

***The future of capitalism in Europe: ethics, principles, values***  
**Rome, 23 June 2009**  
**Pontifical University Regina Apostolorum**

**RESURRECTING RULES, PRINCIPLES AND VALUES:  
 MONETARY POLICY AND FINANCIAL REGULATION  
 AFTER THE CRISIS**

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- The international financial crisis we are suffering is a crisis of rules. Not only our rules proved to be no longer adequate, but compliance with them has been insufficient. This happened for financial regulations and for several other types of rules as well, including best practices in corporate governance, traditional codes for international economic cooperation, personal ethics, sound principles for household budgeting and, last but not least, the rules that should govern monetary policy strategies.
- Monetary policies have been damaging macro-economic equilibria for many years, until the crisis exploded. Interest rates have been set by central banks several points below the levels that existing orthodox monetary rules would have suggested. Enormous increases in the stocks of money and credit have been tolerated – which caused the deterioration of the quality of credit, the blowing of price bubbles in many asset markets and general inflationary pressures. *Consumption price inflation was beginning a serious acceleration just before the disastrous phase of the crisis which started in autumn 2008.*
- Deficiencies in regulatory and supervisory policies are well known and widely discussed. The forbearance of the authorities has been more the rule than the exception, with a financial industry where risk management was conducted with superficiality and myopia, extracting enormous short-run profits from excessive risk exposures. *Politicians, needless to say, have been responsible for these wrongdoings together with the technocracy that was accountable to them.*

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- To the extent that the crisis is one of rules, curing the crisis requires fixing the rules. Actions in this directions are under way. Quite apart from the current management of the crisis, which often brings further, extraordinary breakings of the rules, the international community is making an effort to devise the rules for the future, the ones required to avoid the next crisis.

- The international efforts in resetting and reinforcing the rules should not forget monetary policy: it has been among the causes of the crisis and must be part of its cure. Several rules of the current monetary orthodoxy must be revised and strengthened, including: the primacy of the price stability objective, independence and accountability of central banks, the role of asset prices and monetary aggregates in monetary policy strategies. As to financial regulation, there is a lot to be done but this presentation does not deal with the numerous detailed measures that are currently considered by re-regulators.
- A new relationship must be developed connecting the rules that guide monetary policies with the prudential regulations of financial markets. This can happen in setting the new rules for what is now labeled “macro-systemic financial stability”, to be distinguished from the “micro-stability” of individual financial intermediaries. Systemic financial stability must become an explicit responsibility of central banks.
- In order to be able to pursue two targets – price stability and systemic financial stability – central banks must have two instruments: not only monetary policy, but also a new set of tools which international regulators are currently calling “macro-prudential controls”. This set includes, most importantly, the countercyclical maneuvering of regulated parameters such as capital ratios, dynamic provisioning, liquidity ratios, leverage ratios.
- During the rising part of an economic and financial cycle, when insolvencies are rare, markets are very liquid and a brisk appetite for risk prevails, abundant credit flows must be monitored and controlled with the joint use of monetary and systemic stability policies. Interest rates must be raised together with capital ratios of financial intermediaries, with higher provisioning for their future expected losses and with more abundant precautionary balances of liquid funds. This combination of monetary and prudential restrictions aims at checking the inflationary pressures that develop when the cycle reaches its highest phase as well as at moderating the increase of the leverage of the intermediaries and of their clients and at preventing bubbles in various asset prices inflated by injections of excessive credit. The timely and coordinated adoption of these policies decreases the probability that an excessive boom develops, followed by a crisis, and favors the setting aside of capital and liquidity to cope with the negative part of the cycle that will follow, during which both monetary and prudential policies will be gradually eased, allowing cheaper and more abundant credit to counteract the increase in the probability of losses and in the degree of risk aversion of intermediaries and investors. The profile of the cycle will thus be stabilized and major crises avoided between booms and busts.
- Both monetary and systemic prudential policies must be exercised according to predetermined rules, limiting discretion and flexibility. The central bank is the right institution to be entrusted with gathering the relevant information and exercising the joint powers of rule-based countercyclical monetary and financial policies.
- Some perplexities create difficulties in reaching the required consensus, both in the Us and in the Eu, for legislating a more important role of central banks, making them also the main centre of responsibility for systemic financial stability. These perplexities cannot be justified on rational economic grounds; they are based on political, institutional and bureaucratic jealousies, nationalistic conservatism and pressures from special interests. Having said this, it is true that adding responsibilities and powers to central banks calls for even greater care in reinforcing their independence and their accountability. *The public*

*opinion must become much more conscious of the importance of central banks' independence and accountability.*

- Both independence and accountability will be easier to obtain if policies for monetary and financial stability are exercised following clearly stated rules, downplaying the idea that central banking is a matter of art and mystique. Let me repeat that remedies for a crisis of rules must rely of rules.

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- The discussion on monetary and financial rules and institutions offers an opportunity to devote some brief considerations to three more general interconnected issues: short-termism, the role of independent technical agencies in modern democracies, and the meaning of “ethics” in economics.
- Short-termism is the attitude of our societies and our economies to behave in a myopic manner, forgetting that the short-term will be followed by the long-term when, in contrast to the abused citation from Keynes, we will not be all dead, and when, in any case, “future generations” will have to live.
- Short-termism affects many aspects of societies’ decisions and its influence is by no means confined to finance. It has been at the roots of the current crisis. It has characterized the behavior of households, citizens and consumers, private firms, public agencies and authorities, politicians. It is a cultural problem but, more importantly, is a result of a set of incentives that motivate private and public decisions in our democratic institutional settings where “future generations” – which also include ourselves beyond the short-run – have no possibility to vote but will pay the price of our present myopia.
- Short-termism is a cause of market failures and calls for public interventions and regulations. Several type of measures can help in fighting short-termism. Focusing on finance, some examples can be: limits to the indebtedness of private and public entities, floors to the level of real interest rates, prescribed features of managers’ compensation schemes, regulatory and fiscal incentives for long-term oriented institutional investors such as pension funds as well as for saving instruments targeted to low income households, public support to increase the financial literacy of the population. A recent, successful book by Robert Shiller, shows how economic myopia can result from ignorance.
- An important source of short-termism is the continuous search for real-time consensus by politicians in democracies where elections are frequent. *The rationality and the long-term effectiveness of economic policies suffer a lot from this source of short-termism.* Several devices can be used to partially correct the distortions generated by short-term consensus-seeking politicians.
- A general remedy is an increased reliance on independent “agencies” entrusted with specific objectives of policy-making. Democratic political decisions set the goals of the agencies but abstain from interfering with their decisions that must not be influenced by the short-run cycles of political consensus. Agencies are then accountable for their medium-to-long-term results to the political powers. *Better and more democratic*

*accountability is obtained if agencies are made accountable to the legislative than to the executive.*

- “Governing through agencies” is an important anti-myopia method both at the national levels and for ruling in the globalization process. It can be done in very different sectors of policy-making, from peace keeping to free trade, from ecology to the defense of privacy, from anti-trust to policies for promoting science, from consumer protection to the enhancement of productivity of public employment. There are wide differences among the statutes, the organizations and quality of the performances of the many agencies that exist.
- “Governing through agencies” rarely looks like an explicit and conscious method of government. It is often chosen to solve specific technical problems of regulation. Politicians dislike it, in principle, as it implies the delegation of powers and it means tying their hands. The potential advantage of tying their own hands, for politicians, is the enhancement of the long-term sustainability of their success but comes at the cost of sacrificing short-run consensus-seeking activities aimed, so to speak, to the “next elections”.
- A contrast between the agencies’ technocratic powers and the legitimacy of the powers of elected politicians is sometimes cited. This idea overlooks the fact that delegating well defined powers to independent agencies and fixing their long-term goals is a deeply political act with full democratic legitimacy and long-sighted respect for the public interest. The building of many Eu institutions can be represented as a virtuous international exercise in the self-limitation of political powers that suffer from natural biases towards short-termism and misrepresentation of national interests.
- Central banks and financial regulatory authorities are among the best known and most active agencies. Their substantial responsibilities in causing the current crisis decreases their credibility and nourishes the doubts on the validity of the method of governing through agencies. These doubts are misplaced as most of the agencies’ wrongdoings were a consequence of the insufficiencies of the strength, clarity and internationalization of their mandates, as well as of serious imperfections in their independence when interacting with politicians and market pressures.
- Rules must be supported by values and ethical principles. It is probable that a world that relies a lot on rules – and on the authorities that enforce and supervise their implementation – cannot function in a sustainable way if citizens and economic agents, that are required to make free choices respectful of the rules, are not inspired by ethical values, be they grounded in religious beliefs or elsewhere. We must therefore welcome recommendations made by those – including religious leaders – that address individuals’ consciences and freedoms, also calling for responsible economic behaviors, based on explicitly stated ethical principles.
- There is a danger though: that misplaced emphasis on ethical principles obtains the perverse result of weakening the rules that must govern social interactions and economic relations, instead of grounding them better in a coherent set of extra-economic values. After all, good rules are often dictated by the sole aim of optimizing the functioning of a society composed by individuals that often do not care about ethical principles but that are compelled by the rules to take into account – to “internalize” as economists say – the external costs and benefits of their actions, thus acting in the collective interest of the society where they live.

- On the contrary, high-flying ethical principles, grandiloquent appeals to value public over private interests, are often used by individuals, corporations and politicians, for circumventing more low-profile but basic rules and for trying to go beyond the role for which they are legally and specifically responsible. The result is the confusion of responsibilities and a festivity of deviations from the rules backed by the holy music of ethical rhetoric. Self appointed public benefactors are often managers and entrepreneurs who disregard the interests of the majority of company's shareholders, hide their ineffectiveness and try to find noble labels to pursue their personal ambitions, often connected with the political arena, far away from the interest of their company and, needless to say, from the interest of society at large. Governments are better suited for pursuing public interest, setting the right rules and financing their social-welfare-enhancing activities also by taxing the profits of the self-interest-oriented private companies.
- Having said this, freely chosen, economically sound, non-hypocrite ethical behaviors do exist and can be precious for society. They are behaviors with which financial and non financial firms can be socially responsible in ways that do not contrast with their long-run private interests. Corporate social responsibility – when able to avoid rhetoric and vagueness, wishful thinking and moralistic opportunism, politically motivated moral hazard and short-sighted hypocrisy – offers us plenty of good recipes, ranging from labor market relations to ecology.
- Let me conclude with two examples of credible ethical behaviors, particularly relevant in finance. The first is a strong, explicit and well defined commitment of financial and non financial companies to pay attention to the long run, as advocated above, without surrendering to the temptations of short-termism. Well publicized strategic plans can be framed emphasizing the maximization of the value of the company's assets in the long-run, neatly excluding the unsustainable maximization of short-term shareholders' value.
- A second example of credible ethical behavior of a financial or non financial company is the effort to maximize certain aspects of their transparency, beyond what is required by laws and regulations. Protecting from potential competitors the secret on certain elements of a company's know-how is certainly legitimate and correct. But hiding information that is relevant for evaluating the long term perspective of a company can be an attractive trick only in the short-run as, sooner or later, it turns out to be self-defeating. *Disclosure of data, budgets and targets of strategic plans is key to decrease market discount factors which also yields, for a given expected stream of future cash-flows, an increase of the value of shares as well as a lower risk premium on the company's long-term debt. At the same time, transparency favors the optimal social allocation of resources.*
- A special type of extra-transparency, deeply related with the problems highlighted by the current crisis, consists in disclosing the company's choices along the trade-off between the average expected profitability of its activities and the degree of exposure to various types of risk that they imply. In an efficient organization expected profitability cannot be increased without increasing risk. *For a given degree of efficiency, a potentially more profitable strategy is also riskier.* The temptation of hiding risks and stressing measures of expected profitability that do not reveal their risk-premium component is often difficult to resist. But resisting this temptation has an ethical value.

- The chosen combination of expected profitability and risk must be made clear to all the relevant stakeholders. Each of them, including workers, creditors, clients and the government, bears, in different ways, parts of the risks associated with a given strategy. Progresses in transparency and disclosure on this aspect can greatly benefit public interest by allowing the improvement of the adherence of the allocation of resources to the collective utility function of society. This type of transparency can also make the managers themselves more conscious of their often too implicit choices along the risk-return trade-off. The insufficient consciousness of risks has been at the heart of the explosion of the current crisis. But capitalism cannot function without running risks. To be transparent about the assessment and the distribution of risks can unveil the social and ethical value of running risks in a free and open society.