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Article

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CASINO CAPITALISM AND RISK AS A PRODUCTION FACTOR – ONE EVENING AT A RESTAURANT IN PARIS

CLEMENS FUEST*

It was the evening of 24 October 2008 in the back room of a restaurant in Paris. This was the setting for a dinner following on from the Economic Policy Panel Meetings and hosted by the Banque de France. Around 50 economists were squashed around several tables. Over the course of that day our discussions had focused on academic articles. The main topic of discussion in the breaks, however, was the dramatic unfolding of events in the finance sector, with the collapse of Lehman Bank a month previously and the impending bail-out of the credit insurer AIG with billions in taxpayers' money just a few days later. Although a crisis was obviously looming after the collapse of the British building society Northern Rock in February 2008, the dimensions of the catastrophe that manifested itself in autumn 2008 came as a nasty surprise.

That evening the event organisers spontaneously arranged a small panel discussion focusing on the outbreak of the financial crisis. There were three economists on the panel, including Hans-Werner Sinn. Both of his discussion partners focused on describing financial products of differing complexity with abbreviations like CDS, CDOs, etc. Their message was that the crisis had arisen due to the excessive use of complex financial products, which entailed incalculable risks. Banking supervisory authorities failed to understand these products in many cases, but in the competitive arena of financial markets there were fears that prohibiting individual instruments would prove a disadvantage. It is often overlooked that complex financial products lead to multiple connections between banks,

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meaning that the failure of one bank can easily spark a wildfire.

This explanation presents the crisis as a kind of accident caused by stupidity, recklessness or irrationality. Since the financial crisis international the stock markets have often been described as a chaotic system in which irrational players driven by greed chase astronomical sums around the world with no regard for the consequences. Warren Buffet has even described certain financial derivatives (CDOs) as 'weapons of mass destruction'.

Hans-Werner Sinn argued differently, explaining that the crisis was the result of a combination of limited liability and high levels of debt financing. If investors bear only limited liability and can pass on their losses to others such as lenders, they will take excessive risks. This tends to be alright for a while and investors rake in high profits. By virtue of the very nature of risky investments, however, losses will inevitably arise at some point. Investors who hardly use any of their own capital will not be affected by these losses. Others such as third-party lenders or taxpayers (if the state bails out banks) will foot the bill. Lenders need to be aware of these dangers and demand corresponding risk premiums. Taxpayers, on the other hand, cannot really defend themselves. This phenomenon, widely referred to as 'gambling for resurrection', plays a central role. In his book *Casino Capitalism* Hans-Werner Sinn subsequently explained this point in greater detail.

Today, after years of debate over the crisis, this analysis has been widely recognised as the basis for negative developments. The fact that Hans-Werner Sinn presented these arguments back in October 2008 is characteristic of him in two ways. Firstly, this episode shows the speed at which he can analyse complex economic events and grasp their very core. Secondly, it shows that he is not satisfied with citing the fact that people are irrational or cannot deal with complexity as an explanation for economic problems.

It is equally as typical of Hans-Werner Sinn that he warned against throwing the baby out with the bathwater, despite all the criticism of risk investments and

limited liability once the crisis hit. There should be no objection to investors taking risks, as long as they bear the full costs of doing so. On the contrary, in his inaugural lecture at the University of Munich entitled 'Risk as a Production Factor' Hans-Werner Sinn explained that taking risks is part of our modern civilisation – many achievements of the modern industrialised society would not have been made without a willingness to take risks. Taking risks only becomes problematic when losses are passed onto third-parties like taxpayers.

The option of setting up companies in which the liability of investors is limited to the capital invested is hardly any less important to economic development. Limited liability enables modern companies to mobilise high sums of capital from a large number of investors. In his book *Casino Capitalism* Hans-Werner Sinn describes the history of institutions with limited liability and cites a speech by the then President of US Columbia University, Nicholas Murray Butler, made in 1911, in which he describes limited liability companies as the key discovery of the modern age, and as more important than the steam engine or the use of electricity.

I left the restaurant in Paris that evening with the impression that there were difficult times ahead, but also with the positive feeling of having gained a far better understanding of developments in the financial sector.