Lorenzo Bini Smaghi: Lessons of the crisis – ethics, markets, democracy

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at Unione Cristiana Imprenditori Dirigenti (UCID), Milan, 13 May 2010.

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The events of recent weeks, particularly the Greek crisis, show that the period of economic and financial instability which began almost three years ago is not over yet. The first phase of that instability, starting in August 2007, occurred mainly on the financial markets, ranging from the money markets to the stock markets. With the failure of Lehman Brothers in September 2008, the crisis spread to the real economy, causing trade, consumption and investment to fall worldwide. The economic policy authorities have tackled the recession with massive injections of funds to support the economy. Public deficits have risen to unprecedented levels, driving up the debts of all the industrialised countries: the International Monetary Fund has described the current situation as a "wartime debt, without a war". We have moved into the third phase of the crisis in which the financial markets have begun to question the sustainability of economic policies, in particular as regards public finances and, consequently, the sustainability of the economic recovery itself.

This third phase of the crisis has hit Europe first. Financial markets consider, rightly or wrongly (in my view more the latter, but I won't dwell on that point) that in countries where there is a perfect overlap between the monetary and fiscal authorities the risk of insolvency is limited because the central bank can print money and create inflation to reduce the burden of public debt. However, the euro area, which cannot monetise its debt, has to tackle the problem immediately and ensure that each country is solvent without a monetary contribution. If the euro area is able to overcome the current difficulties and restore its public finances in time, it will exit from this "public" phase of the crisis before others.

The crisis, in its later stages, has revealed a number of common issues to which, it seems to me, insufficient thought has been given, and even less action taken.

At our last meeting, in October 2008, shortly after the collapse of Lehman Brothers, I examined the problems facing modern democracies in making decisions that require citizens to make short-term sacrifices for long-term gains. Lehman Brothers was left to go bankrupt, with devastating effects on the global economy because the US Congress – under pressure from voters a few weeks before the election – refused to provide the US administration with the funds necessary for the rescue. That refusal, which was also confirmed during the vote on the Troubled Asset Relief Program, a few days after the failure of Lehman, even though the markets were already falling, fully reflected the deep feelings of American taxpayers who did not want to pay out of their own pockets to save a financial institution that had hitherto enriched its shareholders and managers beyond measure. The common sentiment was that it was not "right" to save Lehman; those who had made mistakes had to pay. Those taxpayers and their representatives in Congress and the administration did not think that the failure of Lehman would infect the global financial system and endanger their own savings. That short-sightedness cost much more than it would have cost to save Lehman.

It was not however the first time that the American people reacted that way. In 1995, at the time of the Mexican crisis, the US Congress refused to disburse funds to support the IMF's USD 50 billion programme. The US administration found in the labyrinth of the budget a foreign exchange stabilisation fund that did not require Congressional approval to use on that occasion. The facts have shown that without that intervention Mexico would have been hit by a severe crisis which would also have overwhelmed the United States. Although just a few – with the benefit of hindsight – have considered the administration's decision wrong, Congress subsequently adopted a budgetary control act to prevent that budget item being re-used without the consent of Congress.

The most recent phase of the crisis has shown Europe to have the same problems as the US. Taxpayers in some European countries have opposed the aid package for Greece, a country guilty of having fiddled its accounts, without thinking that bankruptcy would have led to a crisis with even more serious consequences for those taxpayers. Finally, despite the difficulties, Europe was able to reach a decision. The respective countries have approved the aid package for Greece. The approval has however taken time and involved debates and discussions – processes that are fully justified, indeed essential, in a democracy – and yet they have fuelled uncertainty about the final outcome and thus prompted market participants to quickly liquidate their investments in Greek securities. This resulted in an increase in the budget deficit and the need for an even larger support package. There is no doubt that the total cost of funding to Greece would have been lower if decisions had been taken more quickly, for example, immediately after the agreement between the European heads of state and government on 11 February, when they promised support to Greece provided it took measures to cut its deficit by 4% of gross domestic product. Indeed, Greece took the steps required in less than a week, but in the meantime in some other countries the popular consensus in favour of the support measures was weakening. Only the signs of a general crisis across the euro area would justify their contribution. For this reason, assistance from the IMF was requested, attesting to the global nature of the crisis and the support. At the same time, the elections in some countries have delayed the IMF's intervention in order to avoid having to decide on support for Greece in an election period.

It seems that the people, their democratically elected representatives, and institutions operating in that context, sometimes need to "see" the crisis approaching in order to realise the dangers and take the decisions necessary to tackle them. This is particularly the case in societies which are based on economic stability, such as Germany, and which are not used to managing crises, especially those of a financial kind. In the global world in which financial markets move rapidly, there is a risk that the reaction times are too slow and that people may sense a crisis looming when in fact it has already hit. To prevent such a risk we need great leadership by those who govern, and we need institutions to convince people to look beyond the short term and take account of the impending crisis. Alternatively, automatic defence mechanisms are needed which permit a rapid addressing of problems before a crisis breaks out.

In the euro area, mechanisms have to be created to respond more quickly to the financial needs of states, even with emergency measures, or to supply funds to support those facing speculative attacks that threaten to undermine the very solidity of the states. It is unclear to me how these mechanisms can be shaped in a way that is compatible with our democracies, which in particular require parliamentary scrutiny of taxpayers' money. But it is clear to me that without these mechanisms our democracies risk getting hurt and being unable to deal with crises that can undermine their foundations, as shown by the speculative attacks against the sovereign debt of the industrialised countries.

We need not only to reflect on these issues but also to find concrete solutions – rapidly.

Let me turn now another problem, which has arisen from the ongoing financial crisis, a problem which, I think, has so far received scant attention. It concerns the functioning of financial markets.

The crisis has forged a broad consensus: financial markets are not always efficient. They do not always use the available information in such a way as to correctly value the assets that are exchanged between financial market participants. Recent experience has shown that there is a natural tendency to underestimate risk when markets are euphoric and to overestimate risk during crises. These behaviours are derived from the incentive that the market participants have to maximize the return on capital employed, on their own account or on behalf of their clients. There is now a large body of literature that explains why, even with

rational agents, markets cannot be efficient at the aggregate level, and in particular give rise to speculative bubbles. [1]

The reforms of the financial system that are currently under discussion in the various bodies that report to the G20, like the Basel Committee, the Financial Stability Board and the IMF are intended to establish or strengthen existing rules that reduce pro-cyclical behaviour, for example, through the banks' capital requirements, accounting rules, the mechanisms that determine managers' remuneration, the specific constraints on major financial institutions.

The effectiveness of the new rules and of the supervisory authorities that will implement them will depend on their ability to affect the incentives of individual market participants and financial institutions. Some have expressed misgivings about it, because it is difficult to change the incentives of financial market participants. Some people think that crises are inevitable in advanced financial systems. As Alan Greenspan, the former Chairman of the US Federal Reserve, remarked: *"The crisis will happen again but it will be different. Crises are all different, but they have one fundamental source. That is the unquenchable capability of human beings when confronted with long periods of prosperity to presume that it will continue."*[2] In other words, financial crises are part and parcel of our society.

The question is whether human nature can and wants to change in order to prevent crises like the present one from recurring. On the one hand, it is to be hoped that the current experience will push the financial community to exercise greater caution in future, especially in risk assessment. On the other hand, the incentives to resort to behaviours like those that preceded the crisis are so ingrained as to constitute an obstacle to change. In particular, it is difficult for an individual market participant to act in an anti-cyclical way, that is, to go against market trends, if the valuation parameters are based on the average trend of the market. During favourable market phases, for example, a less pro-cyclical, i.e. more conservative, behaviour than the average generally leads to lower yields compared with that of other market participants. Since, for an outside observer, it is very difficult to see if this is the result of greater prudence or of lesser ability, that observer will tend to favour the latter interpretation. Those who act in a less pro-cyclical way thus risk being marginalised, and exiting from the market, since they are considered less competent.

The pro-cyclicality of market participants arises because, as Keynes brilliantly explained over 70 years ago, winning strategies are those that manage to anticipate market trends, even though those trends are disconnected from the real economy for some time. An individual market participant behaves like someone in a beauty contest who has to bet on who will win the contest, and that depends on his ability to understand the preferences of others rather than on his aesthetic senses.

One point on which there has so far been less reflection concerns the incentives for individual market participants, not only in trying to predict the behaviours of others but in trying to influence them. To go back to Keynes' analogy, if some market participants manage to communicate to others how they would vote in the beauty contest, they can create a critical mass which others would join, thereby steering the vote in the desired direction.

These behaviours constitute in some cases violations of specific market rules, which can be penalised, or violations of ethical rules, which tend to relate to codes of conduct or self-regulation.

We know that markets will function effectively if they are competitive, that is, if every market participant takes a position according to the information available and if that participant does

[1] Abreu, D. and M. Brunnermeier, (2003) "Bubbles and Crashes", Econometrica, Vol. 71, no.1, 173–204.

[2] Interview with the BBC on 10 September 2009.

not try to influence others. A key aspect of the difference between theory and practice on which I would like to focus is the dissemination of information among market participants.[3]

Markets are competitive if each participant is large enough not to be able to change prices unilaterally. Collusion between market participants to try to steer prices in a certain direction are prohibited, and are monitored by supervisory and anti-trust bodies. However, it is very difficult to detect collusive positions in financial markets, for two reasons. The first is that these markets are moving non-stop and so it is not easy to prove that there has been collusion on investment strategies. The second reason is that any similarities may result not only from ex ante agreements between market participants but also from herd behaviour, which is typical of a market where neither ideas nor investment strategies can be patented. If a market participant manages to act as a herd leader, and to influence the behaviour of others, it can gain an information advantage and influence the markets, which become less competitive and more prone to instability.

A financial market participant can act as a herd leader if it can convince others that it has superior information and greater capacity for analysis so as to obtain better returns on its investments. A herd leader can thus influence, through communications either with the public or with some market participants, the behaviour of others and point the way for the herd. Indeed, major banks and financial institutions, and now hedge funds, publish or disseminate rapidly via e-mail their analysts' views, particularly regarding the assessment of specific companies or countries, and in some cases reciprocal assessments too, e.g. between banks. These assessments also contain recommendations to sell or buy shares or bonds or currencies. In theory, the published analyses are independent. They should not be linked to the investment strategy of the institution. Indeed, financial institutions say that their investment strategies are independent of their analysts' opinions, and may be based on other information. If the herd leader wants to continue playing this role it must keep some of the available information to itself. Whether the opposite is true is unclear, that is, if the analysts' opinion which is widely publicised is independent of the investment strategy followed by traders of the same institution. It is surely not the case for investment funds or hedge funds, which do not even say if Chinese walls exist between their research and operational arms.[4]

In recent years the use of market information for "promotional" purposes has grown considerably. In the mass media, i.e. newspapers and television, the opinions of the analysts of the major banks are often sought. Since information is scarce and should have a monetary value for a financial market participant, one may wonder why it is made available to all free of charge. One hypothesis is that this contributes to the market participant's reputation, attracting new clients. But clients should prefer insider information, the information that others do not have. The alternative, more credible, hypothesis is that with their considerable presence in the media market participants seek to steer the entire market, i.e. acting as herd leader.

Let's look at an aspect that interests me particularly: monetary policy. The opinions expressed by analysts on monetary policy decisions often concern not only the impact of a given decision on the markets, but the substance of the decision, namely whether it is appropriate or not. The parameters according to which the analyst expresses his/her views are however not transparent. It is unclear, in fact, if the analyst is expressing an opinion based on an objective function which is the same as that of the monetary authority – price stability in the ECB's case – or based on his/her specific interest, particularly his/her

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[3] See, for example, Bolton, P., Freixas, X., Shapiro, J. (2007), "Conflicts of interest, information provision, and competition in the financial services industry", *Journal of Financial Economics*, 85, pp. 297–330; Benabou, R. and G. Laroque (1992) "Using Privileged Information to Manipulate Markets: Insiders, Gurus, and Credibility", *Quarterly Journal of Economics*, 107, pp. 921–948.

[4] For an overview, see, for example, Mehran, H. and R. Stulz (2007), "The Economics of Conflicts of Interest in Financial Institutions", *Journal of Financial Economics*, 85, 267–296.

investment choices. One might ask, for example, if a decision to increase interest rates would be judged right or wrong by a financial market participant based on the outlook for inflation – or based on the speculative position that the market participant itself has taken.

What, then, should we think of the views that are expressed even before the central bank takes its decision? What are the criteria when a financial market participant expresses an opinion on what the central bank should do? Do the criteria depend on the speculative positions it has taken or on other, more general criteria?

I'll take a concrete example, which is not related to the decision on interest rates but on the collateral the central bank accepts in exchange for funding provided to the market. On Monday 3 May the European Central Bank decided to no longer follow the rating agencies when assessing the sovereign debt of a country that has an adjustment programme with the IMF and the European Union – a programme which the ECB has judged positively. It was a logical decision for several reasons.

First, while for a company or a bank the rating agencies' analyses may include information in addition to what the central banks have, it is less clear as regards the countries, especially those in the euro area, whose macroeconomic and budget figures are well known. The agencies – there are only three of them – have recently lost their credibility, contributing, with significant conflicts of interest, to the overvaluation of the creditworthiness of asset-back securities, particularly the sub-prime mortgages that caused the financial crisis.[5] However, the recent downward revisions of sovereign credit ratings raise many doubts. Some of these revisions were not based on macroeconomic data or new budgets, but on the assessments given by the market for sovereign bonds and the possibility of contagion. In this way the agencies have not given an independent assessment, but one linked to market's reaction. One might even ask if they have in some cases an interest in pushing the market in the same direction that it has already moved in, contributing to the pro-cyclicality and the phenomena of distorting prices. For example, an agency reduced its rating for Greece just after the first deficit adjustment measures by over 4% of gross domestic product, indicating that, although the measures taken were adequate, the adjustment depended on the reaction of the market. Another agency reduced its rating for Greece three days before the agreement with the IMF was concluded, without knowing the contents of the adjustment programme.

Given that these behaviours are not always clear, it would have been a mistake for the ECB to continue to depend on the judgements of rating agencies. Having helped to draft the programme, the ECB – along with the IMF and the European Commission – is better able to assess the risk posed by Greece than the rating agencies.

The opinion of some analysts on the ECB's decision was negative. Their thesis is that the ECB risks losing credibility and embarking on too lax a path. It is interesting to note that those same analysts had previously regarded the ECB policy as being too strict. Why this sudden change of opinion? Reading carefully what these analysts had written before the ECB's decision, one notes that many had considered the support programme for Greece as inappropriate, and saw a restructuring as inevitable. In other words, they had recommended selling Greek securities and the ECB's decision to maintain the eligibility of such securities went clearly against their interests. So it's no surprise that their response was negative.

The media are often unaware of these conflicts of interest and report the opinions of financial institutions without clearly stating that they have probably taken speculative positions in one direction or another. This approach may undermine the credibility of the media.

The same applies to the views of many professional commentators, and even academics, who are consultants to the financial institutions from which they get information and with which they interact. It is rare to see in a footnote that Professor So-and-So – who evidently

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[5] Benmelech E. and J. Dlugosz (2009) "The Credit Rating Crisis", NBER Macro Annual 2009, 161–207.

does not write for academic purposes, but to influence the opinions of specialist readers – is connected in some way with financial institutions, particularly through consultancy contracts. I was very surprised in the days before the completion of the adjustment programme for Greece to read articles by distinguished professors, many of them consultants to investment banks and – coincidentally – with very similar opinions to those expressed by the same banks, but without any reference being made to the relationship in the articles. I'm not asking for opinions to be censored, but at least there should be transparency and disclosure of any conflicts of interest, then readers are in the picture.

Doubts are raised even by some decisions to publish opinions that all go in the same direction right in the middle of periods of great turbulence, as was the case with Greece. These opinions, often with limited analytical content, were repeating the same mantra: the adjustment demanded of Greece requires too great a sacrifice, so there is only one solution: insolvency or the restructuring of Greek debt. Nobody had made clear what kind of sacrifice the insolvency of a state involved. Nobody had explained the impact on the financial system, contagion to other countries, and if that sacrifice was greater or lesser for the people than the alternative hypothesis. There was talk of a limited default, as if such a concept existed and had been tried out. Ridiculous comparisons have been made with Argentina.

Another aspect that is surprising to read in the media is the lack of precision on some news, especially when they are false and obviously put into circulation to create uncertainty. Let me offer another example related to the recent crisis in Greece. On 4 May the Greek government announced that it had hired a French investment bank, Lazard, for advice on its debt management. In the early hours of that day, the rumour spread in the markets that Lazard had been hired to restructure Greek debt. It was officially denied by both the Greek government and Lazard. It was also absurd because Greece had just received a financial support programme that explicitly excluded restructuring. Despite the denial, a leading financial newspaper ran the headline the following day "Athens calls in the default specialist". And while sensationalist headlines are a commonplace vice, unmerited for sensitive topics, the content of the article did nothing to dispel the doubts: since Lazard has long-standing and undisputed expertise in the default field, suspicion was justified. The reasoning is absurd and raises doubts in other areas.

The payment of funds by the financial community to politicians, generally in order to obtain favourable treatment from the legislature for financial institutions, is well known. These payments are declared to some extent. It is estimated that the US financial sector spent more than USD 5 billion between 1998 and 2008 funding lobbying activities to Congress and the US administration.[6] Less is known about the payments made to other influential sectors of our society, such as the media, opinion makers and academics.

This is a subject on which our advanced societies do not have enough information and, above all, on which they have not reflected enough. In the light of what I said at the outset, we should not underestimate the risk that the consensus needed in our democracies to effectively address financial crises may be distorted in favour of special interests. The ethical question relating in particular to the operation of markets and the use that is made of information does not concern only individuals but has a broader dimension that touches on the functioning of our democracies.

In other words, it is in the general interest that the euro area countries adopt appropriate fiscal policies, reflecting not only the development of their economies but also the sustainability of public debts. However, it may be in the interest of some financial market participants for some states with budgetary difficulties not to pay back their debts and therefore fail, regardless of the impact this will have on the citizens of that country and those

[6] Essential Information and Consumer Education Foundation, "Sold Out: How Wall Street and Washington Betrayed America", March 2009 (www.wallstreetwatch.org).

of neighbouring countries. It is in their interest if they have taken speculative positions in this regard and therefore can gain from the bankruptcy of a state. And since the probability of bankruptcy depends in part on the democratic process in the country itself, and on the other countries that may help the one in difficulty, it may be useful for financial market participants who bet on the failure of countries to use part of their future earnings to convince people that there is no other way possible, that an "orderly" failure that puts public finances back on track is better. The more people who are convinced of it ("As Greece is going to fail, help is useless"), the more likely becomes the outcome desired by financial market participants, although it is not in the general interest.

These issues raise ethical and moral questions that have been widely discussed, but from a limited point of view. The appeal to ethics and individual morality is an important starting point to correct the distortions that I mentioned above. But it's not enough. The experience of recent years has shown that self-regulation and self-discipline do not suffice to prevent market distortions. This stems from the fact that the measure of individual performance, which is the economic result, can be appropriate in a theoretical context of perfect and complete information, particularly about how that result was obtained. Financial markets are, however, characterised by information asymmetries that make it very difficult to identify the source of profit, especially if it has been achieved thanks to the ability of the individual market participant (known in the jargon as alpha) or due to the risk it has taken and that may be improperly measured, precisely because of the informational asymmetries in the financial services available to the client. Other financial market participants and supervisory authorities are not always able to adequately identify the relative contribution of the two factors and therefore to punish unethical behaviour.[7]

However, not all unethical behaviour which shows a conflict of interest is directly punishable. In some cases it is considered that the reputational loss of the market participant who fails to live up to ethical principles is a sufficient incentive to ensure fairness. But if the gain more than compensates for the loss of reputation, the incentive to continue to violate the ethical principle remains, perhaps in a more effective manner. If the unethical practices make it possible to obtain higher returns, those who do not follow them are likely to be penalised. In other words, those who comply with the dictates of ethics may not perform economically so well as those who do not, and so may find themselves out of the market.[8]

Self-regulation works if everyone respects the rules and if that compliance is easy to monitor. Since the financial market information asymmetries make it very difficult to distinguish between those who observe the rules and those who don't, the individual appeal to ethical principles is not enough. It can even penalise those who respect them, pushing them out of the market.

Ethical issues are therefore to be addressed in general terms and must concern all markets and participants. That's not easy, considering the global scope of the financial markets.

Finally, I would like very briefly to summarise some lessons from the crisis, which call for greater reflection.

1. By intervening to support the economy and financial system, the economic policy authorities have avoided a depression, but they have postponed the problem, which is beginning to become weighty.

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[7] See, for example, A. Ashcraft and T. Schuermann, "The Seven Deadly Frictions of Subprime Mortgage Credit Securitization," The Investment Professional, Fall 2008, pp. 2–11. The authors offer an analysis of the information frictions in securitisation.

[8] See, for example, I. Walter, "Reputational Risk and Conflicts of Interest in Banking and Finance: The Evidence So Far," December 2006, mimeo, NYU.

2. The timing of the adjustment may have to be shorter than that of the economic policy authorities, especially if financial markets are not convinced of their determination.

3. The financial market consists of two types of market participant: those who are afraid of uncertainty and those who gain from it, and from the uncertainty about the position of a country's finances. The latter may have an incentive to feed this uncertainty.

4. Financial markets are pervaded by a myriad of conflicts of interest, particularly concerning the use being made of information.

5. These conflicts of interest may have an impact on the media and the academic world.

6. Democratic systems have difficulty coping with financial crises effectively because of the conflicts that such crises produce between short-term individual interests and collective long-term interests.

7. Financial markets and the conflicts of interest that pervade them can infect our democracies and weaken their foundations.

8. The global dimension of the markets makes it difficult to identify specific solutions to these problems.

In conclusion, the financial markets are the "brains" of the economy. It cannot do without them, but if the brains do not work well, the rest of the body is at risk.

Thank you for your attention.