

Ursachen und ordnungspolitische Konsequenzen der Finanzkrise:

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Reasons of the financial crisis and their implications for “Ordnungspolitik”

60 Jahre Soziale Marktwirtschaft - Entstehung, Entwicklung und
Perspektiven einer Integrationsformel

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Ekkehard A. Köhler

Walter Eucken Institut, Freiburg

Walter Eucken **Institut**



ORDO → Constitutio in Libertate

Agenda

- 1. What is “Ordnungspolitik”?
 - Why is “Ordnungspolitik” of interest today?

- 2. The reasons of the financial crisis
 - Implications for a “new” monetary policy

- 3. Implications for interdependent orders
 - How to fight the crisis with Ordnungspolitik

1. What is „Ordnungspolitik“?

The roots of „Ordnungspolitik“: Freiburg School of Economics

- Starting point: Modern capitalism does not create its own institutional / structural preconditions.
- Ordnungspolitik focuses on the installation of an “humane” economic order under special respect of the interdependence of rules and institutions. (Ordoliberalism)
- Key guideline:
 - *“The policy of the state should be directed at dissolving economic power groups or at least containing their functions.”*
 - *“The economic policy activity of the state should be directed at shaping the general forms of economic order, instead of directing the economic process.” (Eucken 1952/2004)*



Walter Eucken



Ludwig Erhard

„If there was ever a theory that has successfully interpreted its surrounding historicity and that could positively influence economic and general policy with strongly needed ideas, then it must have been the concepts and thoughts of those men, who are nowadays described as Ordoliberals. They have accentuated economic policy with common and general objectives and have decoupled it from its isolated, mechanistic-scientific approach....“

Ludwig Erhard (1961)

1. What is „Ordnungspolitik“ today?

„Ordnungspolitik“: Freiburg School + Virginia School = Constitutional Economics

- *Ordnungspolitik in our days is founded on constitutional economics.*
- Starting point: economics as a matter of choice within and among rules. Acknowledgment that rules cannot be found by coincidence or anarchy.
- Idea: enhance citizen and consumer sovereignty.
- Therefore Ordnungspolitik is subject to the following problem:
 - *Which rules should be adopted to ensure a consumer sovereign economic process*
 - *and a citizen sovereign political process respectively.*
 - *Addressee: The people*
 - *Policy: “Ordnungspolitik” : guardrails for the political and market arena*



F.A. Hayek



J.M. Buchanan

1. The new relevance of "Ordnungspolitik"

Two reasons why economics needs a constitutional approach: 1. Methodenstreit 2. The crisis

- The status quo of economics after the youngest „Methodenstreit“ (UK, US, GER)
 - US: Quantitative and formal theory is not „good“ or „bad“ per se – it is a required tool, but not an end in itself. (Krugman Sep 2009)
 - GER: Constitutional Economics is neither History of Economic thought nor harping on ideological principles. but a modern international approach social science research program (New Institutional Economics).
 - UK „Good“ Economics requires a triad of theory, empiricism and institutional economics (Hodgeson).

- ...and the financial crisis calls for a broader perspective on economic phenomena – especially in the field of monetary economics: “Ordnungspolitik for the Monetary Arena!”
 - EMH, Rational Expectations, representative actor based Dynamic Stochastic General Equilibrium) are under attack (Krugman 2009)
 - An INSTITUTIONAL approach to monetary economics is needed.
 - Monetary constitutional economics can serve here as a blueprint.

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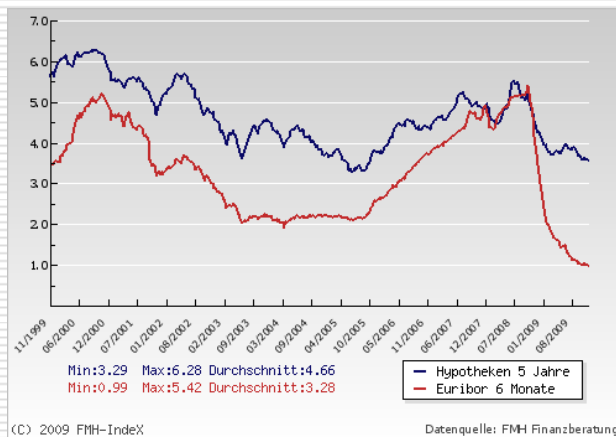
- **2. The reasons of the financial crisis**
 - Dimensions of a “new” monetary policy

- 3. Policy implications
 - How to fight the crisis with Ordnungspolitik

2. The Reasons of the Financial Crisis

The Status Quo: "It's not over, yet"

- The persistence of uncertainty at financial markets:
 - Proof 1: Continuously increased interest spreads. (lhs)
 - Proof 2: continuous refinancing operations by central banks on interbank market. (total CB assets rhs)



Source: www.faz.de



Source: monthly bulletin
ECB Oct 2009 p.87

2. The reasons of the financial crisis

A conjoint hypothesis of two overinvestment theories.

- Hayek (1929;1976) and Minsky (1986) identify two prerequisites for the emergence of financial market turmoils.
 - 1. condition: liquidity
 - 2. condition: „disproportional“ high expectations

- Notes:
 - The two approaches differ w.r.t the expected course of the crisis.
 - Hayek and Minsky reason antithetic implications for the political arena. (political reaction) (2002).
 - Syntheses are methodologically complicated and therefore unsatisfactory.

2. The reasons of the financial crisis

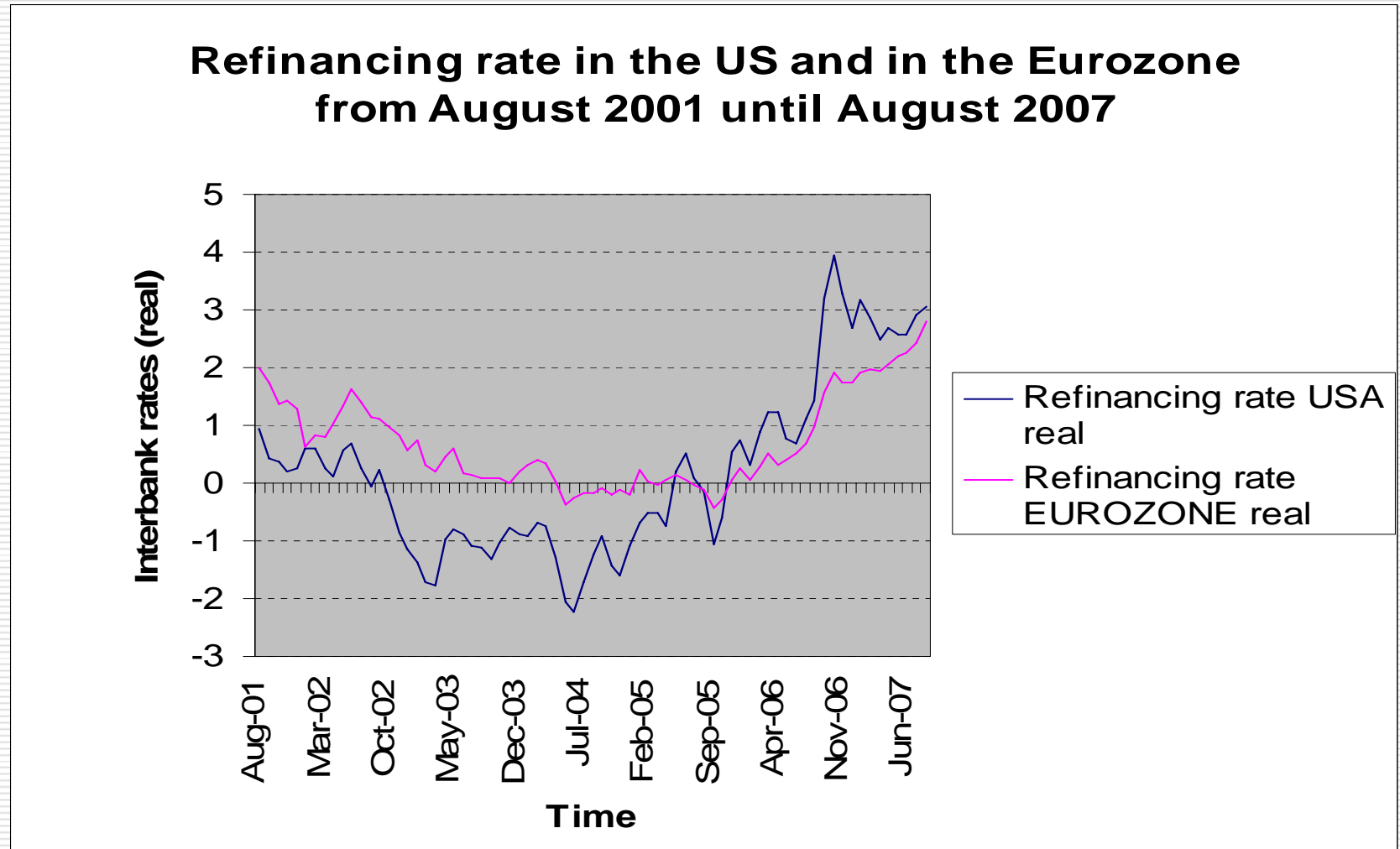
Validation of the hypothesis.

Is the first condition satisfied?

- Has there been an excessive liquidity supply?

2. The Reasons of the financial crisis

Testing the Hayek Hypothesis: (1st. Condition)



2. The Reasons of the financial crisis

Testing the Hayek Hypothesis: (1st. Condition)

- Condition is satisfied

- Monetary policy styles since 1999:
 - Accommodative Monetary Policy (US)
 - Flooding the money markets with cheap money.
 - De facto suspension of the Two-Pillar-Strategy (ECB)
 - Expansive monetary policy. M3 supply growth (1999 – 2009 + 116 %).
 - Worldwide harmonization of monetary policies
 - De facto Bretton Woods II Regime (Dooley /Folkerts Landau 2004)

- Failure of central banking?

2. The reasons of the financial crisis

Have central banks caused the financial crisis?

- NO!
- Moreover an unintended consequence of subsequent developments in academia: i.e. the discourse in the field of monetary economics after Friedman: (policy advise)
 - New Neutrality of Money: Irrelevance of Money
 - Revision of the MV-Rule (Friedman) due to new empirical findings (Woodford, Svensson)
 - (de facto suspension of the Two-Pillar-Strategy)
 - Postmonetarism = CPI focused monetary policy
 - Jackson Hole Consensus
 - Irrelevance of asset price inflation
 - MP Instruments should NOT be used to burst bubbles.
 - In a post bubble environment, monetary policy should refinance financial intermediaries. (Blinder/Reis 2005)

„Home-price increases (...) reflect strong economic fundamentals“ Ben Bernanke 2005

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2. The reasons of the financial crisis

Take Home Message 1: Implications for a “new” monetary policy

- Overall: Monetary policy should neither lead the economic process nor be subject to interest-led objectives.
 - Rule based AND symmetric course of interest rates along the business cycle. (Weber 2008)
 - Central Bank Independence!
 - No politicized monetary constitution!

- Targets for monetary policy: (Asset-) price sensitive monetary policy
 - *Return to MV Rule „utopian“ Issing 30.10.2008*
 - Market Based Liquidity? Adrian/Shin 2009
 - (CPI + Asset price inflation) Borio 2008; White 2008
 - New Two-Pillar Strategy for the ECB (De Grauwe 2009)

- Rule based, independent from the political arena, focused on all monetary aggregates.

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- 1. What is “Ordnungspolitik”?
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- **2. The reasons of the financial crisis**
 - **Second condition?**

- 3. Implications for interdependent orders
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2. The Reasons of the financial crisis

Testing the Hayek Hypothesis: (2nd. condition)

- Is the second condition satisfied?
 - „disproportionate“ expectations?

2. The Reasons of the financial crisis

Testing the Hayek Hypothesis: (2nd. condition)

- ❑ The bust of the Internet-Bubble initiated a search for new investment opportunities:
- ❑ Market meets political motivated incentives for investments on the US housing market
 - CRA Carter-Era
 - Government Sponsored Enterprises (GSE)
 - External effect: stimulated demand
- ❑ Market meets institutional incentives for Moral Hazard behavior
 - Product liability?
 - Oversight?
- ❑ Market meets pro cyclic Reporting Standards (IFAS; US GAAP vs. HGB)
- ❑ Derivates distort future and spot markets: Warren Buffet: „Financial Weapons of Mass Destruction
 - bounded rationality (future value)
 - Lack of negative rules for securitization procedures.
 - Liability (-> Bail outs -> Moral Hazard)

2. The Reasons of the financial crisis

Testing the Hayek Hypothesis: (2nd. condition)

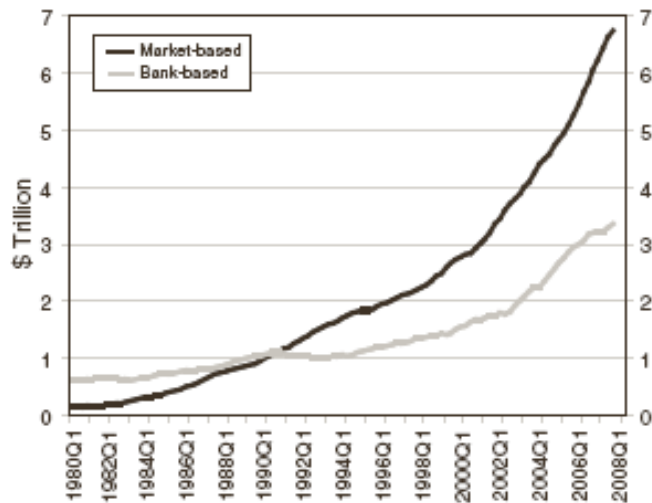


FIGURE 3. MARKET BASED AND BANK BASED HOLDING OF HOME MORTGAGES

Source: US Flow of Funds, Federal Reserve.

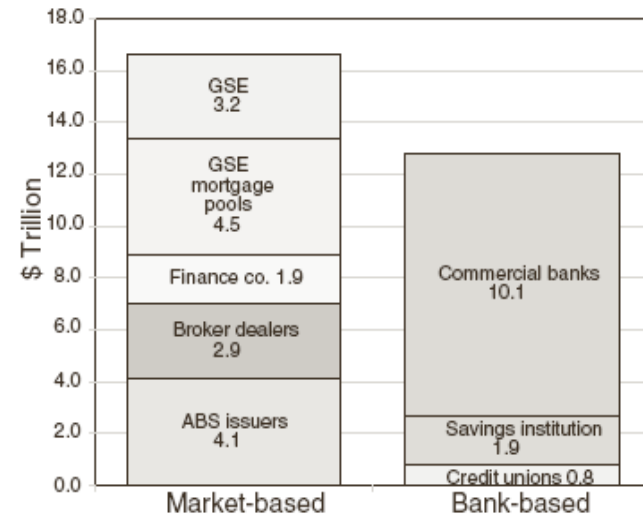


FIGURE 1. TOTAL ASSETS AT 2007:II

Source: US Flow of Funds, Federal Reserve.

Adrian / Shin 2009 AER 99:2

For the United States, Figure 1 compares total assets held by banks with the assets of securitization pools or at institutions that fund themselves mainly by issuing securities. By 2007:II (just before the current crisis), the assets of this latter group, the “market-based assets,” were substantially larger than bank assets.

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3. Policy Implications

Take Home Message 2: How to fight the crisis with Ordnungspolitik.

„Ordnungspolitik“ to fight the crisis:

■ **Mind politicized objectives for financial market constitutions!**

- prevent political motivated investment opportunities
- prevent GSEs

■ **Strict rules for the monetary constitution!**

- Prevent a second prisoner's dilemma: Suspend JHC
- No ex-ante policy measures.
- Rule based monetary policy. (CPI+ asset price oriented)
- Exit strategy for refinancing operation needed.
- Empower an independent oversight institution

3. Policy Implications

Take Home Message 2: How to fight the crisis with Ordnungspolitik.

■ **Re-integrate liability- and budget-discipline enhancing instruments in interdependent orders.**

- Product Liability (financial products/ Issuer's liability) *Private Law*

 - Incentive compatible product liability of banks

- Standardized Bank- (and: State-) bankruptcy procedures *Private and Common Law*

- Debt brakes. Reform the Stability and Growth Pact 2005.

■ **Competition Law for banks & strict enforcement.**

- Binding relative equity provisions for banks.

 - Equity / total assets < 1/20

- Dissolve market power by restructuring or break-ups.

- Oversight of international financial transfers.

 - Minimize type I and type II errors.

3. Policy Implications

Take Home Message 3: Mind the limits of policy! Think constitutional!

“The first and most important lesson that history teaches about what monetary policy can do – and it is a lesson of the most profound importance – is that monetary politics can prevent money itself from being a major source of economic disturbance.”

M. Friedman (1968, p.3) in March 1968 80th annual meeting of the American Economic Association