

## The fruit of hypocrisy

Dishonesty in the finance sector dragged us here, and Washington looks ill-equipped to guide us out

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Houses of cards, chickens coming home to roost - pick your cliché. The new low in the financial crisis, which has prompted comparisons with the 1929 Wall Street crash, is the fruit of a pattern of dishonesty on the part of financial institutions, and incompetence on the part of policymakers.

We had become accustomed to the hypocrisy. The banks reject any suggestion they should face regulation, rebuff any move towards anti-trust measures - yet when trouble strikes, all of a sudden they demand state intervention: they must be bailed out; they are too big, too important to be allowed to fail.

Eventually, however, we were always going to learn how big the safety net was. And a sign of the limits of the US Federal Reserve and treasury's willingness to rescue comes with the collapse of the investment bank Lehman Brothers, one of the most famous Wall Street names.

The big question always centres on systemic risk: to what extent does the collapse of an institution imperil the financial system as a whole? Wall Street has always been quick to overstate systemic risk - take, for example, the 1994 Mexican financial crisis - but loth to allow examination of their own dealings. Last week the US treasury secretary, Henry Paulson, judged there was sufficient systemic risk to warrant a government rescue of mortgage giants Fannie Mae and Freddie Mac; but there was not sufficient systemic risk seen in Lehman.

The present financial crisis springs from a catastrophic collapse in confidence. The banks were laying huge bets with each other over loans and assets. Complex transactions were designed to move risk and disguise the sliding value of assets. In this game there are winners and losers. And it's not a zero-sum game, it's a negative-sum game: as people wake up to the smoke and mirrors in the financial system, as people grow averse to risk, losses occur; the market as a whole plummets and everyone loses.

Financial markets hinge on trust, and that trust has eroded. Lehman's collapse marks at the very least a powerful symbol of a new low in confidence, and the reverberations will continue.

The crisis in trust extends beyond banks. In the global context, there is dwindling confidence in US policymakers. At July's G8 meeting in Hokkaido the US delivered assurances that things were turning around at last. The weeks since have done nothing but confirm any global mistrust of government experts.

How seriously, then, should we take comparisons with the crash of 1929? Most economists believe we have the monetary and fiscal instruments and understanding to avoid collapse on that scale. And yet the IMF and the US treasury, together with central banks and finance ministers from many other countries, are capable of supporting the sort of "rescue" policies that led Indonesia to economic disaster in 1998. Moreover, it is difficult to have faith in the policy wherewithal of a government that oversaw the utter mismanagement of the war in Iraq and the response to Hurricane Katrina. If any administration can turn this crisis into another depression, it is the Bush administration.

America's financial system failed in its two crucial responsibilities: managing risk and allocating capital. The industry as a whole has not been doing what it should be doing - for instance creating products that help Americans manage critical risks, such as staying in their homes when interest rates rise or house prices fall - and it must now face change in its regulatory structures. Regrettably, many of the worst elements of the US financial system - toxic mortgages and the practices that led to them - were exported to the rest of the world.

It was all done in the name of innovation, and any regulatory initiative was fought away with claims that it would suppress that innovation. They were innovating, all right, but not in ways that made the economy stronger. Some of America's best and brightest were devoting their talents to getting around standards and regulations designed to ensure the efficiency of the economy and the safety of the banking system. Unfortunately, they were far too successful, and we are all - homeowners, workers, investors, taxpayers - paying the price.

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