Germany and the global financial crisis: Lessons we need to learn

Speech
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1. Pretence of knowledge – roots of the crisis

We have learned from Friedrich August von Hayek, who taught from 1931 until 1950 at the London School of Economics, that society and the economy are not machines. Anyone who believes it is possible to acquire comprehensive knowledge enabling him to control events has no knowledge, but only a pretence of knowledge. For Hayek, this meant warning economists and social scientists against trying to imitate the "exact" natural sciences. Today, even natural scientists are much more cautious about their disciplines' claims to certainty.

Hayek's warning against such a pretence of knowledge has mostly been understood as a warning against control by a centralized state, as in socialist systems. But it also applies to all human behaviour. Ultimately, it refers to humans' inability in complex systems to predict or truly influence the future, because the knowledge needed to do so is too widely dispersed, and social interactions, for example, cannot be reliably quantified.

The global financial crisis provides us with an apt reminder of this insight. So-called innovative financial products are based on complex mathematical models which claim to be able to quantify all possible risks. But clearly, virtually no one – including the bank management and supervisory boards – is able to comprehend these risks any longer, because they resist intuitive understanding. Something here obviously took on a life of its own.

Lord Dahrendorf has called globalization in the financial sector above all an information revolution, neatly illustrated by the lifestyles of those involved: In the old days, London bankers arrived at their offices in the City between ten and eleven in the morning, had their first glass of sherry at twelve-thirty, then enjoyed a leisurely lunch in the company of interesting people. Then they had to stay at the office until Wall Street opened, at three-thirty in the afternoon London time, and then it was time to go home. Lord Dahrendorf goes on to bemoan how the permanent availability of information today has created a new kind of “economic subjects”: people who wear themselves out working twenty-four hours a day.

Behind the obvious cultural transformation in the banking sector lies the real change: The new availability of information in the financial markets led to the creation and trading of complexities beyond the limits of human comprehension. Trading in derivatives means that risks and information about risks are increasingly detached from their foundations in the real economy, becoming more and more abstract.

With a good, old-fashioned mortgage loan, the bank could inspect the property for which it was putting up money. A cautious bank would lend only 60 or 80 per cent of the property’s value, which kept it safe as long as the value did not fall further. If it did, the bank would only lose a small part of its investment. If in a certain case things went even more badly wrong, then this was clearly due to poor assessment by an individual person in the individual case. The bank backed up the loan with its own capital. The same institution was responsible for making the decision, taking the action and covering the risk.

In today’s financial system things are a great deal more complicated. The lending bank passes on the credit risk to a third party, who must assess this risk based on less knowledge of the property and the loan applicant, and thus with much less information. Every time the risk is passed on to someone else, it becomes more difficult to assess, like the worthlessness of certain debt and mortgages in the U.S. real estate market. The bank which made the loan feels safe, because it has got rid of the credit and default risk. But it is now dependent on the creditworthiness of the institution which took over this credit and default risk. So instead of having to assess a relatively contained risk – such as the value of a certain business property – the lending

bank now faces a much more complex risk assessment: For example, is Lehman Brothers a safe place to park credit risks? To answer this question, the bank has to rely on credit ratings, which in turn are based on highly idiosyncratic collections and weighing of information.

The actual structures are much more complicated than in this simplified example. But the underlying problem remains the same: a lack of transparency; growing acceleration and complexity everywhere, not only in the world of finance; and a weakening of the link between decision-making and responsibility. As a result, gigantic risks of default are dispersed around the globe, due to securitization and so-called financial innovations, right on into the accounts of private individuals.

This is compounded by systems of compensation and incentives which have encouraged bold speculation. Profits from finance markets made up a disproportionate share of net domestic production. And the business grew ever more risky – how else can one explain the 25 per cent rate of return which capital markets were setting as a goal for banks? These returns came at the cost of break-neck transactions which were obviously out of control and which ultimately helped set off the crisis.

So is it all the fault of the banks? Things are not that simple. Years of loose monetary policy set by central banks, the booming American real estate market driven by social and integration policy, the fateful decision by the Securities and Exchange Commission to reduce capitalization requirements for investment banks: All were factors in irresponsible lending.

A whole series of factors led to the crisis. And none of us who played a part has reason to feel especially proud: the bankers and lawyers who developed and sold risky securities; the investors seeking maximum returns who bought securities they didn’t understand; and last but not least the central banks whose policy of cheap money encouraged careless lending. In Germany even our state-owned public banks neglected their real duty, instead engaging in speculation on a grand scale. And we must also acknowledge that the governmental supervision of the banking industry ultimately failed.

“Market Unbound: Unleashing Global Capitalism” is the title of an influential book on deregulation and securitization in finance markets, published in 1996 by Lowell Bryan and Diana Farrell of McKinsey & Company. Today, the book reminds us less of Prometheus than of the ill-fated high-flier Icarus. To understand the current crisis – and earlier ones as well – we must be aware of the human tendency to excess and hubris.

Without our noticing, global finance markets, which actually aim for decentralization and diversity, have become highly centralized. There are hundreds of banks worldwide, but only three major credit rating agencies. In the modern finance system, the intuition of thousands of bank managers in lending decisions has been replaced with mathematical risk models and risk assessment largely dependent on the judgement of a handful of rating agencies.

This brings us back to Hayek: Noting the limits to human knowledge on the one hand, and the unquantifiable complexity of human society on the other, he warned against centralized systems. If we cannot help but make mistakes, then it is better to decentralize decision-making; many actors making decisions on their own will come up with very different judgements and results. Competition then shows which decisions were better and which were worse. The better decisions will be rewarded with market success and will be imitated, the worse decisions will be forced out of the market. But their failure will not bring everyone else down with them. The superiority of the market economy rests on exactly this clever principle, which provides opportunities at the same time it limits risks.

Now, in the financial markets we have not only seen that decisions were largely based on ratings given by a few agencies. We have also seen a concentration of actors which undermines another premise of the free market, namely taking responsibility for one’s own failure. As we politicians have been told, many institutions are supposedly “too big to fail”. As a result, their profits were privatized, but their losses are now being socialized. We must make sure that the holders of high-risk, high-yield securities do not continue to receive their excessive returns at the government’s expense – or at least with the government’s guarantee – while taxpayers bear the risks. Doing so would mean that the government not only covers the loss, but also finances

the excess profit of high-risk securities instead of safer, more conservative investments.

As well as being large, the financial institutions are interconnected, which also has to do with their changed function: Banks now do less business with their clients and more with each other. This is why the failure of one institution can set off a chain reaction which then affects the real economy – or so they tell us. This is an additional problem: When an industry earns a significant proportion of its income from deals within the industry itself, then something is not quite right. Or one could say something is bound to go wrong sooner or later.

Because government cannot allow the financial system to collapse, all the Western industrial nations have now stretched their budgets to the limit – we hope without overextending themselves – to rescue financial institutions with measures which will burden current and future generations of taxpayers for many years to come.

2. Trust and mistrust: Bringing the state back in

In the midst of this crisis, we are thus experiencing a renaissance of the state. Once largely regarded as an unwanted meddler in the economy, the state is now on everyone’s lips. The markets are obviously not able to provide the trust vital to financial markets in particular. Government intervention in autumn 2008 was necessary to prevent a core meltdown of the financial system.

However, we must make sure that the hubris displayed by Wall Street’s “Masters of the Universe” is not replaced with a new form of hubris, this time in the form of unlimited confidence in government’s management ability. What if the numerous stimulus packages around the world cannot prevent a longer recession? Sometimes I have the feeling that many people think things will go on the same as before, now that the government has briefly intervened. In fact, the opposite may be true, and the depth of the current crisis may be the result of the state’s response to economic weakness over the past ten years: with a policy of low interest rates and with increasingly frivolous lending.

Let us turn to a current example of measures against the crisis: In Germany, we have just adopted a “wrecking bonus”: If you take your old car to the wrecking yard, the government will give you 2,500 euros towards the purchase of a new car. There is enough money in the pot to pay for wrecking 600,000 old cars. The programme is a huge success, and demand could well exceed the amount budgeted. Sales of new cars have already increased. We all hope that this continues after the programme ends, that regular demand returns without the help of subsidies. But no one today knows whether this premise of Keynesian economic policy still holds in the current situation. It might well be the opposite, and when we look back two years from now, we will see that demand for cars only shifted from the second half of 2009 to the first. And what if the global car industry simply has a great deal of excess capacity, especially in Europe, North America and Japan?

The greatest mistake we could make would be to blindly interpret the current crisis as a fundamental, systemic crisis of the social market, or mixed economy, or to conjure up the end of the globalized economy. We must not talk ourselves into a systemic crisis. Like no other economic system, the market economy has led to prosperity and progress. But we must also realize that human history does not chart a steady course of constant improvement. A run of successes and progress is always followed by setbacks. This does not mean that a mixed economy is a faulty system – if it were, it could not have functioned so well for decades and created such prosperity. Rather, this is inherent in human nature and the all-too-human tendency to excess which leads to destruction.

I can still remember how Ludwig Erhard, the legendary German minister of economics, later Federal Chancellor, called for moderation in the 1960s, following a phase of unprecedented economic growth, and was ridiculed for it – because no one thought there would ever be hard times again. And then came the oil crisis and global economic stagnation in the early 1970s and taught them all a lesson.

Looking at history, we see that major crises often followed longer periods of stability and steady growth. Especially in the 19th century, in the early years of the modern industrial era, there were serious economic crises which arose out of phases of major innovation followed by speculation and recession.

For those interested in a literary treatment of the topic, I would recommend “L’Argent” by Emile Zola. Already then, hubris and greed led to ruin. Zola portrays this in a way we recognize today as timeless. So we should be cautious about saying there has never been a crisis like the present one. Often, such superlatives only reveal one’s own limited horizon or are themselves a kind of exaggeration. Nor, as the example of Dutch tulip mania in the 17th century shows, are we entirely able to avoid repeating earlier mistakes.

3. Dangers and false remedies

It will be a long-term task to analyse, as free from ideology as possible, the exact causes and triggers for the current crisis and to determine their place in the succession of economic growth and setbacks. We do not yet know when this crisis will end, and we are not very sure what we can do to help. On the other hand, there are some things I am very sure would be deadly.

With the best intentions of saving businesses and jobs, it would be very dangerous to embark on a global contest to see who can provide the most subsidies. It is reasonable to conclude that the situation in the capital markets, which ignored the risks of undercapitalization, helped create or maintain excess global capacity in certain industries. In this case, we must be very careful not to provide government subsidies where adjustment is needed or where poor business decisions were made. In today’s global markets for goods, this would only force other countries to follow suit, and in the end, a great deal of taxpayers’ money would have been spent to very little effect.

A return to protectionism would almost be even worse. I am very glad that President Obama has so far resisted this temptation, which is traditionally associated with his political party. Protectionism too would not remain unilateral but would lead to worldwide competition. And everyone would suffer, especially the many millions in developing countries who are just starting to attain a measure of prosperity.

For Germany, at any rate, it is clear that these problems cannot be solved through currency devaluation. We are a world leader in exports even though we have always

placed a high priority on having a strong currency. After two bouts of hyper-inflation in the last century, the lesson that inflation cannot solve problems affecting the real economy has been burned into our collective consciousness.

At the moment, the greatest danger is that government deficits will balloon out of control, because the problems are too big and the expectations too high to reconcile with a balanced budget. Faced with the costs of German reunification, the current German government has worked hard to consolidate the budget, also by raising taxes. We almost balanced the budget in 2008, which gave us more room to manoeuvre. Some say this policy has now failed, because our goal of reducing deficits has now moved out of reach. In reality, however, the opposite is true: We can be glad that we consolidated our budget during the good years. I am convinced that we cannot go on living beyond our means, and that we cannot keep sending future generations the bill for government spending today. And we also need to recognize that the industrial nations of Europe have a much more problematic demographic structure than the United States, for example, as well as lower rates of economic growth over the long term.

4. Reforming the rules for the financial markets

Reforming the financial markets is much more difficult than pointing out the traps to avoid. The Financial Stability Forum has come up with recommendations. The average non-banker may wonder why their recommendations include keeping an eye not only on the capitalization but also on the liquidity of financial institutions, when constant liquidity should be a ground rule of bank management, at least in the view of non-bankers. But regardless of such details, we politicians welcome and depend on expert input of this kind. My impression of these recommendations is also that, in the past, certain regulatory approaches, namely the rules on capitalization and accounting, tended rather to worsen problems. If that is true, then quickly finding a remedy within the institutional framework of the highly international system of banking supervision is the right thing to do. But I am not sure whether optimizing and expanding the systems for measuring risk is enough. We should not forget that these risk assessment systems are what caused this mess in the first place.

We should also think about how to adapt the institutional framework, including regulation, to take greater account of the globalization of markets. However, I am not at all convinced that standardizing oversight will solve every problem. Another great thinker teaching at the London School of Economics, Karl Popper, referred to “piecemeal social engineering”, a notion which has always been more compatible with decentralized, federal decision-making than with centralized super-regulators. One should not forget that banking regulation in particular is highly internationalized. The most important rules are defined at international level in the Basle Accord. In Europe, all the banking supervision authorities coordinate their efforts. In any case, I am not one of those who think that bigger is always better. Of course we will continue to need international bodies and internationally standardized rules in the future. So we should think about ways to make mechanisms for international cooperation more effective, more efficient and more transparent, and in some cases to increase their democratic legitimacy. We also need to consider whether the process for setting international rules on value assessment adequately ensures the public good, given the importance of such standards, or whether the regulators should be more directly involved.

In Germany, numerous politicians have complained about what they call “locusts”, that is, debt-financed private equity investors who take over companies and dismantle them for profit, but the same politicians have not made a single attempt to close the gaps in accounting and company law which allow such troubling practices.

5. Basic requirements for the market economy and social justice

We must acknowledge that certain basic rules of a market economy did not really work in the financial markets: firstly, the link between opportunity and risk. The opportunity consists of profit and growth, the risk of loss and bankruptcy. This link is already looser in a corporation than in an individually owned firm. Now they are saying that financial services companies cannot be allowed to fail.

This is a problem not only for policy-makers in search of fairness and social justice. In terms of moral hazard, it is also an economic problem. If risks are assumed by a third party, anyone who engages in risky but potentially profitable behaviour will be

encouraged to take even greater risks. It would be an outrage if we not only continued to do business this way, but also forced those who were careful managers and lived within their means to bail out those who took excessive risks.

Already the economist Walter Eucken, one of the thinkers behind the German concept of the social market economy, warned that he who benefits must also bear the consequences of failure. Liability, Eucken said, is a prerequisite for a society governed by freedom and personal responsibility. Due to the impact of bank failure on the larger society, this is the real dilemma. A fundamental question we need to address is this: How can government credibly inspire the confidence that it will guarantee the functioning of financial markets – with state intervention, if necessary – while at the same time asserting, equally credibly, that it will not step in to rescue financial institutions if the worst happens?

What specific form the remedies should take is not easy to decide and is currently being debated. We certainly need better supervision, and possibly limits to passing on risks, which is in any case more the business of the insurance industry, not banking. Contrary to what is often suggested in the public debate, however, this is not about the basic issue of more or less government, in the sense of more or less regulation, but simply about better regulation which is more able to deal with problems.

The superiority of the market economy lies in the fact that it starts with individual creativity, commitment and willingness to work. That is the foundation for economic success, and we must not regulate it to death, even in time of crisis. On the other hand, however, we do need to take precautions against excess, because people are always in danger of being blinded by greed. This is the guiding principle of the social market economy.

Another possible solution could start with smaller units. We need not only huge banks and corporations. Monocultures and giants are often spectacularly successful, when times are good. But they are also subject to bigger crises. Every mistake entails the risk of broader repercussions. This is why we should foster diversity. Diversification is the best protection against the kind of excess and crises we are experiencing today.

The link between risk and opportunity, which produces what we call responsibility, has completely broken down in another area of the financial sector: in its systems of compensation and incentives. These have allowed employees to earn hundreds of millions of dollars a year by carrying out risky transactions which were successful in the short term. Such incentives are not healthy and led to entirely irrational deals which promise fat profits in the short term while ignoring long-term risks.

Bonuses in general are not a bad way to reinforce the shared interests of a company and its staff. But they fulfil their purpose only if the defined incentives do indeed serve the company's interest in positive, long-term development. In the financial markets, the incentive structures had the opposite effect, because company interests were defined as far too short-term. And so, driven by the prospect of bonuses, many were entirely blind to the risks they were taking, to the detriment of their banks, and thus helped bring on the crisis.

We are left with a feeling of unease about the failure of those responsible for managing major financial companies who were obviously no longer able to understand structures they had themselves created. This feeling of unease is all the greater when we look at salaries and bonuses and think of how certain areas of the finance industry have apparently lost all sense of proportion.

I do not believe that improved risk assessment systems or better oversight law will be enough as long as they are grounded in such faulty ideas of order. Any kind of external supervision has a hard time keeping up with what it is supposed to supervise. The market economy needs people who are interested in more than the next day's or the next quarter's results, people who can take on responsibility.

Like many other economists, Hayek also pointed out the importance of morals for functioning markets. Business has as much to do with morals and virtues as with management or accounting tools. Business depends on interaction, long-term exchange. It also depends on tradition and experience. Although some may have lost sight of the fact: Like knowing your customers, tradition and experience are extremely valuable assets, especially in our fast-paced, confusing world.

When the moral foundations of a free-market system are increasingly ignored in favour of just maximizing profit and returns, compensation and incentive systems are probably the key to steering human behaviour. If so, then we may need the state to play a greater role instead of leaving the market to look after itself. However, experience also shows that, due to the mobility of both capital and people, nation-states are finding that their ability to take effective action is limited.

In any case, such arrangements must go hand in hand with greater transparency for the effects of individual action and with an awareness that our open system needs values to function.

In this context, Wilhelm Röpke, another of the thinkers behind the social market economy, wrote in his book “Jenseits von Angebot und Nachfrage” (Beyond Supply and Demand): “Self-discipline, a sense of justice, honesty, fairness, chivalry, moderation, a sense of community, respect for human dignity of others, firm moral values – these are all things people must already have before they enter the market and measure themselves against their competitors.”

These are high expectations, and even after this crisis has passed they will certainly not always be met. And the point is not individual perfection; the point is that we should not lose sight of these virtues. This is something we are all responsible for, and a goal to which we must commit ourselves, while keeping the proper balance between personal responsibility and government action.

The important thing will be to preserve these values even in the globalized information society. Our mixed economy is based on the idea of an open society. It will learn from this crisis. And because it is highly capable of learning, it will master this and future challenges.