

# Farewell to the Invisible Hand? A Global Financial System for the Twenty-First Century

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# Adam Smith's Invisible Hand

- Perhaps the most important insight of modern economics:
  - Individuals (and firms) in the pursuit of their own self-interest are led, as if by an invisible hand, to the well-being of society

# The End of the Smithian Era?

- But no one believes that America's bankers, in their ruthless pursuit of their own self-interest (aka as greed) resulted in the well-being of society
  - Not only did they bring about a global financial crisis
  - But they engage in predatory pricing
  - Anti-competitive practices led to super-normal profits
  - Modern technology allows for the creation of an electronic payments system: they suppressed the creation of this system, imposing in effect a tax on every debit and credit transaction—with proceeds going to enrich their coffers, not to enhance public welfare

# Failure to perform key societal roles

- Financial markets are essential to the well-functioning of a modern economy
- Supposed to allocate capital, manage risk, and run a payments mechanism
  - And an efficient financial system does this at low cost
- America's financial system misallocated capital, created risk, didn't create the 21<sup>st</sup> century payments mechanism that modern technology could have supported
  - But nonetheless imposed huge costs on the rest of society
  - 40% of all corporate profits before the crisis
  - Incommensurate with the benefits that they generated
  - Though there was a small part of America's financial sector that was doing a stupendous job—the venture capital sector
    - A sector that is now weak because of the misdeeds of the rest of the sector

# What does modern economic theory have to say?

- A quarter century before the crisis modern economic theory had argued that Adam Smith was wrong
  - The reason that the invisible hand often seems invisible is that it's not there
  - Whenever there is imperfection (asymmetric information) or incomplete risk markets—that is always—markets are not Pareto efficient
    - Even taking into account the costs of information and of creating and running markets, there are interventions that could improve the well-being of all citizens

# These ideas are central to understanding financial markets

- Information (and information asymmetries) are at the center of financial markets
- **“Agency problems”**: decision makers interests are different from those on whose behalf they are suppose to be acting
  - Bank officials did well, even as shareholders and bondholders lost
  - Problems of corporate governance worse in the US than in some other countries
- A chain of agency problems
  - Investors were off pension funds acting on behalf of retirees

# Compensation

- Illustrates point
- Incentive structures were designed to induce excess risk taking and short sighted behavior
  - Didn't even distinguish between those who increased profits by increasing "beta" (more risk) and "alpha" (better performance)
  - Didn't distinguish between high returns because market was doing well and "beating the market"
  - Inconsistent with "efficient" incentive systems
    - Most of those in the financial system didn't understand this
    - But some may have been deliberate attempt to take advantage of lack of understanding of investors

- In many cases, compensation based on stock options
  - Treating them as if they were manna from heaven
  - Not dilution as shareholder value
  - Resisted efforts even to make this transparent
  - **Enhanced incentives for bad information**
    - Which would increase shareholder value in the short run—though not in the long run
- A market economy cannot run well with such distorted incentives

# Externalities

- Main justification for regulation—a failure of financial system has consequences for others
  - The entire economic system was put at risk
- The US had policymakers and regulators who did not understand these limitations of markets
  - Thought that markets were self-regulating
  - Stripped away regulations—that had provided the only period free of financial crises in the history of modern economies
  - And did not adopt new regulations for changing financial sector (derivatives)
  - We had regulators who did not believe in regulation

# Greenspan's Mea Culpa

- Had thought banks would have managed risk better
  - Ignored distorted incentive structures/agency problems
  - Ignored risk posed by too big to fail banks
  - Ignored externalities—didn't seem to understand why we have regulation in the first place

# Financial Innovation

- Sector prided itself on innovation
- But innovation was mostly directed at circumventing regulation, taxes, and accounting standards
  - Hard to identify an innovation that led to a more productive economy
  - Easy to identify innovations that led to huge risks
  - Borne by taxpayers
  - New risk products didn't even help Americans manage the risk of their most important asset—their home
    - Actually, increased risk—which is why so many are losing their homes
    - There were alternatives—but they have consistently resisted these “good” innovations

## *Not a surprise*

- Incentives led to excessive risk taking
- Incentives led to predatory lending
- Did not have incentives to innovate in ways that would improve the well-being of society
- Fundamental problem: misalignment of social and private returns

ADAM SMITH'S INVISIBLE HAND ONLY WORKS  
WHEN SOCIAL AND PRIVATE BENEFITS/COSTS  
ARE WELL ALIGNED

# KEY TO CREATING 21<sup>ST</sup> CENTURY GLOBAL FINANCIAL SYSTEM

- Understanding functions of global financial markets
- Understanding why financial markets on their own are likely not to succeed in fulfilling their roles
- And how government can effectively intervene

# Principles of Regulation

- Transparency
- Incentives
  - Restricting incentive structures that led to excessive risk taking
  - Dealing with the problem of too-big-to fail banks
  - Conflicts of interest—rife in sector
- But because of problems of corporate governance, providing the right incentives may not go far enough

- Restricting risk taking
  - Basic insight of Modigliani and Miller was that increasing leverage did not bring societal benefits—but could increase costs
    - Bankers and regulators didn't understand this
  - Collateral based lending and capital adequacy standards can act as automatic destabilizers
    - Need for macro-prudential regulation

# Derivatives

- Played big role in crisis--\$180 billion AIG bailout—did more to create risk than to manage risk
- Non-transparent
- Underwritten in effect by taxpayers
- Given preference in bankruptcy
- New bill recognizes the principle/risks of allowing banks to write derivatives
  - But banks got major exceptions

# Regulating Behaviors and Structures

- Glass Steagall—separated out investment and commercial banking
  - Different cultures
  - Conflicts of interest
  - Joining two together exacerbated problems of too big to fail (and too big to manage) banks
- Volcker rule (restricting proprietary trading) was an attempt to deal with these problems
  - But again, Congress put in large exceptions

# Consumer/investor protection

- Financial product safety commission
- Banks sold products that were not safe for human consumption
- Predatory lending
- Predatory credit card practices

# Resolution authority

- Intended to facilitate dealing with problem banks
- But when banks are too big to fail, they almost surely will be bailed out
  - It was fear that motivated not following usual rules of capitalism
  - Socializing losses and privatizing gains
  - And in the next crisis, likelihood that the too big to fail banks (and their shareholders and bondholders will again be bailed out)
- Failure to deal with the too big to fail banks  
critical failure of US legislation

# Creating a new global financial regulatory system

- Finance is global, and without a global regulatory system, there is risk of arbitrage, circumvention
- But power of banking lobby, especially in US, too strong to get adequate regulation
  - Though Goldman Sachs, through its various exposed practices proved best lobbyist for reforms
- Each country has a responsibility to protect its own citizens and economy
  - Global coordination being used as a delaying device
  - Each country adopt its own protective rules
    - Inevitably will weaken financial market globalization
    - Iceland and U.S. toxic mortgages show risks of relying of the regulation of others
  - Then a period of harmonization

# Creating a more stable global financial system

- Better regulation is only part of the answer
- Taxing speculative activity
  - Consistent with principle that it is better to tax externalities (like pollution) than good things (like work and savings)
  - In fact, some parts of the financial sector has received massive subsidies, bailouts, that have contributed to its become over bloated
- Better systems of managing global risk
  - Developing countries still have to bear brunt of exchange rate and interest rate risk
    - Failed to transfer risk from those less able to those more able to manage it

# A new global reserve system

- Makes little sense for global financial system to be so dependent on the currency of a single country
  - Especially in a multi-polar world
  - And especially as confidence in U.S. economy is weakening
- Current system contributes to instability, weak aggregate demand, and is unfair
  - Every year, hundreds of billions of dollars are set aside as “precautionary savings” (reserves)
  - Poor countries are lending to the U.S. at low interest rates (and sometimes borrowing back at much higher interest rates)

- Increasing support for a new global reserve system
  - UN Commission
  - China, other countries holding reserves
- Well designed system could also be used to finance climate change, meet other global needs
- Old idea—Keynes advocated it 75 years ago
  - But it is an idea whose time has come

# Devising a better system of global financial governance

- Global financial institutions have failed
  - Even the financial stability forum—created to prevent another crisis
  - Changing the name to financial stability board may not fully solve the problem
- G-20 is not inclusive and lacks political legitimacy
- What is needed: a global economic coordinating council
  - Based on principles of representation
  - Small enough to reach decisions, large enough to have diverse circumstances of different countries adequately represented
  - G-20 may evolve in this direction

# Silver Lining on Global Crisis

- Has brought home the need for global cooperation—and the risks of failure
- In the aftermath of the Great Depression and World War II, current international institutions were created
- These are now not up to the tasks posed by globalization today
- The hope is that we will seize this opportunity