



Back to Basics: Towards Intellectual
Humility and Respect for Fundamental
Principles

by

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Nature of the Crisis

- The roots of the crisis lie in violations of key principles underpinning a market economy
- Reforms have to aim at restoring the observance of these principles

The Constitutive Principles of the Market Economy (Walter Eucken)

- Market Price Mechanism
- Monetary Stability
- Open Markets
- Private Property
- Freedom of Contracts
- Liability Principle
- Steadiness of Economic Policy

Regulative Principles

- Competition policy
- Moderate redistribution
- Internalization of externalities
- Correct anomalies of supply

Monetary Stability

- Fed kept rates too low for too long after 9/11.
- Asset bubbles did not influence monetary policy – partly because markets were held to be more efficient than they were.
- China enabled U.S. deficits to keep exchange rate low.
- Central banks did not – and do not - coordinate monetary policy very closely.

What to Do?

- Closer coordination among central banks
- Refine inflation targetting by keeping a closer watch on asset price bubbles

Liability: Financial Institutions

- The liability principle implies that companies that make serious mistakes go bankrupt.
- Bankruptcy is a disciplining force against excessive risk-taking.
- We found that we could not let that happen to banks.

What to Do?

Banks must shrink so we can let them go bust, or their ability to take on risks must be curtailed.

Liability: Bankers

- People who take risks should be held liable for losses; this did not apply. Bankers got bonuses for profit, taxpayers paid for losses.
- CEO pay is subject to principal-agent problem.

What to Do?

- Less reliance on bonuses
- Bonus clawback options
- Bonuses in the form of stock that cannot be sold in the short or medium term

Liability: Credit Standards

- U.S. government pushed for a lowering of credit standards for political reasons.
- Financial innovation allowed the diversification of credit risk. The resale of loans allowed originators of loans to avoid liability for bad credit risk judgement.
- Rating agencies enabled this with optimistic ratings for derivatives because they were getting paid by issuers.

What to Do?

- Fundamental question 1: Are the benefits of risk diversification greater than the costs from weakened liability?
- Fundamental question 2: Should governments change incentives in credit markets that lower credit standards?

Suggestions

- Complex derivatives need close supervision
- The role and business model of rating agencies must change drastically.

Liability: How to Deal with Risk

- Mathematical risk models have been deeply flawed:
 - by not taking history fully into account,
 - by using the unrealistic bell-curve distribution
- Reliance on these models has drastically weakened managements ability to evaluate their risks

How to Deal with Risk:

- More intellectual humility
 - the future is too unpredictable.
 - the human mind can't cope with too much complexity.
- Markets have not predicted the world wars or the fall of the Berlin Wall.

Steadiness of Economic Policy

Ad-hoc decisions on which banks to save
and which ones to let die exacerbated
the crisis

Competition Policy

- Break up cartel of rating agencies
- Break up banks whose collapse endangers markets
- Adjust accounting rules that amplify crises

Conclusions

- The financial sector takes bets on the future. It has been, and will always be, a source of instability.
- Most causes of the crisis are due to violations of fundamental principles.
- These violations occur because the government's role is still poorly understood.

Conclusions

- Partly, governments have tried to shortcut markets
- Partly, they have shortchanged markets by putting interests of business above systemic integrity
- And partly, they have overestimated the rationality and stability of markets

Conclusions

- The answer lies not in a simple call for more regulation
- but in regulation that clearly targets to protect the efficiency of markets against vested interests
- and that keeps risks and attendant liabilities transparent and visible

No High Stakes Game Can Do Without:

