Andreas Dombret: The economist and the lamp-post – lessons from the crisis

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a reception hosted by the Deutsche Bundesbank at the 2014 annual meeting of the Verein für Socialpolitik, Hamburg, 9 September 2014.

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1. Introduction

Ladies and gentlemen

I am pleased to welcome you all to the reception we at the Deutsche Bundesbank are hosting here at the annual meeting of the Verein für Socialpolitik.

When I see so many economists assembled in one place, I am naturally tempted to tell one of the many economist jokes making the rounds. However, the short story I am about to tell you is also connected with the topic of my short speech.

In the middle of the night, a policeman on his beat finds an economist walking around a lamp-post, looking down at the ground. "What are you doing?" the policeman asks. "Looking for my wallet," says the economist. "Where did you lose your wallet?", the policeman wants to know. The economist points to the other side of the street. "It might be a better idea to look over there," the policeman advises. "Well, but it's too dark over there."

2. Theory and economic policy

Dear guests, "evidence-based economic policy" is the motto of this year's annual meeting. What this motto implies is that economic policy-making should be based not on what we think we know about the world, but on what we actually do know about the world.

This is ultimately in the tradition of Popper and his dictum that a good theory must be falsifiable. We therefore need empirical research. Empiricism is merely the attempt to falsify theories by subjecting them to a reality check. And only theories that stand up to such a reality check should be used as a basis for economic policy.

Ideally, empirical review of theories is part of scientific practice. Sometimes, however, this reality check overtakes science and reveals, in a very real fashion, gaps in theory. The financial crisis was one such reality check.

In October 2008, Alan Greenspan testified before the US Congress that the meltdown had left him in a state of "shocked disbelief". Many economists and economic policy makers are likely to have had similar feelings.

To the general public, the crisis represented the intellectual bankruptcy of economic research. Nearly two weeks ago, Chancellor Merkel also made reference to this. At the 5th Lindau Meeting on Economic Sciences (attended by Nobel Laureates in this field), she noted that "we are coming from years in which one (...) did not always have the impression that economics already knew everything about the future."

Many are now indeed wondering quite fundamentally what use economics is to society. The question of the usefulness of economics to society is probably also a reason why, at the aforementioned gathering of Nobel Laureates, the closing panel discussion was entitled "How Useful is Economics – How is Economics Useful?"

3. The lessons of the crisis

Ladies and gentlemen, Christoph Schmidt, chair of the German Council of Economic Experts, was quoted in yesterday's Frankfurter Allgemeine Zeitung newspaper as saying that, “Despite the uncertainty surrounding our statements, our work is still important because we can contribute to imposing a limited amount of order on a complex and uncertain world without feigning false certainties.”

The job of economics is to explain economic interrelationships and to use these explanations as a basis for making economic policy designed to increase public welfare. Economics is thus, if we accept that view, a discipline which is certainly of relevance to society.

However, we must admit that economics has not always been up to the task. The financial crisis showed that there were many things about financial markets which we did not know, and that much of what we thought we knew was not reality-based. This is not least because, some of the time, economists act much like the one in the story I told you at the beginning. Often, they were looking where the light was, not necessarily where the knowledge was.

In that vein, precisely what the standard macroeconomic models were lacking was the financial sector, which made these models incapable of predicting the financial crisis. The framework of these models therefore needs to be broadened. In the meantime, many high-ranking economists are working on integrating the financial sector into standard macroeconomic models: Mark Gertler, Lawrence Christiano, Massimo Rostagno, Roberto Motto and Markus Brunnermeier, to name but a few. Although progress is being made, research has not yet reached the finishing line.

But why was the financial sector missing from the models? Well, it is undoubtedly very difficult to model it mathematically. This seems to have been a hurdle initially not regarded as being worth overcoming. For we thought we knew something about the financial markets which has now turned out to be false.

We believed the financial markets would generally perform their task efficiently and smoothly. And if financial markets do what they are supposed to, at least most of the time, there is no need to model them specifically. However, it was the financial crisis, if not beforehand, which showed that the financial markets sometimes do not do what they are supposed to be doing – and on a large scale.

Let me briefly give an example of a problem in the financial markets which, I believe, played a central role in the crisis: banks’ systemic importance, the “too-big-to-fail” problem.

It is a core tenet of market economies that firms can fail. Joseph Schumpeter called this “creative destruction”; Allan Meltzer put an even finer point on it: “Capitalism without failure is like religion without sin. It doesn’t work.”

Not taken into account with regard to banks were the side effects of failure. And one thing came to light in the crisis: these side effects can be so severe that failure is no longer the basis of a healthy market but, in a worst case scenario, the downfall of the market. In order to prevent such a downfall, central government has to intervene and rescue banks. By creating flawed incentives, this implicit government guarantee ultimately exacerbates the underlying problem – a problem that the markets believe has still not yet been solved, as studies by the IMF and other institutions show.

Are these really new insights? No, this is certainly not news. It is precisely here in Germany where the premises of the ordo-liberal school of thought are cited in this context. Walter Eucken is quoted again and again with respect to the “too-big-to-fail” problem. More than 60 years ago, he came up with a short and snappy solution to the problem: “Whoever reaps the benefits must also bear the liability.”

Incentives are appropriate only where the banks’ shareholders and creditors are liable. And only where the banks’ shareholders and creditors are liable will taxpayers not be asked to foot the bill. The knowledge that regulatory policy came up with a fundamental answer to the “too-big-to-fail” problem decades ago is not the end of the road, however.

Although the principles of Ordnungspolitik are pointing in the right direction, they do not give us the precise route. They do not tell us the size at which a bank actually becomes “too big to fail". They cannot help us understand the exact routes of contagion channels in the financial system. And they cannot help us develop the precise mechanisms for bailing in shareholders and creditors.

We need formal models to solve these problems. And this brings us to what post-crisis economic research needs to achieve: it must pour old knowledge into new models. Economics needs to seek the answers to its questions where they are actually to be found, even though there might not be a lamp to shine a light on the solution.

4. Awarding of the Carl Menger Prize

Ladies and gentlemen, economists are facing major challenges, for which they have recently received a lot of criticism but precious little praise. I am therefore glad to now present the Carl Menger Prize, which will be awarded biennially at our annual meeting. Since this is a first, I would like to begin by saying a thing or two about the prize.

The Carl Menger Prize is awarded by the Verein für Socialpolitik in honour of innovative international research accomplishments in the field of monetary macroeconomics, monetary policy and foreign exchange policy – precisely the areas in which the crisis revealed gaps.

Jointly awarded by the Oesterreichische Nationalbank, the Swiss National Bank and the Bundesbank, the prize money is €20,000.

Candidates can be nominated in written proposals detailing their worthiness by the heads of the research departments of the three central banks as well as by the heads of the Verein für Socialpolitik's committees for monetary theory and policy, macroreconomics, and external economics theory and policy.

The lead editors of our association periodicals – the German Economic Review and Perspektiven der Wirtschaftspolitik – are also eligible to nominate candidates.

The prizewinners are chosen by a vote among the Verein's former and current chairs and by one representative (each) of the Oesterreichische Nationalbank, the Swiss National Bank and the Bundesbank.

I would like to leave the "technicalities" of the new prize at that. What is much more interesting is: who will the prizewinner be?

Ladies and gentlemen, it gives me great pleasure to announce that, for her outstanding academic achievements, the first Carl Menger Prize is awarded to – Ms Hélène Rey. Ms Rey, my warmest congratulations!

Hélène Rey has been researching and teaching at the London Business School since 2007. Before that, she was at Princeton University and the London School of Economics. In her research, she particularly focuses on both the determinants and implications of globalisation for product and factor markets.

Her findings help to better understand how, under current conditions, exchange rates are determined; how external imbalances emerge; and what pros and cons are associated with the further integration of the global economy.

More recently, Hélène Rey has conducted research into how international capital flows can contribute to financial crises, and looked at the options central banks have in fulfilling their objectives in a globalised world.

Hélène Rey's research has not only substantially advanced the academic discussion; proving its practical relevance, it has also found its way into the concrete work of central banks.

Ms Rey, among your academic contributions which can be found on your impressive list of publications, a preliminary working paper is entitled "Exorbitant Privilege and Exorbitant Duty", referring to the specific role of the United States within the international monetary system.

In this paper, you argue that privilege and duty are two sides of the same coin, which means they cannot be separated from one another. Fortunately, privilege and duty are not always inseparable in daily life.

For with respect to this evening, I want to underscore that awarding the Carl Menger Prize to you is by no means a duty to me: quite simply, it is an absolute privilege and a pleasure.

My colleagues from the Verein für Socialpolitik, the Oesterreichische Nationalbank, the Swiss National Bank, the Bundesbank and certainly I personally, too, congratulate you wholeheartedly on being awarded the Prize and on your impressive academic achievements so far.

May the Prize serve as an incentive for you to continue in this direction – we are definitely looking forward to your future work!

Ladies and gentlemen, thank you for listening. The buffet is open.