Too Important

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In his book The Big Short: Inside the Doomsday Machine, recently dramatized in the film of the same name, Michael Lewis describes a complex problem in an easily understandable manner. The 2008 collapse of the financial markets constituted the end of years of development of products increasingly more complex and dependent on variables that, their creators supposed, were not connected. When reality imposed itself, the result was that what under normal conditions was not linked was indeed correlated under critical conditions, magnifying the risk. The problem is that Lewis solely details, with immense grace, the symptoms; he never arrives at its ultimate causes.

The succession of events leading to the collapse, and the instruments involved, is known; however, what this and other books tend to omit is the reason for which those "infernal" instruments were designed. Decades of observing several of the most brilliant actors of the international financial sector have convinced me of two things: their extraordinary intelligence and inventiveness, on the one hand, and their conduct, neatly Pavlovian, on the other. This has to do with a combination that can be extraordinarily beneficial for economic development, but also lethal under certain circumstances. In the language of the economists, when the incentives are misaligned, the risk of mixing intelligence and creativity with perverse objectives can bring forth mammoth crises, such as that of 2008.

The heart of the matter does not lie in the facts themselves, widely recognized at present, but in the circumstances that ushered them in. What was it that prompted the development of such clearly risky products? What we all do know is that the crisis was produced because loans were granted, above all mortgages, which the banks that had supplied them later "securitized" and then resold far and wide. Under normal conditions, the families that had obtained these credits would have paid them off over decades, generating the funds for the proper functioning of the system, and the holders of the securities grounded on those properties would have earned the agreed-upon return. The problem was that many of the families awarded the credit, as ridiculed by Lewis' book and film, abandoned their mortgaged houses, severing the virtuous circle. What Lewis never provides is an explanation for what brought about the granting of loans to persons plainly without the ability to pay.

Mervyn King,an ex-Governor of the Bank of England, describes the other side of the phenomenon:instead of heroic and self-justifying scenes, typical of this types of books (like Ben Bernanke's, Chairman of the Federal Reserve System's Board of Governors at crucial moments), King approaches the transcendental: what occurred for the financial sector to become the Achilles heel of the world economy?

The title of Mervyn King's book says a lot: The End of Alchemy. King dissects the riddle at the crux of the financial system from ancient times: the fallacy residing in accepting deposits from the public whose payment can be exacted at any time vs. the granting of long-term credit. This, of course, is nothing new: it is the lifeblood of the financial system. King takes it upon himself to spell out the way that bankers have devised complex mechanisms that do not ensure sufficient funds in case of an excessive short-term demand and the risks inherent in those mechanisms.

The deeper issue, argues King, is the innate risk of a financial system that confronts increasingly intricate problems and challenges to financial stability vis-à-vis the operators of the system, gifted individuals without the least incentive to be cautious or to safeguard the stability of the system. That is, King, as an ex-Governor of one of the most important central banks in the world, sees the problem that appears when the incentives are in misalignment from a regulator's perspective.

At the core of the collapse of 2008 is found political pressure that the financiers dealt with in a highly creative manner but that was at the same time scandalous and riddled with vices. The politicians, especially a U.S. Senator and a Congressperson, had for years pressured the banks to lend money to poor families to purchase a home. Canny, the financiers designed a type of mortgage that entailed minimal payments and no interest charges for three or four years, with these payments to skyrocket dramatically at a later date. Those given credit lived in the houses as long as payment was feasible and abandoned them immediately afterward: utterly rational actors. On their part, the financiers had satisfied the political requisite, securing their bonuses (for allocating many, very profitable, credits), allowing the deluge to come some years afterward. By then all those mortgages had been sold to investors duped into buying them up.

Enormous creativity and enormous risk. As King observes, the phenomenon is perfectly explainable and highly difficult to eradicate because political demands clash with the incentives of very smart and rational financial operators. These are conflicts that never get resolved cut can be mitigated with adequate regulation that stems from the recognition of human nature as it is and not as it might be desirable.

Agustin Cartens, Mexico's central bank governor, has just been appointed head of the Bank of International Settlements, the most important global regulator in banking matters. His experience and intelligence may well help avert the next crisis. Not a minor source of recognition.

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