WHAT THIS FINANCIAL CRISIS TELLS US*

Daniel DĂIANU

The significance of the current financial crisis is huge, and its policy implications are manifold – and one of those is that we need to learn from previous crises. I recently heard one leading central banker saying that the depth and magnitude of this crisis could hardly have been predicted a year ago. His is not an isolated voice. But their remarks should be a surprise, for it is the job of a central banker to focus on the health of the financial system, and not just the stability of prices.

There have been various crises over the past decade and there are people who learned from them. Some financiers and economists – such as Warren Buffett¹, Edward Gramlich, Paul Krugman², Alexander Lamfalussy³, Nouriel Roubini, Paul Volcker – warned another crisis was in the making, underlining the menace posed to financial stability by new types of financial innovation. Studies of the Bank of International Settlements and the Bank of England had examined roots of the current crisis before it erupted. I would add here reports of the European Parliament (one in 2002, in particular) that pointed the finger at issues that are being widely debated these days.

1. THE CALCULATION DEBATE REVISITED

The failings of rating agencies and financial institutions in evaluating synthetic financial products and the rising opacity of financial markets have reminded me a famous debate in economic thought.

The calculation debate took place among several leading economists during the interwar period, in the last century. One camp fielded, among others, Ludwig

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¹ This text is based on three articles which were published by European Voice: The Calculation Debate revisited (13 June 2008), What this crisis teaches us (9 May 2008), and “Purging the toxins” (27 September 2008)
² In a BBC interview, in March 2003, Warren Buffett named derivatives “financial weapons of mass destruction”.
³ In “The Return of Depression Economics” (New York, Norton, 1999) Paul Krugman writes: “…modern financial markets, by creating many institutions that perform bank-like functions but do not benefit from bank-type safety nets, have in effect reinvented the possibility of traditional financial panics” (p. 162).
⁴ Alexander Lamfalussy: “…even if we were to reach a state of generalized competition on a worldwide scale financial markets ought not be left to their own devices. Those who attribute the virtues of global stability to a fully competitive and liberalized financial system may be right. But how can we know? …I believe that we should not try to find out in practice how smoothly and swiftly self-correcting our system would be in the absence of the active care of the public authorities” (“Financial Crises in Emerging Economies”, New Haven, Yale University Press, pp. 88-89).
von Mises\(^4\) and Friedrich von Hayek\(^5\), who stressed that free markets and clearly defined property rights (private property) are essential for proper calculation of costs and benefits and economic development; these were very dear tenets of the Austrian school of economic thought. Hayek highlighted also the ubiquity of information/knowledge in society and, in this context, the role of entrepreneurship (like Joseph Schumpeter did) in promoting technical change. The other debating camp used the intellectual guns of Oskar Lange\(^6\). The latter, while being against private capital, acknowledged the importance of markets in economic development and tried to build on them a mechanism of “market socialism” (which relied on social property). But Lange’s model had its own major flaws. One originates in the inadequate pricing of capital, which undermines its accumulation as a source of economic growth over the long run. Moreover, entrepreneurship could not blossom in conditions of market socialism, where capital and risk-taking are not properly rewarded.

What came closest, in modern history, to an implementation of market socialism was the texture of socially owned firms in the former Yugoslavia, which has brought some prosperity to its citizens as against what occurred in the typical command economy in the former soviet system. Goulash communism in Hungary was also an attempt to introduce market reforms in a socialist economy. Much worse than “market socialism” was the command (communist) system. While having the power to mobilize resources for major projects it suffered from fundamental original sins: lack of proper valuation of factors of production and stifling of innovation (apart from the suppression of political liberties). The collapse of the command (communist system), as well as the market economic reforms in China and, later on, in Vietnam, have proven, in a spectacular way, which camp of economic thought won the debate.

To put more emphasis on this victory and make the hook-up with the current financial crisis I would recall something of great significance. There was a group of soviet economists –Leonid Kantorovich\(^7\) and V.V. Novojilov among them-- who thought that quantitative models can replicate markets and offer scarcity valuations to capital, labor and land. They tried hard to work out general equilibrium (input-output) models and came up with so called “shadow prices” as substitutes for free market prices. Interestingly, Kantorovich got a Nobel prize for his work. But his models were far away from being able to help the command system --for nothing


can substitute real markets and clearly defined property rights as foundations for an
efficient economy. In addition, entrepreneurship cannot be simulated, or stimulated
by decree; it has to happen in reality, as a result of incentives and economic
freedom. That there is need for a public sector (that supplies public goods) in a
modern economy and that markets have their own failings which need to be
addressed is another serious matter for discussion and public policy response.

Above I have linked the calculation debate to the current financial crisis. A
financial system which has been increasingly based on capital markets
(securitization) – as it has evolved in the last couple of decades – has brought the
key issues of transparency and proper valuation to the fore. Ironically, these are
exactly some of the main negative traits which have brought the command system
down. As a matter of fact, models which were used by leading investments banks
(brokers) and rating agencies in assessing risks, and the ratings that were assigned to
new (synthetic) financial products, have proven to be highly erroneous. Likewise, a
certain type of securitization, which has distanced lenders from the consequences of
their actions more than dangerously, has obfuscated risks (the counterparty risks)
and enhanced the opacity of markets. The non-existence of effective markets for
derivatives (OTC) has compounded the diminishing transparency of markets and
added to inadequate valuation. The credit crunch could not be avoided due to an
overwhelming lack of transparency and trust. The bottom line is that missing
genuine markets (for various derivatives) and highly questionable valuation of
securities pushed toward a freezing of credit markets.

The causes of the current financial crisis should prod many to remember the
lessons of the famous calculation debate: we need genuine markets, transparency
and proper valuation of factors of production and products (services). Simulation
and models cannot be but a very imperfect and insufficient substitute of actual
markets. And the transparency and smooth functioning of markets need to be
propelled up by adequate regulations and supervision. For, markets, by themselves,
cannot protect themselves against their inherent weaknesses and the public good
needs, sometimes, the work of a visible hand.

2. IS ONLY GREED TO BE BLAMED?

As the markets come to terms with what is happening and as thoughts focus
on how to save and re-build the financial system, there is one statement among
Paulson’s remarks on 19 September that deserves particularly close attention: "We
must now take further, decisive action to fundamentally and comprehensively
address the root cause of our financial system's stresses." Do we understand the root
causes that have transmitted the diseases that now ail every branch of the financial

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system inside and outside the US? What is the transmission mechanism that has been at work so intensely?

The media is now full of condemnations of greed; for many this is the quintessential source of this financial crisis. But is it only greed that should be blamed for this mess? What about the flaws of the originate-and-distribute model, which decouples loans from assets, has spread risk and facilitated the emergence of systemic risk. What about skewed pay schemes in the financial industry that have stimulated reckless risk-taking at the expense of prudence (not to mention the ethical dimension these schemes carry)? What about the nonchalance with which rating agencies have assigned investment-grade values to derivatives of more than questionable value (such as ‘collateralised debt obligations’ and ‘credit default swaps’)? What about the conflicts of interest that plague the financial system? What about banks engaging in casino-type transactions on a massive scale? And, not least, what about the lightness of or the absence of any regulation of the ‘shadow’ banking sector, made up hedge funds, private equity funds and the like that are extremely leveraged and engage in speculative operations?

These questions highlight a thesis: the root cause of this crisis is an inadequately and under-regulated financial system. These are in part the effects of the Phil Gramm-Leach-Bliley Act passed in the US Congress in 1999, which was, basically, a repeal of the Glass-Steagall Act of 1934. That act triggered a further wave of deregulation in the financial industry that, inter alia, brought to the market a plethora of fancy products whose risks were poorly understood. Mortgages are not toxic per se; badly constructed securities based on them are toxic. The packaging and repackaging of financial products are toxic, making their valuations increasingly unclear and reducing their tradability. Reward schemes that shape the decisions of managers and agents in markets and that make their behaviour irresponsible, when judged from a systemic perspective – that is toxic. Misleading quantitative models are toxic. Not to address these and other problems would be totally wrong. The tripwire for this financial crisis may have been in the housing industry, but housing is not the structural cause of the crisis.

What this crisis should make plain to everyone is that not all financial innovation is benign. It is therefore baffling to hear the argument that fresh regulation is bad because it would stifle financial innovation. Fresh regulation is necessary because there has been a lack of proper regulation and supervision. The enormous mistakes that have been made by allowing finance to develop its own, highly risky “raisons d’être” must be undone.

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8 Which put Chinese walls between commercial and investment banking.
But are we capable of learning that lesson? Why is it that we fail to learn from previous crises? At a recent Eurofi conference in Nice, Nout Weelink, the governor of the Dutch central bank, cited greed as a key factor driving people’s propensity to forget and repeat behavioural patterns conducive to euphoria, excesses, over-indebtedness and finally, panic and crisis. A famous book on financial crises by the Massachusetts Institute of Technology professor Charles Kindleberger traces the same sequence of mindsets and behavioural patterns.

I accept this explanation, but not without qualification. A market economy involves cyclical movements and ups and downs. The entrepreneurial spirit lifts the economy, but, together with the herd instinct, it can also bring it down, by overshooting. This is indisputable, and a reflection on how free markets function. But just as modern economies need public policies, so they need regulations. As traffic needs rules and lights in order to protect people’s lives, so market economies need regulations to limit collateral damage and enhance the production of public goods and restrict negative externalities. A lax monetary policy can lead to higher inflation and, ultimately, to a recession, but cannot, by itself, cause the meltdown of a financial system. This is the crux of the matter: the features of the financial system that have brought the threat of collapse are structural features of the ‘new’ financial system, including a breakdown of due diligence.

Regulators and supervisors are supposed to think about the good of economy and of society, rather than to pursue specific interests. And they are supposed to learn. They may espouse ideological beliefs, for none of us is devoid of intellectual kinship. But, even so, they are supposed to learn and think in terms of what is good for society. They are supposed to have a good grasp of systemic risks.

Vested interests can have a long arm and try to influence regulations and supervision (the mortgage industry pressed Congress hard to roll back state rules aimed at stemming the rise of predatory tactics used to lure homeowners into high-cost mortgages). But vested interests must be strongly resisted, and with all means. Regulators and supervisors should know that financial markets are volatile and prone to instability, and that the efficient-markets hypothesis – that prices reflect all known information – is a fantasy.

In the real world, we need regulators and supervisors who have a good understanding of how financial markets function in practice and who do not succumb to market fundamentalism. They should never underestimate systemic risks; they should always be alert to financial stability. Strains and crises cannot be entirely avoided – but we can limit the damage they cause. For that to happen, we need to learn from mistakes and establish better, more effective and comprehensive regulatory and supervisory setups.
3. WHAT THIS CRISIS TEACHES US

Some use the complexity of financial markets as a leitmotiv when explaining this crisis. But this is pretty much a self-serving argument, hard to accept without qualification. Not all financial innovation is sound. Not all products and services are accepted by markets; and regulations are needed to protect consumers and investors. Some financial products are better than others; some are flawed by design, among them those that underpinned the international quasi-Ponzi scheme that has enabled companies to report abnormally high profits that do not reflect revenues generated by their businesses. It therefore makes sense to judge the nature of various financial products, and to regulate the financial industry as a whole.

One of the questions posed by this crisis is about policies. As a rule, the procyclical use of monetary and budget policies should be avoided. One can argue that price stability should play second fiddle when financial stability is at stake, but one has to keep in mind the effects of injecting liquidity into the system when inflation is on the rise. This crisis reminds us again about the risks of financial liberalisation when institutions are not congruent or when markets are not functioning smoothly.

Market structures should be re-examined. We have undoubtedly seen a massive failure of regulatory and supervisory frameworks. Risk management, at both micro and macro levels, has failed miserably in countries that claim to epitomise good practices in banking and finance. Those who keep saying that things are better in Europe than in the US have to think twice about the national fragmentation of regulatory and supervisory structures in the EU, a fragmentation that clashes glaringly with the logic of single markets. The Lamfalussy process, which has been developing regulation of the financial service industry in the EU since 2001, needs much improvement if it is to cope with mounting challenges. Some argue that since the crisis started in the regulated sector of the financial system, its non-regulated area should be left alone. But this argument is ridiculous: banks have made use of loopholes and poor regulations to develop the non-regulated sector, creating a shadow banking sector.

The current crisis is a stern indictment of the incentive structures in the financial industry, which have stimulated reckless risk-taking at the expense of necessary prudence. Some banking turned into a “casino”-type activity, through the creation and selling of new types of securities. This asymmetric compensation scheme has to be corrected and the culture of investment banking has to change for the benefit of the economy as a whole. But inappropriate compensation schemes operate in other industries, too. There are numerous CEOs who receive incredibly high salaries and bonuses despite the shaky performance of their companies. There is a huge ethical issue here, one that needs to be addressed by politicians and policymakers: How can we ask citizens to bear the brunt of painful adjustments when
some of those who have been deeply involved in creating this mess are shunning responsibility, or are not accountable?

The structuring of fiscal policies also has to change. It is, for example, quite odd to see Americans saving so little and their deficits being financed by emerging economies. Moving further along this line of reasoning one reaches the issue of policy coordination against the backdrop of financial globalisation: Is coordination appropriate? Do we have proper structures of global governance? Unless we manage globalisation adequately, rising nationalism (principally in the form of protectionism) and populism in policy-making could reverse the evolution toward more open markets. The quest for energy security and affordable food could easily make things worse.

This financial crisis, in conjunction with the “food crisis”, brings to prominence another issue: Is there an optimal degree of openness for an economy? The debates about international financial institutions, prematurely asking emerging economies to open their capital account, about energy dependency and about food dependency make glaring the question of the optimal openness of a market. In addition, open markets should not to be confused with deregulated markets; deregulated markets could easily backfire and cripple the functioning of a free society, one in which social cohesion and social justice are meaningful. Open markets, in order to operate as such, have to be accompanied by wise public intervention, which should consider both market and government failures. The bottom line is: Full openness is not necessarily advantageous economically and socially.

Arguably, the view that the market should be seen as the solution for all decision-making, a view that has much influenced policy-making in the last couple of decades, has been fatally wounded by this crisis. It is high time to be pragmatic, open-minded and commonsensical. Open trade, markets and competition are good. But we need effective regulations and sensible public policies if the majority of our citizens are to benefit from free markets.