1. Can finance be the young's best friend? An interview with Ignazio Visco

EIEF: We thank Ignazio Visco for having accepted our invitation to this "collective interview". We want to get his opinions on two broad themes. On the one hand, the current dissatisfaction, expressed by many young people, with the finance industry; on the other hand, the role of merit and of competition in our society. What links these two themes is the idea that those who today are rich in ideas and willingness to work hard, but poor in accumulated resources and powerful networks to rely upon – namely young people – should naturally see finance, merit and competition as allies. Yet, they often see them as anathema.

So, let us start with finance. As economists, we see finance as the way to provide resources to those who today have good ideas, but not wealth or income, allowing them to turn those ideas into real, additional wealth that can reward both them and those who originally provided the resources. How has it been possible that, instead, finance is seen by so many young people as just a treacherous, mysterious and unfair mechanism that generates humongous "paper wealth" for a tiny minority and real misery for the rest? What did finance do to deserve this bad reputation? Do regulators share part of the blame? And is it possible tomake a better, clear case in favour of a positive role of finance?

Ignazio Visco (IV). I broadly share your view of finance as a mechanism for the good. There are many liquidity constraints hampering the working of the economy and the exploitation of good ideas, and finance can remove those constraints. In theory, at least. In practice, however, things get less clear cut. And there are cycles in the way in which finance is perceived and assessed. Before the 70's the intellectual debate used to take for granted the idea that a regulator is needed, that the market left to itself can generate inefficient results. Then came the big inflation of the 70s, combined with high unemployment. The State, the regulators, which had not prevented those developments, were blamed and the ground was ready for an ideological swing: a push for reducing the size of the State.
To buttress this swing, besides the failures of the "regulated economy", there was a powerful change, taking place in the political and economic arena. The end of the Cold war, a major opening of the economies to trade, the transfer of the technological innovations, many of them generated in the military sector, to civilian uses. The revolution in the Information and Communication Technologies (ICT) radically transformed the way in which information can be generated, collected, transferred. And this in turn allowed the ebullient innovation in the finance industry, the financial innovation. The idea, in principle correct and fruitful, was that a proliferation of new financial instruments, allowing

agents to insure themselves against many dimensions of risk, was a way to "complete the markets", to get closer to the theoretical idea of the Arrow-Debreu model with complete markets, allowing the efficient transfer of resources across time, space and states of the world. But all this was based on the presumption that the world is stationary, that the future is pretty much like the past, that we can extrapolate from relatively small samples, that there is a single "Data Generating Process" which, with enough data, we can eventually identify and learn about. If instead the world is non stationary, we end up with wrong estimates of the probabilities. And, based on these wrong estimates, the decisions to invest in the various financial instruments can lead to big mistakes. For a number of years the big investment banks were able to sustain returns much higher than what was justified by the real increase of wealth in the economy. Until at some point the day of reckoning arrives, and there is a big crash. In a way innovation, based on the presumption of stationarity, sows the seeds of the non-stationarity that will end up to undermine that very presumption.

EIEF: So, do you think there was some form of hubris, of excessive self-confidence, based on a wrong perception of risks?

IV: Yes, the fundamental non-stationarity of the economic developments were not well appreciated. But complexity was also used, somewhat perversely, as a way to obtain from the regulators a sort of benign neglect. The big players in the finance industry successfully argued with the regulators that financial innovation was too complex and too opaque for the regulators to get their head around it: you will always be behind it, so allow us to self-regulate, we can take care of ourselves. Accepting this argument was a key mistake.

EIEF: Why do you think this happened? Didn't the regulators have the right incentives to acquire the necessary information?

IV: Well, there are probably two reasons. On the one hand, the big financial players were, and are, global. They operate in the world market, and national regulators were too small and had too narrow powers to be able to confront them. The need to coordinate the regulators' actions acted, in the face of a natural tendency to preserve each regulator's sphere of influence, as a powerful drag on the ability to raise up to the challenge posed by a finance gone global. On the other hand, phenomena of regulatory capture surely happened. Powerful political and economical influences were at play, and in some cases prevailed.

EIEF: What are the regulators doing to prevent the same mistake to happen again?

IV: Several things have already been decided (though not all yet implemented in full). Most countries have revised their systems of regulation and supervision to reduce the risks for stability, to increase cooperation among authorities and to broaden the scope of the rules. With the new regulatory framework, the so called Basle III, the ability of banks' capital to absorb potential losses will be definitely improved: basically, only common equity will count as capital. And formal liquidity requirements for banks' investments are being introduced. Principles to make compensation in the finance industry more responsive to the long-term prospects of the firm have been introduced. The transparency of trading in derivatives is being increased by moving most of the transactions on centralized exchanges. Many of the perverse incentives that encouraged the assumptions of excessive

risks in securitizations have been eliminated. The reform has not yet been completed, however. Several other issues are being actively discussed, for example on the role of rating agencies, accounting standards and prudential rules. Also distinguishing between banks, reducing their complexity: to avoid facing the ugly alternatives posed by the existence of too-big-to-fail institutions, preventing them from becoming too big. And putting in place rules to allow orderly resolution schemes, in case of failures. It would be foolish to pretend that failures can be avoided, but we need to be prepared for their occurrence. Not everybody agrees on the various proposals, there are good arguments on each side of the debate. For example, the Commission does not fully share the proposals contained in the Vickers' report. And, as you hinted at the beginning, I am fully convinced that much more efforts should be devoted to better explain to the young people both what happened and what are the positive aspects of the finance industry, those from which they can benefit the most. One problem with this is that it is not simple to identify the culprits of what went wrong. Some see a bigger role played by the so called global imbalances, i.e. by the emergence of structural surpluses and deficit areas in the world, with some countries consuming persistently more than they produce and others doing the opposite.
Others blame the so called regulatory arbitrage, that is the tendency of financial players to move in search of the economies where the regulation is more favourable. It is also important to be clear on the trade-offs. Decisions to limit the power of the big financial institutions would likely reduce the efficiency of the system, but can yield a more robust and resilient system, one which does perform satisfactorily even if the assumptions under which the regulatory framework design had been derived turned out to be grossly wrong.

EIEF: Among those moves to limit the power of these institutions there is also the idea of introducing a tax on financial transactions. What is your opinion about it?

IV: When I was the Chief Economist at the OECD we published in June 2002 a special chapter of the OECD Economic Outlook on exchange market volatility and securities transaction taxes. What we wrote then pretty much represents, still today, what I think about it. I have concerns about its practical implementation, I think that if the objective is to tax financial profits there are better ways, and if the objective is to curb the size and the amount of financial transactions it might end up, if it is successful, to bring little revenue.

EIEF: But why should we want to reduce the size and the amount of the financial transactions? Do you think that there is a disconnect between the amount of financial activity and the amount of real activity?

IV: Is trading in derivatives good or bad? This is, I think, what you're asking me. Because a large part of the explosion in the value of financial transaction is attributable to derivative trades. In principle, a derivative contract is an insurance mechanism. As such, it is a beneficial addition to the set of markets available, it is a clear example of the trend towards the completion of markets which I mentioned before. But you need to know the probabilities! And if the world is non-stationary, this is a problem.

EIEF: Yet, precisely because derivatives are in zero net supply, why should we care? If they make mistakes in assessing the probabilities, some would gain what others would lose, can't we let them play their game?

IV: You see, this is to some extent the same argument used by the big finance to justify self-regulation. We're big guys, we can take care of ourselves. This would be fine, except that then there are failures and there are bailouts. There are important externalities, the unregulated markets do not take them into account.

EIEF: You're right, there are externalities. Indeed, a large part of the most recent and most interesting literature on the crisis is trying to identify precisely the nature of these externalities. But time is running short, let's briefly move to the second theme of our interview, the role of merit, and of competition, in Italy and for the young generations. In particular, there is a legitimate debate on whether the poor job prospects of graduates in this country are a consequence of a lack of qualified demand from firms, or instead the poor growth performance of firms is a consequence of poor quality of skilled labour force. Which side would you take in this debate?

IV: I think it is a bit of both, plus a third element. Italian firms, recovering from the ravages of WWII, specialized in sectors of basic production, which did not require very high skills. Moreover, to a large extent they remained small, often choosing their management within the boundaries of a single family. Neither of these factors, then, seemed to put a steep premium on merit, on the need to reach for the best talents. And, at the same time, there has been a long lasting ideological opposition to the idea of merit, in favour of a somewhat abstract notion of equality. Firms were then not well equipped to deal with radical technological changes, and they have been were slow in adopting the new ICT, let alone innovating on them. So their need of a well educated workforce, able to adopt the new technologies and to innovate on that front was also slow to emerge. All this on the side of the demand for labour, on the production side. On the supply side, the quality of our education system was not particularly high and, in some segments, it has been deteriorating. This also means that firms have faced a labour supply of mixed and uncertain quality, that presented a typical "lemon problem". As a result, the salary has been kept low, reflecting a composition of the labour force that discounted the presence of "lemons". These two aspects, the composition of our productive system and the quality of human capital, have interacted with a third factor, the introduction and the widespread use of more flexible contractual forms, which made it convenient for firms to roll-over their hiring rather than investing on longer-term, stable, but rigid, relationships. Indeed, the high turnover makes it more difficult for firms to identify the true quality of its workers, and reduces the incentives on the side of the workers to invest in firm-specific skills, rationalizing ex-post the low average salary.

EIEF: The debate concerning the responses to the crisis seems to be dominated by distributional issues: who should pay, what is the fair way to share the burden? This is so in the U.S., in Germany, in Italy. But, in particular in our country, this risks obfuscating the fact that there is a big efficiency gap to be overcome. Would you agree with this?

IV: Yes, I do. The best way to increase the lot of those who are behind is not to give them a bigger spoon, but to increase the size of the pot. You see, when I was at the OECD in the second half of the 90s, the idea of building a "knowledge economy" came out. I confess that at the time I was somewhat sceptical. The concept seemed a bit woolly, I could not quite put my finger on what it was that needed to be done. Yet we went on a technical assistance mission in Korea, which had just joined the OECD and was dramatically hit by the Asian financial crisis. They took the report, and decided that it was the right way to go. And they did it! Now they almost invariably cap the education rankings, and have had an economic miracle. The lessons I would draw from this, which are very relevant for our country, are: plan for the long term; and make sure that education is one of the main pillars of that plan.