

Antony P. Muller
Univesidade Federal de Santa Catarina

The Failures of International Financial Crisis Management

Prof. Dr. Antony P. Muller
Dept. de Ciencias Econômicas
Universidade Federal de Santa Catarina
Cx. Postal 476
BR-88010-970 Florianópolis, SC
Brazil
Tel. (0)48-331-9889
e-mail: apmuller@cse.ufsc.br
Antony P. Muller
The Failures of International Financial Crisis Management

ABSTRACT

Current financial crisis management is largely based on a peculiar mixture between neoclassical economics and Keynesianism. On the one hand, this combination implies a reliance on

the efficiency of markets and rational behavior, while, on the other hand, demand management appears appropriate to stabilize the economy as a whole. This way the dominant paradigm tends to ignore the persistence of disequilibria, the potential for erroneous behavior of market participants and the validity of the fundamental law of scarcity.

This paper argues that financial crises, when analyzed in the light of the theory of capital and money as elaborated by Hayek and Mises, are to be analyzed as symptoms of economic distortions. The malinvestments at their roots are typically brought about by excessive credit growth or government interventionist policies, and as such the disequilibrium may be exacerbated when new liquidity is injected into the economy, resulting in the familiar patterns of boom and bust.

In contrast to the currently dominant line of thinking, the Austrian approach would suggest to take into account that erroneous behavior on the micro level may occur for a prolonged period of time when economic actors are exposed to misleading signals. In the perspective of Austrian economics, macroeconomic balance, as it is measured by standard indicators, does not imply microeconomic equilibrium. With new liquidity, macroeconomic indicators may show temporary improvement but there is the risk that this will make fundamental microeconomic disequilibria more severe and more rigid.

A number of factors tend to make these processes of boom and bust more frequent and more severe when foreign lending is involved.

I. A Tradition in Need of Revival

Before the Keynesian revolution the modern representatives of the 'Austrian school of economics', Ludwig Mises and Friedrich Hayek, were held in high esteem, and with Hayek's publication of 'Prices and Production'¹ a new paradigm for mainstream economics was about to be set.² With the continuation of the 'Great Depression', however, and due the change in the intellectual

¹London 1931

²Cf. John R. Hicks, The Hayek story, in: Hicks, Critical Essays in Monetary Theory, Oxford, 1967, pp. 203-15

climate which began to favor interventionist solutions the Keynesian paradigm began to triumph.³ In the past decades there has been a revision of Keynesian economics which came in the wake of the revival of neoclassical economics but from the perspective of Austrian economics it has been incomplete. At first sight it could appear that Austrian and neoclassical economics share the same methodological approach as both stress individualism, subjectivism, and marginalism. However, there are number of subtle differences: The methodology of Austrian economics demands strict individualism and radical subjectivism of values. The central concept is 'human action'⁴ which is not merely utility maximizing behavior but is seen to take place in time and space under the condition of limited knowledge. The main feature of 'human action' is the fundamental human condition that plans are more likely to fail than to succeed. Thus the interrelationship between error and adaptation are central to economic life and the business cycle in particular. The methodology of Austrian economics is dynamic, it adheres to a strict methodological individualism and radical subjectivism which would not allow for concepts such as the 'representative' consumer or business and would reject utility maximization under static conditions with perfectly known preferences, prices, and technologies. In particular, the Austrian approach is highly critical as to the usefulness of aggregation and index numbers and instead stresses relative prices and the time structure of capital.

In contrast to the theory of capital which both Keynesian and neoclassical economics hold, and according to which capital is a stock which can be increased by investment resulting in capital accumulation and thus higher growth, Hayek's view of an economy's capital is that of a stream of production.⁵ Capital thus has a structural and a time dimension, it is dynamic and flexible. In Hayek's view, capital is not just a heap of production goods. The important aspect is the multidimensional structure of capital which is given by relative prices. Thus per se neither the enlargement of capacity nor higher demand does guarantee higher output and employment.⁶ In fact, capital accumulation may be a wasteful activity. In this view, economic models which abstract from relative prices are highly deficient, and when, as it is so often case with current economic policy, Keynesian macro-economics and neoclassical equilibrium theory are mixed, total confusion will result with the tendency to produce disastrous outcomes.⁷

³As to the 'conversion' of Lionel Robbins to the Keynesian paradigm due to the duration of the Great Depression, see Robbins, L., *The Great Depression*, New York 1934

⁴This is the English title of L. v. Mises' opus magnum 'Nationalökonomie. Theorie des Handelns und Wirtschaftens', Genf 1940; Mises, L., *Human Action: A Treatise of Economics*, Chiacago 1949

⁵Hayek, F. A., *Der Strom der Güter und Leistungen*, in: *Die Anmaßung von Wissen*, ed. By Wolfgang Kerber, Tübingen 1996, pp. 130-147, first published by Walter Eucken Institut, *Vorträge und Aufsätze* 101, Tübingen 1984

⁶Hayek, F. A., *The Pure Theory of Capital*, London 1941

⁷Hayek (1984)

II. Critique of the Current Approach to Financial Crises

Following the footsteps of neo-classical economics, modern financial market theory conceptualizes financial markets in terms of equilibrium and efficiency, attaching, however, peculiar meanings to the concept of “equilibrium” as well as to “efficiency”.⁸ According to this theory a financial market is in “equilibrium” when actual asset prices “efficiently” reflect information in the best possible way. Given rational market participants who act in a profit maximizing manner, disequilibria, by definition, must be a short term phenomena. This way, modern financial market theory is severely hampered in explaining financial crises which in this perspective appear foremost as mere ‘anomalies’. The theoretical neglect of financial crises phenomena stands in sharp contrast to the economic, political and social impact these occurrences have in the real world. As any sincere student of financial history must admit, financial crises have been an essential feature of modern economies.⁹

Modern financial market theory assumes that deviations from equilibrium are largely a short term phenomena and that fundamental disequilibrium does not occur. Even excessive financial booms and the following panics can be shown as being ‘rational’.¹⁰ While this would be a minor ignorance when it were only a theoretical issue, it poses a severe problem given the impact modern financial market theory has on actual portfolio management and the credit policy of banks. As many of the risk models being in use are based on the concepts derived from modern financial market theory, the risk arises that by ignoring the potential for long-term disequilibria, practitioners in financial markets are misled into taking excessive risk positions and making boom and bust cycles not only more frequent but also more severe. Political decision makers as well are led to believe that financial markets are inherently ‘efficient’ and market prices the ‘rational’ result of the behavior of utility maximizing agents. But when prices of financial assets are deemed to be efficient and when diversification is applied as a means for risk reduction, the fundamental aspects of an investment become less important than the market action itself with the resulting tendency of herding among investors.¹¹

In the view of Austrian economics modern financial market theory ignores the possibility that - for some prolonged time - investors may be induced to pursuit erroneous activities, in particular when monetary policy and/or the banking system induce excessive money supply.¹² Even if we assume

⁸Markowitz, Harry M., *Portfolio Selection: Efficient Diversification of Investments*, New York 1959

⁹Kindleberger, Charles, P., *Manias, Panics, and Crashes. A History of Financial Crises*, New York 1989, see also by the same author: *A Financial History of Western Europe*, New York 1993

¹⁰Cf. *Crashes and Panics. The Lessons from History*, ed. By Eugen N. White, Homewood, Ill., 1990

¹¹For an overview of various microeconomic concepts of financial instabilities see Andrew Crocket, *The Theory and Practice of Financial Stability*, *Essays in International Finance*, No. 203, April 1997

¹²Monetarists, neoclassicists, and Keynesians alike, work with highly simplified theories of monetary effects on interest rate, investment and capital, and widely ignore the Wicksellian theory of the interest rate which was

that humans try to act rationally and in an utility maximizing way, this does not guarantee that the collective outcome of their behavior is rational as well, i.e. that market prices of financial assets represent equilibrium. Firstly, equilibrium in terms of information efficiency may be misplaced because knowledge in society is unevenly distributed and different agents hold different and often contradictory theories which may generate non-rational expectations.¹³ Secondly, misinformation must not necessarily be random but is systematic when the money rate of interest conveys false expectations about the availability of real resources and time. Therefore, monetary effects are not limited to the general price level but may fundamentally disrupt equilibrium relations.¹⁴

In neoclassical economics the rational expectations assumption serves as a means 'to close the model' as does the assumption of market efficiency in the modern theory of finance which closes the models by transforming 'action' into 'reaction'.¹⁵

Doing away with fundamental uncertainty discards the essence of financial and economic decision making in favor of the simplified concept of 'risk'. While 'risk' can be calculated, 'uncertainty' implies the ubiquity of error. On a practical policy and management level these models contribute to a narrow understanding of financial markets as the assumptions prevails that in finance and economics there are 'constants' or 'averages' which may form the basis for calculations that hold in the future. This way, the importance of adaptation, i.e. the continuous transformation of plans and facts as the major feature of human activity gets lost in favor of a mechanistic view which presumes 'normal' conditions but is at a loss in dealing with financial crises.

III. Boom and Bust in Financial Markets

In contrast to the markets for goods, financial markets are characterized by higher degrees of flexibility and lower transaction costs. Therefore, financial markets are prone to disconnect with the

the starting point for Mises' and Hayek's monetary theory of the business cycle. For the highly differentiated Austrian theory of interest rates, see: Mises (1940), pp. 474-532 et passim

¹³Lachmann, Ludwig A., The role of expectations in economics as a social science, *Economica* NS 10 (1), 1943, pp. 12-23 and Mises, L. v., 'Elastic expectations' and the Austrian theory of the trade cycle, *Economica*, NS 10(3), 1943, pp. 251-2

¹⁴Central bank action as human action is also exposed to fundamental uncertainty and as with any other economic action, intention and results will deviate most of the time when it comes to determine the appropriate interest rate and the growth rate of the monetary aggregates.

¹⁵The new classicals use the rational expectations hypothesis as a means of closing their models to uncertainty which allows determinate solutions. This procedure raises the paradoxes of omniscience. Rational expectations is a sort of practical omniscience: not everything is known, but the structure of what is unknown (as randomness) make it effectively irrelevant to current decisions. See Hoover, Kevin D., *The New Classical Macroeconomics*, Oxford 1988, p. 239

real economy. While some financial transactions reflect the real exchange of goods and services, an ever increasing part of them is based on expectations about the trend of asset prices themselves. While, in a monetary economy, each real exchange is reflected in the exchange of money, financial market transactions must not always reflect real exchange. On the contrary, financial transactions may impact and even determine the direction of real exchanges not only at inflection points but in the form of establishing real business trends and cycles. Credit, and international credit in particular, possesses the potential of changing real market situations, and money in general may cause disequilibria in the real economy even when it is regarded as being “neutral” when measured in terms of the price index.¹⁶

Credit is one of the prime determinants of shifts in purchasing power within an individual economy, and, when international credit relations occur, between different economies. This becomes obvious when the perception of creditors changes and abrupt losses of creditworthiness occur. Such volatilities of perceptions are tantamount in international markets and sudden changes in the assessment of creditworthiness once and again have had severe effects on the economies involved when as a result of these changes sudden withdrawals of purchasing power took place¹⁷. The impact of credit shocks which result from the process of expansion and contraction of credit may deeply change the structure of capital and thus have much more long lasting effects than Keynesian and neoclassical models account for. Neoclassical theorizing assumes that expansion and contraction of credit are more like ripples than waves.¹⁸ Due to credit, money is not a mere veil but an active force which does not only affect the structure of the exchange of goods and services but also does have profound impact on the time dimension of an economy’s production process. Even under a regime of price stability, the way credit is allocated will change the structure of capital and is thus a major determinant of the allocation of goods and services in an economy. While it is the financial crisis which gets the attention and makes the authorities to apply a host of measures, it has been the excessive use of credit which allowed for the misallocation which is then revealed when liquidity gets tight. It is not the outflow of monetary capital which produces the distortions but it is the massive inflow which makes malinvestments happen and which are brought to light once additional liquidity vanishes.

Given that creditworthiness, i.e. the assumption of future payment ability for an economic entity or a group of potential debtors, is established by the creditor, the potential for the inception of a self-fulfilling prophecy is being set with the inherent tendency to get ever more momentum when more and more creditors will be attracted to the scene. *Uno actu* the availability of credit establishes payment ability, and the transfer of purchasing power which comes with the extension of credit

¹⁶Mises (1940), pp. 356

¹⁷Kindleberger (1989)

¹⁸It took the financial and economic crisis in South East Asia that authorities and observers finally woke up to the destructive force of massive international capital flows. Cf. Barry Eichengreen, *Toward a New International Financial Architecture. A Practical Post-Asia Agenda*, Washington 1999

opens the way for an increase of growth rates and profits which in turn may attract new creditors. The extent and the duration of credit cycles depend on a variety of factors such as the time horizon of the creditor, the general liquidity situation and regional and sector specific outlooks. There is no reason to believe that some self-correcting processes will always be at work. Rather, the opposite seems to be true as re-enforcing trends tend to exaggerate the upside as well as the downside movements, creating the familiar boom and bust sequences which are so common in international financial markets.

For a variety of reasons, the swings of expansion and contraction of credit are more pronounced in the international economy than within a closed economy:

1. In contrast to credit expansion and contraction in a closed economy, in which the boom and bust sequences are mostly limited to individual sectors and only rarely do affect the whole economy, international credit relations tend to affect whole economies and regions and the regional contagion helps to increase the impact on the individual economies.

2. As the market structure in which the major international creditors operate has oligopolistic features there is a widespread tendency for similar behavior within the group.

3. In international markets it is technically easier for the authorities to initiate a bail out and as the stakes are unusually high, the authorities in the creditor countries as well have been willing to act this way with the aim of controlling 'systemic risk' within the international financial system..

4. The assumption that an international safety net does exist tends to lower the risk perception of creditors which leads to an oversupply of credit whose limit is quite flexible and may only find an end when the authorities lose the willingness for further bailouts.

5. International credit relations are deeply interwoven with political and strategic aspects and this, too, will increase the tendency of credit expansion to the ultimate limit while in the process of contraction these very same political elements cause an acceleration of credit implosion.

6. With international credits there is the additional transmission mechanism of the exchange rate which tends to re-enforce the processes of expansion and contraction.

7. The authorities in debtor countries are inclined to maintain strong currencies in order to attract foreign capital. When their policy fails, a self-enforcing trend to the downside usually does set in.

The concept of 'systemic risk' usually refers to the risk of a global contraction of liquidity. But the very nature of international credit relations implies that 'systemic risk' is also virulent in the process of credit expansion. Credit expansion tends to lead to growth and higher profits with both the creditor and debtor, and phases of international credit expansion usually are periods of global or regional booms. There is an inherent tendency that, once the path is set for such a boom, it will

hardly stop before it is overextended. Empirical evidence shows that there is no bust without a boom which has gone out of control¹⁹.

IV. The Pitfalls of Current Crisis Management

The standard paradigm of current crisis analysis and management which is derived from a mixture of neoclassical and Keynesian economics²⁰ and the IMF designed programs which follow this approach usually run down to the three basic elements of currency devaluation, a reduction of government expenditures and additional external credit lines. This way one hopes to address and amend so-called 'macroeconomic imbalances'. But the typical pattern about to emerge after the application of these programs consists in the sequence of a short lived recovery with a new and even more severe plunge thereafter. Without achieving a higher level of prosperity, most of the crisis countries are confronted with a heightened debt burden which hampers further economic progress. The conventional wisdom that is being applied is based on the assumption that growth per se implies future prosperity. While it were ridiculous when a company would confuse turnover with profits, conventional macroeconomic thinking makes their followers believe that a higher gross domestic product will be equivalent to wealth creation.²¹

The current global financial crisis management is characterized by a peculiar mixture between neoclassical theory of economic equilibrium, Keynesian macroeconomics and the modern theory of finance. Despite the divergences between these theoretical models, they all share the common believe in the microeconomic neutrality of money and that money is essentially liquidity. There is nearly a complete ignorance of the capital effects of money and the impact of credit on an economy's capital structure. The paradigm which guides current management of international crises ignores disequilibria as a process, and in the wake of the Keynesian tradition the illusion that an increase in demand may in fact reduce scarcity has become a widespread assumption. The very foundations of neoclassical economics plays down malinvestment, and the Keynesian perspective ignores scarcity as a fundamental economic condition. Both set of ideas combined lead to the current policy prescriptions of bail outs and liquidity expansion while ignoring the fact that by doing this there is an ever increasing distortion in the capital structure whose very nature remains uncovered as long as this policy of 'après nous la déluge' continues. The peculiar mixture of modern

¹⁹For one of the most recent expositions see Edward Chancellor, *Devil Take the Hindmost: A History of Financial Speculation*, New York 1999

²⁰Most typically represented by Paul R. Krugman, *Currencies and Crises*, Cambridge 1995

²¹The final end of all production is consumption and the value of production goods is given indirectly by the subjective valuation of consumers. While producing more capital does create growth, it does not create value when malinvestments occur.

economic policy which takes from neoclassical economics the idea that the markets always get it right and from Keynesian economics that demand must be expanded ignores that markets cannot get it right when interventionist policies increase demand and macroeconomic accounting ignores the problem of scarcity by assuming that higher demand is the same as the creation of wealth.

This way whole economies and regions are exposed to excessive sequences of boom and bust. When each and every financial crisis is ex ante diagnosed as the result of a lack of liquidity, and when, in the same line of thinking, the effects of money and induced demand on the capital structure of an economy are ignored, each of these interventions tends to increase existing distortions until a point will be reached when new interventions are less and less effective. Even the rich economies hardly escape this point because, in the end, even the richest economies will have wasted most of their savings - as recently has been demonstrated by Japan. Poorer economies with their proper lack of savings are pushed deeper and deeper into the quagmire of dependence on external financing and an ever increasing foreign debt burden.

When due to these policies, liquidity is made freely available, and the government or individual economic actors make excessive use of abundant credit, the economy as a whole is at risk of being exposed to a form of collective error as monetary liquidity will be confused with sustainable availability of real resources and time to increase investment and enlarge the relative proportion of production goods with a deepening of the capital structure. With interest rates falling below a critical level,²² economic agents overestimate the availability of real resources and tend to initiate investment projects whose proper realization is impeded by the lack of real resources and by the inadequacy between current consumption needs and the maturity structure of the investment projects. This situation should not be confused with 'over-investment' or the theory of 'under-consumption'.²³ For Austrian economics the decisive point is the existence of malinvestment, which show up when finally complementary investment is lacking and investment projects must remain uncompleted, and when realized investments lay idle as consumers are in need of more urgent goods which in turn are not

²²Austrian economics has not establish operational criteria on that matter although Mises (1940) provided a plethora of points to be considered. Some confusion has arisen due to the position of Keynes who put the Austrian approach into the same pot as the Wicksellian concept of the 'natural rate of interest' which refers to the general price level as the major indicator of equilibrium and disequilibrium. In contrast to an analysis in terms of averages and aggregates, Hayek (1931) stresses that even a 'neutral rate of interest' in the sense that price stability is maintained may cause profound disequilibrium when credit causes shifts between the production and/or consumption of particular groups of goods. The elaborate theory of interest rate by Mises (1940, pp. 434-532) is based on the concept of an 'original interest rate' which is not a price but the expression of 'relative values', i.e. of the valuation between present and future goods (Mises 1940, pp. 476). Cf. Keynes, John M., *The General Theory of Employment, Interest and Money*, London 1973 (first ed. 1936) pp. 183 and pp. 242, see also his 'Notes on the Trade Cycle, chapter 22, pp. 313, and Knut Wicksell, *Geldzins und Güterpreise. Eine Studie über die den Tauschwert des Geldes bestimmenden Ursachen*, Jena 1898

²³Cf. Gottfried Haberler, *Prosperity and Depression. A Theoretical Analysis of Cyclical Movements*, Geneva 1941, pp. 29-105

being produced because their provision has been ignored by investors in favor of investment projects for which the economy is not wealthy enough.²⁴

In this perspective, high growth rates, even when they are accompanied by low rates of inflation, are not necessarily the sign of a stable economy. High growth rates may be the result of interventionist policies which make distortions within an economy more rigid. High growth rates may also be deceiving when they are based on excessive supply of credit. Here, too, foreign credit is more perilous than pure domestic credit creation due to the volatility of the perception of payment ability in international markets. The measurement of price stability by standard indexes does not guarantee that distortive effects are nonexistent taking into account counteractive deflationary effects from technological progress, international competition and the exchange rate. Standard measures of equilibrium and economic strength such as the stability of the price index, GDP growth, high investment rates, and a 'strong' currency will be misleading when they are brought about by excessive credit creation within the economy or by the accumulation of foreign debt.

Overcoming a bust once or a number of times as measured by macroeconomic aggregates is no guarantee that stability and equilibrium in an economy have been restored. Rather, the opposite may be the case: While the inception of an economic crisis or a liquidity squeeze may be the symptom that distortive effects have been building up, new impulses of liquidity will postpone corrective measures as new credit will push economic actors deeper into continuing the pursuit of erroneous investments as they are misled by these monetary signals about the proper time preference structure. Economies afflicted by crises of this kind exhibit the familiar picture of structural distortions in form of the co-existence of unemployment and idle capacities. While being diagnosed as a lack of demand, new liquidity impulses tend to perpetuate disequilibria as they allow the postponement of microeconomic adaptation. The policy of overcoming the crisis by injecting more liquidity may relieve the burden of adaptation in the short run but usually demands a much higher price later on when due to this crisis policy the distortions have become more severe and thus need a much longer time to be resolved. Finally, when the deepness of the crisis becomes manifest, new liquidity tends to perpetuate the crisis and contribute to increasing the rigidities of the structural distortions. With the aim of achieving 'macroeconomic balance', more severe imbalances are being created on the microeconomic level. Typically, poor countries experience profound recessions interrupted by spurts of growth, while the richer economies are pushed on to the path of stagnation.

V. Revising the Paradigm

²⁴This overestimation of wealth refers to investors and consumers who confuse the free flow of liquidity with real capital. Cf. Mises (1940), p. 509, whose point, however, is largely directed to the activity of entrepreneurs while modern economies are also prone to malinvestments induced by excessive consumer demand.

In Keynesian economics, capital is a rather passive and static entity which is supposed to respond in a predictable way to impulses of demand, and in neoclassical economics capital is quite often reduced to a single production function as a feature of the 'representative' firm, while in the Austrian perspective, capital is a process of production which possesses specific structural forms which are determined by relative prices and a time dimension. In the Austrian view, capitalist production is foremost the application of 'productive deviation' from direct satisfaction of consumer demand. The production of capital is time consuming and extracts resources from immediate use. On the microeconomic level it is burdened with uncertainty. For the economy as a whole it may seem that there are always more productive technologies available than are presently in use. At the same time, however, there are always more pressing needs, more urgent immediate desires that want to be satisfied and thus there is a permanent scarcity of time and resources which inhibits the application of the most productive ways of production. Even idle resources do not necessarily allow for an easy shift between the production of capital goods and immediate consumption.²⁵ Abundant supply of money which comes as the result of excessive credit creation tends to mislead investors into the illusion that the economy is rich enough to acquire and maintain the best standards of capital goods. The illusion of prosperity that, for some time at least, accompanies the extension of the process of production and is statistically recorded not just in higher growth rates but in an increase of productivity as well, demands a high price later on when it becomes clear that the investment projects initiated do not meet consumers' needs or more urgent demands. Keynesian economic policies are based on the assumption that the emergence of an economic crisis should be interpreted as a lack of demand, i.e. as a situation where scarcity seems to have vanished and artificially inducing higher consumption or investment or government expenditure appear as a means of creating prosperity. However, the scarcity of time and resources poses a limit to any economy to produce and consume at will. Therefore, in most of the cases, an economic policy of demand management is risking further malinvestments or making existing distortions more rigid. For individuals and policy makers alike, economic realities sometimes are hard to accept and any remedy seems to be welcome which promises to do away with the iron law of scarcity. Keynesian economics in particular has helped to feed the illusion that for economic growth and prosperity the recipes are readily available, and neoclassicism is caught in the schizophrenia of assuming hyper-rationalism for the private sector while lamenting public policy failures.²⁶

Coping with financial crises based on the perspective of Austrian economics would require, first of all, a heightened awareness of ignorance, the human tendency to err due to the pervasiveness of uncertainty. As such it would strengthen the case for an active policy which is directed at fostering those institutions which further individual adaptation as a response to relative prices as the proper signals of scarcity. Secondly, Austrian economics suggests to be very careful as to the effects of monetary expansion and credit supply. Central banks must be on the heed to take into account that

²⁵Hayek (1984)

²⁶Cf. Robert E. Lucas, *Models of Business Cycles*, Oxford 1987

price stability may not be sufficient in determining the appropriate level of interest rates. Thirdly, high investment and growth rates may be deceiving when they occur as the result of interventionist policies. Theoretically, Austrian economics assumes firstly, that macroeconomic balance does not imply microeconomic equilibrium; secondly that the pursuit of macroeconomic balance may in fact make microeconomic disequilibria more severe, and, finally, given the tendency for erroneous behavior of economic agents, policy should be directed at opening the free process of adaptation as a way of continuous correction of mistakes.

There is the problem involved that, once interventionist policies have been practiced for some time, rigidities have increased and the economy has been set on a wasteful path. However, the longer such a policy is being continued, the more difficult and costly the change will be. There is a perverse trade-off in political matters which makes decision makers more inclined to continue false policies because they seem to bring some relieve in the short time while a change may be costly right now and the returns lie in the future and appear to be rather fuzzy. Institutionalized labor and entrepreneurs alike as well as public opinion in general, tend to favor short term interventionist solution, too. This way, ignorance on the one hand and hybris on the other hand has become the trade mark of economic policy making in many countries in the past decades. This has produced a pattern of general decline interrupted by short periods of growth only to be followed by a new bust.

VI. Outlook

The currency and economic crisis in Southeast Asia in 1997, the default of Russia in 1998, and the Brazilian currency crisis in 1999 are just the latest incidents in a long chain of severe economic crises which have inflicted large parts of Asia, Africa, and Latin America. To make matters worse, each of these crises has increased the interventionist impetus. But interventionism comes with high costs although these are less visible than the immediate burden of non-intervention. In some respects, it is always easy to find a rationale for an interventionist policy as long as it promises immediate relieve. But even an economy like that of Japan has been brought down by the combination of excessive credit growth at first and the endeavors to maintain prosperity by Keynesian style demand management later on. Right now, it remains to be seen how the U.S. economy will behave when the supply of external credit will stop. In Europe, a moderate but continuous dose of demand management has brought about a peculiar form of mild stagnation while in Germany excessive credit growth and misplaced governmental incentives to integrate East Germany's economy in the wake of unification have brought about severe distortions and rigidities.

With the events of the past years the coffers of the International Monetary Fund have been depleted and the willingness for yet another bail out seems to have weakened. With very few exceptions, almost every developing country is paralyzed by high external and internal debt burdens.

In Europe, Japan and North America, demand management has reached the limits, too. Therefore, a new policy paradigm is not only a matter of intellectual insight but a political necessity as well.

References

Chancellor (1999): Edward Chancellor, *Devil Take the Hindmost: A History of Financial Speculation*, New York 1999

Crockett (1997): Andrew Crocket, *The Theory and Practice of Financial Stability*, *Essays in International Finance*, No. 203, April 1997

Eichengreen (1999): Barry Eichengreen, *Toward a New International Financial Architecture. A Practical Post-Asia Agenda*, Washington 1999

Haberler (1941): Gottfried Haberler, *Prosperity and Depression. A Theoretical Analysis of Cyclical Movements*, Geneva 1941

Hayek (1931): Friedrich v. Hayek, *Prices and Production*, London 1931

Hayek (1941): Friedrich v. Hayek, *The Pure Theory of Capital*, London 1941

Hayek (1984): Friedrich v. Hayek, *Der Strom der Güter und Leistungen*, in: *Die Anmaßung von Wissen*, ed. By Wolfgang Kerber, Tübingen 1996, pp. 130-147, first published by Walter Eucken Institut, *Vorträge und Aufsätze* 101, Tübingen 1984

Hicks (1967): John R. Hicks, *The Hayek story*, in: Hicks, *Critical Essays in Monetary Theory*, Oxford, 1967, pp. 203-15

Hoover (1988): Kevin D. Hoover, *The New Classical Macroeconomics*, Oxford 1988, p. 239

Keynes (1936): John M. Keynes, *The General Theory of Employment, Interest and Money*, London 1973 (first ed. 1936) pp. 183 and pp. 242, see also his 'Notes on the Trade Cycle, chapter 22, pp. 313 ibd.

Wicksell (1898): Knut Wicksell, *Geldzins und Güterpreise. Eine Studie über die den Tauschwert des Geldes bestimmenden Ursachen*, Jena 1898

Kindleberger (1989): Charles P. Kindleberger, *Manias, Panics, and Crashes. A History of Financial Crises*, New York 1989

Kindleberger (1993): Charles P. Kindleberger, *A Financial History of Western Europe*, New York 1993

Krugman (1995): Paul R. Krugman, *Currencies and Crises*, Cambridge 1995

Lucas (1987): Robert E. Lucas, *Models of Business Cycles*, Oxford, 1987.

Lachmann (1943) Ludwig A. Lachmann, *The role of expectations in economics as a social science*, *Economica* NS 10 (1), 1943, pp. 12-23

- Mises (1940): Ludwig v. Mises, Nationalökonomie. Theorie des Handelns und Wirtschaftens, Genf 1940
- Mises (1943): Ludwig v. Mises, 'Elastic expectations' and the Austrian theory of the trade cycle, *Economica*, NS 10(3), 1943, pp. 251-2
- Mises (1949) Ludwig v. Mises, *Human Action: A Treatise of Economics*, Chicago 1949
- Markowitz (1959): Harry M. Markowitz, *Portfolio Selection: Efficient Diversification of Investments*, New York 1959
- Robbins (1934) Lionel Robbins, *The Great Depression*, New York 1934
- White (1990): Eugen N. White (ed.), *Crashes and Panics. The Lessons from History*, Homewood, Ill. 1990
- Vaughn (1994): Karen I. Vaughn, *Austrian Economics in America. The Migration of a Tradition*, Cambridge 1994
- Wicksell (1898): Knut Wicksell, *Geldzins und Güterpreise. Eine Studie über die den Tauschwert des Geldes bestimmenden Ursachen*, Jena 1898