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Environment and Finance: Lessons to be Learnt

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The world has been changing. Only a few years ago finance was meant to be the panacea for all problems and, at least until 2006, big banks and financial institutions were believed to be the so-called masters of the universe. Since then, things have changed, and now finance and big banks are considered to be the villains. They are blamed for being the culprits of the recent crisis.

Two Dimensions of the Same Problem

When I started preparing this lecture, I saw the title, and I thought that it sounded completely out of fashion. It seemed like the speech for the last world while the speech for the next world should be something completely different.

I think that there are many lessons to be learnt by comparing finance and environment. I'll attempt to argue that there are very useful interactions between these two areas, both in theory and in practice. It is a convergence worth exploring.

First of all, finance is still crucial in the development of key technological process in investment, in energy production and energy storage, and in transmission and use. Second, finance is crucial, because it moves resources from sector to sector and from period to period.

My point is that whatever happened in environment and finance is two dimensions of the same problem. **Lessons can be learnt in both areas by analysing this distortion**. These lessons could be very useful for policy, for human behaviour and for the progress of economics.

The Greenspan Put and the Financial Crisis

I'd like to say a few words about the crisis, which are drawn from my experience. As Minister of Finance I had been sitting in the G7 for five years from 2001 to 2006. During that period, everything that occurred in the real economy in terms of shocks was tackled by injecting huge liquidity into the system. This was called "The Greenspan Put": any sort of problem or risk in the financial world or in the real economy, was basically cured by over expansionary monetary policy. Real interest rates were almost zero, and inflation seemed to be completely under control. Finally, there was a huge deregulation which was not related to risk and banks were allowed to sell any sort of product, from derivatives to the so-called CDO and CLO, with very thin capitalization.

This deregulation of the financial sector is very important because it transformed the business of banking into the business of product selling, and eventually free riding. For instance, if I have a client, and if I give him a mortgage, I will keep that mortgage into my balance sheet for 10 years. I know the client, I'll take care of him, and I'll know if he is going to return the money. But if I give a mortgage to a client and then I put that mortgage into a bond and I sell it immediately, I will loose all accountability and responsibility for that bond. As you can easily imagine, this is a huge incentive for free riding.

This situation I just described, connected with big trends of the globalisation and the so-called **"global imbalances"**, can be summarized in this way: on the one hand the US financial system was

consuming more then 100% of the disposable global income by extracting equity from the housing sector. On the other hand, China was consuming too little, saving too much, and was producing for the western consumer as a whole. China was even financing western consumption by lending money. **These are the big global imbalances: excess of consumption on the one hand, excess of saving on the other hand, and a financial market connecting the two**.

"Don't Fix it if it's Not Broken"

At that time many people pointed out the unsustainability of this model by either discussing in terms of twin deficits or discussing the global imbalances per se. If you search on Google for "global imbalances" you'll find thousands of papers, but nobody took interest in them. I perfectly remember that when we were sitting around the G7's table, when you talked about global imbalances, they treated you like an academic doing wrinkles on odd topics, and as you finished your speech, they looked at you and said : "Ok, now kids, give way and let the big boys work around the serious matters." It was impossible to discuss these matters. The general attitude was well known and it sounded something like this: don't fix it if it's not broken.

Thanks to these global imbalances, financial deregulations and monetary policies, a strong interdependence developed not only among regions, but also among generations because **we were postponing problems to the future**. And that future is now.

We also have a cultural problem because finance basically swallowed everything. It swallowed the best students that were attracted to Wall Street by reputation and by huge compensations. Finance swallowed the ethical principles, the real economy (compare the compensation of a CEO in the banking sector to the compensation of an equal CEO in the industry sector; you can't avoid seeing a big disproportion) and the society, too.

Amartya Sen told us that the world rests on three pillars: markets, state and civil society. For 20 years the market (the financial market in particular) overwhelmed states and whatever was happening in the real economy. Observing this process in depth, you can find several kinds of externalities involving groups and agents, regions (because there are plenty of bonds issued by US banks in the balance sheet of local banks), generations, and middle classes emerging in the developing countries by the consequence of globalization.

Paralleling Finance, Environment and Economics

In 2007, the financial system had the first big shock and again in 2008, with the Lehmann collapse, the bubble burst. The management by the central banks and the government of the crisis were successful in stopping the panic, but at the same time they planted the seeds for future problems. In fact, they socialized the private debt by transforming it into a public one. They nationalized banks, which meant putting the responsibility of the banks on the taxpayers. In doing so, they bailed out whatever needed to be bailed out. In my opinion this was a necessary thing to do, even though now we are left with a delicate question: what is the exit strategy?

The only answer is **to reduce public debt, to withdraw all the liquidity we injected in the market and to rewrite the rules**: all solutions should require international policy coordination.

There are enormous parallels between the financial crisis and environmental economics. The famous journalist Thomas L. Friedman wrote a book that is considered to be a hymn to globalization, *The World is Flat*. In his following book, *Hot, Flat and Crowded*, Friedman wrote

about the excess of US consumers, and of the western world in general, including finance and energy sources, a sort of bulimia, which brings consequences to the global level.

Other writers and economists such as George Akerlof and Robert Schiller are developing theories of these excesses by analysing human nature, which include greed and the desire to overwhelm people.

Coalition theory is another parallel that easily comes to mind because when you consider both financial and environmental issues, you cannot rewrite the rules unless you do it in an internationally coordinated way.

We can continue to discover other similarities, which involve growth theory. We should return our thoughts to sustainability in the long run and the **intergenerational equity** because what we are doing now will involve the future of young generations.

I believe that if you go into the deepest theoretical structure of the problem you will discover plenty of parallels between the financial crisis and the environmental crisis.

Now it is up to environmental economists to speak up and explain to the policy-maker and to the general public that sustainability is really a serious matter.