Ten years ago a good number of countries in Southeast Asia were hit by a financial crisis – far away from the major established industrialized nations. At the time, there were many in whose opinion the crisis was alone the result of failures and shortcomings in and on the part of the countries in question, with lax economic policy, poor regulation of banking activities, fragile financial systems. The general conviction was that this could never happen in Western Europe or the USA. However, things turned out differently to what was presumed at the time. What were then the crisis-hit countries are now economically stable, and financial crises are happening elsewhere – namely in the USA and in a number of European countries. What are the reasons behind this state of affairs?

In 1926, John Maynard Keynes wrote in his essay “The End of Laissez-Faire”: “Many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance”. This characterizes the core idea of Keynesianism as counterposition to a market-radical/liberal neoclassical view. And the experiences in recent months have shown that there is a further reason for financial systems’ proneness to crisis, namely greed. None of this is new, and is something that Hyman Minsky already set forth with rare lucidity decades ago. Minsky had no faith in equilibria which are created automatically by market participants. He saw the necessity for state intervention. In his view, financial crises were the result of capitalism’s inherent tendency towards instability. During long phases of economic growth, banks, business enterprises and investors lose the instinct for risk. Driven by the greed for ever-greater profit, they ignore potential risks. Financing arrangements become increasingly risk-laden. Banks to an ever growing extent endeavour to circumvent existing regulations. Fierce competition between the banks compels them to throw new, complex financial products onto the market. The longer the boom continues, the chancier the arrangements under which financing is provided. A blind eye is then turned to risks. Borrowers who service their debts in an orderly manner are ultimately followed into the arena by tricksters as well, or Ponzi debtors as Minsky calls them, referring to business enterprises or private individuals that are only able to afford the servicing of their loans for as long as the interest rates remain extremely low because they place their bets on future rises in the prices of assets they have purchased on credit. This house of cards collapses when the asset
prices cease to rise or there is even only the slightest hike in interest rates. That can plunge the entire financial sector into a state of crisis. When that happens, however, supervisory authorities and central banks are called upon to prevent financial systems from collapse, and this situation is precisely what has been seen in recent weeks in the USA and Europe.

What is wrong with the financial system, and why? Let me start with a brief description of an ideal case of financial markets.

Macroeconomic trends are dominated by three prices: the wage rate, the exchange rate and interest rate. Of these three central prices, two are formed in financial markets, namely the respective currency’s external value and the interest rate levels. Against this background, one could assume that the significance of the financial markets in terms of a country’s macroeconomic development can hardly be overestimated.

Actually the case was long the opposite, the price of which is crises in the financial markets. The evil goes back to Léon Walras and his theory of exchange, his theory of capital, in which decision situations under certainty are discussed and equilibrium solutions are demonstrated. This Walrasian concept of equilibrium is at the heart of what I describe as market fundamentalism, in other words neoclassical orthodoxy. It has been passed on to the financial markets. The Walrasian equilibrium economy is based on the precondition of certainty, but this cannot be applied to financial markets since these are subject to prevailing uncertainty. This is the reason why there are commercial banks at all. At best, financial market protagonists can form conditional expectations in respect of an uncertain future.

Eugene Fama takes the stage in a second act. In 1970 he showed that current and anticipated occurrences with relevance for the future in terms of financial market prices are well depicted. The inference that follows from this is that the restrictive assumptions of the Walrasian equilibrium model are not needed in order to arrive at the conclusion that prices and yields in financial markets are fair and reasonable and in other words represent efficient solutions. For this reason there was a feeling of certainty that financial markets left to their own devices can deliver the best contribution for economic well-being. The consequence in terms of economic policy was that the state was to largely refrain from exerting any influence on the happenings in the financial markets, and deregulation and flexibilization were the order of the day. Economic policy adhered to these principles, this being reflected in the dropping of the Bretton Woods system of fixed exchange rates, the liberali-
zation of capital movements, the deregulation in financial markets, in other words Laissez-Faire. All of this was based on a consistent conception, underpinned by a diversity of empirical studies.

Up to the beginning of the nineteen-nineties, economists had been largely unanimous in their opinions and views on the happenings in financial markets. Temporal sequences in terms of yields on shares and bonds were regarded as just as unpredictable as the exchange rate developments in the currency markets. It can now be established that future prices and yields in financial markets contain predictable elements. It was also thought that the capital market model would provide a reliable depiction of why yields on some shares, portfolios, investment funds or strategies are higher than those on others. Now, it can be ascertained that it is not possible to explain yields on a diversity of investment vehicles by way of the capital market model. The fraternity of financial market experts used to opine that long-term interest rates reflect expectations in terms of future short-term interest rates and that interest differentials between countries are an expression of anticipated movements in foreign exchange rates. In the meantime, one has learnt that time-variable risk premiums on bonds and exchange rates must be taken into account to the same extent as risk premiums on shares. It also used to seem secure knowledge that the volatility of financial market prices doesn't change in the course of time and that it is identically distributed throughout that time. On that basis it is not then possible to draw any conclusions from current volatility as to future volatility. That too has turned out to be erroneous.

What was in those days presumed to be secure knowledge as to how financial markets function pointed to a sharp convergence to an information-efficient market. On that basis, there can be no excess returns of a systematic nature, no more than there can be in other fiercely competitive sectors of an economy. The only possibility for achieving above-average returns lies in taking on additional risks.

Meanwhile the empirical evidence looks different. Fama/French found in 1992 that in the normal case risk parameters displayed no statistically significant interaction with differences in returns. With this, the entire concept collapses. It was further found that in exceptional instances there is a statistically significant risk-return link, though in a direction contrary to that postulated in the theory: high-risk instruments have a small return, while low-risk instruments have a high return. It may be concluded from this that no instrument is on the securities market line. This implies that several central assumptions of the capital market model must be invalid. Experts in financial investment are therefore agreed that the crucial assumption of
the information-efficiency of financial markets must be relinquished. Empirical studies on the efficiency of the foreign exchange market and actual experiences in Germany point in the same direction. The results clash with the supposition of constantly rational forming of expectations on the part of economic agents as the keystone in the concept of information-efficient markets. Carry trades between currency areas give rise to exchange rate movements which intensify the foreign trade and payment imbalances.

We must then say goodbye to the idea that financial markets steered solely by private striving to optimize potential yields will consistently produce results that are also efficient in macroeconomic terms. There is no longer any justification for the reliance on consistently correct price signals, given unrestricted price formation, that has hitherto been the basis for deregulation of financial markets if the financial markets fail to process information efficiently. Configurations of interest rates, exchange rates and wage rates necessary to achieve non-inflationary growth at a high level of employment can be established only by chance if economic policy accepts price movements in financial markets even when such acceptance sows the seeds of undesirable macroeconomic trends. But what are the underlying forces of misdirected trends of prices and returns in financial markets? First of all: globalization and deregulation.

The faith in the information efficiency of financial markets was the driving force behind the deregulation of financial markets, the internationalization of financial relations and the globalization of the financial system. In this case, everything is optimally set up. Market performance is efficient, for which reason the state as regulatory authority must withdraw from financial markets. It cannot improve matters. Flexibilization, deregulation, internationalization and globalization are called for in the interests of raising the level of well-being across the world economy. And this path has been rigorously followed, beginning with the breakdown of the Bretton Woods system of fixed exchange rates.

The basis for this “financial innovation” of flexible exchange rates was the confidence and trust in the efficiency of financial markets, for if markets left to their devices and freed of rules succeed in achieving efficient solutions it would be a sin to go against the spirit of free enterprise by fixing foreign exchange rates as price hinge between currency areas.

Fixed hinges get rusty and lose springiness. Flexibility, on the other hand, guarantees elasticity and adaptability. So much for the pure doctrine pursued in those
days by economic policy. The motto was: Deregulated financial markets regulate themselves of their own accord because the market protagonists miss no opportunity for profit, so equilibrium values are continuously generated in terms of exchange rates, prices and yields in financial markets.

Today, we know that some aberrations in financial markets could have been avoided if the path laid by the concept of efficient financial markets had not been followed. Clearly defined rules on the financing of current account deficits and on the movement of prices in the currency markets were abandoned with the transition to flexible dollar exchange rates. Those responsible for economic policy, but also the business enterprises and other private players, were thus persuaded that any episode of excess expenditure, regardless of amount, will be seamlessly financed by those who achieve surplus revenues. That is a reason for many of the problems in international financial relations and for the overindebtedness of various countries, as was drastically illustrated in Argentina in late 2001, where the impoverished population plundered supermarkets.

Following the deregulation of exchange rates, the financial markets became more and more independent of commodity markets. Since then, prices, exchange rates and yields in financial markets have been subject to fluctuations of an enormous nature and much more marked than previously. Together with the swollen surpluses, respectively deficits on the part of other protagonists in financial markets, three problems arose which are intertwined.

Firstly, a volume problem, arising from the fact that monetary wealth growth is far more rapid than that of global aggregate output. The result is a decoupling of the goods sector from the financial sector and the striving of investors to achieve the highest returns in the short term. This leads to rapidly reversible capital flows between countries in a constant search for the best investment opportunities.

This volume problem in turn triggered a price problem: the fluctuations in prices, exchange rates and yields in financial markets have increased, and even the slightest of rumours now lead to abrupt price movements in asset markets, like those for shares and real estate. Thereby speculative bubbles may develop which could burst for trifling reasons but with catastrophic impact in terms of economic growth, employment and people’s life situation.

The price problem in financial markets gave rise to rapid growth in the area of financial derivates. Financial derivates are instruments derived from underlying fi-
nancial transactions, and they do not really have anything to do with the meaning of financing. Derivatives are made use of for the purposes of making risks linked with financing more manageable and to transfer them elsewhere. Of course it is not possible to eliminate the risks involved in financial contracts with the help of financial derivatives. Financial derivatives are linked with bets on future price movements in financial markets. If such a bet doesn’t come off, with prices dropping instead of rising as anticipated, the result is losses for those who had acquired the derivatives in question. These losses can be transferred to other financial market participants, or also to the non-monetary sector, to other countries all over the world.

These three problem areas are interlinked. An intensification of the volume problem, for example as result of large foreign trade and payment imbalances with switching of financial assets between currency areas, leads to increased proneness of the financial system to abrupt price and yield fluctuations, while demand for financial derivatives grows simultaneously. Financial derivatives simplify the spreading of risks, though the risks in question are not reduced in sum but atomized, given new and more attractive packaging, sent once around the globe and thus – supposedly – diversified. Financial derivatives became new classes of assets, with the original risks blurred beyond recognition. These instruments literally extend an invitation to take part in a sweepstake with the bets on rate and yield movements in asset markets, with the result that the volume and price problems grow further. This goes well until the occurrence of a stress test. The upshot in the event that the speculation doesn’t come off is that entire classes of assets become worthless – and the vicious circle has closed. This is the systemic risk of inefficient financial markets.

The transition to flexible exchange rates marked the beginning of a new era for international financial relations. The call for deregulation of national financial markets and for internationalization and globalization grew increasingly loud. Offshore financial centres were set up in quick succession, largely free of public regulation, banking supervision, basic principles on compliance with regulations on capital and reserves, large exposures or similar. The warnings of major banking houses grew increasingly urgent to relocate their business activities to free banking areas, thereby drying out national financial markets, and thus complicate the financing conditions and bring down tax revenues on financial transactions.

Economic policy understood and went along with the urging to assert the investor’s interests, the opinion being that freeing financial markets from public interven-
tions and regulations would lead to a thrust of economic growth and to greater prosperity throughout the world. Even more acceptance was gained that political and social conditions ought to be adapted to new economic necessities based on the trust in the efficiency of deregulated financial markets.

That was put on the recipe by those who had recommended the complete liberalization and deregulation of international financial relations. However, what this prescription’s package leaflet did not mention was that these measures can lead to hazards which could concentrate to form a systemic risk, not only for financial markets but also for economic relations between countries, and for the world’s well-being and the stability of free-market systems. Systemic risks, therefore, are the result of economic policy decisions. Economic policy released itself from the task it had previously taken on, namely to restrict risks resulting from sharp and unpredictable changes in the value of assets. However, dropping institutional precautions towards restricting volatilities in asset markets has failed to release any stabilizing market forces, and has instead given rise to risks and contributed to trends in financial markets that have caused headaches for those responsible for economic policy. This is a case of the story of the sorcerer’s apprentice being repeated: it is of advantage to keep the broom in action oneself and sweep the room, but the possibility of the broom developing a life of its own and sweeping the sorcerer’s apprentice out of the room is not ruled out.

The explosive growth of financial derivatives is the most serious change to have taken place in the financial sector since the start of financial markets’ globalization. New financial market instruments such as swaps, futures and options are the result of unpredictable volatilities attributable to economic policy decisions. The associated risks are unmistakable, and from time to time lead to the call for bank supervisory authorities and central banks to control financial innovations in the most prohibitive possible manner. This argumentation disregards the fact that derivative financial products are first of all market reactions to rising uncertainties in terms of interest and foreign exchange rate trends. Gradual reactions are therefore necessary which are orientated not towards paralyzing the creativity of the financial design but rather towards curbing the resultant possibility of imperilment of the financial system and developments on the non-monetary front.

The elimination of risks shouldn’t start with symptoms. In this respect I will confine my attentions to macroeconomic aspects. Growing and repeated calls for greater transparency and better risk control have had no tangible result to date. I shall leave the definition of these expressions in terms of their content to the zealous
microeconomists who like to proclaim that the reworking of the micro structure of finance is the right way to success. Go ahead, we’re waiting for practicable proposals.

However, I see this as a case where once again the symptoms alone are to be tinkered around with. Since many of the undesirable trends in financial markets are attributable to the dismantling of institutional restrictions on financing procedures which gave rise to growing uncertainties and thus risks in financial markets, my view is that the start should be made by working on these causations. Reintroducing previously dismantled regulatory measures is not a suitable option to this end, since the open world trade system requires an open world financial system. What is urgently necessary is a greater degree of stability of the global financial system. What we need is an international institutional design that accords with the globalization of financial markets.

This is not to be done at the national level alone. Radical changes to the global financial system call for international cooperation in terms of economic policy. A precondition for stabilizing the international financial system is a credible macro-economic policy with medium-term orientation and a very much higher degree of coordination of monetary policy between countries of great importance for the world economy. What is therefore needed is a stability pact between monetary policy, financial policy and wage policy in each and every country and an internationally coordinated code of conduct covering those three policy areas. The rules required therein are not to be discussed at this occasion. What is also called for is the elimination of exchange rate trends that generate false allocation signals. There is a clear cut rule to be observed in this case, namely to eliminate real exchange rate movements if they are not substantiated by the real economy.

Taken together this can contribute towards reducing risk, uncertainty, and ignorance – factors identified by Keynes as causes of the greatest economic evils of our time. It goes without saying that, because financial transactions link the present with an unknown future, it is not possible to set risks in financial markets to zero. However, it is possible to curb these risks with a sensible economic policy.

To curb instability potentials in financial markets calls for three preconditions: firstly an understanding of the necessity for adjusting the institutional framework of financial markets and international financial relations to globalization, secondly a consensus on a code of conduct of macroeconomic policy in each and every country, and, thirdly, international cooperation of economic policy. Once these precon-
ditions are in place, the globalization of financial relations can enhance prosperity worldwide without generating instability potentials that give rise to fears of systemic risks.

None of these considerations briefly outlined are to be heard in the discussion taking place at present on the current financial market crisis. The main elements of the debate are still and since a decade questions of transparency, accountability, best practices, corporate governance. All right, no objections. But where is the blueprint to achieve the goal? And is this alone sufficient? No. What we need is global governance of financial markets that accords with globalized economic relations.