends of exaggerating or overheating in time and on the other one the responsibility and effectiveness to overcome a period of stagnation or recession as quickly as possible.

I certainly do not need to point out specially that this is an extremely complex and difficult political challenge concerning the intelligence as well as the instruments to be used. In the upper part of the corridor, politicians have to watch out for signals and possible developments included in the supply-oriented Schumpeterian theory which can be systematically analyzed and cured in that context. In the lower part, the demand-oriented Keynesian theory and policy certainly have a higher value, especially when it comes to alleviating and curing the deflationary consequences of serious crises in their intensity in a short- and medium-term perspective. Schumpeter and his theoretical work offer in that respect the first part of a “boom-bust”-story, which concerns the core explanation of capitalistic development processes in the real economy. Keynes and his politico-economic instruments focus more on the subsequent part, which has to deal with the financial repercussions concerning the demand for investment and consumption. Therefore, it should only be implemented at the end of such a “boom-bust”-cycle, when it is all about hoisting the broken economy back into the corridor and balancing and animating the appearing

demand deficits through stimulating, debt-financed fiscal measures. This therapy may take the edge off in times of a “Schumpeterian crisis”, the sickness of a market economy in very grave and delicate situations, such as the current one. And, if not heal, at least it can bring some short-term, temporary relief and improvement. So, let’s imagine that this will actually be the case in the months and hopefully not the years to come.

This is where my analysis goes concerning the situation of the national governments and their role in this crisis. But, especially here in Lisbon, we should not forget the particular situation of the European Union as an economic conglomerate and political body of independent member states. When we look at the European dimension of the current turmoil, we should ask especially, whether the European Union is a burden or an asset in mastering the financial and economic crisis. In this context, we find many commentaries on either side of the argument.

While there is not much dissent when talking about the important interrelatedness of the European market and its function as a strong and supportive link for the entire European Union, we find harsh arguments discussing the political integration and its consequences in this situation. Is it rather detrimental or beneficial?

Many people argue that the diversity of the key topics national governments in Europe focus on, is to a large degree responsible for the reluctant and low volume response in Europe to the looming threat of a most severe crisis. The political integration is by far not as completed as the economic integration and therefore, the measures proposed by politicians to alleviate its effects lack a European focus. Their impact is limited compared to a coordinated strategy of all European countries.

Economists such as the Nobel Prize laureate Paul Krugman warn that the huge variety of different political approaches seen in Europe today, which does not follow a concerted overall strategy, will make the continent fall way deeper

into the crisis than for example the US economy and might threaten European integration by increasing national tendencies and boundaries.

On the other hand, we witness how all national governments vow to rescue any bank in Europe with a systemic relevance and that this is possible even in smaller countries thanks to the backing of the larger ones. Some EU countries, like Austria, are strongly hit by the current crisis, but their situation seems not to be as precarious as the one in Iceland which doesn't belong to the EU. For such countries, the European Union could serve as a safe haven, avoiding that they have to face the economic storm hitting the world right now by themselves.

It is also true that there exist protectionist tendencies within Europe which may rather worsen the crisis than help to cure it. A fall into a nationalistic view and the threat of major, possibly violent conflicts would be far more urgent and unequally larger, if the grown bond between the EU countries didn't exist.

The Union's reaction of working in a concerted way on the critical financial sector and in an individual way on the Keynesian strategies of re-inciting the economies also provides large advantages and offers opportunities which were not given in a ruling only undertaken by Brussels. Regional and national plans may be implemented way faster and far more specifically targeted than a centralized European solution could provide for. While an integrated consensus approach would include many debates based on the different political backgrounds of the delegations and take lots of precious time, and while the agreed on measures may be too loose for one and too restrictive for another country, the decentralized approach taken by the EU may prove at the end, to be more efficient in the process of stabilizing Europe and its countries.

As an outlook, the European Union faces the current crisis with an increased challenge of not only stabilizing each national economy but also holding the countries together and in the game. Whether the diversity and freedom which still remains with the national governments is a burden or an asset will be shown in the next years.

But, it is certainly of utmost importance that Europeans act as Europeans – even when they decide on a national or regional scale. Then, the challenge of

returning not only single countries but the entire continent into the Neo-Schumpeterian Corridor and restoring its influential position in the world becomes far more workable and realizable.

It will be on us to watch closely how this process continues, to actively engage in the discussion and to provide our insights and ideas. Today's conference certainly has shown that we can add valuable input and constructive proposals to this debate.

The way from Bust to Boom is our way. Thank you for being part of those who advance on it allowing others to follow.

Thank you very much!