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**Article**

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# Heterodox Reflections on the Financial Crisis

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I would like to offer some reflections on the current financial crisis in order to challenge a certain uniformity of interpretation, which is preventing attention being focused on issues of key importance. These reflections are rarely to be found in the discussions among experts, or even in the lively debate which has taken place in most of the media. For the sake of simplicity, I will try to present them in the form of answers to four questions. Naturally these are difficult questions, to which it is equally difficult to provide satisfactory answers. Nevertheless, the very seriousness of the crisis, requires us, for once, to reflect on wider issues. The four questions can be formulated as follows: 1) Can financial crises be predicted or not? 2) Is it true that such crises are due to a failure to regulate financial markets properly? 3) Why do trust, distrust and reputation play such an important role in financial crises? 4) How do market regulators protect their reputations in the event of an unexpected crisis?

## Can financial crises be predicted or not?

History offers one answer to this question by showing that the business cycle in market economies follows a wave movement. But it also teaches us that we are unable to predict the shape, timing and peaks of these movements. We also know that speculative bubbles, booms and financial crises follow, as Keynes (1936) and Minsky (1982) clearly stated, a pattern of waves of trust and distrust, optimism and pessimism, in which cognitive and emotional dimensions intertwine with herding behaviour and collective contagion. However, as yet we do not have an integrated theory of all these dimensions. Finally, the nature and makeup of the causes triggering the crises appear to vary considerably (e.g. speculative bubbles on tech stocks, real estate bubbles, bubbles generated by excessive bank exposures, as in the case of the sub-prime loans i.e. loans made to clients without sufficient guarantees etc.). It is therefore highly likely that future crises may be triggered by causes, or combi-

nations of causes which may be completely different from those of the past and, hence, unpredictable.

The unpredictability of crises and bubbles is the result of financial innovation and the costs that go with a risk economy. But it is also a consequence of strong uncertainty due to unexpected, idiosyncratic events, to aggregate and systemic risks, and to discontinuities that cannot be incorporated into linear forecast models based on time series or Gaussian distributions (Taleb 2007). Such situations are difficult to capture, even using the most sophisticated financial mathematical and social simulation models available. Such models too have huge limits in accounting for the oligopolistic nature of financial markets, and hence the strategic dimension and power exercised by the major financial organisations. Unfortunately, these difficulties tend to be neglected in the current debate among economists on the sub-prime loan crisis. Positions for or against the dominant economic model are generally characterised by an implicit optimism in the ability of economic theory to overcome its limits both in terms of forecasting and managing the business cycle.

All these difficulties help to explain why the scale of the recent financial crisis, as with previous crises, was not foreseen early enough to be averted. If we exclude the authoritative, but minority voices of Krugman, Roubini, Shiller and Stiglitz (who, however, failed to predict when exactly the bubble would burst, as happens with geologists in the case of earthquakes) it is easy to verify that although the analyses produced by government and regulatory authorities, private think-tanks and by analysts and economists did detect some weaknesses and risks in the financial system before the summer of 2007, they were not considered to be of a magnitude that would pose a grave threat.

## Are crises the result of an unregulated financial sector?

The absence or lack of sufficient rules or failure to comply with them are undoubtedly important explanatory factors behind crises. But overcoming these limits, and thus managing such crises, is not at all as simple as one

might construe from the present debate, which is entirely centred on identifying more effective systems of rules. These difficulties are due not only to the obvious fact that it is humanly impossible to write perfect rules, but above all to the fact that the rules behind financial markets may be ambiguous and easily manipulated, and that applying these rules may produce unexpected consequences. Furthermore, there are situations that are inevitably difficult or even impossible to regulate. These elements of uncertainty, which globalisation and the liberalisation of markets of the last thirty years have exacerbated, have compounded the problems of information asymmetry of market players and greatly increased the opportunistic behaviours of financial players with very different levels of power. These «complications» deserve closer analysis.

Historical and sociological research over the last twenty years (Hoffman et al. 2007) has shown very clearly that, even when there are well designed formal and informal rules to govern the market and contain the opportunistic behaviours of financial players, these rules are likely to experience alternating periods of compliance and non-compliance. In periods of expanding, buoyant financial markets there is a general slackening of regulatory and supervisory systems. This is partly responsible for speculative bubbles and financial scandals. When these bubbles burst, and there is a downturn, calls (above all from the middle classes most affected by the crisis) grow for stricter rules, more accurate information and greater transparency. New regulations are then brought in, checks become more stringent and rules are more closely adhered to. However, booming financial markets lead, once again, to checks and rules being relaxed in a kind of cyclical pattern. The present financial crisis too, as has been widely documented, was preceded by years of euphoria and excessive deregulation of the markets, with financial players and regulators as well as government all participating to a cultural climate which saw widespread relaxation of the regulations and checks on derivatives, securitization and bank debt. In this case too, the bursting of the speculative bubble has been followed by calls for new rules, greater transparency and new supervisory bodies to oversee globalised markets.

In addition to the presence of these cyclical trends in applying regulations and checks, there are in any case always significant margins for ambiguity and flexible interpretation of the rules, as well as unexpected consequences in implementing them. Market players play out

this game of manipulating the rules according to their different power relations. This can produce conflicts among the various regulatory authorities and a failure to co-ordinate. The financial market is an oligopolistic market in which the big institutional investors have the power to significantly influence its overall shape. Hence, the metaphor of a horse race is not an appropriate one to describe this market. According to this metaphor gamblers are free to bet what they want but, in the end, the horse will win or lose regardless of the bets placed (provided the race has not been fixed). The metaphor works well for a market that is perfectly competitive, but not an oligopolistic one. In the financial markets the big gamblers exert a powerful influence on market value and act using strategies based on expectations and anticipating others' expectations, in which cognitive and emotional dimensions are complexly intertwined.

As for the unexpected effects deriving from the implementation of the rules, it should be underlined that applying excessively homogeneous and standardised regulatory criteria to financial markets can worsen matters rather than have a counter-balancing effect. For example, the use of rigid *mark-to-market* accounting (based on market value) at a time of serious crisis and a collapse in the value of assets, as at present, may end up further exacerbating the balance sheets of businesses. These unexpected effects, precisely because they are «unexpected», can only (when possible) be corrected *ex post*.

Of course, the existence of rules does not exclude the presence of a shadow financial system that is as yet unregulated or impossible to regulate. This explains why even a well devised system of rules, designed to avert the financial crises of the past, is unable to prevent new crises triggered by radically different and unpredictable causes. A proliferation of financial innovations creates new situations, that often make a system of pre-existing rules ineffective. If these innovations operate *over the counter*, beyond the pale of regulated markets, then the problem of the efficacy of regulatory systems becomes more complicated. Each wave of innovation generates problems for the traditional control systems. These costs go hand in hand with a risk and innovation-based economy, which can only be resolved in time through new, more effective regulation. Finally, it is worth recalling that there are processes inside the financial markets which cannot be regulated, linked to situations of strong uncertainty, which has become particularly acute in a context of globalised financial markets. These types of

uncertainty, due to unexpected and idiosyncratic events, cannot be transformed into probability-based calculable risk or, for that matter, be quantified in statistical or mathematical terms.

### Why are trust, distrust and reputation so important in financial crises?

The uncertainty present in financial markets, and the inevitable “incompleteness” of the rules which govern them, leave considerable room for issues of trust and reputation. Trust and distrust of financiers and of financial products, as well as the reputations of financial institutions, powerfully affect the expectations and decisions of market players. In other words they constitute elements designed to reduce uncertainty through cognitive and/or emotional reassurance.

Research in the field of social psychology (Mutti 2007) provides some understanding of the dynamic features and specific characteristics of trust, distrust and reputation which also apply to financial markets. It is worth briefly recalling the specific features which connote interpersonal distrust as compared with trust. Distrust lacks the moral dimension of co-operation and sociability that is intrinsic to trust. Distrust, unlike trust, does not need to be “honoured”, at most it needs to be proved wrong. Distrust is less likely to evaluate the proof offered by experience and finds it more difficult to transmute into trust than the shift required for trust to turn into distrust. This is due to the fact that communication and social interaction are more restricted with distrust. Negative expectations are characterised by rigid, closed and defensive positions. It is generally more difficult to modify negative opinions than to modify positive ones. The result is that an active distrust policy ends up having more stable effects, which are more difficult to reverse than those produced by an active trust policy. Something similar occurs to the reputation of financial brokers and market regulators, understood as the stability of the trust or distrust they enjoy. Negative reputations are more impervious to evidence to the contrary than positive reputations. It is therefore easier to maintain a bad reputation than it is to keep a good one. As a result, actions or policies which damage the reputations of financial products and financial institutions, have more irreversible effects than actions or policies which promote their good reputation. What’s more, a bad reputation tends to spread more rapidly than a good one. It is

accepted more easily, as a spontaneous aversion to risk and a natural predisposition to defensive behaviour. These observations, while useful, are anything but exhaustive. We know even less about the patterns of trust and distrust which characterise financial cycles. Researchers in sociology and psychology have yet to produce significant analyses on the contagion patterns underlying these processes. Can economists, sociologists and psychologists work together on these issues of crucial importance? One can only hope so, though there is more than one ground for pessimism.

From what I have said so far, it is clear that anticyclical monetary and fiscal strategies adopted by various governments should be evaluated, not only in terms of their efficacy on the economy, but also in terms of the trust and reputation effects they produce. Continuing demands for new rules to get through the crisis clearly conveys this need to restore mutual trust among financial players. And this is true regardless of the inevitable limits which characterise the proposed new rules, which I will now consider briefly. One set of proposals focuses on the urgent need for a global regulation of financial markets, to be achieved through transnational conventions, agencies and regulators. However, achieving such a goal is made difficult due to the different interests of the various nations which are unable to reach a satisfactory agreement, as the numerous G8 and G20 meetings have shown. Furthermore, it is equally hard to achieve agreement on a suitable mix between state and market in managing regulation. This mix can only be the result of a historically variable process. Economic theory cannot tell us what is the ideal mix between state and market, one which would not suppress but encourage the “animal spirits” of economic agents, in particular of entrepreneurs and innovators. A second set of proposals focuses on the content of the new rules, believing that the self-regulatory principles adopted by financial players will be radically revised in the knowledge that any regulation system, in order to be successful, inevitably requires co-operation between the regulators and the regulated. This second set of proposals suggests four solutions. The first solution seeks greater transparency in the products offered on the market, in particular those *over the counter* whose weight it is hoped will shrink drastically. Improving and democratising the infrastructure of information is also undoubtedly a priority (Shiller 2008). But unless we really believe that perfectly competitive financial markets can actually be achieved, we need to be aware of the fact that there will always be margins of

information uncertainty and asymmetry, however small, where power strategies and opportunistic behaviours assert themselves. The second solution calls for a reduction in the financial leverage (ratio of exposure to risk to own capital) of banks and other financial institutions, above all in periods of boom. In this case the biggest problem is deciding what is the appropriate level of financial leverage that can prevent speculative bubbles without compromising the income opportunities of financial agents. The third solution calls for the elimination of every form of conflict of interest between the supervisors and supervised, between control and consultancy, which particularly affected the auditing firms and credit rating agencies. However, in this case too, players have various opportunities to get round the rules, as the Sarbanes-Oxley Act, which was passed in the United States in 2002 to combat opacity and conflicts of interest in corporate governance, has shown. The final solution proposes limiting the bonuses and stock options financial institutions give to their executives, so as to curb excessive exposure to personal and corporate risk. Once again, how do we go about defining the appropriate level of bonuses to pay managers and executives? The answer is not an easy one, though it may well be possible to establish maximum thresholds in order to limit excessive compensation packages by encouraging codes of ethics in corporate governance.

It is easy to speak of new rules. But less easy to identify rules which could avert crises such as the one we are experiencing and, even more so, could prevent different types of future crises.

### How do market regulators protect their reputations in the event of an unexpected crisis?

Whatever their limits, the measures taken to combat the present financial crisis should also be read as attempts to restore the reputation of financial institutions and their regulators, which suffered a serious blow because of their inability both to foresee the crisis, as well as avoid conflicts of interest and opportunistic behaviour. It is no coincidence that the question of "who supervises the supervisors" is growing more relevant. Since this is a systemic crisis, the mass substitution of managers and CEOs or the market's unconditional acceptance of the bankruptcy of many financial institutions would appear to be inadequate solutions. Such eventualities would in

fact increase rather than reduce systemic distrust. On the other hand, financial institutions and regulators, save in a few cases, are incapable of effective self-criticism, and tend instead to hide behind organisation strategies to protect their reputation which entail lobbying government, adopting formal and standardised evaluation criteria that are increasingly unable to gauge the true health of the firms being assessed, and using evaluation criteria that lack transparency, especially the more qualitative and arbitrary ones. Such lines of defence are clearly inappropriate in situations of systemic crisis.

Thus, the introduction of new rules to assess risks and guarantee the transparency of markets and evaluation procedures put in place by regulators, as well as the creation of new national and international super regulatory agencies with stronger reputations, end up performing the task of producing a positive reputation for the financial institutions by introducing new and more complex regulatory systems. In other words "reputation is created through regulation". This may partly explain why, for example, auditing firms and credit rating agencies continue to issue influential certifications, despite being in the eye of the storm.

But where does the game of trust ("who supervises the super-supervisors?") stop? The threshold can be found in the presence of political and institutional actors which, since they enjoy the public's trust, act as more prestigious supervisors and as guarantors of "last resort" for the trustworthiness and reputation of the financial institutions. The American President Barack Obama is a very significant case in point. His appeals to trust are clearly based to a large extent on manipulating emotions, thanks to his charisma. But it is equally important to note that these appeals are accompanied by cognitive reassurances. These reassurances consist in presenting the crisis in all its gravity, together with full, detailed and credible plans of action for the short term (to deal with the emergency and panic situations) and the long term (to produce a global re-organisation of the financial system). These action plans are also accompanied by promises and measures to safeguard social justice, i.e. to pay compensation to victims of fraud and to contain the "moral hazard" of institutions which are considered too big to fail. This strategy appears to be more successful than ones which minimise the gravity of the crisis and the decline in trust and, as a result, limit government intervention in support of the economy and finance. But, given that we know little about the dynamic patterns of

systemic trust and distrust, we should let history be the judge of the success of Obama's strategy.

However, history does teach us that systemic trust and reputation improve only when the business cycle is on the up, on the basis of mechanisms that even the most acute analysts cannot predict, though it is true that appropriate policies to support the economy can undoubtedly boost economic and financial recovery. This improvement also depends on two further elements which are specific to systemic trust, as compared with interpersonal trust. The first is the "inertia" produced by the public's sense of detachment towards impersonal and hyper-complex institutional systems, which in the long run tends to regenerate a pragmatic acceptance that they exist and work. At some point financial players need to believe in the credibility of financial institutions and regulators, while knowing they are fallible. In other words, a kind of collective reassurance sets in as regards the actions of financial institutions and regulators to reduce anxiety. The second element is linked, as financial crises of the past show (Herring 2002), to a collective amnesia over time, of crises and the damage they cause (with the exception of the Great Depression of 1929 which has remained in the collective memory). This explains why, despite their frequent crises, sooner or later investors always return to the financial markets.

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