



A FAILURE OF CAPITALISM?

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A Failure of Capitalism?

Since the financial crisis erupted, there has been no lack of opportunity to put on trial the people presumed responsible for the upheavals of recent times: the bankers for taking excessive risks; the regulators for not supervising the bankers; the rating agencies for mispricing the risks; the central bankers for creating too much cheap money; the economists for not foreseeing the crisis; the journalists for turning that crisis into a drama.

Such calls to account may be useful to understand what went wrong and what must be done to put the system right. But as it's tempting to regard all of them as culprits, each of them can then escape the blame, and the accusing finger turns to the system itself: it's capitalism that's at fault. The system can be improved – and many initiatives are under way to that end – but it includes inherently unstable elements that we have to live with. One example of this position is reflected in a comment made to the BBC by Alan Greenspan, the former Chairman of the US Federal Reserve: “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”. [1]

In other words, it's human nature to drive fast, over the limit. So accidents are inevitable. You can only try to make them less serious by fitting stronger brakes in cars, or by giving them airbags or by improving the roads. This analogy is frequently used to explain the financial crisis and to suggest that since we can't really avoid new crises, we should rather try to reduce their impact and enhance our defences by having tougher regulations and more effective supervisory mechanisms.

In his book ‘A Failure of Capitalism’, Richard Posner [2] – one of the leading ideologues and advocates of the free market – offers a critique of the capitalist system. In his view, the root of the crisis lies in the explosive mix of an expansive monetary policy and excessive deregulation – a mix that has caused financial operators to take risks of a magnitude greater than they could manage. But Posner goes one step further. He claims that those who made the misjudgements, in particular financial operators, knew that what they were doing was very risky, and could even lead to a crisis, although they weren't able to estimate its scope.

Posner writes: “I do not believe that the financial crisis is the result of stupidity or irrationality, criminality or even ignorance. I think that even most of the consumers who bought houses with mortgages they could not “afford” knew what they were doing – speculating not unreasonably on a continued rise in house prices.” And he adds : “I believe that the senior executives of the major banks were aware that there might be at least a small probability of bankruptcy as a result of the risks they were taking”.

Alan Greenspan, who must have known many of these senior executives, seems to be of the same opinion, for in that same BBC interview he said: “The bankers knew that they were involved in an under-pricing of risk and that at some point a correction would be made”.

This view seems to be confirmed by the memorable comment made by Chuck Prince, former Chairman and CEO of Citigroup, in the summer of 2007, just a few days before the crisis broke: “As long as the music is playing, we've got to get up and dance. We're still dancing”. [3] This remark – which I believe is not only symptomatic of the crisis but also key to understanding it – has often been quoted but perhaps not sufficiently analysed. It seems to support Posner's argument that the managers of the big banks knew they had taken major risks and ventured into activities rather

like the game of musical chairs. Those managers were well aware that, sooner or later, the music would stop and the race for the remaining chairs would start. They didn't know how many chairs would be left or how far away they would be from them – all they knew was that at some time the music would finish. Evidently, each of them expected, or hoped, to beat the others to a chair. Why were they so confident? Their expectations were based on the assumption that the most profitable financial institutions would also be the most resistant to any abrupt stopping of the 'music' – an assumption linked to the yardstick by which they were measured in the financial sector, in other words, profitability. One bank is more capable than another, and thus worth more, if it earns more than another, not in the space of five or six years, but in a period of three months. A trader is more capable than another if he earns more for his bank and, as a result, earns more for himself. A bank (plus its managers) which made large profits in the past would feel justified to regard itself as being more capable than the others and would continue to think like that even if it foresaw the crisis. It did not consider, or did not want to consider, that its profits were larger than those of the other banks because it had taken more risks – risks that would slow it down in its rush for the empty chair when the music stopped.

There's another interesting detail in Chuck Prince's comment – his use of the verb "got to" ("you've got to get up and dance"). Prince seems to be suggesting that there are no alternatives, as if some external force is pushing him and his bank, along with the others, to take more and more risks. It seems difficult to believe, but not that difficult after all. In her book 'Fool's Gold', Gillian Tett [4] explains how the continual comparison of the results of various banks, and even inside the banks between the various teams – results based on profits obtained – encouraged the banks and employees to take ever greater risks in order to obtain better results. Reporting on an internal discussion at an investment bank, Tett writes: "2005 had been another record year for the banking world: the largest investment banks had collectively raised their revenues by 31% to USD 289 billion. In that time, however, JPMorgan Chase had produced only a modest result. So what should JPMorgan do? Was it time for the bank to reconsider entering the mortgage CDO and CDS game?" (p.164).

This quote confirms that the bankers were well aware that if they wanted to make their bank more profitable they had to increase the degree of risk, to "join the game", in other words, to enter the casino.

We should not make the mistake of considering that such a perverse system of incentives is limited to the banking world. In the end, it's the shareholders and savers who demand better returns on their investments. It's the savers, both large and small, who want their fund managers, be they banks, pension funds or investment funds, to beat the competition, and the benchmark is the rate of return. If their savings bring poorer returns than others, then they will invest them where the returns are higher. The fund managers will try to anticipate such shifts, replacing their less effective personnel with those who obtain better results, even if they take greater risks.

Profit maximisation by entrepreneurs is what drives capitalism. It is the best way to reward investment and thereby promote long-term economic growth. This assumption underlies the theoretical models we use to analyse economic development. It is also consistent with the kind of human incentive that Greenspan and Posner were referring to.

The literature has analysed how perfect competition in the product and labour markets ensures that the benefits of growth are distributed among all market participants. In an ideal world with perfect competition the profit on marginal investments tends to zero, as all resources are fully exploited. However, we know that in reality we do not have fully competitive markets. Indeed, sometimes even the entrepreneurs themselves take strong action to prevent markets from operating under

conditions of perfect competition. In their book ‘Saving Capitalism from the Capitalists’, [5] Rajan and Zingales explain well the inherent contradiction of a market economy, namely that entrepreneurs can benefit from regulation that reduces competition and maximises their rent. The entrepreneurs thus have an incentive to lobby the legislator to adopt regulation aimed at increasing the barriers to entry. Such legislation tends to redistribute welfare from consumers to producers, but also reduces overall demand and investment and thus economic growth. Excessive regulation, aimed at safeguarding inefficient monopolistic rents, can cause an economy to stagnate. This leads Rajan and Zingales to argue that, for capitalism to produce all its benefits, it must put up strong barriers, also at the political level, to that reflex of capitalists to over-regulate markets. These barriers encouraged the wave of de-regulation which spread through advanced and emerging market economies as from the mid-1980s.

The same reasoning has been applied to finance – maybe without understanding that financial services are quite special, and different from other products. This difference has become even more difficult to understand during the crisis, as some – like the German Chancellor Angela Merkel – have asked: “ Why is it when I buy a product I know what I am buying, but when I buy a financial product I do not know?” [6] Many of us have probably wondered this when trying to understand what caused this crisis.

The answer is twofold. Firstly, if you buy a financial product you are, by definition, buying risk. If you only want to preserve the nominal value of your savings, you should just hold cash. The return on an investment compensates you for the inherent risk of the asset you acquire. In other words, the value of a financial instrument is uncertain because it is subject to risk. The greater the risk, the greater the return should be.

The second part of the answer is that it is not always easy to assess risk. Anyone who enters into a transaction should make his or her own assessment. That may vary not only because of the probability of a specific event, such as the default of the counterparty, but also because of the probability of other events, affecting for instance the other assets held in the portfolio of an investor. But, more importantly, the buyer and seller may value the risk of an asset differently because they might have different information about the asset itself, and its characteristics. In particular the seller – by which I mean the originator – of the asset tends to have more information than the buyer. If the former can hide some of the information, in particular about the risk of the asset, he can sell it at a higher price. In other words, the rate of return will not cover the intrinsic risk of the asset.

This is where the difference between financial products and other products is relevant, not only for individuals but also for society. Earlier I mentioned that, in a world of perfect competition an industry should attract investment, and thus grow until marginal profits are brought down to zero. This assumes that both the seller and buyer are able to assess the price of the good or service exchanged. If the buyer believes that the good is of higher quality than it really is he or she will buy a larger quantity, for a given price, and thus increase the sales and profits of the company selling the product. In other words, if an investor thinks that a financial asset is less risky than it really is, he or she will buy a higher amount, and the profits of the financial industry will increase. This means that the more the risk is undervalued by investors, the greater the profit opportunities for the financial industry are, and the greater the scope for further expanding in particular through financial innovation, which may hide the inherent asymmetry of information. Pushing the argument further, in a competitive environment there are incentives for the financial industry to increase the asymmetry of information – it can increase its revenues and profits that way.

To sum up, a market economy has a natural tendency to produce and consume financial assets to an excessive degree, and that may destabilise the economy. The key difference, again, compared with the other sectors of the economy, is the inherent asymmetry of information which underlies the relationship between producers and consumers of financial instruments. This is why (some) regulation is needed to preserve sound and stable financial markets. The financiers' incentives are diametrically opposed to those of the capitalists considered by Rajan and Zingales. For the latter, the more regulation there is, the better, because it protects the incumbents from external competition, and thus maximises their monopolistic rents. The incumbents are ready to lobby the regulators and legislators to increase the regulatory barriers, to protect their rents. The regulatory pressure will only abate if the potential external competitors and consumers can mobilise sufficient resources and forces to counter such lobbying.

In the financial industry, it's the other way round. The outsiders, who are not subject to regulation, can become more profitable than the insiders if they are able to sell to investors high-risk assets with returns which appear to offer disproportionate rewards. Financial regulation does not protect the incumbents from outside competition, unlike in other industries, but instead prevents the insiders from conducting more profitable – and more risky – business practices that the outsiders can perform in the non-regulated sectors.

I will not consider in detail why the non-regulated financial sector has grown to become more profitable than the regulated one, the opposite of what should happen in the real economy. Asymmetric information is again at the heart of the matter. In the real economy the inventor of a product can protect his intellectual property and investment in production by seeking a copyright. Production, distribution and sales can be planned on the basis of such protection. In the financial system there is no such a thing as copyright. No product can be protected. No copyrights exist for CDOs, CLOs, CLSs, swaps, etc. This is why financial instruments or financial institutions' balance sheets cannot be perfectly transparent. It would destroy the business. If a successful fund manager were obliged to fully disclose his investment strategy, others would immediately do the same and he would go out of business.

Financial regulation was intended primarily to prevent very opaque and risky products from being produced by financial institutions and sold to savers. Over the years, however, a shadow banking system, unregulated, has developed, which aims to produce and sell the kinds of product not normally available in the regulated market. This trend has been tolerated by regulators because these high-risk financial products were developed and purchased by wealthy institutions and individuals who were supposed to understand the risk and deal with it. Moreover, the institutions developing such products were not considered as being systemically important – it was not thought that their failure would jeopardise the stability of the financial system. This was why hedge funds were left unregulated, even after the collapse of LTCM, an event which should have raised the alarm.

The shadow financial system was relatively small at the end of the 1990s. But over the past decade it has grown enormously, in particular the hedge funds and investment banks. The speculative activity of the traditional banking sector has also developed exponentially. Let me give you some figures: the total assets of the five major US investment banks as a percentage of US GDP increased from about 13% in Q1 1999 to 31% in Q1 2008. [7] As for the global hedge fund industry, the capital under its management went up from USD 155 billion to USD 1.5 trillion between Q1 1999 and Q1 2008. That's a staggering 853% increase. [8]

There are basically two factors behind this development. The first, as already mentioned, is the higher profitability of the non-regulated financial sector compared with the regulated one, which

has pushed the former to enter aggressively into the latter's business. The quote taken from Gillian Tett's book is quite telling in this respect. The higher profitability of the non-regulated sector attracted the attention of the regulated one, which tried to equip itself to enter into higher-risk business, in particular to originate and distribute high-risk products, in particular through off-balance sheet vehicles. The more regulated institutions entered such high-risk business, the less profitable this business became, because of the greater competition. This in turn created the incentive in the non-regulated sector to innovate, creating more sophisticated products, which often were too sophisticated for other institutions. As I mentioned, increasing competition in finance tends to promote risk-taking and thus potential instability.

We know what the solution to this problem is – regulation. This brings me to the second factor behind the development of the shadow banking system: the lack of regulation or even the deregulation of the system. In the ten years leading up to the crisis, not only was the burgeoning shadow banking system left unregulated, but also the traditional banking system was deregulated and allowed to enter into businesses which should have been reserved for the shadow banking. The US offers the best-known example of deregulation. The repeal, in 1999, of the Glass-Steagall Act removed the barrier between commercial and investment banks. As a consequence, the latter started to operate in the traditional banking business although they were not subject to supervision by the Federal Reserve. In particular, the investment banks entered into the mortgage business and developed portfolios that were repackaged and resold as CDOs and other instruments. The result was that the commercial banks came under greater competitive pressure and probably felt they had to enter into riskier kinds of business. The lack of regulation as regards several components of the financial system has been highlighted in a number of reports. Activities of systemic importance were, for instance, not subject to any form of regulation. There was, for example, a lack of transparency in the OTC derivatives business, a lack of oversight for hedge funds, not to mention other shortcomings. Moreover, the narrow focus of the regulation that did exist, relating to traditional commercial banks, encouraged them to transfer parts of their business to unregulated entities off the balance sheet, and they thus exploited gaps in the accounting framework. Why did this happen? This is a key question that must be answered if we want to build a better system and not just plug the leak. Let me start by suggesting how it happened. Clearly, the decisions not to regulate the shadow banking system and to deregulate the financial industry were taken deliberately. It was undeniably in the interests of the shadow banking system not to be regulated. And it was also in the interests of the banking system to be deregulated. The increased profitability of the financial sector – which in the middle of this decade reached 40% of corporate profits in the US, more than double the average over the previous forty years – was also used to lobby the political authorities and the regulators with the aim of reducing regulation and supervision. A recent publication by two non-profit organisations, Essential Information and the Consumer Education Foundation, have estimated that over the 1998-2008 period about USD 5 billion was spent by financial institutions (including banks, investment banks, hedge funds, insurance companies, etc.) on campaign contributions and lobbying activities for the US Congress and Administration in order to get rid of a large part of the financial regulation enacted after the Great Depression. [9] The outcome is ironic: the lobbying ended up sowing the seeds of the biggest economic and financial crisis since the Great Depression. The report details all the draft bills that pushed deregulation forward. International competition in the financial sector has no doubt led legislators in various countries, in particular in Europe, to compete in order to secure a level playing field, which turned out to be lower and lower, in terms of regulatory constraints. A veritable race to the bottom.

Lobbyists have even been granted some dignity in recent years as legislators have made it their custom to consult the industry whenever new regulatory – or should we better say deregulatory – initiatives were proposed, so as to ensure that the interested parties could express their views and

influence those of the legislators. Asymmetry of information plays a role also in this relationship. Typically, financial market participants have greater knowledge of the financial products that are subject to regulation than political authorities and regulators, and can better assess and explain the reasons – including the advantages they would obtain – from deregulation, thus helping to implement what is in their best interest. The holding of regulators and political authorities captive by the financial industry has been one of the main factors underlying the deregulatory process and the regulatory delays in recent years.

To sum up, a downward spiral has been created: the increased profitability of the financial sector over the years has encouraged lobbying for further deregulation of the industry, which then leads to still greater profitability and even more lobbying pressure.

It's reasonable to ask why no contrarian force has emerged to try and stop this spiral. One of the reasons is that the beneficiaries of deregulation and the developers of the shadow banking system have been quite diverse. Shareholders benefited from the search for higher yield, and from banks being able to enter into more profitable, albeit more risky, business. Companies benefited from the development of sophisticated financial products which allowed risk to be securitised, thus reducing the burden of debt. Rating agencies benefited from the development of new sophisticated instruments to which they had to attribute a synthetic rating. They even gave advice to banks on how to develop such instruments. Households benefited from the development of financial instruments which allowed them to borrow cheaply in order to buy consumer goods or houses. It's difficult to imagine who, if anyone, during this Goldilocks scenario was a loser, except maybe those financial institutions and operators which were more cautious about playing the game. In other words, the losers were those who did not dance.

And if so many people benefited from the system, the political authorities could only benefit, and encourage it, and their acquiescence increased. To quote a recent article by Simon Johnson: "Because everyone was getting richer, and the health of the national economy depended so heavily on growth in real estate and finance, no one in Washington had any incentive to question what was going on". [\[10\]](#)

Until something went wrong, that is. It was bound to go wrong, because the system of incentives led economic agents to search for higher and higher yields, even at the cost of reducing regulation or permitting unregulated activities, and thus made instability inevitable sooner or later. What I have just described might be considered as another way to characterise the reference to the "human factor" made in particular by Greenspan or to the rational behaviour mentioned by Richard Posner. It's the chain of incentives of investors, institutions, supervisors, politicians which lead society to take upon itself a greater degree of risk of a private or public nature. As Alan Greenspan said: "Unless somebody can find a way to change human nature, we will have more crises and none of them will look like this because no two crises have anything in common, except human nature". It's a very clear warning. What are we doing about it?

I don't want to give the impression that human nature cannot be changed. Hopefully this crisis will have thought some lessons. The problem is that the interconnectedness of the financial system makes it vulnerable to the behaviour of the less competent, those that do not learn the lesson. The dangers do not come from the 'good dancers', to use again Chuck Prince's analogy. The good dancers will always find their seat when the music ends. The danger comes from the 'bad dancers', especially those who believe that they are as good as the others and embark on pirouettes, eventually stumbling and making others fall when the music stops. The functioning of markets is bound to be affected by those participants who have taken excessive risks, relative to their ability to

manage them. They represent a danger for the system, as drunken drivers represent a danger for safe drivers.

Hopefully this crisis has also convinced that it is difficult, if not impossible, for market participants to self-regulate in a way that would produce a less risky environment for financial systems. Again, self regulation works when all market participants agree to it, but the worst dancers will always have the incentive not to agree, and to deviate from regulation in order to be able to deliver similar returns.

Under these conditions, regulation can only be imposed by an authority outside financial markets. Indeed, it should be in the interests of market participants – and of taxpayers – to have a powerful regulator “ established with the authority and courage to slow down the music for everyone”. [11] The initiatives that have been taken over the last few months, in particular by the G20, the FSB and the IMF, aim to fix the problems that gave rise to the crisis. I won't go into all the initiatives, measures and commitments that have been made, for they are well known. They are all very important and necessary. We should nevertheless ask ourselves whether they are sufficient to tackle the causes of the crisis. We must ask ourselves whether, with their current status, the supervisory authorities will indeed have the power to slow the music down when they consider it essential to safeguard financial stability.

We know that the pressures for deregulation will mount again, as soon as the crisis is over, financed by the huge profits that the financial sector will generate again. This is not a theoretical question, nor so far distant in the future. It is well known that very strong forces are at play right now – as we speak – to minimise the changes to the regulatory framework proposed after the crisis. And these forces will grow as the crisis recedes. Just to give an example, on 3 October 2009 the Financial Times had a front-page headline ‘ Top bankers launch fightback against feared regulatory overkill’ – an article reporting on discussions at the annual meetings of the Institute of International Finance. At a roundtable discussion at the IMF-World Bank Annual meetings in Istanbul recently, I heard a comment often made by some financial market participants: “ We don't really need new regulation: everything is there. It should just be applied”. If this was true, the real question should be why the supervisory authorities have not made full use of the existing regulations, in particular the discretionary elements allowed for, such as in the second pillar of the Basel II framework. The answer is that the supervisory authorities have been put under extreme pressure, by the financial industry, market participants and even political authorities, not to use these discretionary powers, as they would cut the profits of the banking system. As capital is internationally mobile, financial companies tend to penalise those countries where supervision is tougher by moving their funds and operations to those where supervision is lighter.

The crisis has shown that the countries that have incurred the lowest costs from the crisis are those where the supervisory authorities have stability as a top priority and where they have implemented regulation with the discretion available. One example is the use of dynamic provisioning of capital in Spain. In contrast, in several countries where the supervisory authorities have opted for a light approach, because they were pressured by the political authorities or were required to promote their domestic financial system, the taxpayers have paid a very heavy price. The costs of these regulatory and supervisory failures have been borne not only by the residents of the countries concerned but also by those of the other countries as a result of the crisis.

The principle of home country supervision, which assigns responsibility to the supervisory authority of the country where the bank is incorporated, is viable only if there is confidence in the foreign supervisory body – that it can be trusted to do a good job and not be held captive by its industry or its political authorities. Without such confidence the single market cannot survive.

How can we address these issues?

Let me mention three areas in which, in my view, we should make progress – they are essential if we want to establish a more efficient supervisory structure and better protect the system from future crises.

The first area concerns the independence of supervisors. As I just mentioned, at the root of the crisis is the regulatory and political ‘capture’ of supervisors. It leads them to favour short-term priorities over medium-term stability. It’s nothing new. It has been examined notably in the literature on the time inconsistency of optimal policy. Decision-making systems which are closely associated to political institutions tend to be biased towards the short term. Politicians are inevitably induced to aim at achieving something that is visible to their constituents during their term of office. For obvious electoral reasons, they are tempted to pursue policies that are more likely to have a short-term impact but which may be counter-productive over the medium term. In the same way, the electoral cycle discourages them from adopting policies of benefit to society over a time horizon which goes beyond their electoral mandate but which entails some hardship to be endured before then. Short-term pain rules out longer-term gain.

A case in point is monetary policy. When it is implemented by policy-makers who are accountable to their constituents in the short term and who pursue two contrasting objectives – such as inflation and growth – the result might be a highly expansionary policy with excessive inflation. The solution has been to create, in most countries, independent central banks in charge of monetary policy and with a clearly defined objective, i.e. price stability. When this happened, some people reacted negatively, saying that a key aspect of economic policy should not be left to unelected technocrats. With the benefit of hindsight, few today would overturn this decision, as over the years independent central banks have kept prices stable – but not at the cost of economic growth.

Can supervisors be made as independent as central banks? In some cases they can, at least from the operational point of view, when the task is assigned to central banks. Supervision conducted by independent central banks has proven to be more resistant to regulatory capture and to political pressure. But making supervisory authorities fully independent is a bit more complicated than doing the same with monetary policy-makers, because the objective of supervision cannot so easily be turned into a benchmark as simple as a percentage for the inflation rate. [\[12\]](#) If financial stability became the sole objective of the supervisory authority, the result might be excessive regulation to prevent the failure of any bank. But, for monetary policy, the primary objective of price stability does not rule out secondary objectives, which should be pursued without infringing the primary one. For supervisors the primary objective should be to promote the stability of the financial system, domestic and globally, but secondary objectives could also be foreseen, entailing in particular efficiency.

Another constraint on the independence of supervisory authorities, one which is often mentioned in policy discussions, is that their decisions may have an impact on the taxpayer. So it requires some control by government authorities. I personally believe that this argument is flawed and misplaced. In the conduct of monetary policy, or the lender of last resort functions, independent central banks also take decisions which affect taxpayers, in a way which might be even more relevant than when supervisory authorities take their decisions, for instance when they assess the solvency of an institution. Can it be denied that it's better for society if such decisions are taken by an independent body which can assess in a fair way the options available for handling an insolvent bank and present those options to the fiscal authority? I will not dwell longer on this issue, but it certainly deserves further thought.

The second area where progress is needed concerns international cooperation between supervisors. There is a broad consensus on this issue and certainly much progress has been achieved over the

last few months. However, here, more than in other areas, the devil is in the detail. We can see it within the European Union, where the creation of three supervisory agencies, as proposed in the de Larosière report, is currently being discussed in the Council. Attempts to limit the scope of cooperation and avoid interference with national competences are never far away. Some progress has been made with the creation of Colleges of Supervisors, which exist for the major banks. However this can only be an intermediate step as the many Memorandums of Understanding do not necessarily guarantee a level playing field for supervisory functions. The presence of European Agencies' representatives in the colleges, as is currently proposed, would represent a first step towards ensuring some consistency in supervisory approaches.

The third area refers to the accountability of supervisors. Who supervises the supervisors? Accountability is currently established at the national level, because – it is often stated – it's up to the national taxpayers to pick up the bill. In other words, it's up to the national political authorities, who represent their taxpayers, to be in charge of assessing the activities of the supervisors. However, as the current crisis has shown, some taxpayers had to pick up the bill of institutions which should have been better supervised by foreign supervisory authorities. In a global financial system, the domestic political authorities cannot by themselves really ensure the accountability of the domestic supervisor.

Another constraint on the current system derives from the complexity of the activities performed by the supervisory authorities. This makes the exercise of accountability quite difficult, especially for non-experts. Unlike monetary policy, the effectiveness of which can be summarised in a few statistics, supervisory activity cannot be reduced to just the number of institutions which are supervised or have failed, or to the number of warnings which have been issued.

What is currently missing is a system of expert international monitoring and assessment of the activities performed by supervisory authorities. Institutions like the IMF, the OECD, or the European Commission in the EU, are in charge of monitoring and assessing the performance of central banks, fiscal authorities and governments in a general way, with respect to a wide range of policies and activities. Supervision does not fall within the realm of this international cooperation. There are forums where supervisory authorities hold discussions in order to achieve convergence in supervisory practices and to exchange information on how they perform their functions. But there is no independent assessment of how these functions are performed.

After the Asian crisis of 1997-98, the G7 agreed to entrust the IMF with Financial Sector Assessment Programs in all countries to assess the resilience of the financial systems in advanced and emerging economies. Aside from the fact that not all countries participated in that assessment, it is only a snapshot of the current situation. What would be needed is a periodic evaluation of the activities performed by the supervisory authorities in the major countries, in order to assess not only their independence but also the way in which they carry out their functions. Such an assessment would be of great benefit to the national political authorities to whom the supervisors are accountable.

To sum up, the current initiatives to strengthen the regulatory framework are essential. On the other hand, the institutional framework underlying the supervisory functions needs to be reinforced. Supervisory authorities need to be made more independent, i.e. more capable of slowing down the music. They also need to cooperate more with each other, because it is no good slowing down the music in some jurisdictions if it continues to run fast in others. Finally, we need a system that will monitor and assess internationally the activities performed by the supervisory authorities, one which will strengthen both cooperation and accountability.

Let me conclude. The current crisis has been characterised by many as a crisis of capitalism. I wonder whether it might also be a crisis of our democratic system, a challenge to its ability to manage complex and global financial markets. Indeed, many parts of society benefited from the loose approach to supervision and regulation of the financial activities which took place in the run-up to the turmoil. Market participants have been short sighted, and so have the political authorities and institutions. Can this crisis convince them to look further ahead? Can we expect the longer-term interests of society to prevail once again over short-term incentives which led to instability? The signals coming everyday from several financial market participants as well as political authorities do not seem so encouraging. The former are waiting for the dust to settle and for things to return to 'normal'. The latter can only be as far-sighted as those they represent, i.e. those who elect them. What is really needed then, to quote that famous phrase, is somebody who will "take the punch bowl away just as the party gets going" again; somebody who has the authority to slow the music down. I am fully aware that this is not easily done, but it is not impossible. It took the high inflation of the 1970s to convince the political authorities that monetary policy should be implemented by independent central banks. It would be better not to 'waste' another crisis to come to the same conclusion for financial stability.

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

[2] R. Posner 'A Failure of Capitalism', Harvard University Press, 2009.

[3] Interview with the Financial Times, 10 July 2007.

[4] Gillian Tett, 'Fool's Gold', Little Brown, 2009.

[5] R. Rajan and L. Zingales, 'Saving Capitalism from the Capitalists', Princeton University Press, 2003.

[6] Angela Merkel also said, in Linz on 20 September 2008: "Financial products have to meet certain standards and be easier to understand... you also have to know [in respect of those products] what you are dealing with. Otherwise things happen for which we all have to pay."

[7] Data refer to the total assets of Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers. Data are reported until Q1 2008, i.e. when Bear Stearns was taken over by JP Morgan.

[8] Source: Lipper TASS.

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

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