The Moral Economy of Money and the Future of European Capitalism

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Abstract

The financial and economic crisis has raised new questions about the future of the capitalist system. This paper looks at the normative foundations of a monetary economy and what they mean for political values. It confronts the neoclassical paradigm of an exchange economy with the logic of a monetary economy based on contracts between free and equal individuals. From this certain implications are derived for the conduct of fiscal and monetary policy and the institutional framework of policy making in Europe.

The Moral Economy of Money and the Future of European Capitalism

Stefan Collignon[1]

Karl Marx, was he right - after all?

The financial and economic crisis has raised new questions about the future of the capitalist system. 20 years after the fall of the Wall in Berlin, the alternative is clearly no longer a planned economy, Soviet style, but the fragility of the capitalist system is again apparent to everyone. Curiously, Marx never fully understood the nature of money, finance and capital. He explained the capitalist crisis by the fall of return on real capital, but the system's systemic instability resides in the financial sphere.

Financial crises have occurred frequently in the history of capitalism. Their re-occurrence was slowed down after central banks assumed responsibilities as lender of last resort, although the inter-war period saw major breakdowns in 1919-20 (UK), 1924 (France), 1929 (US, Germany, Austria, Hungary) (see Kindleberger, 1984). The period of Bretton Woods was marked by exceptional stability, but after the collapse of the System in 1971, successive waves of crisis have again occurred around the world: the turmoil of 1972-73 in the exchange markets was followed by Herstatt bank failure in Germany in 1974 and the fringe bank crisis in the UK 1974-5; the LDC debt crisis threatened the stability of the world financial system in the early 1980s. The 1990s saw the ERM crisis in Europe (1992-3), the Japanese and Swedish banking crisis, the Mexican peso crisis in 1994, the Asian crisis in 1997, the Russian crash in 1998 followed by the near-bankruptcy of the LTCM hedge fund (Goodhart and Illing, 2002). It may not be a coincidence that these disturbances started to become more frequent in an era when neoliberalism was on the ascent. Re-thinking the future of capitalism requires today re-examining the fundamental assumptions underlying the economic model that has dominated policy making for the last 40 years. We will look here at some paradigmatic foundations of economic policy in a modern monetary economy and then draw conclusions for policy making.

[1] An earlier version of this text was published in the CER Rapport on Europe, 01.2009. *Mastering the Crisis.* I thank Charles Goodhart for very useful feedback.

1. T he Normativity of Money and Capital.

Are money, banks and finance good or bad? Trillions of euros have been spent on bailing out banks, which are thought to be responsible for the economic mess we are in, while no funds are available for schools hospitals or higher wages. People are angry. After the excesses of the financial bubble, the conservative reaction is to go back to the fundamentals of the "real" economy. The French President Nicolas Sarkozy has declared "Anglo-Saxon" capitalism for dead[2] and called for the "moralization of capitalism"[3]. But what does it mean? Is it moral if profit is made with ecology, but greed if it is obtained by financial derivatives? Is the source of all misery the economic rationality of the price system, which allocates scarce resources to satisfy unlimited wants but neglects basic needs, or is it the "irrational exuberance" of financial markets, where fortunes are made (and unmade) over night? Should companies adapt a code of ethical corporate governance? If the provision of public goods conflicts with private goods, are the first morally right and the second evil? Or is it the other way round? In the confused debate about these issues, one is reminded of the phrase by Coluche, the French satirist: "Capitalism is the exploitation of man by man, socialism is the opposite".

Marx (1845) famously wrote: "Philosophers have only interpreted the world differently; what matters is to change it". However, he did not see that how we interpret the world, determines how it is. Norms and values give sense and direction to human actions and are the intentional content of institutions (Searle, 1995). For this reason, economic doctrines shape the world we live in. Capitalism has its own ethos, a normativity that is functional to the market system and at the same time determines the most fundamental values of modern society. Some of its elements, notably the issue of balancing liberty against equality are inherent to the modern capitalist economy; others have their roots in traditional hierarchical economic systems and are opposed to a modern democratic society.

[2] At the G20 Meeting in London, 2 March 2009
[3] At the United Nations in New York, 23 September 2008

Historically, capitalism has emerged together with the financial system. In fact, it was the invention of banking, the de-penalization of usury and the acceptance of interest taking, together with the introduction of double-entry bookkeeping in the Renaissance that ended the repressive culture of the middle ages and liberated individuals: the transformation, which took place between the 17th and 19th century in Europe was the gradual and sometimes violent substitution of the traditional norms of hierarchy by the modern principle of contracts. This principle presupposes and at the same time generates the acceptance of freedom and equality as political norms. Economic agents must be free to conclude (or not) contracts, *and they are equal in their freedom*. As a consequence, freedom and equality are the two dimensions, which define the modern political space in which individual autonomy and emancipation become possible. The entire political philosophy of modernity is based on this pair of values. Without the contract economy and without financial markets, modernity remains incomprehensible.

These modern values became dominant – Gramsci would have called them hegemonic – after the American and French Revolutions. While the articulation of "freedom" became the rallying cry of liberalism, "equality" was trumpeted by social democrats and socialists. However, both these political ideologies and movements are grounded on the same economic principle: contractarian individualism. They stood in stark contrast to conservative hierarchy, which emphasized subordination of individuals to the community and allocation of resources according to the hierarchy of rank and status. John Locke (1689/1988) was the first to design a clear modern counter-program to the conservative Tory ideology defended by his opponent Robert Filmer (1680/1991). It was based on the private property of free and equal individuals. Karl Popper (1995) has later described the cleavage as the conflict between "the open society and its enemies".

Political values must be consistent with the functional norms of the economy. Otherwise society becomes dysfunctional, as manifested in failed states and failed economies. But even if the basic norms and values are coherent, they can be articulated in a variety of forms and these "moral economies" are shaped by economic paradigms.[4] With respect to

[4] The term "moral economy" was first coined by Edward Palmer Thompson (1971) and James Scott (1977). For an application to the monetary economy, see also Muldrew 1998.

the modern economy we may distinguish two fundamental paradigms according to the role they assign to time and uncertainty.

The exchange economy

The dominant paradigm in economic theory is the *exchange economy*, where people improve their welfare by exchanging goods, of which they produce more than they need. Money is supposed to be a neutral *means of exchange*, which facilitates barter transactions, but otherwise can only cause harm and does not contribute to "real wealth". The motivation for holding money derives from its convenience in carrying out exchanges.[5] If too much money is put into circulation, prices increase and inflation will distort the efficient allocation of resources by markets. Thus, monetarists emphasize the control of money supply and price stability as primary objectives for monetary policy. This is the core idea behind Milton Friedman's monetarism, but it has deep roots in the exchange paradigm of classical economic thought, starting with John Locke, David Hume and Adam Smith.

Continuing this line of thought, neoclassical economics has shown that exchanging goods in spot markets in proportion to their marginal utility will maximize individuals' welfare. Subsequently the rational expectations revolution has introduced an intertemporal dimension to the exchange economy. In these models utility is not only maximized by market transactions today, but also by exchanges into the indefinite future. As a consequence, modern economic theory starts with the assumption of "complete markets", where there is a system of markets for every good. By carefully defining "good" to include the date and environment in which a commodity is consumed, economists are able to consider consumption, production and investment choices in a multi-period, risky world. They can do so using largely the same utility theory originally developed to analyze timeless certainty (Flood, 1991). The only additional dimension introduced by time is the choice of trading present against future consumption according to a given rate of time preference. Complete markets provide consumers, producers and investors with perfect flexibility in allocating payoffs and planning for uncertain contingencies, so that asset prices are always and everywhere the "correct" prices. This assumption is called the "Efficient Market Hypothesis". Markets

[5] The demand for money is derived from the "real balance effect", i.e. economic agents hold a given amount of money in proportion to their planned transactions and purchases.

for futures and options are shown to improve the efficiency of marketplaces and this has far-reaching implications for regulatory policy. Even if it is acknowledged that in the real world markets are not complete, the Efficient Market Hypothesis still serves as a theoretical benchmark. In practical terms this approach has reduced uncertainty to calculable risk and has set off the dramatic development of financial derivative products and markets, through hedge funds, forward contracts, futures options, swaps and similar products.

In political terms, the idea that every contingent state of the world could be traded on a market opened the door for the neoliberal distortion of liberalism. If markets are complete and efficient, everything, including externalities, can be traded and there is no place for distributional issues or concern for material equality. When privatization, liberalization, deregulation and monetarism become the dominant political creed, what role is left for politics?[6]

All of the most influential New Classical and New Keynesian theorists have worked with the 'complete markets paradigm'. But, as Buiter (2009) has pointed out, in a world where there are markets for contingent claims, which span all possible states of nature (all possible contingencies and outcomes), and in which intertemporal budget constraints are always satisfied by assumption, default, bankruptcy and insolvency are impossible. It is then not terribly surprising that critical questions regarding the functioning of a modern market economy were never asked nor answered.

The contract economy

This is different in the alternative economic paradigm, which views the economy as a network of contracts and assigns a crucial role to money. It is influenced by the "banking view" of monetary theory. It goes back to Keynes and owes to Minsky, Shackle (1991), Goodhart (1989), Stiglitz, and Riese (2001). It sees market agents constrained by limited information and explains the need for money by its function of *means of payment*, caused by the existence of uncertainty (Goodhart, 1989). In an uncertain world, where people lack trust in their trading partners' willingness and ability to make promised future payments, sellers of spot goods (goods that are delivered now)

[6] I once heard Michael Heseltine, a minister in Margaret Thatcher's government say, "Ideally government will meet once a year to hand out the subcontracts".

require immediate payment by transfer of a reliable asset. The asset, the transfer of which extinguishes debt obligations, is money (Keynes, 1930), because money is liquidity and has the "advantage of immediacy" (Demsetz, 1968).[7]

Holding money gives security. Giving up this advantage has a price: the interest rate. In an uncertain environment, liquidity trumps other assets. The higher the uncertainty in the economy, the higher the advantage and therefore the price for the safety of liquidity. A high price may lower the demand for credit, but could also create an adverse selection bias, which would constrain the supply of credit (Stiglitz and Greenwald, 2003). Thus, trust and stability in the macroeconomic environment will increase the likelihood that people will pay with money, buy things and lend against promises.

Money is not printed paper dropped by helicopter. In a modern economy, money is a by-product of credit, and liquidity is provided by the central bank. Central bank liabilities extinguish debt because they are legal tender, i.e. a legally certified claim to the assets owned by the bank.[8] Commercial banks obtain liquidity by "discounting" debt titles against central bank money,[9] debt they have themselves previously granted or acquired. In other words, they transform their own claims for future money payments from clients into the immediate advantage of being able to make payments now. The need of banks and other agents to hold liquid assets as reserves allows the central bank to steer the interest rate in the money market and indirectly for the whole economy, because the rate, at which the central bank discounts securities from commercial banks, is the price for liquidity.

This has three implications: first, there is a structural shortage in the money market, created by the fact that when a *loan plus interest* are repaid, *more* money is needed to redeem the debt than initially borrowed.[10] This additional money must come from the

[7] Economists tend to speak about liquidity, while lawyers refer to possession; both concepts express the advantage of immediacy. Shackle (1991: 12-13) summarized it: " Money does have a value in use, for it has *value in possession,* and not merely a mechanical and token value for perpetual exchange".

[8] The certification by some authority (the state) is necessary, because in a contractual economy *property is a claim to possession*, and this claim has a representation in the liability side of the balance sheet. This distinction is easily blurred when thinking of money as gold or silver coins, which are simultaneously the asset and its representation. In fact the English term "asset" confounds possession with property.

[9] I use the notion of "discounting" here in a generic sense, which includes open market operations, reverse tenders, etc.

[10] One implication of this statement that I cannot develop here, is that according to Walras Law, the structural excess demand for money and equilibrium goods markets generate a structural surplus in the labour market. See Riese 2003.

central bank itself. Hence, in aggregate commercial banks are always structurally short of liquidity and the central bank is the monopoly supplier of money. The mirror image of this shortage is excess demand for central bank reserve assets in the money market. This makes money "the scarce asset" par excellence, not because money is strictly limited in supply, as monetarists claim, but because the way, by which money is supplied, generates excess demand for it.

Second, if the interest rate reflects the scarcity price of money, at zero interest rate the monetary economy becomes dysfunctional, because money and bonds[11] are then perfect substitutes and any promise of future money payment is equivalent to immediate payment.[12] But this means, there is no need to hold money as a reserve assets to cover for the uncertainty of having to make future payments; the demand for money is then only derived from the purpose of exchange, i.e. efficient barter. The system behaves as an exchange economy.[13]

Third, the scarcity of money relative to resources yields the relative price signals that ensure the efficient allocation of resources in the context of general uncertainty (Keynes, 1936: 213-217). In a zero interest rate economy, or in the exchange economy, a different mechanism for the allocation is needed. With the focus on utility, possession takes precedence over property, and power and hierarchies rather than promises and contracts determine the allocation of possessions. This changes not only the economy's long run dynamics, but also the society's political normativity. The exchange economy reproduces values of submission to authority; the contract economy is based on free and equal individuals, who conclude their social contract to manage their common affairs democratically.

The consequence is that capitalism cannot work properly with zero interest rates. In the long run, a zero interest rate policy leads to the euthanasia of capitalism, although not of the exchange economy. Economists working with the exchange paradigm see no

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other markets, notably the labour market, have a structural surplus (Riese, 2003).[10] Unemployment is therefore logically an intrinsic feature of capitalism, although this statement says little about how much unemployment is compatible with a functioning credit economy.

[11] For convenience let us call securities discountable at the central bank "bonds".

[12] When the central bank is owned by the state, the cost of possible default is born by the treasury and covered by taxes.

[13] We may also say that the exchange economy is the special case of a monetary economy where the interest rate is zero.

disadvantage in lowering interests to zero and dropping helicopter money in a depression. But a zero interest rate switches off the engine of growth. An example was the late Soviet Union, where money was no longer the economy's hard budget constraint.[14] Growth was planned by a centralized authority, but the system lacked the mechanism to sustain it. Similarly, it is possible that the Japanese economy has suffered from extremely low interest rates over the last decade. Classical economists have explained output expansion in a decentralized exchange economy by profit and greed. But greed does not explain why individuals continue to labour and endure stress and hardship long after the greedy temptation has vanished. Without this persistence capitalism would long have disappeared. Greed is no equilibrium phenomenon. The human mind is fickle and so would be the choice between labour and leisure if greed were the only motivation. In the contract economy, profit opportunities may well be the carrot for starting economic activity,[15] but it is the obligation to service debt, the moral obligation to keep one's word, that forces individuals to persist in the production of wealth.[16]

A positive interest rate is therefore a necessary requirement for money to remain scarce, and it is the cause for the long run expansion of capitalism. The economic mechanism is simple and powerful. In order to be able to service his or her debt and repay the credit plus interest, a borrower must generate a surplus, i.e. income over and above her immediate consumption. By definition, the difference between income and consumption are savings and the part of today's income that is available for future consumption is investment. If households borrow from each other for the sole purpose of consumption, the savings of one are consumed by the other and the net effect is zero. In aggregate, savings are only positive if aggregate income is higher than aggregate consumption. This can be the result of an intertemporal substitution of consumption, or by an increase in aggregate income (the wealth effect). But at a *given* interest rate (i.e. with unchanged time preferences), there is no substitution effect; servicing the outstanding debt then requires producing additional output and selling it for money.

[14] See Riese, 1990, for the analysis.

[15] Keynes (1030) was well aware of this; his "entrepreneurial profits" were windfall profits or quasi-rents that disappeared in equilibrium.

[16] Obviously, people do not keep their word all the time. Society has therefore developed commitment devices and sanctions, mostly based on social exclusion. In this context Max Weber's observed link between capitalism and Protestantism would deserve a reinterpretation.

This explains how money could historically become the engine of growth. Because dynamic equilibrium is attained when the growth rate equals the interest rate (Blanchard and Fischer, 1989), maintaining a positive interest rate is the best guarantee for long run economic growth.[17] Standing in the classical tradition, Marx has correctly described the mechanism by which the surplus is produced. But he did not understand the interaction between liquidity, uncertainty and credit contracts with the need to produce a surplus. By contrast, Keynes, who was a philosopher of probability, understood the nature of uncertainty and formulated it operationally for economics by his liquidity theory. He saw the fragility of financial markets and recognized that policy had a role in stabilizing the economy. But his thought was more subtle than subsequent "Keynesianism", which reduced his vision of the monetary production economy to the so-called neoclassical synthesis and focussed mainly on fiscal policy.[18]

The essential difference between the two economic paradigms consists in the treatment of uncertainty: in the classic/neoclassic/monetarist tradition, uncertainty is reduced to *temporary* disturbances (shocks), which disappear automatically.[19] In the Keynesian/informational paradigm *uncertainty is inherent to the human condition* and there is no guarantee that the probability characteristics of past observable events will also govern the probability distribution of future events. If that is so, uncertainty requires management. The implications for economic policy are important. If capitalism and markets have a natural tendency to return to a long run equilibrium, the role for policy and government is limited: keep out of the way and make markets flexible, because utility maximizing economic agents would then do whatever it takes to overcome the shock. But if uncertainty is an natural condition, which may distort and prevent the return to equilibrium, then government has to stabilize the macroeconomy.

[17] Strictly speaking, we should distinguish absolute scarcity of money when the nominal interest rate is positive, from relative scarcity of money when the real interest rate is positive. In this paper, I assume both rates to be positive, unless stated differently.

[18] Keynes (1987: 408-412) explained his Monetary Theory of Production in the Festschrift for Spiethoff in 1933. The neoclassical synthesis was developed by Hicks (1937) and later formalized and popularized by Paul Samuelson.

[19] In most econometric models, these shocks are calculable and assumed to follow a normal distribution. This assumption provides the rational for the often highly complex mathematical models underlying financial derivatives.

Public debt

We have so far focused on the logic of the moral economy of money in relation to private debt contracts. We must now introduce government. For Keynes public debt and fiscal policy were important when the economy was caught in the liquidity trap because interest rates were close to zero. But given his theory of money, fiscal policy did not imply that it should be the main economic policy tool.

There is a fundamental distinction between private and public debt. Private debt is redeemed by additional income; public debt is serviced by taxes, which lower future disposable income. Private borrowing for investment purposes therefore fosters wealth creation, while government borrowing does not.[20] The Ricardian equivalence theorem has derived this result from the fact that government bonds are not net wealth (Barro 1974). It argues that given certain informational assumptions, rational consumers should internalize the government's budget constraint, whereby the present value of future tax liabilities is equal to the value of newly issued government debt. Tax payers will then reduce consumption today and save in order to pay for future taxes, so that the government‘s net borrowing leads to a substitution effect, and not to a wealth effect. This logic of public debt is consistent with the exchange paradigm, insofar individuals trade off present against future consumption. In this case, fiscal deficits have no income effects and cannot stimulate aggregate demand.

However, Barro (1974) has recognized that Ricardian equivalence does not hold when the government has a monopoly in liquidity services. But this is exactly what the contract economy requires. In last resort, only money that is legal tender can extinguish debt contracts. Furthermore, public debt has important distributional effects and this can matter for wealth creation. If government bonds are held by individuals with high income, while the debt service is financed by non-distortive taxes, public debt effectively transfers wealth to the rich. This may have consequences for the accumulation of capital, although the precise impact is *a priori* not clear. Alternatively, government bonds may be bought by monetary authorities. Given that central banks are owned by governments, the interest paid by government is effectively its own revenue

[20] The distinction is somewhat blurred at the margin. When taxpayers anticipate higher taxes (Ricardian equivalence), and if instead of lowering consumption they are increasing their output in order to pay (lump sum) taxes, then public debt may contribute to growth. Alternatively, if governments borrow to finance public investment that increases productivity and economic growth, public debt functions effectively like corporate debt.

(seignorage). This is equivalent to saying that if all government debt is monetized, it is in fact interest free (or zero rated) and government borrowing represents an increase in aggregate consumption and a net reduction in aggregate savings. If government debt is only partially monetized, the cost of government borrowing is effectively subsidized and government bonds are net wealth. Under these extreme conditions deficit spending is an unambiguous tool for macroeconomic stabilization policy. However, public borrowing does not generate any incentive for long run growth, because the debt service is covered by taxes, i.e. a reduction in disposable income, and not by an increase in output.

From a normative point of view, public debt does not generate contracts between free and equal citizens, but submission to tax authorities. Only in a democracy can citizens affirm the modern values of freedom and equality, insofar they are the sovereign and ultimate owner of the republic.

Political normativity

The two economic paradigms have also implications for political values and morality. In a neoclassical world, people strive to maximize their utilities, where more is better. The dominant political value that allows to achieve this is what Isaiah Berlin (1958) called “negative liberty”, i.e. the protection against interference by others. In economic terms, negative freedom signifies free markets. There is a consistent theme from Lockian liberty to Adam Smiths’s invisible hand, from modern property rights schools to neoliberalism: reduce the sphere of public/government interference. Few questions are asked about the nature of governments, as long as they successfully implement free market policies. Thus, Friedman (1987) could call Pinochet’s Chile “an amazing political miracle”. This reduction of freedom to negative liberty is what defines *neoliberalism*.

With the alternative Keynesian paradigm, governments have a role to play as guarantors of systemic stability. They must minimize uncertainty; this is the role for macroeconomic policy. However, this is not all. The monetary economy imposes its own normativity on society. It opens the gateway to “positive” liberty, namely the capacity of individuals to determine their lives as free and equal masters. The most important institution in a modern economy is the contract. By understanding money as a mean of payment that extinguishes debt contracts, the Keynesian paradigm sees the monetary economy founded in an extensive web of contracts. As we have seen, this implies the normative matrix of freedom *and* equality. Keynesian liberalism is the political liberalism of *equal* individuals, and not by coincidence do American neo-conservatives define political liberalism as being to the left of the political spectrum.

This normative framework of modernity is distinct from the holistic values that dominated traditional societies and nowadays re-appear in neo-conservative ideology. In the traditional society, the individual exits to serve the whole; for the modern individual, society is there to empower her individual self-realization.[21] In the pre-modern paradigm, resources are allocated by hierarchy and power and the holistic society demands the individual to surrender to the authority of the leader, the dogma of belief, the imperatives of community.

Not surprisingly these two views give rise to two very different interpretations of the State and government. In the traditional/holistic perspective, the State is the incarnation of hierarchical authority. It has the monopoly of power and can legitimately interfere with individuals' freedom. The modern view sees the State founded in the social contract by free and equal citizens, who are owners of common public goods as well as owners of private goods and decide themselves how to use these goods. Hence, the modern state is democratic, the traditional is authoritarian. It is the collective determination of the public good through democratic public deliberation and choice that gives citizens the positive liberty of determining their life plans, of being their own master. This distinction between the authoritarian and the democratic State is prior and more fundamental than the conflict between freedom and equality, between economic liberalism and social democracy.

The foundation of modern democracy is the contract economy. If free and equal citizens conclude the social contract, they must have equal rights to appoint governments as their agent, and to charge them with the implementation of policies which reflect their collective preferences. They need a government that is accountable. Contrary to the role of government in traditional societies, where legitimacy is derived from collective identity and cultural homogeneity, modern government is functional and preference choice oriented.

[21] See Popper (1995) for the full development of these ideas.

These normative considerations have important consequences for how one perceives the interaction between governments and markets. The Anti-Keynesian revolution by Friedman and the monetarists in the 1970s has given priority to the exchange paradigm of microeconomics and ignored the need for macroeconomic policy in minimizing uncertainty. The reduction of liberty to the "negative" concept of non-interference has prevented using the democratic state as an instrument for positively defining the collective preferences of individual citizens. It therefore has also minimized the redistributive function of the State. Neoliberalism became a program to dismantle the social welfare State. Re-defining a new policy agenda for the post-neoliberal era requires a return to the fundamental norms of modernity.

2. Models of Capitalism

Although the credit economy has been the historic engine of growth, it has also generated increasing social inequality. Owners of securities have a claim on the increase of income and wealth. The accumulation of capital concentrates property in the hands of few, unless some form of redistribution re-establishes the balance. Thus, the freedom of economic liberalism remains purely formal, unless it is counterbalanced by principles of equality and fairness. The modern approach to redistribution is to use the democratic state for making laws that will establish a fair balance between economic freedom and equality according to citizens' tastes, even if the balance between these principles may shift over time.

Because citizens are the sovereign in a democratic state, legislation has to adapt to the general will of the people. The conservative approach is to use the authority of the state in conjunction with communitarian identity to restrain the unfettered liberty of markets. Here, the will of the people has to adapt to the authority. Thus, if the monetary economy has generated freedom and equality as fundamental norms of modern contractual individualism, it has also created the modern democratic State. However, these principles have also interacted, sometimes uneasily, with the norms of traditional society. In other word, the *political norms* of modern contract based and those of traditional exchange economies are articulated in a variety of forms, in accordance to which norm becomes dominant. If conservatism takes over, individualism is suppressed.

Communism, fascism and now Islamic fundamentalism are attempts to return by force to traditional authoritarian and hierarchical forms of social relations that suppress the individual. In Western Europe, as in the United States, modern individualism has prevailed, although holistic conservatism has often become a subordinated ally of either economic liberalism or socialism This has given rise to different social models. With a little help from the American friend, Europe has found a social equilibrium after the Second World War that has preserved individual freedom and equality in the context of a stable monetary economy. European monetary union is the pinnacle of this long process.

Models of welfare capitalism

The emergence of modern individualism as the dominant political philosophy did not mean that Europe had to converge to a single model of capitalism. In fact, despite the common normative structure of a modern contract economy, social models in Europe are highly diversified. Some countries have given greater weight to liberal market freedom, others to social equality. These political norms translate into specific institutional forms with respect to the regulation of capitalism. Each country has developed its own mechanism for providing social protection to less privileged groups and classes. Nevertheless, three basic models of welfare capitalism may be distinguished (Esping-Anderson, 1990): the liberal Anglo-Saxon model, the social democratic Scandinavian model and the conservative model at the centre of the European continent. In addition there are some variations in Southern and Eastern Europe that are different, but largely dominated by traditional values of patriarchy and political clientelism.

Is there an optimal social model? What is the 'best-practice' of capitalism in the face of global markets, not only for firms, but also for the institutional fitness in the globalization process? A number of different answers have been discussed in the political economy literature.[22] Most prominently, Peter Hall and David Soskice (2001) have argued that the choice of social models is not arbitrary and cannot be "switched" at will, because each institutional arrangement must be seen in its functional context. For example, the Anglo-Saxon model, which they call *liberal market economy,* is more short-term oriented due to the dominance of financial markets, and therefore also requires highly flexible labour markets; this institutional set-up supports product

[22] For an overview see Sopart, 2005

innovation. By contrast, due to its banking regulations the German model of *coordinated market economy* has a long term bias and with that comes the labour market, that produces the German skill machine and a comparative advantage for product development.

Edwards and Fischer (1994) have challenged the consensual view according to which the Anglo-Saxon model is capital market orientated and Germany is dominated by bank-financed structures. Banks are not more involved with running businesses in Germany than in the USA. And the contagion of German banks by the meltdown in the US subprime market for mortgages is proof that even in Germany securitization had progressed significantly. Vitols (1998) found that at least until the 1990s the uniqueness of the German banking system lied (1) in its unusually high capacity to provide industrial finance in the form of long-term debt capital, and (2) in its avoidance of the "speculative boom-credit crunch cycle" experienced by almost every other advanced industrialized country in the 1980s and early 1990s. These two key characteristics are attributable to a regulatory framework, which involves strict prudential regulation, access to long-term refinancing sources, and a federalist form of corporatism. However, these features have been gradually eroded in recent years, due to the creation of a single European banking market, the globalization of capital markets and neoliberal economic policies. Nevertheless, these institutional characteristics have made an important contribution to Germany's spectacular economic stability after the introduction of Social Market Economy in 1949. Even if there is no way back to the early days, there may be lessons to be learned from Germany for a future restructuration of Europe's financial system.

3. Redefining the policy agenda in Europe

After the crisis, is there a future for capitalism? The financial crisis does not invalidate the viability of the system. But it challenges well-established believes about how the system works. Conservatives call for a return to the "real" economy and the "good old moral values" of decency and trust. But trust depends on systemic stability and this requires government action. There is today a real risk that one throws the baby out with the bath water, that the recognition of the excesses of the last decade leads to excessive repression of contractual liberty and undermines claims for social and political equality.

The conservative backlash - at the political right and left - blames greedy bankers, fantastic bonuses, and financial derivatives for the crisis; it seeks returning to pre-modern forms of regulation, either by imposing authoritarian rules or oppressive morality. In the European context, the backlash takes the form of economic protectionism and the defense of national identities. When the French president declares[23] "we cannot be naïve, we must protect our industry", he announces double damage to French and European citizens: he prevents international trade from stimulating demand in the European market, although this would support French companies, which do not have the privilege of being "protected"; and he denies French consumers the right to buy goods and services at lower prices and better quality. Similarly, to impose limits on how much a person may earn, as discussed in Germany and even in America, does not remove the growing gap between rich and poor. In fact, it distracts from designing fair income policies.

These ideological reflexes are incompatible with monetary union or a single European market. By definition a single market implies the development of free and equal opportunities to conclude contracts and transactions without the impediments of borders or regulative competition between local authorities. But the democratic will of free and equal citizens must decide a legal framework, within which private contracts may be negotiated without harming others. With the single European market, such legal framework must be European, not national.

The state and European democracy

Rethinking European policies requires now redefining the relationship between the single market and the many states in Europe. The ultimate function of the State is to manage and regulate the externalities, which arise from individual actions. As we have seen, the modern State does so by giving a say to individual citizens, who are affected by policy decisions. It is citizens who have the ultimate authority (sovereignty) to decide how they want their interests pursued.

[23] Speech before the European Parliament on 21.10. 2008.
http://www.spiegel.de/international/europe/0,1518,585558,00.html

A paradigmatic shift has policy consequences. The first, economic, priority must be to stabilize the financial system, so that uncertainty is reduced and credit contracts become the engine of growth again that sustains the moral economy of money. This implies rules for financial regulation that restore trust in individual banks, and also macroeconomic policies that stabilize the economy. The second, political, priority must be to prevent conservatism from restricting individual freedom and political and social equality. The narrowing of political discourse to the provincialism of local identities[24] contributes to this as much as the protection of national communities by authoritarian means of the State.

Markets cannot exist without governments because governments guarantee their functionality. Governments own central banks, institute legal tender and set rules and regulations for markets. This insight is not new, but two dimensions of government interference need to be acknowledged. For example German ordo-liberals have always recognized the need for a strong state as the guardian of market rules, but they were strongly opposed to Keynesian market intervention, where governments become market participants (Tietmayer, 1999). On the other side, French interventionism has been fond of an active state, but refused to let the government's hands be bound by markets. The proper design of an efficient European market economy must combine macroeconomic management for the entire Euro Area with prudential supervisory rules, without inhibiting access to the single European market.

As a consequence of the single European market and the single currency, an increasing number of policies is affecting today all European citizens. But policy making in the European Union is dominated not by concerns for collective European interests, but by factional interests of national governments who often justify the usurpation of power to the detriment of citizens by referring to the defense of national identity. This form of governance is incompatible with the modern idea of free and equal citizens, who are masters of their own destiny. The fundamental break-through of the French Revolution, inspired by the liberalism of the first Dutch Republic (Israel, 2004), was the principle that people, citizens, are Sovereign, not

[24] Italy's Finance minister G. Tremonti (2008) has said it superbly: "People no longer believe in the future, but in tomorrow; they no longer believe in the nation, but in the village."

governments. Citizens conclude the social contract to further their interests, not because they "belong" to a community with a given identity. Hence, European citizens must have the authority to agree on appointing a European government as the agent of their common concerns and interests.

An Economic Government for Europe?

The economic crisis opens the perspective for re-founding Europe's polity. A European government must assume responsibility for macroeconomic policies. Intergovernmental coordination can no longer guarantee welfare, because many macroeconomic policy issues require coherent and discretionary decisions, and binding guidelines or open methods of coordination are unable to produce them (Collignon, 2004). Most importantly, if the liquidity premium contained in the price for money reflects macroeconomic uncertainty, then it is unthinkable not to have an institution responsible for stability in the whole currency area.

French political élites have proposed setting up a "*gouvernmement économique*", without ever specifying what it meant. The problem with this proposal is that such government is necessarily bureaucratic and authoritarian, because of its technocratic reduction to the sole economic sphere. Just as elites in the *Ancien Régime* imposed bureaucratic policies on France, the *gouvernement économique* would not offer democratic choice to citizens, but impose elite-designed policies on Europe. In order to be coherent with the norms of modern societies, a government must be democratic and accountable to its citizens. The age of paternalism is gone. Citizens must have the liberty to choose collectively between different policy options and be able to deliberate on the options elaborated and presented by political parties. The nature of government is political. Moreover, a democratic government must be able to propose policy compromises across the entire range of policies, including economics, security, foreign policy. Otherwise citizens' preference-frustration, which emerges when specific issues are rejected without compensating policies in a different domain, will impede the democratic policy consensus that is necessary for a well-functioning democracy. Thus, it is time that European democrats start thinking about setting up a democratically elected European government for issues that concern all European citizens together.

Monetary policy

A European government's economic purpose must be the maintenance of financial and economic stability in the Euro Area in order to minimize the general uncertainty under which investment decisions are made. Macroeconomic stability is the precondition for raising the rate of capital accumulation, creating jobs, improving productivity and sustaining equitable standards of living. I have argued that fiscal policy can make a small contribution to this, if the redistribution of income supports economic growth and if at least some part of the public debt is monetized. But this implies that monetary policy is a crucial economic policy instrument, not only for dealing with short term fluctuations but also in the long run, because in a monetary union all financial contracts are written and settled in the same currency, and most economic decisions depend on monetary and interest rate decisions by the central bank. Fiscal policy, on the other hand, must interact with monetary policy. The Euro Area's present institutional arrangement with uncoordinated national fiscal policies and the sole constraint of the Stability and Growth Pact is suboptimal.

Monetarists have argued that the best instrument to overcome a financial crisis is by providing quasi-unlimited liquidity to the banking system. They see the cause for the crisis in the collapse of the money stock and seek restoring the flow of money to the economy through open market operations and "quantitative easing". They believe that if the central bank "prints" enough money, economic activity will return. However, a crucial requirement for this strategy to work is that financial markets operate smoothly, so that banks efficiently redistribute the liquidity provided by the central bank. Clearly, this is not the case in the present crisis.

The "banking view", which understands money as an information tool in an uncertain environment, allows a better assignment for monetary policy. Asymmetric information and lack of trust have disrupted the interbank market. In this context, the most important task is to preserve money's role as a reserve asset. Because of asymmetrical information and externalities in the interbank market, banks may be denied access to liquidity despite being solvent. Therefore they need assistance. The central bank must act as a lender of last resort. The IMF could also do so in the international context with respect to international reserve assets. The need for central banks to act as a lender of last resort has already been formulated by Bagehot in 1873[25] and was summarized by Goodhart (2002: 227) in three propositions:

1. le
nd freely,

2. at
a high rate of interest,

3. on
good banking securities.

Central banks' response to the financial crisis has been closer to the monetarist view. They have lent freely, at low interest rates, on bad collateral.[26] This policy is repeating the mistakes of the exchange paradigm that have led to the financial crisis in the first place.

Conclusion

To summarize, the future of capitalism is its past: credit and interest are the engine of growth in the modern economy, but also the normative foundation of capitalism. Like all morality, the moral economy of money is ambivalent: its functional norms are freedom and equality, the factual reality is material constraint and inequality. Average income per person is today 12 times higher than it was 200 years ago (Clark, 2007) and this development of "real wealth" would not have been possible without the financial sphere. But the system-immanent tendency for capital to create inequality requires an authority capable of leaning against the wind, of correcting social injustice, of providing a stable legal framework.

Capitalism remains a fragile construct: uncertainty makes it potentially unstable and the accumulation of wealth in the hands of few is a permanent challenge to the modern idea of justice, which is based on freedom *and* equality. The modern *democratic state* is the ultimate guarantor for the sustainability of capitalism. The democratic state is not the authoritarian imposition of traditional values on a liberal economy, but the instrument by which free and equal citizens jointly determine their preferences and how they wish to

[25] See Goodhart and Illing 2002 for excepts of his book.

[26] In most industrialized economies, nominal interest rates are now close to zero and real rates often negative. The ECB has lost € 10bn in toxic assets and ECB president Jean Claude Trichet (2009) has evaluated the total risk at € 600bn, equivalent to 6% of Euro Area GDP.

set the balance between liberty and equality; the democratic state integrates externalities of policy decisions, which affect all citizens. But the validity of modern norms does not guarantee their implementation in actual life. In Europe, too many governments behave as authoritarian agents, irresponsive to citizens' preferences and life designs. And European citizens have been denied a European government that would allow all of them together to make choices about the policies that determine their prosperity and future wealth. It is time this changes.

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