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Article
Hans-Werner Sinn on the Global Financial Crisis

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Hans-Werner Sinn possesses four qualities to an exceptional degree: courage, clarity, cleverness, and combativeness. This rare combination of gifts has allowed him to work as an excellent economic theorist, path-breaking policy analyst and powerful polemicist. He has also magnified his influence via his roles as President of the Ifo Institute and Founder of CESifo. He is not just an intellectual of astonishing energy, but a true organiser. He is not only Germany’s most influential policy-oriented economist, but one the most influential in Europe. One does not have to agree with everything he has written to recognise the importance of his contributions. Indeed, the clarity with which he argues forces those who disagree with him to clarify their own arguments. That is really valuable.

His qualities are shown in full in his work on the global financial crisis, above all, in *Casino Capitalism*. This early study of the sources of the global financial catastrophe puts forward a simple and powerful idea: “the disaster happened because the bacillus of limited liability, non-recourseness, and irresponsibility spread throughout the world, infecting the financial markets without the regulatory bodies doing anything to stop it. Banks, hedge funds, special purpose entities, investment funds, and real-estate financiers were able to do business almost without any equity. Those having no equity are not liable, and if not liable, they feel free to gamble. They will look for risk wherever it can be found, because they can privatize the profits and socialize the losses. By cutting off part of the loss distribution, they can conjure returns out of mere risk”.

A market economy can only work if decision-makers bear costs if things go wrong. Yet this principle is not absolute: that is why limited liability and bankruptcy exist. In practice, then, a balance has to be struck. In the case of the global financial system, that balance was struck in the wrong place, with far too little equity in lending institutions, far too little recourse against irresponsible borrowers, and far too much risk-bearing by the wider public. As Hans-Werner stresses, this debacle vindicated the central insight of German post-second world war ‘ordoliberalism’, namely, “that markets can only unfold their beneficial effects if the government sets the rules of the game. There is no such thing as self-regulation of markets, only self- ordering within a firm regulatory framework set by the state”.

The idea that the institutional framework of financial markets was defective is correct. But not all the actors were aware of the risks they were taking. Many fooled themselves with the notion that ‘this time is different’. But this does not mean Hans-Werner’s analysis of incentives is irrelevant. Awareness that one would be protected from severe consequences tends to lead to ‘rational carelessness’, not so much a deliberate courting of risks as indifference to remote consequences.

From the correct perception of the nature of the incentives for imprudent behaviour, Hans-Werner drew a number of powerful and cogent recommendations. The most important by far is that financial institutions and other relevant actors need more ‘skin in the game’, with, above all, substantially higher equity requirements. Yet it is vital that, in the aftermath of a crisis, the additional equity not be supplied as a gift either from fiscal resources or via low interest rates. The right solution is direct equity infusions by government and consequent dilution of private shareholdings. If the banks are undercapitalised, they should either accept government equity or raise more equity themselves. Hans-Werner also suggests that breaking up banks might not make them safer. Indeed, more diversified banks are more likely to survive crises. Moreover, if a large number of small banks were to go under at once, they would still need to be rescued.

*Casino Capitalism* also argues in favour of common minimum regulatory standards, to limit the competition in laxity we saw before the crisis. It also argues for
paying careful attention to flawed accounting rules and stresses the defects of risk-weighting of balance sheets. Higher risk weights should be imposed on anonymous securities than on conventional loans to borrowers who face a genuine bankruptcy risk. On all these points, Hans-Werner is right. Yet making such a regulatory regime work is going to be hard. Shareholders may continue to believe they will be rescued. Or they may become convinced they will not be. If they hold the first belief, banks will take too many risks. If they hold the latter, they will cut back loans and dump assets as soon as they come close to the regulatory minimum level of capital. This, in turn, might trigger a crisis.

Hans-Werner’s analysis of the origins of the global financial crisis and the lessons to be drawn from it demonstrate his greatest virtues. The work is clear, accessible, intelligent and persuasive. It addresses a huge economic challenge in a sober and convincing manner. It draws, not least, on the best aspects of the German tradition of thinking on the underpinnings of a market order. We can all learn from this outstanding analysis.

Why, one wonders, is Hans-Werner retiring? German labour market rules still need some more flexibility.