

## **Sustainability as a dynamic process**

Speech by Kaspar Villiger at the 10<sup>th</sup> International Sustainability Leadership Symposium 2009.

Ladies and gentlemen,

First of all I would like to congratulate the Sustainability Forum Zurich on its 10<sup>th</sup> birthday. In an increasingly complex economic and political world, reflecting on the sustainability of our actions is of great importance. As is always the case with complex problems, there are no simple or irrefutable truths with regard to this topic. Contentious but constructive discussion is therefore essential. This requires forums and platforms which adopt an interdisciplinary approach to organizing, stimulating and promoting this discussion. The Sustainability Forum Zurich has conducted, and continues to conduct, ground-breaking work in this area. I would like to congratulate you for this and wish you continued success in the future.

Your topic for this event is taken from the front pages: the issue of sustainability on the financial markets in light of what has come to be called the financial crisis. In light of my practical experience first as manager of my own firm and then as minister of finance of my country, I would like to formulate a few thoughts on your topic of sustainability. In doing so I will come to a few conclusions which may not always be in keeping with current trends.

I.

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The environmental damage caused by economic activity, consumption and wars around the world, as well as the over-exploitation of exhaustible commodities, has placed the question of sustainability at the forefront of political and economic agendas. The financial crisis and its consequences for the real economy have shown that the financial markets are also subject to the requirements of sustainability. Both published opinion and political discussion have unanimously placed the blame for the crisis on market failures, raising the question as to whether a market economy is actually sustainable at all without greater state intervention. But what does sustainability actually mean?

The term sustainability was originally used in forestry. It means cutting down no more trees than will subsequently grow. This clever principle can be applied to other areas. For example, sustainable financial policy must ensure stability, promote economic growth, contribute to social cohesion, safeguard the state's capacity to act in times of crisis and preserve opportunities for future generations.

None of this is new or original. It suggests that sustainability ultimately means stability, ensuring balance and avoiding crises while preserving natural resources. However, a closer look reveals that this cannot be the whole truth. Many forests require occasional fires to ensure that they remain healthy in the long term. Schumpeter sees recession as a necessary phase in creative destruction. Unemployment will only remain low if structurally weaker areas are allowed to disappear and thus create room for renewal. Because everything is constantly changing, everything must also continually adapt. Things that can no longer survive will die out and be replaced by something new. It thus appears that both destruction and renewal are part and parcel of sustainability.

This leads me onto my first claim:

1. *Crises are necessary elements of sustainable development.*

## II.

A crisis is Janus-faced as it both destroys and renews. But what happens if the crisis rages so intensely that it also destroys the seeds for renewal? This, for example, is the case when constant forest fires lead to erosion and then to the creation of desert lands. Such crises are not sustainable. However, where a consistent strategy of avoiding crises hampers renewal, such as in over-regulated markets, rigidity, weak growth and ultimately poverty are the consequences. Such excessive crisis-avoidance strategies can thus in turn lead to crises.

This leads me onto my second claim:

*2. A policy of crisis prevention should help to avoid existential crises but must neither lead to stagnation nor plant the seeds for a new crisis.*

## III.

In a market economy there are countless markets which ensure the provision of goods and services with the correct quality, at the cheapest price, in the right quantity and in the right location through an almost infinite number of decentralized individual decisions. Competition stimulates top performance from market participants and results in a long-term increase in prosperity. All attempts to achieve this through central management have failed.

I am aware that my third claim is rather simple:

*3. Only a market economy based on competition can create prosperity.*

#### IV.

For many people, the crisis has given rise to doubts as to whether the pure market economy, in particular in the financial sector, actually needs to be controlled by state interventions in order for sustainable results to be achieved.

The cheap and quick *transport* of commodities and people, the rapid development of IT and the liberalization of commodity, capital and service markets have taken the global division of labor to its highest point and created enormous potential for global growth.

Because jobs, capital, wealthy individuals and knowledge can shift at any time to any location in the world with supposedly more favorable conditions, a merciless *competition ensues between the various business locations*. The competition affects not only classic location factors such as infrastructure or taxes; “soft” factors such as performance orientation, performance motivation, technological affinity and even mentality in the broadest sense are becoming increasingly important. This competition also limits the degree of freedom policymakers enjoy in their decisions.

However, the consequences of globalization are far more positive than the critics would let you know.

During the second half of the twentieth century, the *global standard of living increased* to a greater level than ever before. On average, per capita income quadrupled between 1950 and 2000. During the last 20 years, developing countries have grown at a quicker rate than industrialized countries. This has led to a reduction in both absolute poverty as

well as the income disparity between industrialized countries and the rest of the world. In particular, hundreds of millions of people in emerging economies have been able to escape poverty thanks to globalization.

Progress has been made in countries which have opened themselves to world trade. In contrast, the situation remains dramatic in those countries that isolate themselves, are subject to political arbitrariness, have corrupt governments and elites and weak institutions.

This leads me onto my fourth claim:

4. *Continued liberalization is essential for ensuring the creation of sufficient prosperity to eradicate world hunger and poverty.*

## V.

It was not so long ago that it appeared we were living *in the best of all worlds*. Impressive global growth, low inflation rates, the emergence of economic stability in emerging markets, a significant improvement in public-sector finances in many countries and the strengthening of the balance sheets of many important companies backed up this view. Of course, there were *signs* that advised caution. Neither the notorious US current account and budget deficits, the US consumption boom based on credit, nor the years of low interest rates which no longer reflected the risks could be sustainable. Suddenly the financial hurricane began to howl with great force. The governments and central banks of many countries stepped in with hundreds of billions of dollars of public funds in order to avert a complete collapse on the financial markets. *State interventions* which would have been considered impossible only a few weeks

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previously became reality, and nobody knows for sure what their effect will be in the long term.

Although bashing the unrestrained financial markets has become somewhat of a fashion, their importance as the bloodstream as it were of the real economy should not be forgotten.

They have many essential functions for the economy as a whole: They accumulate capital by converting savings into long-term investments. They simplify risk transfer by diversifying and restructuring risks. They facilitate the financing of international trade. And they aggregate an enormous amount of information, which is reflected in market prices. Liberalization, rapid advancements in technology and product innovations have allowed for unimaginable dynamic on these markets.

Around the world, capital has sought the best investment opportunities and always found new entrepreneurs. This has made a significant contribution to the positive growth of the world economy during the last 20 years. Nobel Prize winner Myron Scholes estimates the global *increase in prosperity through financial market innovations* at around USD 30 trillion.

Of course, much of the value created through this growth has been destroyed by the crisis. A few years from now, however, we will see that the net balance remains positive – if we manage to avoid major errors. The value created throughout the world by the push towards global capital allocation will not simply be lost. We will see it manifest again in future phases of growth. A similar process was observed after the dot-

com bubble burst. If we want to learn real lessons from this crisis, it is important that we now clinically analyze its causes.

At the moment the prevailing opinion is that the management of the financial system by the market has failed and that insatiable greed, arrogance and the professional incompetence of the economic players lie at the heart of the crisis. The necessity for *greater control of the markets through politics* has been derived from this.

Unfortunately, there are a series of facts which support this theory. Ordinary *human error* has undeniably contributed to the crisis.

Managers, like everyone else, can apparently become unconcerned, complacent and self-satisfied if everything goes well for too long. Many bankers blindly believed the mathematical risk models and the erroneous assessments of the rating agencies. The bonus systems provided excessive rewards for ostensible success and thus created no incentive for sustainable value creation. In order to increase return on equity by a few basis points, the debt level was increased beyond all measure. "Leverage" was the magic word. Those who now believe that the greed of managers could be tamed through greater influence by shareholders should consider that it was also activist shareholders and analysts who pressed for managers to deliver greater return on equity and thus induced higher leverage.

However, the more I look into this crisis, the more convinced I become that *political failures rather than market failures* are at the root of the crisis and that many critics among politicians and journalists have little justification for pointing the finger exclusively at managers. The markets have reacted to the misguided incentives set by politicians in

an absolutely logical manner. This does not excuse the grave and crisis-aggravating errors of many managers. I would like to specifically stress this because UBS made huge errors, which currently give us hard work to correct. It does, however, put the one-sided finger pointing into some perspective.

I see four factors which have come together in a fatal fashion.

1. The US Federal Reserve must simultaneously serve two objectives: monetary stability and economic growth. This generates constant political pressure to achieve the latter. After the dot-com bubble burst, the Fed kept interest rates far too low for far too long. The competitive pressure generated by globalization kept inflation low, meaning the money supply did not have an inflationary effect but instead created a bubble elsewhere. Yield spreads no longer reflected the underlying risks and it became attractive to live on credit. The excessively cheap money created overcapacities in many areas.

2. From around 1992, the US Congress placed enormous pressure on the mortgage financiers Fannie Mae and Freddie Mac, both of which enjoy an implicit state guarantee, to promote mortgages for low-income individuals. The political objective of promoting home ownership may be respectable. From an economic point of view, however, it was reckless. Hundreds of billions of dollars flowed into the subprime sector. The two mammoth institutions squeezed serious mortgage banks out of the market due to their implicit state guarantee. The authorities allowed Fannie and Freddie to become grotesquely undercapitalized. The Community Reinvestment Act also pushed many other banks in the same direction. All this together with wrong taxation incentives and

low interest rates dramatically increased the demand for housing. Hundreds of billions of dollars were politically misdirected and created the subprime bubble.

3. Regulation, now acclaimed as the magic formula for avoiding crises, also worsened the crisis. An example are procyclical accounting rules.

4. Many regulatory authorities have also failed. They are burdened with this knowledge and are therefore inclined to overreactions in order to ensure they do not find themselves in the same situation again.

With this in mind I come to my fifth claim:

5. *Many banks have made inexcusable mistakes. However, these mistakes are not the cause of the crisis. The markets have not failed; instead they have reacted logically to the misguided incentives set by politicians, in particular in the US.*

## **VI.**

The crisis hit the financial markets with a force that threatened the stability of the system. The rapid, decisive and coordinated reaction of the central banks was necessary. It was also right that countries were not tempted into pro-cyclical fiscal austerity. As you may have gathered from this cautious formulation, I am more than skeptical about the exorbitant spending programs of many countries. They may momentarily ease the pain, but they will hinder a lasting upturn.

I see five dangers in the aftermath of the crisis:

Firstly, the central banks will come under enormous political pressure if they wish to tighten their monetary policy in good time. This pressure may even endanger their

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independence. If they continue the pronounced low interest rate policy for too long, inflation or a new bubble will follow.

Secondly, the enormous budget deficits that have been recklessly accumulated will lead to big problems, in particular with regard to the pending demographic changes. Following the crisis, instead of restructuring government budgets by reviewing the range of public services provided, it is likely that we will operate under Keynes's notion of deficit spending. All this may adversely affect the creditworthiness of major countries to a dangerous extent.

Thirdly, increased political pressure will be placed on the financial and goods markets, in order for countries to supposedly shield their own economies by means of protectionist measures. This toxin has the potential to bring the global growth driver to a halt.

Fourthly, the mistrust that has been generated towards the market economy combined with the newly burgeoning illusion of state capability may lead to grave economic policy errors.

Fifthly (and this is connected to my fourth point), there is the threat of a wave of overregulation.

All this leads me to my sixth and seventh claims:

- 6. The rapid response of the central banks and governments was necessary in order to avoid a breakdown of the system. However, there is now the risk that due to the incorrect diagnosis of the causes of the crisis, the patient will be administered the*

*incorrect medicine for too long. This may significantly worsen global growth perspectives.*

*7. The time has come to fight again for the market economy.*

## **VII.**

As many opinion leaders are unanimously convinced that tighter regulation will provide the remedy for all our problems, I would like to make a provocative claim: Perhaps it would have turned out better if there had been less regulation.

It is interesting that the crisis broke out in the most regulated of all economic sectors. In a study, a Swiss professor came to the conclusion that the banks would have been better capitalized without capital regulation, as they would have had to work out the lowest capital limit in own responsibility and would not have been able to rely on a state seal of approval.

A different study concluded that the Schweizerische Kreditanstalt (now Credit Suisse) would not have survived the Chiasso crisis according to today's accounting principles. Switzerland has overcome two mortgage crises with similar levels of losses to those of the current crisis without great turmoil; probably because undisclosed reserves were still permitted. This is the model of the female Alaskan bear that eats enough salmon in the autumn to survive the winter without nourishment and still be able to feed her offspring. Of course, I do not wish to advocate the previous lack of transparency with regard to accounting. However, it is clear to me that today's regulations have a procyclical effect and have intensified the crisis.

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Without rating agencies, the banks would have had to think about toxic papers themselves. And who manages the bank with regard to regulatory requirements? The supervisory authorities or bank management? And who is to blame if something goes wrong?

A new word has been coined: hypegiaphobia. It means the fear of responsibility in strictly regulated areas. Processing checklists instead of thinking. The feeling that you have met your obligations through adhering to the regulations. Overregulation can also put the skids on creativity and progress. This slows down global growth, which we need to overcome poverty and hunger, more greatly than the periodic setbacks of crises. If best practices are regulated by law, then no better practices will develop.

The enormous effort that an industry such as the financial sector has to dedicate to the handling of regulations poses a further barrier to entry for newcomers. This creates a kind of cartel, restricting competition.

This leads me onto my eighth claim:

*8. The financial markets do not need more regulation, instead they require better regulation. Only then can they sufficiently meet their economic function.*

## **VIII.**

The economy, including the financial sector, requires sufficient freedom in order to remain innovative and dynamic and thus generate growth. If regulation becomes too tight, growth drivers will weaken. However, the economy must use this freedom responsibly. Just because something is not forbidden does not mean it may always be done. Those working in the private sector must adhere to unwritten ethical and moral

norms in order for the economic system to remain sustainable. I'm thinking of simple values such as fairness, truthfulness, proportionality and community spirit. It is no coincidence that reputation has become one of the key factors of a company's success. My bank has had to learn this the hard way. When too many economic players breach such values too frequently, calls for regulation immediately gather pace.

This brings me to my ninth claim:

9. *Those managing the economy must use their freedom responsibly. Many of the regulations that they bemoan arose due to their own misconduct.*

## **IX.**

Finally, I would like to try to summarize my thoughts with regard to sustainability and the financial markets. I have come to eight conclusions:

*Firstly:* Without efficient financial markets, national and international economies will also be inefficient.

*Secondly:* Financial markets are only efficient if they are structured as a market economy, based on freedom and competition.

*Thirdly:* For the financial markets to be sustainable, the system must be prevented from collapsing, but growth and consistent renewal must not be made impossible. As renewals often take place in a discontinuous fashion, crises are unavoidable in such systems. However, they must not be existential in nature.

*Fourthly:* A market economy requires an intelligent state regulatory framework, but also the consensus of the market players with regard to a basis for moral and ethical values.

*Fifthly:* The state regulatory framework must force competition, ensure the transparency of the financial markets and prevent the system from collapsing. It may neither stall growth drivers nor prevent constant renewal.

*Sixthly:* Consensus on basic values cannot be forced by the state. Good corporate governance, the public condemnation of those who breach unwritten rules and the revocation of licenses for gross breaches may offer incentives to act responsibly.

*Seventhly:* When selecting management staff, the sector must give the same importance to the suitability of an individual's character as it does to their technical skills.

*Eighthly:* If the sector does not pay sufficient head to these issues, political pressure for overregulation will be unavoidable. And it will have nothing to blame but itself.

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