“The debt crisis, financial reform and the common good”

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Around 2008, after a relatively long period of stability and growth, the global economic and financial system entered into a period of crisis and it is fair to say that despite the various recent indications of recovery, the crisis cannot be declared to be over.

As the recovery continues in a number of countries, it is in the interest of both present and future generations not to return to practices and values that led to the crisis in the first place, and to ensure the necessary governance reform. On a broader scale, the words of Pope Benedict XVI in his encyclical *Caritas in veritate* are highly appreciated and globally recognised. The Pope stated that “the current crisis obliges us to re-plan our journey, to set ourselves new rules and to discover new forms of commitment, to build on positive experiences and to reject negative ones. The crisis becomes an opportunity for discernment, in which to shape a new vision for the future.”[1]

This statement invites policy makers and the broader international community to reflect on some major questions such as the corporate and fiscal practices, the competence of regulators and the various factors that in aggregate led the world to this crisis situation.

As in any crisis, there is a tendency to pinpoint the culprit or to attribute blame on a particular factor. Initially analysts attributed the collapse to the accumulation of excessive debt, regulatory failures and asset price bubbles. When the euro area crisis erupted, the blame was shifted onto governments of various countries, which had piled up large debts, partly to finance subventions to the banking sector but also in some cases due to inappropriate public finances.

In recent decades one finds that both market participants and the authorities engaged in practices that in a number of instances fell short in terms of ethical standards, causing hardship and a broad range of negative outcomes.

The scale of the crisis

The global financial crisis of 2008 was the worst since the Great Depression of the 1930s, affecting the world economy, but with particular detriment to the advanced economies. The financial crisis triggered a global recession characterised by a contraction of world trade and in GDP, and higher unemployment.

[1] *Caritas in veritate*, Encyclical Letter of His Holiness Benedict XVI, Vatican, 2009.

International trade has recently followed a persistent downward deviation from a long-run trend (see Figure 1). In fact, the divergence from the long-term average for world trade appears to be widening.

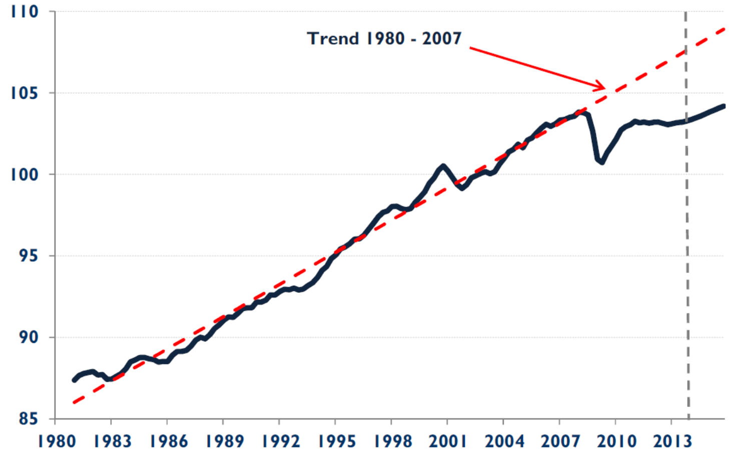


Figure 1. Global trade relative to world GDP, 2000 =100.
Source: ECB.

Similarly, GDP in the advanced economies contracted during the crisis, and in recent years has shown a persistent and possibly permanent departure from its long term trend (see Figure 2). This may signal not only immediate but also future economic losses.

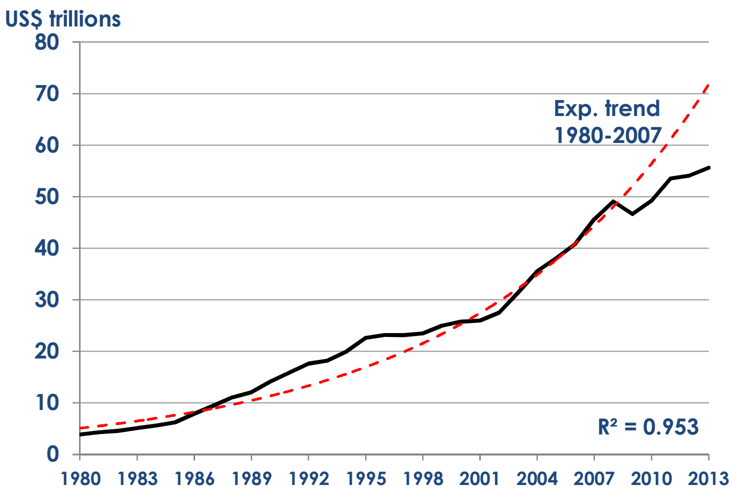


Figure 2. GDP in advanced economies (constant 2000 prices).
Data source: IMF WEO Apr 2013.

Perhaps the most serious manifestation of the crisis is found in the unemployment situation, where jobless rates are reaching record highs, such as in Spain and Greece. In common with other macroeconomic indicators, unemployment statistics reveal large divergences between member countries in the euro area (see Figure 3a).

As a whole, the euro area faces a particular challenge in this regard. In recent decades, euro area Member States have had higher unemployment rates than in other advanced economies (see Figure 3b). This suggests the presence of structural factors including labour market characteristics that may continue to impede labour market correction. Moreover, many European countries are facing very high youth unemployment rates.

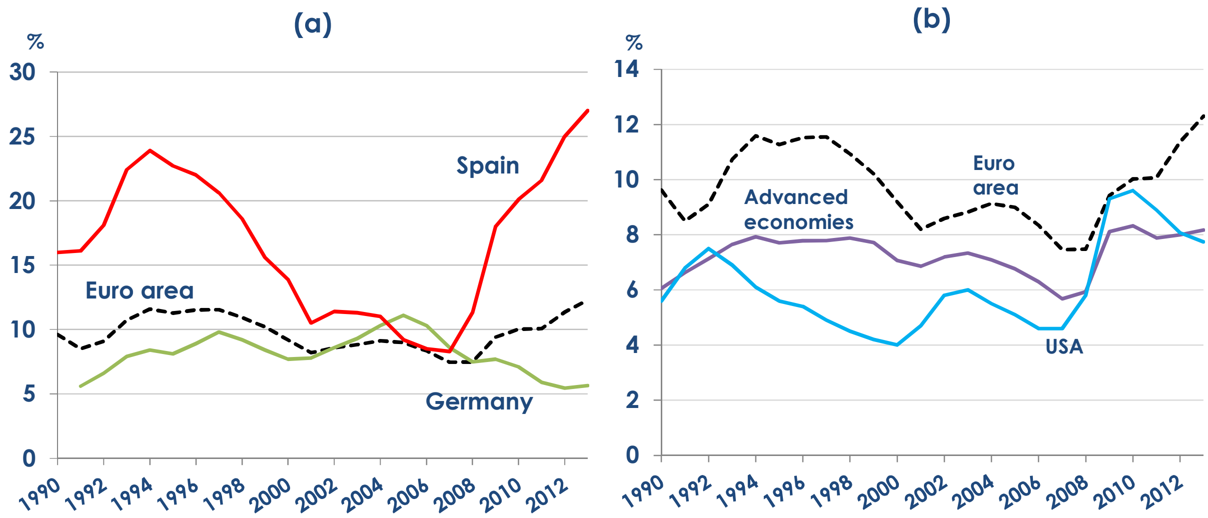
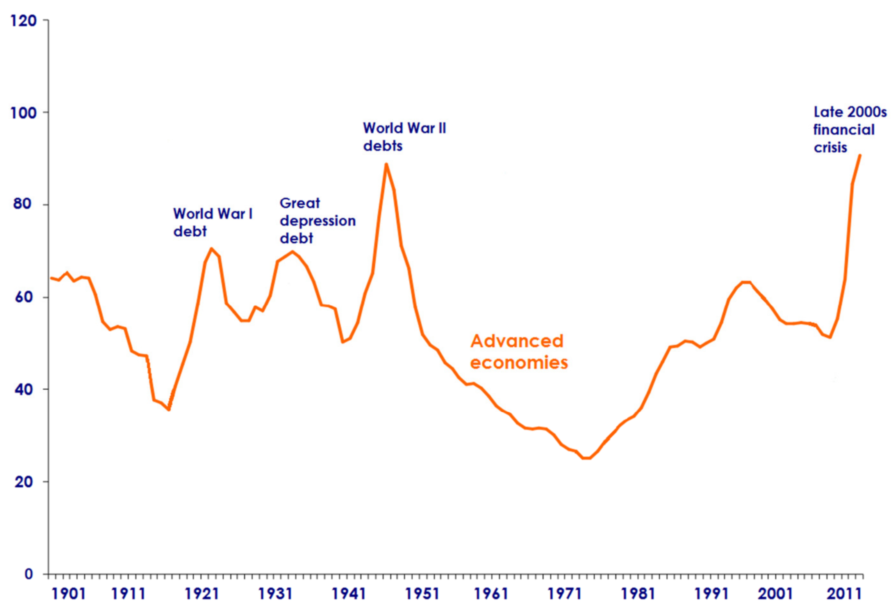


Figure 3. Unemployment in euro area (a) and high income countries (b).
Data source: IMF WEO Apr 2013, World Bank.

Factors behind the crisis

A major structural feature of several economies is the large volume of accumulated debt, in particular government debt. The recent excessive growth in leverage in advanced economies and emerging markets is shown in Figure 4.



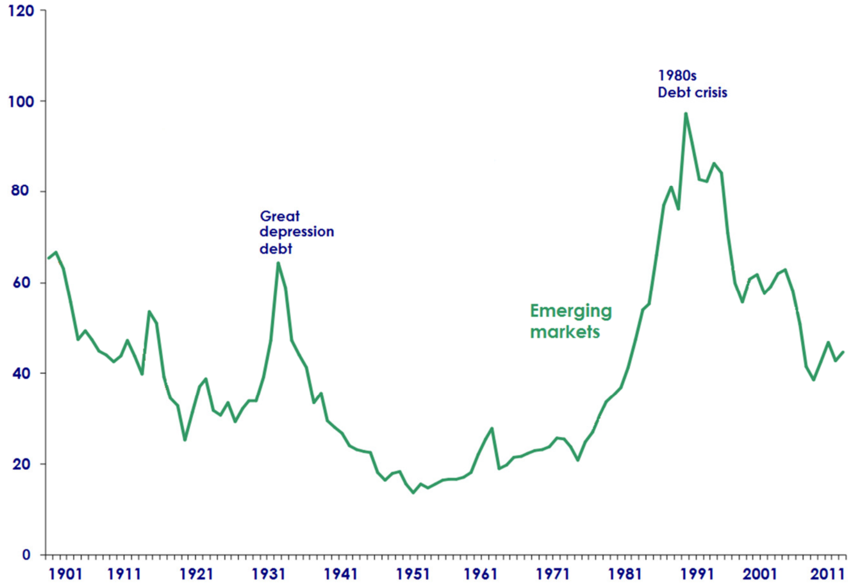


Figure 4. Public sector debt as per cent of GDP: advanced economies and emerging markets. *Source: Reinhart and Sbrancia (2011).*

Historically, debts were predominantly domestic and denominated in domestic currencies (Reinhart and Rogoff 2009). Throughout history, excessive debt has been reduced by stimulating economic growth, fiscal austerity plans, a default or restructuring of debt, or a burst in inflation, this last one being only effective for domestic-currency debt. Nowadays, the debt of advanced economies is often external, with debtors being liable to foreign creditors, increasing debtors' fragility.

An examination of the chart identifies a total of five peaks in indebtedness. Three episodes – two world wars and the current crisis – were almost exclusive to the advanced economies. The 1980s debt crisis was unique to emerging countries while the Great Depression was common to both groups.

The accumulation of debt allows increases in government spending without recourse to higher taxation or other revenue sources. Such policies, however, are unsustainable, in that they also raise the government's exposure to adverse market conditions and reduce the room, when needed, for countercyclical budgetary expansion. There has been similarly strong growth in private sector debt. Such increases in leverage amplify profits in good times but also amplifies losses in adverse times, raising the possibility even of insolvency.

Since the inception of the European Union, the concept of defaulting Member States was not contemplated until recently. The EU was not equipped with the institutional structure that was required to address the situation. It was not prepared for an economic scenario characterised with public debt reaching proportions not seen in advanced economies since World War II.

The institutional mechanisms that are now in place, or else that are being contemplated can be assessed from various ethical points of view. Public sector subventions to the banks, deposit insurance schemes and bail-out provisions suffer from a moral hazard problem. This because the cost of negative outcomes ensuing from the accumulation of debt and excessive risk on the part, say, a government or a bank is not entirely borne by that government or bank. Manifestations of this problem in the public sector include fiscal deficits driven by the political cycle, while in the private sector the problem is reflected in profitability levels that are resilient to the severity of the crisis. If risk takers are able to avoid paying for all the consequences of their ill-judgment, remedial policy measures create an incentive for taking on more risk. This is where the preventive arm of supervision (as against the corrective arm) should be used.

A similar logic can be applied to the credit rating agencies. The entities play a crucial role in the assessment of borrowers, and have been criticized for not being diligent enough to spot weaknesses at both the micro and systemic levels.

Excessive debt can also be criticized for shifting the servicing burden onto future generations, who will be loaded with large debts incurred by the current generation. In the words of Mark Carney, Governor of the Bank of England, in this crisis "the present was overvalued and the future heavily discounted". [2]

In parallel with the build-up of debt, there has also been a massive increase in financial market trades. Global trade in equity has outstripped economic activity, until the reversal that occurred during the crisis. The spike in market transactions spiralled during the dot.com bubble around 2000, but this was significantly exceeded by the spike during the run-up to the current crisis, around 2008 (see Figure 5).

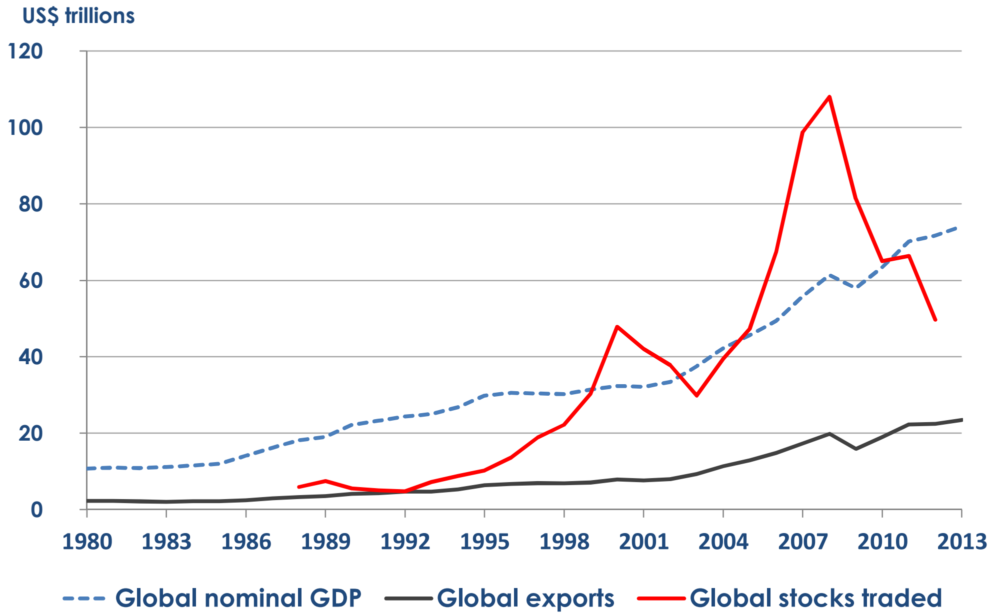


Figure 5. Global GDP, finance and trade.
Data source: IMF WEO, April 2013, World Bank.
Note: All values are in current $US trillions.

The same phenomenon can be seen in foreign exchange market. In 2008, the daily global turnover in foreign exchange was 45 times larger than underlying foreign trade.

[2] Speech by Mark Carney on Rebuilding Trust in Global Banking, 7th Annual Thomas d'Aquino Lecture on Leadership - Lawrence National Centre for Policy and Management - Richard Ivey School of Business - Western University, London, Ontario, 25 February 2013.

In addition, there has been a proliferation of new financial products that are in some instances unregulated. Financial innovation is supposed to contribute to risk mitigation but has instead in some cases led to heightened risk and price volatility. Observers tend to underestimate the ethical dimension of these developments.

For example, the year 2000 saw the launch of a new derivative, the credit default swap (CDS). This consists of an insurance contract where the seller insures the buyer against losses that could arise from the default of a particular bond. There are bond holders who acquire these CDS's for the purpose of financial protection. In addition, however, there are financial market participants who are not necessarily owners of the underlying security (the bond) and who trade in the derivative instruments in a bid to turn a profit from price fluctuations.

Between 2001 and 2007, outstanding CDS jumped from $919 million to over $62 trillion (Blinder 2013). Of these, 20% were estimated to involve hedges on the part of holders of the underlying instruments. Speculative trading has fuelled asset price bubbles in the financial markets with dramatic consequences in the rest of the economy.

Dubious banking practices and inadequate regulation have led to asset price bubbles. Prospective home buyers were enticed with borrowing terms that often overlooked the inadequate collateral and the low earnings capacity of the borrower. This led to a spiral in outstanding mortgages and fuelled steady increases in house prices. Eventually, when the expectations of continuing price growth were not met, a large number of mortgaged households defaulted. Recovery from foreclosed property was insufficient to meet losses, and doubts emerged on the debt-based instruments.

These included securitized loans, where similar loans are bundled into securities which are traded in their own right. Unfortunately during the packaging process and the subsequent selling and reselling of these bonds, information about the underlying mortgages was lost or possibly ignored. Credit rating agencies, in a number of cases, gave such instruments an excessively high rating based on low historical default rates on mortgages issued back at the time of more prudent lending practices. However, when the housing bubble stopped inflating and sub-prime mortgages started defaulting at a higher rate than the historical default rate inappropriately assumed, panic set in across financial markets, pulling down the whole pyramid of debt-based instruments. Dubious loan contracts in one part of the world ended up causing severe problems for far-away banks who had invested in securitized loans. There was contagion on a massive scale.

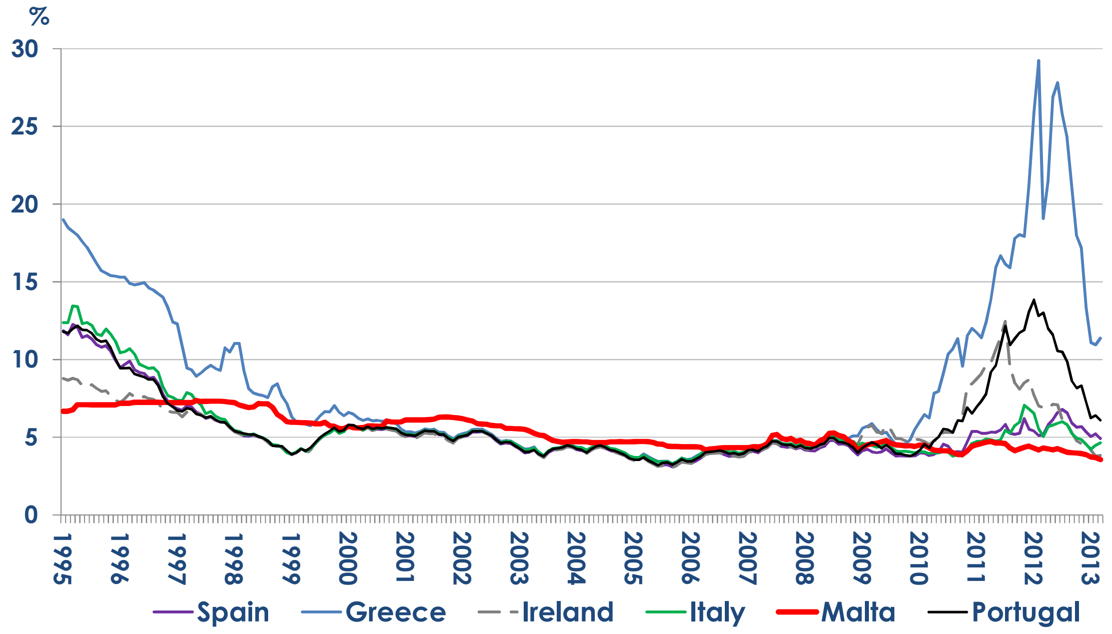


Figure 6. 10-year sovereign yields.
Data source: Eurostat.

Collective misjudgement by market participants takes a share of the blame. Mispricing in financial market transactions was manifested, for example, in the behaviour of sovereign bond spreads in the euro area. As can be seen on the left side of Figure 6, yields were originally spread across a broad band but were then funnelled into a narrower band as countries joined the euro area. Investors mistakenly viewed the euro area as a homogenous bloc, and ignored national differences in competitiveness and fiscal soundness.

As we move to the right side of the chart, the spreads re-emerged as the crisis unfolded, revealing the scale of the miscalculation during previous years. In retrospect, the convergence seen during the middle phase as seen in the chart reflected risk mispricing in the financial markets, followed by the eventual correction. This correction was a source of severe distress in the affected countries. The period of low interest rates had provided those countries the opportunity to avail themselves of favourable market conditions to finance structural improvements and instead the opportunity was lost.

Also noticeable from the chart is the more stable yield (shown in red) faced by Malta, essentially following a slightly declining path throughout the period, that is, prior to, during, and following the crisis. A number of factors are behind this more stable result by the smallest economy in the euro area, which has been exposed to the discipline of international competition since its independence in the mid-1960s.

First, the banking practices followed have been based on a very prudent and traditional model, funded domestically with a loan-to-deposit ratio of around 70%, compared to over 110% in the euro area.

Second, the lending model used by banks has been traditional, appropriately taking into account the ability of the borrower to repay back both principal and interest, and not having to rely on future price increases in the housing market to extricate the borrower from the unsustainable burden of the loan. This prevented the emergence of a boom-to-bust housing bubble.

Third, the state has followed prudent budgetary policies, never abusing the monetary printing presses. Structural changes were implemented when various fundamental elements in the economy appeared unsustainable and likely to hinder the rest of the economy from being internationally competitive, and thus able to earn its living from foreign trade.

Of course, this is not to say that everything has been perfect over the decades, and many challenges remain. But perhaps there are some lessons to be learnt from a small open economy which has only one resource, namely its human resources, and which prior to the economy's successful internationalisation, used to have only one major safety valve, namely emigration, with all its negative consequences in the home country. The reasons for its current economic and financial stability, reasonable employment growth and low rates of inflation and unemployment, are worth reflecting upon, especially when one considers that the economy is functioning in an environment that has had catastrophic effects on much bigger and in principle, more resource rich, economies.

Going back to euro area in general, a number of governments became unable to raise funds at reasonable rates on the financial markets as government bond prices fell. The balance sheets of banks and other financial institutions took a hit. Bank collapses necessitated subventions from public funds that further aggravated public finances. What emerged was the negative feedback loop between the banking crisis and the sovereign debt crisis.

There has been insufficient discussion of the ethical shortcomings behind these developments. Regulatory oversight failed in monitoring financial market innovations, whether in the form of new and riskier financial instruments or riskier practices by market participants, let alone anticipating the consequences. Over a number of years, financial institutions engaged in excessive leverage, took on excessive risk and ignored the social ramifications of possible failure. They ignored signals of bubble conditions, for example in property prices, and in all this, supervision and regulation lagged behind market innovation. Engaging in riskier activity, by for example offering lax conditions for mortgage loans is in effect misleading loan applicants, and the eventual unwinding of these practices has been a very costly exercise, not least for evicted homeowners.

The importance of moral values in governance is specifically indicated in the Greek case. As I indicated earlier and in line with what happened in other euro area countries, following the euro adoption in 2001 the Greek economy enjoyed a reduction in interest rates. At the same time, however, the country's international competitiveness had eroded, while on the fiscal front, Greece was not in adherence to the Maastricht criteria.

These problems were compounded by misreporting in official statistics, such that the extent of misalignment from the benchmarks was highly underestimated. A former colleague at the European Court of Auditors, Ioannis Sarmas presents three dimensions of the Greek governance problem: "[first] the lack of an internal control system allowing the government to pilot the country out of turbulence zone; [second] the absence of a culture of accountability requiring public fund managers to demonstrate the results achieved [and finally] the inadequate powers for the auditing mechanisms preventing them from focusing on the waste of public money" (Sarmas 2011).

The responses

In the European response, safeguarding the euro has been a key priority. However, intervention has also embodied the value of solidarity with the countries in question and their citizens. These were the reasons for the establishment of the European Stability Mechanism and its predecessor the European Financial Stability Facility. By providing financial assistance to troubled euro area members and committing to lend money in support of the global economy through the IMF, Europe has mobilized over €1 trillion. By adding a financial crisis management mechanism to the current European institutional architecture, Europe has yet again managed to embody solidarity in an institutional form. However the funds are made available only with conditions attached, particularly those calling for fiscal correction and structural reform. The Fiscal Compact has introduced corrective measures that allow national governments to maintain a sustainable fiscal path.

Turning to monetary policy, one has to recognise that the ECB has limited tools to respond to the crisis. It has the necessary facilities to provide breathing space in terms of liquidity, but structural and fiscal reforms in the economy will remain largely the responsibility of governments.

It was however the ECB that took an immediate role in Europe's response to the crises. By providing extra liquidity at the onset of the crisis, the ECB was crucial in ensuring the functioning of not just the banking sector but of the whole economy. As the crisis deepened, the ECB implemented various measures to facilitate access to credit, preventing a meltdown in the financial system which would have had dire consequences right across the European Union and beyond. The ECB also implemented a number of so-called non-standard measures, including significant liquidity diffusion measures and increasing the number of counterparties eligible for refinancing. These measures were complemented by several cuts in policy interest rates and most recently through forward guidance. The ECB also launched a new measure called Outright Monetary Transactions (OMTs) to provide a fully effective backstop in the sovereign bond market. This was done in part to remove the unfounded fears about the future of the euro area that were undermining the stability of the currency and threatening sovereign defaults.

The negative loop between sovereign bonds and the banking system threatened the well-functioning of the euro area. By putting in place a credible backstop, the ECB succeeded in removing the fears at source. Figure 7 shows the reaction of 2-year sovereign bond yields in Italy and Spain to each of these actions, and especially the extended positive reaction to the last measure.

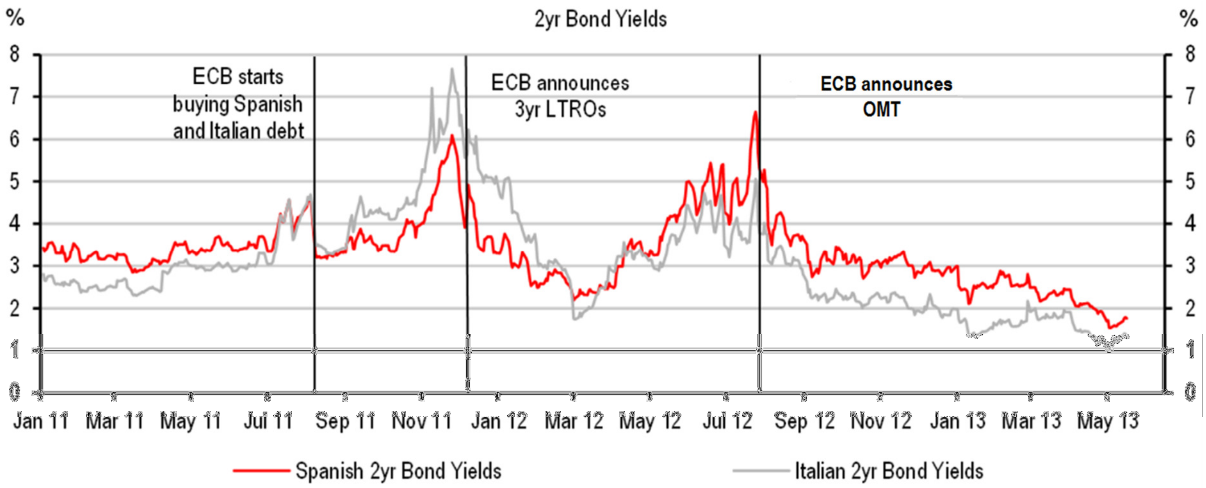


Figure 7. Effect of ECB initiatives on bond yields.
Source: Bloomberg, HSBC.

The repair work on the euro has started and imbalances are slowly receding. However, structural reforms need to be maintained and the unwinding of excessively large public and private sector debt will take time to come back down to more sustainable levels.

The road ahead

The crisis revealed the need for cross-border financial supervision that would address the problem of contagion. It would also reduce the risk of regulatory forbearance, further ensuring that all financial firms own up to their corporate responsibilities.

As the Single Market continued to deepen, financial markets have become even more integrated. This definitely brought on additional risks since "integration increases contagion risks, and thereby jeopardises financial stability" (De Larosiere et al. 2009). While cross-border conglomerates have grown over the past years, supervision and regulation have remained largely the responsibility of national authorities, creating an ever increasing asymmetry. It is therefore evident that the consolidation of regulatory oversight at the European level is imperative since "fragmented financial regulation and supervision makes no sense in a monetary union and is potentially lethal" (Munchau 2010).

Since the current institutional architecture is clearly unable to address the realities revealed by the crisis, the respective Presidents of the European Commission, Council, euro group and ECB drew up a report advocating the completion of the monetary union by way of an additional four unions. The banking union, economic union, fiscal union and political union are envisaged to work in tandem and reinforcing each other.

The goal of the proposed European banking union is to cut the negative feedback loops between banks and sovereign debtors and to limit the increasing fragmentation of European financial markets. The institutional framework of the banking union comprises two key elements.

The first is the Single Supervisory Mechanism (SSM) under the auspices of the ECB and charged with the oversight of all euro area banks. The SSM will reduce regulatory forbearance at the national level. The second is the Single Resolution Mechanism (SRM) a

European restructuring and resolution mechanism that would be responsible for the consolidation or winding up of non-viable banks.

In tandem, the euro area and the European Union are also firming up fiscal integration, reducing the space for unsustainable fiscal policies at the national level. Several elements of the enhanced fiscal union have already been implemented. The Stability and Growth Pact has been strengthened by the so-called six-pack of economic measures, including the Macroeconomic Imbalance Procedure. The latter extends surveillance of imbalances and corrective action to include not only the fiscal dimension but also the broader economy.

Improved fiscal policy coordination will also help to correct the imbalances that have been building up over the past years. However, for this to materialise, prescriptions need to be transposed into national law and adhered to at every level of government. This element of national responsibility is essential for the proper functioning and sustainability of the euro area as a whole.

Euro area countries need to become more flexible, open and competitive. The euro area and the European Union need to return to growth. Raising productivity levels and reinforcing competitiveness will also contribute towards convergence between countries and reduce the imbalances and risks that exist.

Catholic thinking

Today we need not only an economic and political recovery but also a moral recovery that re-establishes ethics and values at the heart of economic policy-making. Catholic Social Teaching provides a rich inspiration as we consider the kinds of institutions and governance mechanisms that need to be developed.

Central to these values is the respect for human beings and their essential dignity, especially as they shape their own destiny through active participation in economic life. This consideration takes on greater significance as countries face the unemployment challenge. Resumption of growth and the restoration of economic and financial stability is the key to the reduction in joblessness.

Unemployment is a social and economic tragedy since human potential goes to waste, preventing individuals from playing a full and meaningful part in society. This consideration calls on all policy makers to be totally focused in their efforts to support sustainable job creation initiatives. Society needs to fully recognise the rights that every person should be able to enjoy, which, however, are also inextricably linked to responsibilities.

Closely linked to the discourse of responsibilities is the value of solidarity which is defined by Pope Emeritus Benedict XVI in his *Caritates in Veritate* as “first and foremost a sense of responsibility on the part of everyone with regard to everyone”. Solidarity demands therefore that we work towards the common good; in other words, towards the creation of communities in which all people are able to flourish and achieve fulfilment. This is probably best described by Blessed John Paul II in his *Sollicitudo Rei Socialis* (1987): “When interdependence becomes recognized in this way, the correlative response as a moral and social attitude, as a ‘virtue’, is solidarity … not a feeling of vague compassion or shallow distress at the misfortunes of so many people, both near and far …[but] a firm and persevering determination to commit oneself to the common good; that is to say to the good of all and of each individual, because we are all really responsible for all."

Creating work opportunities is one avenue for people to flourish and fulfil themselves. However, it is even more important for governments and communities to invest in human development through education. In today's world, the success of countries themselves depends on the skill-base of their population and working force. Investment in education at all levels is imperative including life-long learning and retraining.

Solidarity therefore demands that we work beyond individual interests and towards the common good. The European Union provided a prime example of solidarity in its response to the crisis. The various support mechanisms that have been launched by numerous European institutions are a tangible form of solidarity. In discussing the value of solidarity in politics and economic policy making, one must also mention the importance on inter-generational solidarity. Responsible and sustainable policies especially related to public finances are another embodiment of solidarity. The crisis has shown us that one day someone will pay for the excesses of the present and therefore the drive towards fiscal sustainability reflects this moral teaching.

The principle of subsidiarity places a duty on communities and institutions to ensure the participation of all stakeholders and to find the right balance between individual and the common good, and is closely related to solidarity. The subsidiarity principle is a European value which also echoes a central tenet of Catholic Social Doctrine as described by Pope Pius XI in his *Quadragesimo Anno* as "a fundamental principle that one should not withdraw from individuals and commit to the community what they can accomplish by their own enterprise and industry."

Subsidiarity also gives rise to an obligation to participate in economic and social life. Free-riding on the system is unfortunately a vice that weakens both the economic and social fabric. Free riding can take various forms, from not contributing one's fair share of taxation, to abusing the social safety net by, for example, claiming undue social benefits. It can also happen on a state level where one state may free ride on the other members of the union instead of making the necessary changes that would put the country back on a sustainable path of recovery. This involves the creation of productive work opportunities to its citizens, and also providing the social support system for those in genuine need. At the international level, the absence of free ridership would eliminate the risk of contagion across the union. This reminds me of the parable of the talents in which the main message is for each to utilise the capacities that they have been favoured with fully and not to hide or misuse such talents.

Everyone has to contribute in rebuilding society. We cannot return to past practices. We cannot have an economic model that allows excesses to go uncorrected and which relies exclusively on the self-regulation of markets. We cannot have governments that do not pursue fairness between generations. Piling up debt means nothing else than passing the burden onto future generations.

Fortunately, we are already seeing this revaluation in Europe and beyond. Governments are correcting accumulated imbalances, but this however comes at a painful cost. It is a hard road ahead; however it is a courageous one and needs time to bear fruit. We cannot correct imbalances that have been accumulating for decades, instantly. Germany only finished paying its restructured debt from the 1950s Marshall Plan, the Schumann Plan and the London Debt Conference in 2010 (Schmidt 2011).

It is these paths which will help us create jobs, support our social model and contribute to a fairer society.

Concluding remarks

As the currency union evolves, its institutions need to adapt to changing circumstances. It has already evolved significantly from the monetary union as once envisaged in the Werner Report of 1970. Throughout the years, Europe has learnt the right way forward from its errors. There is still the potential for the currency union to contribute to convergence, stability and prosperity. Above all, in the words of the President of the European Council, "Europe is more than an economic project. It is a political project. It is the choice for a society in which peace, a social market economy and political democracy are secured" (Van Rompuy 2010).

The founding fathers always believed that Europe ought to be based on values. The economic crisis has shown that we need to fundamentally rethink the moral frameworks that underpin our economic and political institutions. Accordingly, ethical criteria can serve as important pointers to the way ahead.

It is evident that ethics in the post-crisis world places the common good at the very core. Although it is an ambitious journey, we are fortunate enough to have a set of values to guide us. During the course of the 20th century, the Catholic Church elaborated a clear set of social values that are increasingly relevant today as we appraise institutions and governance mechanisms.

Fiscal imprudence and certain corporate practices pose an ethical challenge that needs to be further addressed. While the misrepresentation of fiscal statistics is clearly mendacious, the evaluation of general fiscal laxity and corporate irresponsibility is somewhat more subtle.

Government expenditure is necessary for the provision of public goods and the assurance of a welfare safety net, and is appropriate for the financing of an infrastructure that generates benefits over a long period of time. Deficit financing is justified within the bounds of counter-cyclical policies that stabilize the economy in a contraction. Prudence would require the running of a budget surplus during boom times, building a fiscal buffer that would then be applied in the form of a deficit or a reduced surplus during a contraction. In practice, however, there were other drivers behind the accumulation of public debt.

A budgetary deficit allows increases in public sector spending that are not financed from higher concurrent tax revenues, and seemingly at no cost except for the payment of interest. Superficially, deficits accommodate today's demand for government largesse without the need for a matching concurrent sacrifice on the part of anyone. The beneficiaries are quite easily identifiable while those who will carry the burden are not always as apparent. There is often a lack of clarity as to who it is (within or outside the country) that carries that burden.

Over time since the debt ratio cannot keep rising forever, future taxpayers will have to set aside the funds needed to repay the accumulated debt, but from today's point of view, such concern for these future taxpayers tends to be relatively weak, as is also evident when governments fail to address the ageing-population problem in a timely manner.

In practical terms, persistently large deficits are unsustainable because the buyers of the resulting debt will demand a higher yield and in extreme cases (as have been observed recently within the euro area), they ultimately shut that government completely out of the debt market. It is immediately convenient but short-sighted and unethical for governments to engage in unsustainable practices with disregard for the consequences, including those affecting future generations. Overruns that are driven by increases in recurrent spending are a cause for additional concern.

Cross-country contagion aggravates the irresponsibility, as negative outcomes in one country trigger a rethinking in the market that leads to higher risk premia on the debt of other countries.

Similarly, higher leverage in the private sector provides business owners with larger profits, but also amplifies the losses that follow when things go wrong. On ethical grounds, excessive private-sector debt is unacceptable, and the failure to anticipate the resulting financial difficulties exposed a serious flaw in the regulatory system.

Excessive debt is potentially even more harmful when taken on by banks or other financial institutions. Distress in the banking sector has serious repercussions on the whole economy, including both the public and private sectors. Recently the spreading of financial distress has been contained by large government outlays, while the impairment of credit flows has had to be countered by determined central bank measures.

The collapse of big and interconnected financial institutions would have serious repercussions on the rest of the financial system and on the broader economy. For that reason, government intervention becomes inevitable but, as a consequence, the institutions involved are spared all or part of the responsibility for the consequences from taking on excessive risk. This is perhaps one reason behind the observation that the remuneration of bank executives has not always been susceptible to the severity of the crisis. Indeed, in some cases bonus systems in pay packages contributed to riskier and less prudent practices. Moral hazard arises from the fact that without preventive measures by the regulators, such bail-outs bring along an incentive for the recurrence of the problem.

Proper corporate citizenship is inconsistent with the housing bubble that was one of the initial sparks in the recent crisis. This was also prompted by the spread of opaque financial instruments which became a tool for rampant speculation. In retrospect, extending high volumes of credit to households with dubious financial credentials was immediately profitable for lenders, but toxic for the same households, as well as for financial institutions and ultimately governments. The packaging of these loans into securities was not properly monitored by the regulators and supervisors and ended up becoming another layer of opacity that further blinded speculative trading.

A monetary union promotes economic growth by increasing price stability and transparency and reducing trading costs. It is a source of economic stability in that it eliminates the use of exchange rate depreciation for the purpose of restoring competitiveness, even if internal price correction is the only effective way to achieve that end in the long run. It also eliminates the resorting to inflation to neutralise debt.

In practice, a number of countries within the euro area did not avail themselves properly of the benefits of membership. Economic policy and financial supervision were undisciplined and did not safeguard national competitiveness and financial stability. These countries abused their access to cheaper borrowing that initially came along with membership. At the heart of the crisis there were what I have described as ethically-deficient dimensions at the collective level, whether government policy, corporate governance or financial supervision.

The creation and growth of the euro presented some unfamiliar features from the point of view of the financial markets, in that the geographical components were sovereign states with their own sovereign debt, rather than states, regions or provinces within the same country. As the financial crisis unfolded, speculative trading and cross-country contagion became prevalent and tested the integrity of this monetary union, as the markets assessed the dynamics of a monetary union of sovereign states.

A number of reforms have been implemented, or are in the pipeline. These have to be complemented by a better communication of the necessity of adherence to stronger ethical standards at all levels of economic management and financial activity.

It is perhaps relatively easy to identify the values and principles that should form the foundations of institutions and business models. What is far more difficult is to ensure that these values are applied in everyday life and dealings. This relies on us as individuals, professionals and policy makers.

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