Background

Particularly lax regulations in the provision of credit in an environment of a low interest rate policy of the US Federal Reserve Bank (Fed) have led to the oversupply of cheap loans. This enabled banks in the USA to invest without considering the risks of those investments – indeed, without even, on occasion, fully understanding the risks. They then passed on those risks to unsuspecting competitors around the world. These competitors have hidden these transactions from the public by dubious means that removed them from their balance sheets. These mechanisms have also been used by banks and other financial companies to move risks beyond the purview of regulators. The bankruptcy of several million US home owners that stemmed particularly from the interest rate increases by the Fed in the spring of 2007 has, since then, spread in both breadth and depth. The credit markets were the first to be hit by the crisis. The banks then followed. The crisis then spilled over into the real economy by the end of September 2008. The latter stage was most conspicuously marked by the collapse of Lehman Brothers, the US investment bank, which because of its extensive links was a systemically important financial institution. Its collapse, therefore, had serious repercussions. The most serious downturn in the global economy in decades is, as a result expected for 2009.

The Most Important Explanations

Simplifying greatly, three theoretical interpretations of the crisis and its causes can be discerned. Each interpretation has its own implications for regulations (see, for example, Funk 2008).

For a while now, those who are, in general, critical of globalization have stressed the lack of sustainability and the dangers associated with the de-regulation of financial markets. Those Keynesian-inspired economists who espouse this viewpoint to the demand-side issues and to the inherent instability of the capitalist market system (see, for example, Hickel). At the same time, they tend to call for the greater regulation of labour, product and capital markets. This is despite the fact that current

levels of de-regulation in product and labour markets have been shown to have had a positive effect on the average wealth levels in the global economy. Moreover, the positive effects have been felt, in particular, amongst the poorest sections of society in many developing and emerging economies. Those who represent this view go, according to those who emphasize supply-side concerns, too far, however, in suggesting that interventionist economic policies in individual countries and, in particular, that a permanent focus on the macro-economic demand-side issues will alleviate the problems. This is shown, for instance, in the calls for relatively high national minimum wage levels and the counter-cyclical economic policies even in normal times. Carrying out such proposals runs the risk in the medium and long term, however, of reducing the prospects of growth and employment to an extent that is not actually needed. This is because these measures may create inflationary pressures that will need to be addressed by means that slow growth. If these Keynesians had been listened to in normal times “then the public debt would, in all probability, be higher and the political room for manoeuvre would be greatly reduced. And lower interest rates by the European Central Bank (ECB), which could have been justified by references to the lower US rates pursued by the ‘clever’ Fed, would have increased the bubble in the financial markets to an even greater extent and, thereby, would have exacerbated the problem after the bubble burst” (Döhrn and-Schmidt 2008).

Those who adhere to a fundamental economic liberal view of markets stress, on the other hand, the unavoidability – or ‘accident characteristics’ – of economic crises due to errors which hardly can be precluded. Those who espouse this economically liberal view strongest argue that, especially in Germany which already has numerous regulations in place, “banks … need neither more nor higher levels of regulation nor new regulatory authorities” (Paul 2008). This view is represented in the USA most significantly by those who, as before, have had a strong influence on policy making and who have, in terms of personnel, been strongly integrated with government; that is, Wall Street. According to this view, financial crises are, in fundamental terms, as difficult to eliminate as road traffic accidents. In addition, market forces are said to be able to overcome ‘stupid accidents’, such as the current financial crisis which has called the whole system into question, relatively quickly. This mechanism is also argued to be better from a macro-economic perspective as over-regulation. However, many academic critics even in the USA who focus on supply-side concerns, and who also argue in favour of the, in principle, self-healing powers of product and labour markets, contend that considerably more government regulations may, in light of the recent failures in the financial markets, be needed. This latter view is based on the insight that, firstly, the pressures exerted on investment banks and, secondly, the remuneration schemes for managers and investors led to incentives that were highly inappropriate (see, for instance, Bhagwati 2008, Phelps et al. 2008).

Ordo-liberal economists who are mainly based in Germany trace the roots of the current crisis back, principally, to the deficits in the regulatory system. They call into question the dominant view in public discourse, which is based on a moral understanding of the financial crisis (namely, greed). In the ordo-liberal view, the very fact that, in a market economy, individuals strive to increase their income and
wealth is not a problem. Indeed, it should form part of the motor to raise social welfare. It should be the task of an appropriate economic policy framework “to shape the actions of financial actors who are primarily motivated by their own self-interest, so that they, in practice, serve the common good” (Emunds 2008). This has, in recent times, not been the case. This lack of success can be attributed to a problem of complex combined market and government failures. The supporters of this view unravel the problems that are characteristic of financial and asset markets; such markets differ considerably from other markets. Those who espouse this view point to the inadequate exercise of rule-setting and rule-enforcement functions (control and sanctions) of the responsible government bodies – this was because they were, despite these functions, not infrequently both ‘teammate’ and (supposed) beneficiary of the new situation. (This was, for instance, the case with regional publicly owned banks, or Landesbanken.) Amongst others, Stefan Voigt has identified a central and fundamental problem: ‘Because bank insolvencies affect the whole financial system, the state will (on the whole) attempt to avoid them. Banks anticipate that they can count on a bail-out in the event that they go bust. And it is precisely this expectation that leads them to take on risks that are greater than those that are economically sensible for society as a whole. If the high risks lead to high profits, banks can expect to share in this in the form of a bonus; losses do not, in the main, have any consequences for them” (Voigt 2008). From an ordo-liberal perspective, therefore, a considerable dilemma results from the fact that the systemic structure of the financial sector provides banks with a notable threat potential vis-à-vis the state because sanctions often have major macro-economic consequences that are also unwanted.

The dividing line between those who adopt a fundamental view of markets and ordo-liberals in their analyses has, however, recently become nebulous. This is because for a long time instability in asset markets has in developed economies – with the exception of the new economy crisis in 2001 – played a relatively minor role, and the global economy has been growing rapidly (see Stark 2008). As a result, the effects of de-regulation in asset markets were, at times, seen even by ordo-liberal economists as being of benefit to society and as being as without risks as the de-regulation of other markets. This was despite the increase in the threat potential of the financial sector that accompanied financial market de-regulation (see, for example, Donges 2008). This view has been shown, in hindsight, to have been exceptionally dangerous. It also explains why at the moment ordo-liberal economists who all too often un-critically stressed the advantages of free capital markets and who underestimated – or ignored – the risks are being criticized. The surprise at the extent of the financial crisis, which can often be observed amongst many mainstream economists in Germany, shows that ‘economist failure’ and ‘academic system failure’ have (as in some other countries), completely justifiably, become the subjects of debate in analyses of the causes of the current crisis. This situation has arisen because in the teaching of economics today, for example, historical, psychological and institutional insights are all too often ignored (see Hens 2008). This may, amongst other things, have led to inadequate policy advice. It should be noted that all economic schools of thought have, in part, arrived at incorrect assessments. Such assessments can often be described as either an exaggerated
Keynesian belief in stabilization policies or over-optimistic neo-liberal belief in efficient markets. Such beliefs mirror one another (see, for example, Chancellor 2008).

In assessments of the different perspectives of economic analysts in German-speaking countries, however, too little differentiation is often made (see particularly Wohlgemuth/Zweynert 2009). This is because the most important causes of the crisis tend to be seen, apart from the financial market across and regulatory failures, first and foremost in a ‘bastard Keynesianism’ (Joan Robinson). With such an interpretation and biased, theory-based allocation of blame to Keynesianism, these analysts run the risk, however, of inappropriately downplaying the involvement of economic liberals in the events of the financial crisis. Therefore, a more objective discussion of those who are responsible for the crisis is necessary. Such a discussion would recognize that many, on the whole, ordo-liberal-oriented macro-economists are, at least, involved as ‘accomplices’. They did not draw sufficient attention to the possible dangers and consequences of the extensive de-regulation of financial markets. Only a sober assessment of the causes of the crisis will lead to a sustainable and adequate remedy. Such an assessment should not ignore the over-estimation of market efficiencies in the financial sector (see Shiller 2008).

**Implications for Economic Policy**

By pursuing a monetary policy that, to a greater extent than has been the case until now, contributes to the preservation of financial stability and by undertaking further necessary reforms under the motto of ‘as much market as possible, as much state as necessary’, it may be possible to reduce considerably the probability of a ‘major macro-economic accident’. However, such accidents can, because, amongst other things, of the herd mentality in credit cycles and the resourcefulness of humans in overcoming regulation not be completely eliminated (see Nemeskeri-Kiss/Malvergne 2008). Although supra-national solutions may, in part, appear sensible because of international interdependencies, improvements to national regulatory frameworks may also help. They may also, in practical terms, be easier to implement. In the end, it is about reducing the systemic risks in the banking sector by, for example, implementing stricter competition policies. This should be done to lessen the threat potential of this sector. The competencies of the regulatory authorities in the financial sector should be strengthened. Similarly, the accountability of managers who make wrong decisions should be increased further. This should be done, however, without strangling market forces, which is what some opponents of market-based solutions are striving for. If market forces are severely restricted this will come at the cost of future social welfare. Finally, in the curriculums of universities, it is time, once again, to place more emphasis on a holistic economic way of thinking.

**References**

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