The Moral Limits to the Market Economy, and the Financial Crash

Philip Booth

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About the author

Professor Philip Booth is Editorial and Programme Director at the Institute of Economic Affairs, and Professor of Insurance and Risk Management at Cass Business School

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Institute of Economic Affairs
2 Lord North Street
London
SW1P 3LB

www.iea.org.uk

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General principles

Christians often express concerns about the way in which self interest in the market economy can become disordered or bent and thus manifest itself in greed, selfishness and exploitation. In this context, I have been asked to indicate what the moral limits might be to a market economy.

There is no question that a market economy functions better and also better serves true human development when there is good moral behaviour. It was said, for example, in *Caritas in Veritate*: 'Without internal forms of solidarity and mutual trust, the market cannot completely fulfil its proper economic function.' (35)

The empirical evidence certainly bears this out. If people do not trust each other, if we cannot rely on people to pay others what they owe, and if people renege on their debts and other contracts, economic activity will suffer greatly. When speaking at a conference I often use the example of a conference to illustrate the economic value of trust. Imagine for a moment that none of us trusted each other but we still wanted this conference to happen. Instead of all just turning up and trusting each other to turn up, the organiser would require us all to present copies of our air tickets to him – perhaps pay a deposit and so on. We would all demand evidence from the organiser and from each other that we were all going to attend. The transactions costs of all economic activity would be much greater. And there is a sense in which we have reached this state of affairs in financial markets with so much being dictated either by regulation or by ever-more complex contracts.

The good news is that a market economy can help nurture good human attributes such as trust, good timekeeping, professionalism, concern for others, and so on. There are many particular examples such as the development of stock exchanges in England and Holland in the nineteenth century and the development of friendly societies in Britain. These organisations thrived, it is true, because there was a sound moral background in wider society. However, these organisations, in turn, encouraged moral behaviour and the practice of virtues. There was exclusion from participation in financial markets for those who disobeyed the rules and rewards for those who behaved virtuously. From the earliest days of modern stock exchanges in mid-eighteenth Amsterdam and a little later in London, the most virtuous rose to the top and those who were not trustworthy were excluded from these new financial markets.

The fallen nature of man, however, means that we cannot rely on the market entirely to generate and nurture the necessary moral values. There will be the opportunity to gain from immoral behaviour within a market economy through sharp practice, dishonesty, environmental exploitation and the exploitation of labour and so on. This is one reason – amongst many – why the Church's message is so important in an age when all values are seen as relative.

Again, as *Caritas in Veritate* puts it: 'It must be remembered that the market does not exist in the pure state. It is shaped by the cultural configurations which define it and give it direction. Economy and finance, as instruments, can be used badly when those at the helm are motivated by purely selfish ends. Instruments that are good in themselves can thereby be transformed into harmful ones. But it is man's darkened reason that produces these consequences, not the instrument per se. *Therefore it is not the instrument that must be called to account, but individuals, their moral conscience and their personal and social responsibility*.' (36) (my emphasis).

The first response to the problem of man's darkened reason is not a political or economic one. We cannot assume that statutory regulation of financial markets, for example, in a fallen world, can rectify the problems caused by man's darkened reason. Imperfect human beings cannot perfect other imperfect human institutions.

We cannot assume that the motivations that lead to malfunction in financial markets are absent amongst regulatory bureaus. Individuals within them can also get carried away by euphoria regarding the latest financial trends. This, for example, is the now Deputy Governor of the Bank of England talking about securitisation in 2007 just before the Northern Rock failure: 'So it would seem that there is a good deal to welcome in the greater dispersion of risk made possible by modern instruments, markets and institutions.' Of course, given the information available, Paul Tucker may have made a wise judgement – the point is that it was not different from the judgement of market participants.

Individuals in regulatory bureaus can also follow their own self interest and this is why comprehensively regulated financial markets often have poor outcomes – indeed regulatory bureaus can be a magnet for corruption. The production line of regulations can also lead to a society where people tick all the regulatory boxes – like Pharisees - and believe they have delegated virtue to the regulatory bureau. The recent Catholic Bishops' pre-election document in England and Wales pointed out that: 'In place of virtue we have seen an expansion of regulation. A society that is held together just by compliance to rules is inherently fragile, open to further abuses which will be met by a further expansion of regulation.'

Regulation can also crowd out market-generated responses to problems such as lack of virtue and this has certainly happened in financial markets. One thinks here of the professions, stock exchanges, financial institutions with a special ethical mission and so on.

At the interface of economics and theology we also have the important point that it is impossible for regulatory bureaus to know the best way to regulate financial markets – limitations on human knowledge mean that we cannot plan and perfect society. We have, on the one hand, the problem of the fallen nature of man that can lead to serious problems at times in markets. On the other hand, the very same problem means that we cannot assume that statutory regulation is the solution.

Overall, it is not clear that the right language to use is to talk about the 'moral limits of the market' – the subject I have been asked to address. The market does not have moral limits as such. The market can encourage virtuous behaviour, but the market cannot guarantee virtuous behaviour. Virtues must be practised by those who have a sincere heart and a sincere heart is not generated by the market. The problem though is that the state cannot guarantee virtuous behaviour either. The state cannot replace the need for a sincere heart. Regulation is not an adequate response to a lack of virtue.

So what are the roles and limits of government here? In Catholic social teaching, government exists to promote the common good – that is to help bring about the sum total of conditions that allow people to reach fulfilment more easily. That is not the same as trying to remove every imperfection in the world. But if people are to flourish then it is important that contracts are honoured, property rights enforced and so on. These things are clearly essential for human flourishing because, without them, interpersonal agreements and economic activity would not be possible – as we see in much of the under-developed world. These sorts of rules of basic law, which the Catechism points out are so important, are distinguished from *discretionary regulation* in that they do not tell people what to do. Instead, they ensure that people can do what they themselves wish to do in the economic sphere

– in other words, a strong framework of basic law helps people flourish in the way they believe God would like them to.

There may be a wider regulatory role for the state, including in financial markets, but there is nothing in Catholic social teaching that will definitively tell us where that role will start and finish. Regulation is certainly an inadequate replacement for virtue but the extent to which regulatory intervention is appropriate in order to promote the common good is a matter for prudential judgement. Remoralisation and evangelisation are the first-best tools to deal with a lack of virtue in a market economy.

The financial crash

I now want to look more specifically at the financial crash and how we should respond to that as Christians. I have already dealt – in a more general way – with one aspect of that: the regulatory response. I now want to talk about other issues.

Perhaps I could begin by saying that I do not think that ethical failings were at the root of the crash. They were, though, important. Ethical failings were widespread and not just confined to highly-paid workers in large banks. Mortgage applicants lied about their income; bank branch managers 'over-sold' loans; traders created new products that did not provide long-term value for shareholders; senior managers did not monitor junior managers; directors did not properly manage senior managers on behalf of shareholders; and so on.

If these ethical failings had not occurred it is *possible* that there would not have been a crash of 2008. More likely, though, the crash would have manifested itself in other ways, given other economic tendencies at that time. It is certainly true to say that ethical failings are at the heart of a great deal of human misery – not just in finance but in other spheres of life. In the financial sector, ethical failings are responsible for particular mortgages not being repaid, for foreclosures on particular properties and for losses being made on particular transactions by banks. But, the charge has been laid that ethical failings are to blame for the failure of the financial system as a whole. If this is the case we have to ask ourselves whether, somehow, ethical behaviour was worse in 2008 than in 1968 or worse in 1929 than in 1959. I do not think this is the case.

More generally, a financial system cannot be built around the assumption that participants in it are saints. The financial system as a whole must be relatively impervious to ethical failure. If it is not, we are in trouble. I think therefore that we should ask a different question from that of whether ethical failure was at the root of the crash and ask if certain characteristics in the financial system encouraged – on a widespread scale – imprudence.

My own view is that several mistakes in regulation and monetary policy came together to create a situation in which financial risk was underwritten by the state and that this led to imprudent behaviour.

Some examples of the problems to which I allude were:

- Excessively loose monetary policy – especially in the USA – that led to an asset price boom, low interest rates and excess borrowing.
- The encouragement of sub-prime lending by the US state and Federal government.
- The underwriting of risk in the financial system – again especially by the US government. Fannie Mae had a commitment to spend $2trillion expanding home ownership amongst low-income earners and minorities, all ultimately underwritten by the US government. 40% of loans Fannie Mae bought and securitised in 2007-2008 were sub-prime or Alt-A loans (mainly) without documentation – again underwritten by the US government.
- Entirely misguided regulation which encouraged securitisation and also encouraged banks to remove all risk from their balance sheets in complex vehicles (reducing the incentives to monitor).

- Weak personal bankruptcy law in the USA.
- The absence of proper risk premiums in deposit insurance systems.
- Continual bailing out of the US financial system (savings and loans in the 1990s, LTCM, and so on).
- Tax penalties on equity finance encouraging financial gearing.

These were, I think, huge public policy errors that provided significant incentives for people to behave imprudently, made it more difficult for market participants to discern what was and what was not ethical behaviour and created complexity in the financial system. Legal systems are dysfunctional if they do not ensure that bankrupt financial institutions are wound up without threatening the financial system as a whole.

It is true, of course, that there were also huge errors by participants in financial markets. However, we have to ask why those errors were so pervasive and why the firms that made those errors did not – as would happen in other sectors of the economy – fail. It is really quite impossible to have a free economy where those who make mistakes do not suffer financially.

Responses to the financial crash

I don't think that Christians, as Christians, have that much to stay about the technicalities of financial regulation in the wake of the crash. However, we can say that it is both unjust and also militates against human flourishing in the economic sense to have a banking system that is allowed to impose the costs of either poor moral decisions or poor economic decisions on wider society. There are many ways of addressing this problem – from the liberal approach of evolving legal systems so that creditors take full responsibility for the losses of banks to tighter regulation of banking activity. I lean to the former approach, but the key is that good economics can be brought into harmony with economic justice in different ways compatible with Catholic social teaching.

Secondly, we should be thinking about some of the trends in wider society – not just in the banking sector – that led to the banking crisis. The accumulation of debt was undoubtedly a problem. Prudent behaviour, not becoming attached to material goods to such an extent that huge debts are incurred, and so on are virtues that should be cultivated. Saving reduces our reliance on others in old age, in the event of unemployment etc. We should also be asking whether welfare states undermine saving. Saving is a good discipline which, by its nature, requires us to wait for material goods. It also provides capital that enables an economy to thrive. Lack of saving and the accumulation of credit were two of the causes of the financial crash.

In the UK, the Archbishop of Canterbury said many things in the wake of the crash with which I disagreed, but he did take up a point that I think is very important. He called for a 'return to the primitive capitalist idea' of risk-sharing in the form of an increased reliance on equity capital within businesses. This is a key concern within the usury debate and equity finance is exempt from the prohibition on interest even within Islamic financial systems. In this context, it is, worth mentioning that the taxation system in nearly all developed countries strongly discourages equity finance and encourages debt finance. The over-taxation of equity finance is something that I think academics are beginning to see as a real problem but which gets very little attention from policymakers – understandably as they do not wish to reduce sources of revenue by reducing tax penalties on equity finance. However, I think it deserves attention and a Christian case can be made for action.

The final area that I would like to bring to your attention is that of the need for new forms of financial institutions – perhaps financial institutions run explicitly on Christian principles. Christian social action is not primarily about changing public policy. There is a long history, in all Christian denominations, of Christian social movements in the fields of health, education and also in financial and insurance services. These social movements do not only serve Christians of course.

Such institutions and movements were discussed explicitly in Pope Benedict's encyclical *Caritas in Veritate*. Credit unions are perhaps the best-known current example of financial institutions with a Christian foundation that lie outside the mainstream proprietary sector in the UK today. Historically, many other forms of financial institution based on Christian principles existed. These institutions might be based on principles of reciprocity rather than on profit maximisation.

As policymakers we need to ask what the impediments to the development of such institutions might be. Research suggests that the form of financial regulation in recent decades has played a major part in making our financial scene look more uniform. In the days before regulation and government guarantees for financial institutions, they had to demonstrate to those using them that they were ‘sound’. Having a clear ethos and a particular corporate structure was one way that could be done. To this end, many financial institutions remained relatively small, rooted in the community and owned by their member-customers; others had unlimited liability or double liability for shareholders.

In addition, modern forms of regulation make it more difficult for new entrants to enter the market and compete with the existing giants – there are huge economies of scale in the costs of complying with the literally thousands of pages of financial regulation. Others would disagree with the above analysis and suggest that smaller, credit making institutions should be explicitly encouraged by government. Whichever position you err towards, I think it is an issue that should be taken seriously. We should also be thinking about whether equality legislation potentially discriminates against financial institutions that might be explicitly run on Christian principles – certainly it is likely, as least in the UK, to limit the extent to which such an institution can employ Christians.

I suppose that my greatest concern is that, though developments in regulation and the creation of financial safety nets have had advantages, we need to ask whether they have made it more difficult for participants in financial markets to discern behaviour that is genuinely moral and also made it less likely that prudent behaviour will be practised. It is interesting, as has been pointed out by a theologian Samuel Gregg, that the words ‘moral hazard’ are deliberately used to describe the situation where people have incentives to behave in imprudent ways rather than the words ‘risk hazard’. In other words, safety nets within financial systems do not just socialise risks but chip away at the moral fibre too. Once again, we can turn to Pope John Paul’s statement in *Centesimus annus*: ‘The social order will be all the more stable, the more it takes this fact into account and does not place in opposition personal interest and the interests of society as a whole, but rather seeks ways to bring them into fruitful harmony.’ Perhaps the same could be said for the financial order too.

Thus, yes, there needs to be moral renewal – in all parts of our society, not just in the financial sector. But the legal and economic system must run with the grain of moral renewal. Here the detail of regulation is less important than having legal systems underpinning financial systems so that, in so far as is possible, those who make mistakes bear the consequences of those mistakes. There are many ways in which this can be done. There also needs to be room for the rebirth of different kinds of financial institutions including those that publicly display their ethical principles. There should be space for all the intermediate institutions in society to play their part in regulating behaviour in the financial sector.

All these responses, though economic in the widest sense of the word, are compatible with or rooted in the best of the tradition of Catholic social teaching.

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2 Lord North Street
London
SW1P 3LB

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