FINANCIAL TIMES – 16 MARZO 2010

It is better to have explicit rules for bail-outs

di Lorenzo Bini Smaghi

One of the many lessons we can draw from the financial crisis - and one supported by the literature on behavioural economics - is that economic agents do not always behave rationally, especially when they take decisions affecting others. Research has shown in particular that agents are not only motivated by self-interest, as economists are keen to believe, but also by considerations of fairness.

Various studies have demonstrated that under certain circumstances individuals may even be prepared to renounce additional income if they believe this achieves a more equitable distribution of wealth within the community. For instance, experiments have been conducted, in particular at the universities of Oxford and Warwick, in which participants could pay for the opportunity to "burn" money belonging to other members of the group. Most chose to do so and targeted the richest participants.

This behaviour is not unlike the many negative reactions recently to the prospect of taxpayers' money being used to bail out the banking system, even though a systemic failure would have represented an even greater financial loss for taxpayers and society as a whole. It might well explain also the opposition in some countries to providing assistance to other, financially distressed countries, even though the distress of the latter might ultimately spread to the former.

Such attitudes make it difficult for governments to act consistently in times of crisis, especially when elections are close. This was notably the case in September 2008, shortly before the US presidential election, when Congress, despite the gravity of the situation, rejected the government's bail-out plan until Lehman Brothers' failure made it apparent that the risk of financial collapse would have devastating effects for all.

In short, if people react irrationally, at least in the short term, democracies may find it very difficult to tackle crises that demand swift decisions. Systems and institutions with specific crisis-resolution mandates thus need to be established to permit rapid responses, while at the same time maintaining democratic legitimacy.

The traditional counterargument to this view is that it increases moral hazard. If the way out of a crisis, including any hint of financial support, is indicated too clearly, economic agents or even countries may be inclined to be less financially disciplined, in the expectation that they will ultimately be bailed out. "Constructive ambiguity" is the approach needed to ensure that agents take appropriate action to avert a crisis. They are more likely to follow such a path if they cannot be certain of receiving financial assistance should their problems escalate.

However, constructive ambiguity also means that, if and when needed, assistance is provided as a last resort to ensure that corrective measures are taken and contagion is avoided. If the authorities responsible for taking the decision to grant assistance are in the end not able to deliver, the whole concept of constructive ambiguity collapses. The impact on the financial markets might lead to greater instability as opportunities for destabilising speculative strategies increase.

The developments of the past few months related to market assessments of the solvency of financial institutions, or even of sovereign countries, suggest that the issue of moral hazard cannot be tackled simply by assuming that crises will not occur. Nor can it be assumed that letting an institution or a country fail is always and everywhere the most desirable solution, as the post-Lehman experience has shown. Decision-makers in both the public and private sectors must thus be ready to deal with worst-case scenarios and make sure that they are not prevented from delivering the appropriate decisions. Moral hazard should then be addressed by establishing institutions and procedures that allow for incentive-compatible solutions (carrots as well as sticks).

This means, in particular, that financial assistance, if needed to avert a major systemic crisis, can be granted on strict conditions that aim to prevent any recurrence of the problem. It also entails harmonised insurance mechanisms and resolution regimes that do not create distortions between countries, especially within the European Union.

In the light of recent developments, policymakers should not assume that they have plenty of time to address these issues.