Lorenzo Bini Smaghi: Some thoughts on the international financial crisis

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at a meeting with the Unione Cristiana Imprenditori e Dirigenti, Milan, 20 October 2008.

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I should like to thank you for inviting me here today. I will share with you some personal views regarding the ongoing financial crisis and how we can rebuild a better system.

The current crisis could be the starting point for many ideas, and must certainly be subjected to extensive analysis. Today, I intend to dwell on one particular issue, which is founded on a simple question: Why was Lehman Brothers allowed to fail?

I wish to start with this question because the collapse of this investment bank on Monday, 15 September 2008 was one of the factors which turned the period of turmoil in the financial markets that started in summer 2007 into a full-blown crisis. Following the failure of Lehman Brothers, panic set in that any bank, irrespective of its size, could go bankrupt. Market participants revised their investment decisions. The banks themselves started to fear that any of their counterparties could fail and stopped lending money to each other, causing the interbank market, which had already been under stress for months, to dry up. In the four weeks following the bankruptcy of Lehman Brothers, the European stock exchanges plunged by around 30%, more than the total fall recorded over the previous 12 months. The three-month Euribor spread, which measures tensions in the interbank market, more than doubled, exceeding 170 basis points.

The first steps taken by the authorities to calm the markets did not succeed in restoring confidence. This did not happen until mid-October, when a coordinated action, which took the form of substantial recourse to public funds and concerted action by the central banks, was initiated in Europe and North America.

Looking back at the events of last month, it seems clear that the failure of Lehman Brothers could have and should have been avoided. This is not just an ex-post assessment, made in the light of what happened afterwards, but also an ex-ante one. It was obvious that in a crisis of confidence, such as had existed for months, the failure of a bank, even a medium-sized one, would have a contagion effect, triggering a flight from the system. This was why, in previous months, in both the United States and Europe (for example, Denmark, Germany and the United Kingdom), the authorities had intervened precisely to avoid the collapse of banks that were in difficulty (Bear Sterns, Northern Rock, IKB and Roskilde).

In the light of this assessment, it is legitimate to ask why the failure of Lehman Brothers was not prevented.

Various theories have been put forward in this regard. The one I find most credible is that there was a political veto, at the highest levels, against the use of public funds to rescue an investment bank. Indeed, right after the bank's failure was announced, the US Secretary of the Treasury himself confirmed that, "I never once considered that it was appropriate to put taxpayer money on the line in resolving Lehman Brothers".[1] The timing of the Lehman crisis also played a key role. Only a few days later the US Treasury had taken on the sizeable debt of Fannie Mae and Freddie Mac, a decision which was criticised in the press. Straight after this step was taken, it appeared that the US Treasury did not want to be charged with using

[1] "I never once considered that it was appropriate to put taxpayer money on the line in resolving Lehman Brothers", Dow Jones, 15 October 2008.

public money and practising what has been called a kind of "financial socialism". There is no doubt that the pressure of public opinion played a role.

We could stop here, with a negative assessment of the political decision taken by the US administration, which proved to be wrong. However, perhaps the problem might be more complex than that.

As subsequent events have shown, in particular when the first rescue package was rejected by the US Congress, opposition to providing the financial sector with public funds came not only from within the government, but also from parliament. The Members of the US Congress, many of whom face voters at the beginning of November, feared that such a decision would compromise their re-election. There was opposition to rescuing Lehman Brothers, therefore, not only from within the Administration, but also from Congress and, more broadly, from public opinion. In other words, the decision was largely the result of a democratic process. Ultimately, it was the US citizens who did not want to rescue Lehman Brothers.

This analysis is not restricted to the Lehman Brothers case alone. Even in countries where bankruptcies were successfully avoided through intervention, the decision was fiercely criticised by the respective parliaments and public opinion. In some cases, it was only possible to take the decision because immediate approval by parliament was not required. There is no denying that the conditions could have existed for letting some banks in difficulty to fail had the political situation been different, for example, if elections were imminent in Europe, as in the United States. Fortunately, this was not the case. Nevertheless, it is necessary to reflect on what might have happened. The question that needs to be asked is the following: why do democratic decision-making processes lead to the wrong decisions being taken from the point of view of the common good, not only ex-post, but also ex-ante?

The response given to justify the decision to let Lehman Brothers go bankrupt is that, for citizens in general, and for tax-payers in particular, it is not fair to use public funds to bail out financial institutions which, in the preceding months and years, had accumulated massive profits for their shareholders and executives. Obviously, for those assigned the task of deciding whether or not to come to a bank's rescue it is not an easy task to convince the electorate that the future losses must be nationalised, when the past profits were privatised. The rational explanation is that, without the rescue operation, the whole economy would have suffered as a result, with direct consequences for citizens and tax-payers. Given the contagion effect which is generated following the collapse of a bank, nationalising the losses prevents an even greater evil being unleashed. The financial sector is different from other sectors, precisely owing to the systemic and contagion effects that a crisis would have on all the other sectors. It is thus in the interests of the individual citizen to support the decision to rescue a bank in difficulty, as the individual interest coincides with the public interest.[2]

What happened, however, suggests that the rational arguments that I have just propounded do not always chime with public opinion. Again, it strikes me as interesting to ask why this should be the case.

To answer this question, it is necessary to enter the realm of the analysis of human behaviour, via the field of behavioural economics. Several laboratory experiments have been carried out, which show that, when faced with some economic choices, individuals may behave in ways that are apparently not rational. In general, it has been shown that economic agents are not only motivated by self-interest, as economists have been keen to believe, but are also motivated by considerations relating to fairness and relative conditions. According to some studies, a rise in income is only seen in a positive light if it exceeds that of the reference group; if, instead, the increase in income is less than that of the reference group, it

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[2] Bini Smaghi, L. (2008), "La UE non segua l'esempio USA", *Corriere della Sera*, 3 October 2008.

is perceived as being an absolute loss, even if it is only relative. One consequence of these tendencies, borne out in a number of experiments, is that individuals may even be prepared to renounce additional income, just to have a more equitable distribution of wealth within the community, particularly when this is to their advantage. Zizzo and Oswald,[3] researchers at the Universities of Oxford and Warwick respectively, outline the results of an experiment in which the participants can pay out of their own pocket to "burn" money belonging to the other members of the group. The majority of subjects choose to do so, even if this reduces their own income. On average, it is the richest subjects who are most affected.

This line of research suggests that inequalities create tensions within given social groups and lead to backlashes. These results are consistent with recent studies which attempt to account for the "happiness" of individuals in terms of a series of parameters, including income. In this context, the Easterlin paradox is well-known.[4] It suggests that when individuals see an increase in their income, their level of satisfaction does not necessarily rise if the increase is very unequal.

This literature offers an explanation of the behaviour recently observed in our societies, namely the opposition to helping the crisis-hit financial system, because it is perceived as being richer and well-off. On the contrary, there is greater readiness to help other sectors of the economy, such as agriculture or the automotive industry, even though these sectors have a smaller direct impact on people's well-being. This is probably because these sectors are perceived as being less well-off and faced with difficulties arising from exogenous factors rather than recklessness, unlike the financial sector.

It is interesting to note that such attitudes opposed to inequality have also emerged recently in the United States, where income disparities have tended to meet with greater acceptance than in Europe, as shown in studies by Alesina, Di Tella and MacCulloch.[5] One possible explanation is that the mechanisms of upward mobility in American society, which in the past made inequality more acceptable, have ground to a halt in recent years.

In the last few years, statistical indicators have shown an increase in income disparity in most advanced countries. The Gini index, which is typically used to measure income inequalities,[6] rose in the United States from 34% at the end of the 1980s to over 36% at the start of this century. The index also increased in the United Kingdom, rising from 30% to 34%, and in the euro area, on average, where it rose from 29% to 31%. Within the euro area, the largest increases were recorded in Germany (from 26% to 34%) and Spain (from 30% to 34%), while in France and Italy the figures remained substantially unchanged (at 29% and 34% respectively).

The growing income differences recorded in the last few years have been accompanied by two other distinct phenomena. First, a progressive decline in the average rate of growth of income has been recorded in advanced countries. In per capita terms, the last decade has been the worst experienced by the United States in over 100 years, barring only the 1930s. In Europe, the slowdown has been comparable, albeit not so marked. Second, the difference seems to have mainly favoured the financial sector. For example, in the United States the profits of the financial sector have in the past five years amounted to 40% of the total profits

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[3] Zizzo, D.J. and A.J. Oswald (2001), "Are People Willing to Pay to Reduce Others' Incomes", *Annales d'Economie et de Statistique*, Vol. 63-64, pp. 39-65.

[4] Easterlin, R.A. (1995), "Will raising the income of all increase the happiness of all *?*" *Journal of Economic Behavior and Organisation*, V*ol.* 27, pp. 35-47.

[5] Alesina, A., R. Di Tella and R. MacCulloch (2004), "Inequality and Happiness: Are Europeans and Americans different?", *Journal of Public Economics*, Vol. 88, pp. 2009-2042.

[6] The index varies between 0% (perfect income equality) and 100% (maximum inequality). In general, advanced countries have a lower Gini index than developing countries; see, for example, Brandolini, A. and T. Smeeding (2007), "Inequality: International evidence", New Palgrave Dictionary of Economics.

of the corporate sector, i.e. double the average of the period 1960-2000. This is simply to report events, not to make a value judgement.

The combination of these three factors – the worsening inequality, the economic slowdown and the high profitability of the financial sector – may partly explain public opinion and the attitude of the political authorities vis-à-vis the rescue package for the financial system.

This crisis reveals that in our advanced societies, which are subject to far-reaching changes that affect people's daily lives, the resolution of financial crises is becoming more complex, not only in terms of costs to the community, but also in terms of decision-making procedures. There is a risk that, in order to reach the democratic consensus necessary to act effectively, matters must be pushed right to the brink so that the precipice is clearly visible. In other words, there is a risk that a mistake, such as letting a bank fail, must first be committed, and the prospect of widespread hardship must make people realise that their vital interests are at stake, before effective action can be taken successfully.

The problem is particularly acute in the case of the financial system, which is inevitably prone to instability. In particular, the financial system is typically more innovative. Since financial products cannot be patented, an institution's ability to compete rests partly on its ability to create new products that enable it to increase returns without changing the level of risk or to diversify risk without for a given return. However, financial innovation tends to generate information asymmetries across agents, particularly between those who have created new instruments and those who buy them. Such asymmetries fuel market instability, leading to a tendency to underestimate risks until they materialise, and, subsequently, to a propensity to overestimate them when markets change direction. The procyclicality of the financial sector tends to produce a disproportionate increase in its profitability at times of economic growth and a decline during slowdowns, with self-propagation and contagion effects on the rest of the economy.

Essentially, the financial system is of systemic importance to the economy. The stability of the system is therefore in the public interest. Consequently, the system is subject to regulation and supervision. Therefore, it is somewhat problematic if rejection mechanisms develop within a society preventing effective action being taken to counter a financial crisis and contagion of the rest of the economy.

So, what is the answer?

There are some time-honoured lines of action which relate to the prevention of crises, namely better regulation and supervision, in particular at the international level, and more effective crisis resolution mechanisms. I will not dwell on these two points, which will be the subject of technical and political discussions in the coming months and years.

One new point for consideration that has emerged from this crisis relates equally to ethical, social and political aspects. In our advanced societies, which in years to come will continue to undergo periods of great transformation bringing real problems for many sectors of the population, the emergence of stark inequalities entails the risk that decision-making mechanisms will be blocked, in particular in crisis situations, with negative repercussions for the collective good and social cohesion. This should be solved both by governments, so that decision-making mechanisms can be adopted which allow the abovementioned problems to be overcome in a crisis, and also by the financial sector itself, which must clearly draw some lessons from recent events.

In a market economy, maximising profits and shareholders' interests are a priority for management. They permit the efficient allocation of resources within the economy. However, when a sector such as the financial sector is of systemic importance to the functioning of the economy and is prone to instability, the objective function must be broader. It is a problem of rules, incentives and individual responsibility.

Much more work must be done on these points if we wish to avoid repeating past errors.