Philipp M Hildebrand: Do financial markets promote responsible behaviour?

Speech by Dr Philipp M Hildebrand, Member of the Governing Board of the Swiss National Bank, at the 35th ICS-Symposium, University of St Gallen, 21 May 2005.

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I am honoured to join this distinguished panel. In his opening remarks to this year's ISC Symposium, Federal Councillor Moritz Leuenberger compared the symposium's theme – Liberty, Trust and Responsibility – to the Holy Trinity. Let me assure you. I will be less ambitious. In my formal comments, I will take the liberty to reflect not only on financial market but on markets more broadly.

The great economist Adam Smith has famously written that "it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest." This often-cited reference from the *Wealth of Nations* can be interpreted as suggesting that markets function best when market participants are not concerned about any particular normative values of responsibility but simply pursue their self-interest. Led by the "invisible hand", this collective pursuit of self-interest produces the optimal economic outcome. In other words, market participants need not be concerned about responsibility or, to use Adam Smith's term, benevolence. The "invisible hand" of the market will take care of that.

It seems to me such a reading of Adam Smith is too narrow. Two sentences prior to the quote about the butcher, the brewer and the baker, Smith states: "In civilised society [man] stands at all times in need of the co-operation and assistance of great multitudes, while his whole life is scarce sufficient to gain the friendship of a few persons." Here, then, is our dilemma: to be civilized and to have functioning markets, we need vast cooperation. Yet, human nature is such that it is impossible to base cooperation with millions of unanimous fellow market participants on common values of responsibility or, in Adam Smith's language, on benevolence. In other words, self-interest and the "invisible hand" of the market are not just the optimal but the only available path to cooperation.

The story does not end here, however. Adam Smith clearly recognized the importance of the "laws of justice". By the laws of justice, I take it he meant what we would refer to as the rule of law with a specific focus on property rights. He says explicitly: "Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men."

The "invisible hand" therefore cannot function in the total absence of government. Indeed, apart from assuring the rule of law, Smith saw two other functions for government: "the duty of protecting the society from the violence and invasion of other independent societies" and the "the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain".

Against the backdrop of these brief reflections on the great Adam Smith, let me turn back to the specific question put to us. I have no doubt that together with a functioning rule of law and limited government intervention, free markets in general and financial markets in particular are the optimal path to the promotion of wealth. I am equally convinced that responsible behaviour has the best chances of flourishing in an environment of economic opportunities and rising standards of living. Trust clearly enhances the rule of law as there will never be enough courts to permanently monitor all market transactions. Modern means of communication and transparency, in turn, are trust-enhancing. Think of seller and purchaser ratings on many internet auction sites.

Now, let me conclude my remarks with a final and in my view crucial note of caution. As Charles Kindleberger demonstrated convincingly in his 1978 book *Manias, Panics and Crashes*, financial markets are prone to phases of irrationality and exaggeration. Such market disequilibria lend support to the need for the rule of law and the utility of *limited* government intervention in a number of areas. I want to emphasize the word limited. Notwithstanding Adam Smith's own reference to government intervention, the role of government must remain a limited one.

If temporary market imperfections or difficult market adjustment periods give rise to the justification for relentlessly expanding the role of government, there will be a point when markets will no longer function effectively and when welfare creation will seize to advance. There is no better breeding ground for irresponsible behaviour than an environment of economic stagnation or worse, welfare decline.

There are times in history when the world economy undergoes fundamental structural change. With the rapid integration into the global economy of China and India, we are experiencing such historic change. Fundamental structural economic change invariably produces economic victims. The temptation for governments to interfere excessively with the free market is therefore particularly acute during periods when dramatic change occurs. Paradoxically, it is precisely then that the forces of the "invisible hand" are most needed to help bring about the welfare that can ultimately help absorb the negative externalities of change. If I am right that we are currently traversing such a period of historic change, it is more important than ever to ensure that government intervention in markets is limited and remains subject to continuous checks.

Free markets under the rule of law, Ladies and Gentlemen, provide the optimal path to welfare creation and ultimately responsible behaviour by market participants. As the history of the Industrial Revolution which began shortly after Adam Smith's death demonstrates compellingly, there will always be people who endure great difficulties when rapid economic change occurs. Chairman Greenspan has recently noted that "a significant minority, trapped on the adverse cycle of the market's process of creative destruction, are suffering. This is an issue that needs to be more fully addressed if globalization is to sustain the public support it requires to make further progress."

Perhaps this will indeed be one of the major challenges we will face in the years to come. Dealing with it by way of relentless government interference with the forces of the free market will at best fail to produce desirable results. At worst, it will begin to reverse the dramatic welfare gains we have enjoyed since the time of Adam Smith.