INTERNALIZING OF THE FINANCIAL CRISIS COSTS

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Rezumat

Articolul enunță principalele învățăminte de care trebuie să ținem seama în urma declanșării și generalizării crizei financiare și economice din august 2007. Accentul principal este pus pe evaluarea conceptuală și de impact a aplicării principiului „*too big to fail*”. Se identifică rațiunile pentru care principiul trebuie (sau poate fi) aplicat, precum și unele consecințe ale aplicării sale. În context, se argumentează asupra costurilor (financiare și nu numai) pe care le antrenează aplicarea acestui principiu și, îndeosebi, asupra modalităților în care acest cost trebuie (sau poate fi) internalizat la nivelul organizațiilor implicate.

Abstract

The article sets out the main lessons that we have to consider from the onset and generalized financial and economic crisis of August 2007. The main emphasis is on conceptual and impact assessment of the principle of "too big to fail". Identify reasons for that principle should (or can be) applied, and some consequences of its application. In this context, it is argued on the costs (financial and others) which entailed the application of this principle and, in particular, on how that cost should be (or be) internalized inside the organizations involved.

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Lessons arising from financial and economic crisis

Recent economic and financial crisis on 2007-2009 has the potential to provide both general lessons and special lessons on managing the economy and society.

Some general lessons emerges: a) the concurrent existence of market failure (which justifies government intervention) and the government failure (justifying market freedom); b) the need to institutionalize an optimal threshold concerning the regulation quantity of the economic game, that eliminates both under-regulation and over-regulation; c) the prevailing need for non-discretionary[1] policies and instruments instead of discretionary, for macroeconomic adjustment; d) the need for a new synthesis of economic theory in order to reduce the break between the economic subject as participant in the economic process and the economic process itself. General lessons have to be "learned" by experts, analysts and governments.

Meanwhile, recent financial and economic crisis suggests a number of specific (special, sectoral) lessons: a) which are root causes of the gap occurrence between nominal and real economic flows (this gaps are the phenomenological causes of the crises); b) which are the standard features of an international monetary and financial structure, in order to limit or even avoid these gaps; c) which are the transmission channels of financial crisis into economic crisis; d) which are the transmission channels of external crisis into domestic crises; e) which are the role of cost internalizing, both in the case of crisis emergence and of crisis exiting.

In this paper, we consider only the last of the special lessons of 2007-2009 financial and economic crisis.

Is the "too big to fail" principle justified?

We will identify two main denotations of this principle.

[1] *The so-called automatic stabilizers.*

Firstly, it is only opposable against the government[2]: indeed, in terms of market, there is no reason why a large organization to be saved (supply-demand dynamic relationship is the only mechanism of action here). Instead, from the government's perspective, the systemic risk created by an economic organization is directly proportional[3] to the size of that organization. Therefore, the government has to apply this principle based on general considerations beyond market reasons, as a result of social contract "provisions", for example, in order to reduce systemic risk in the economy.

Secondly, an organization may claim that the rules established by the government are just the cause for which the organization have verified the eligibility conditions for application of the principle. Unfortunately, this justification is both general and symmetric: the organization can claim both an under-regulation (as was, I think, the case of the 2007-2009 financial and economic crisis) and an over-regulation. As long as the government has the social responsibility of regulating the economic game, the "trap of regulation" will automatically work.

In view of the above said, I think there is a clear justification for applying that principle. This justification is a theoretical and not a practical one, so it is particularly strong. Of course, the effectiveness of its implementation is another issue that is of a practical nature.

Necessary consequences of the "too big to fail" principle

The decision to implement the principle (bail-out action) has three necessary[4] consequences.

Firstly, it generates moral hazard: not only the organization saved but, by contagion, even other organizations, more or less similar, will reduce their vigilance knowing that the government will intervene in case of emergency. Therefore, there is a perverse effect -

2 For the present paper needs, by the term "government" we mean all public institutions with macroeconomic adjustment functions (i.e. including central bank).

3 In my opinion, this dependence is nonlinear. I believe that systemic risk induced by an economic organization in the market sector (and in the economic system as a whole) is a logistic function of the size of that organization. Certainly the structural aspects are important here, but we will ignore them (the economic sector, the rate of growth of the organization, etc.).

4 Here, the term "necessary" has the significance from logics, that means mandatory, inevitably, inexorably, inherent.

government action to rescue the organization will just encourage expansion of eligibility for future government interventions, resulting in a vicious circle[5].

Secondly, avoidance generating systemic risk by saving large organization has the potential to distort market structure, namely, competition[6]. Threshold by which the government must intervene to save a large organization avoiding concomitant deformation of the economic competition is an extremely delicate issue and, so far, unsolved by the economic theory. As consequence, the decision to implement this principle is, eminently, a political one but not technocratic, which means that it depends essentially on the structure of political power, professional competence, scientific and moral decision-makers in time etc.

Thirdly, bail-out action involves social costs, i.e. costs payed by society as a whole, although the blame for the danger into which the organization in question entered is its own fault.

Two ways to internalize the costs of financial crisis

Firstly, it is desirable to create and operate a financial assistance fund (FAF), in the exclusive use of government, that must be completed by the organizations that could apply for the "too big to fail" principle implementation[7]. This fund would constitute the first pillar. If capacity of FAF is exceeded, the government can turn to public funds[8], the second pillar. This internalization of the crisis costs are of ex ante nature. Current discussions by the European Commission and European Central Bank are addressing this category of crisis costs internalization.

Secondly, it must recover funds spent by government through the implementation of the principle, regardless of the funding structure of

5 In terms of systems theory, a vicious circle is an information relationship based on positive feedback.

6 More specifically, it can make, here, the issue of compatible state aid.

7 Certainly, one can proceed and otherwise: the FAF may be completed only by groups of organizations that could (based on which criteria?) generate the nominal-real gap above mentioned, that generate financial crises; for example, for the historical case, discussed here, commercial banks, investment banks, hedge funds etc.

8 Or it can be established from the outset, a "consortium" between government and selected organizations, so that the financing structure of FAF is mixed as a public-private partnership sui generis.

the FAF: on the one hand to replenish the FAF after bail-out intervention and, on the other hand, to recover public money spent (if applicable) following the intervention. Current discussions on institutional measures aimed at to recover public funds spent to rescue the U.S. banking system, are addressing such internalization of crisis costs, so it is of ex post[9] nature.

All these considerations should be part of the "issues portfolio" to discuss restructuring the financial and monetary international system, and, also, at EU level.

9 The institutional mean through this recovery is operated does not matter conceptually, but methodologically only: financial transactions tax, contributions to manage the systemic risk etc.