Economic Policy in the Financial Crisis

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The first major financial and economic crisis of the 21st century led to many disruptions, including a loss of confidence in the market economy and free-market institutions, and in the self-regulating and self-healing forces of the market. Do we now need 'less market'? Are the market mechanisms to blame for the systemic crisis? Do we need more *dirigisme* and political commissioners to reign in the market?

The market can only exercise its ordering and welfare-enhancing function if policy-makers properly establish the framework for this development. This they failed to do. In retrospect, the financial crisis was largely the result of policy failure. The question for the future is how framework conditions can be created that ensure the positive effects of the market and avoid its misalignments.

In recent years, many economists have exercised harsh judgement on themselves and their own discipline. Others have very rightly pointed out that their microeconomic instruments are quite excellent. The behaviour of the players that led to the crisis can be well explained by these instruments. Many microeconomic theories that assume that people are opportunistic as well as strategic and rationally proactive can explain the behaviour of the actors in the financial markets only too well. These theories also point to possible dysfunctions that could be corrected, at least in part, by competent framework conditions.

We need only think of the incentives of actors who have their backs to the wall and who have nothing to lose, or of financial companies who for other reasons are not able to bear the larger losses that result from their actions, for example, because when they are in trouble they cannot cover their own losses and must rely on government bailouts. These actors are unfortunately willing to take on bad risks: risks whose odds for winning lag behind the risk of losses. One economist who has long recognised and analysed this behavioural motivation is Hans-Werner Sinn, who already in his doctoral dissertation examined key aspects of this problem. In his economic analysis of the financial crisis (*Casino Capitalism*), he took a renewed look at the behavioural motivation of the financial actors.

One of the consequences of this analysis is the call for correspondingly high capital requirements for banks so that capital is available to cover losses from banking operations. This demand has met with broad acceptance, even though the economic-policy implementation has been slow. These considerations are by no means new ideas in the wake of the Lehman Brothers bankruptcy just as theories on the vulnerability of bank capital and the ensuing incentives for balance-sheet reductions or theories on the development of bank runs are also not new. This is not surprising, because the crisis itself is not the first financial crisis that economists have studied and analysed.

But how do we prevent the on-going policy failure that leads to the non-implementation of these conclusions, particularly with regard to the design of financial markets? This is the question that still needs to be resolved. The remedies are available. Many economists like Hans-Werner Sinn have devoted their efforts to advising policy-makers, either directly or indirectly *via* public forums, in the same way as civil engineers, who like to see their knowledge put to good use. These economists hope, of course, that their policy expertise is correctly interpreted and optimally implemented. This, as we also know from economic theory, is unfortunately not so easy and sometimes even impossible. Theories convincingly explain why even slight differences in the objectives of experts and politicians can make the communication process enormously complicated. We also have good theories on how interest groups influence policy and the functioning of the political process.

This is perhaps the reason why, despite our basically sound understanding of the economics, there are still

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economic-policy failures and why, despite the enormous potential that a well-functioning market economy would have for the general welfare, this potential is not fully exploited. Perhaps the solution to the economic-policy dilemma is that economic experts become more active in the public forum. For many years, Hans-Werner Sinn has devoted much of his energy to just this. His message, aimed at enhancing the common good, often generated considerable headwinds, especially from various interest groups. But his efforts have also earned him much approval and widespread popularity. As he continues these activities in the coming years, I wish him all the strength and energy that he may require.