International Workshop

Prudence vs. Liquidity

Alternative Approaches to Money, Finance and Accounting

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Organised by

Bocconi University, Department of Public Policy and Management

ANC, Autorité des normes comptables
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PROGRAM

International Workshop

Prudence vs. Liquidity. Alternative Approaches to Money, Finance and Accounting
1 March 2013
Andrea Sironi (Rector, Bocconi University) Welcome address

Panel 1 Money

moderated by Yuri Biondi (Tenured Research Fellow, CNRS - ESCP Europe)
Luca Fantacci (Assistant Professor, Bocconi University) The drawbacks of liquidity and alternative ways of organizing finance
Gennaro Zezza (Professore Associato, Università di Cassino e del Lazio Meridionale and Research Scholar, Levy Institute) An international Clearing Union to address global imbalances?
Jean-Luc Gréau (Economist) Instability out of control. Thirty years of financial liberalization

DISCUSSION

Panel 2 Accounting

moderated by Luca Fantacci
Shyam Sunder (Professor, Yale University) Accounting Antecedents of the Financial Crisis
Jerome Haas (President, Autorité des Normes Comptables) The fantasy of being almighty. The abolition of time in market-based accounting
Angelo Casò (Presidente del Consiglio di Gestione, Organismo Italiano Contabilità) Back to business. From assets and liabilities to profits and losses accounting
Yuri Biondi Liquidity and Prudence: Perspectives from Accounting and Valuation

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1 The workshop included a presentation of results of the research “The return to Keynes. Speculation and stabilization policies” (PRIN 2008)
The ongoing crisis has shown how much the current financial system relies on liquidity. In fact, the liquidity draught that broke out in 2007 produced dramatic repercussions on financial markets, financial accounting, and financial intermediation: certain security markets became inactive, mark-to-market valuation of those securities became impracticable, ensuing losses were difficult to assess, mutual mistrust spread through the banking system, interbank lending froze, credit was drastically curtailed for all debtors, public and private.

It is not surprising, therefore, that extraordinary measures have been deployed, in the effort to restore liquidity. Central banks have cut interest rates to the minimum, expanded money supply on unprecedented scale, and stretched their lines of intervention to the limits of their prerogatives, and sometimes even beyond. And yet, liquidity remains elusive. However bold they are, liquidity injections may be mopped up by an unquenchable thirst for safety under the pressure of generalized uncertainty.

While the financial system and its architecture prove to be based upon liquidity, the current state of financial affairs invites to question this liquidity preference, heightened by distress, as self-deceiving and self-defeating. This appears quite clearly if liquidity is considered from the viewpoint of the economic system as a whole: not only does the accumulation of money not imply the accretion of real wealth, or the satisfaction of individual and social needs, but it may even hinder production of goods and services and the satisfaction of those needs, by reducing effective demand. From this perspective, liquidity might end up being a curse even when it is successfully pursued as a blessing.
Today, it may appear desirable to boost liquidity in order to ease the credit crunch, to refinance distressed borrowers, to ensure the negotiability of securities, and to facilitate their evaluation at fair value. Yet, it is difficult to deny that, in recent decades, abundant liquidity, fuelled by lax monetary policies, contributed to create the conditions for the current and previous crises, by displacing prudent behaviors and regulations, lowering risk awareness and fostering high-leveraged operations. It is also difficult to deny that further liquidity injections would create moral hazard by encouraging reckless behavior with the prospect of an eventual bail-out by governments and central banks – a roadmap to future crises. In sum, liquidity is part of the problem as much as of the solution.

Now, despite what is commonly assumed, liquidity is not an essential feature of financial systems, whereas an overall principle of prudence may work well as a permanent guideline and reference. It is possible to conceive alternative forms of financial markets, intermediation and accounting that do not rely on what Keynes called the ‘fetish’ of liquidity. For example, the establishment of a clearing system between businesses or nations does not require to set aside any precedent amount of liquid reserves; the financing of enterprise through loans and profit-sharing agreements does not rely on the liquidity of the investment; the evaluation of securities by historical cost accounting does not rest on the hypothesis of their ready marketability through liquid exchanges. If these and other financial practices can do without liquidity, no financial relation can be properly established without reference to an overarching principle of prudence. This principle serves as a reminder of the fundamental solidarity between debtors and creditors which is crucial to the fulfillment of every financial transaction as well as to the creation and maintenance of every financial system.

This workshop is dedicated to the discussion of alternative forms of finance, banking, and accounting, which have been or may be developed within the framework of a system where money is not conceived as liquidity, i.e. as a reserve asset. In particular, it will investigate the interrelations between the monetary system, financial intermediation, modes of control and accountability of operations and entities, within the financial system as a whole. Scholars, professionals and policymakers will question the current state of financial affairs, by contrasting it with alternative financial systems, in historical and comparative perspective.
The first panel is devoted to the monetary system that constitutes the somewhat neglected but critical condition for banking and accounting to exist and operate; it will investigate innovative monetary policies and possible reforms of the international monetary system, aimed at depriving money of its character of liquidity. The discussion will consider also the banking system, its current role in creating and absorbing liquidity, and its possible role in providing credit not based on liquidity. The second panel will discuss the accounting systems that proved to be central to the functioning of operations and entities in the current and past crises, comparing fair value accounting with alternative approaches. The final discussion will provide the opportunity to consider the interrelations among these various levels and to evaluate specific reform proposals with a view to enhancing the resilience of the economic system as a whole.

Andrea Sironi

Welcome Address

Good afternoon, it is a pleasure for me to be here. I wish to welcome all of you here. I think we have a very prestigious panel. Let me thanvk very much the Autorité des Normes Comptables (ANC), Monsieur Haas, who is co-organizing the conference and the journal ‘Accounting, Economics and Law: A Convivium’ which is also a co-organizer of the conference and, of course, professor Fantacci who has been working very hard on this conference. The subjects are very much hot topic nowadays. I am mostly a banking scholar. We all know there is a lot of work being done in terms of financial regulation. If we only look at Europe we have, for example, the Vickers Report in the UK, which is studying innovations in banking regulation, and at the same time the Liikanen Report in the EU, which is proposing quite significant changes in the way financial institutions are regulated. I have the impression that this seminar has two great advantages in dealing with these problems.

The first one is that it is very much interdisciplinary. So, it basically takes a look on all these problems on monetary systems, liquidity and banking looking from different types of perspectives. So accounting, banking, finance, economics and, of course, history.

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I have a very simple example that often comes to my mind when we deal with these issues that in some way highlights the importance of using different perspectives. And that is when the Spanish authorities introduced, a number of years ago, capital requirements that for banks tended to be less pro-cyclical. One of the problems we have with banks’ capital requirements is that they become more restrictive when the economy is in recession. And so banks tend to contract lending. Which is exactly what is going on right now: we are in a recession, capital constraints are very binding, and banks, even if they have liquidity (because they got it from the European Central Bank), are capital constrained so they cannot increase lending. The *Banco de España*, a number of years ago, introduced a very innovative provision, which I think was very clever, which was called “statistical provisioning” or “dynamic provisioning”. In some way they were asking banks to provision less in bad times and more in good times. Which is very reasonable, in some way, like saying: “You put aside more reserves when things are going well but when things get worse you can use these reserves”.

But, of course, when you do something like that – which is very natural and very reasonable from a risk management perspective, which is my perspective – it becomes very difficult from an accounting perspective and a tax perspective. This is because accountants rightly saw that we tend to say: “You can only provision when there is a loss, when there is an incurred loss”.

And so you cannot actually provision more in good times. And at the same time banks would say: “Ok, we can provision more in good times but we want it to be tax deductible” and the tax authorities would reply: “No, you cannot do that”. So, it is quite clear that when you have to deal with these problems, you need to take into account different perspectives all together: accountants, regulators, risk managers, finance people and, of course, macroeconomists. So, I think that is a very good perspective.

The other point I think is very important is that – it seems to me – you are very much focusing on liquidity which is a key issue nowadays. As you probably are aware, there are proposals by the Basel Committee for new liquidity requirements for banks. And these are themselves very problematic because it is very difficult to define liquidity: what are liquid assets that banks should hold? Some types of assets that we always thought were very liquid – think about government bonds during the recent sovereign debt crisis in Europe – resulted not to be so liquid. And also you are looking at institutional factors, which are, of course, very relevant. So, it seems to me that there is a very good mix of starting points for dealing with these problems. Thank you very much and I wish you all a very productive seminar.
Thank you very much, Mr. Rector. Hello to everybody and thank you for being here. We shall organize the workshop in the following manner. We will have a first session more focused on monetary issues, which will be moderated by professor Yuri Biondi. I will not introduce – nor moderators will have to introduce – the individual speakers since you all have the programs. Then we will have, after the coffee-break, a second session more focused on accounting.

**Panel 1 Money**

*Moderator Yuri Biondi*  

We plan to have two discussions, which look quite disparate but are indeed complementary from our viewpoint. At the end of the day we hope to convince you that money and accounting are strictly related. They are actually complementary institutions that lay at the connection of economics and finance. So Luca will start giving you this broader understanding of monetary-accounting issues; professor Zezza and Mr. Gréau will then go on discussing macroeconomic and financial perspectives on these issues.

**Luca Fantacci**

*The drawbacks of liquidity and alternative ways of organizing finance*

I have the task to make the opening remarks in this workshop. So I will try to give them an introductory character focusing on the main theme of the workshop which is indeed, as has been recalled, liquidity. Liquidity is a distinctive feature of the financial system, which plays an important role in accounting systems, monetary systems and banking systems. I will start by stating from the outset the main argument that I will support in my contribution.

The idea is that liquidity has traditionally been seen as a desirable feature of the financial system in all its different aspects. However, what the crisis has told us – and perhaps, even more than the crisis, what an appropriate and deep understanding of the financial system suggests – is that liquidity has dramatic counter-effects and perhaps is not as desirable as we are accustomed to think. At the same time it is possible and desirable to conceive alternatives, to conceive ways of organizing the financial system that are not based on the concept of liquidity.
I shall start by discussing briefly some of the reasons why liquidity is traditionally pursued as a desirable feature of the financial system, as a virtue – we can say – that has to some extent supplanted the traditional virtue of prudence as one of the fundamental principles of accounting and finance. Throughout the past decades – and I will not specify how many because, of course, it very much depends on how far back in history you are willing to look, and it is, I would say, more than three or four decades, as usually argued – liquidity has indeed been pursued as a distinctive feature of financial markets. Markets were made increasingly liquid by liberalization on a global scale in the assumption that this would ensure several advantages. Let me just briefly discuss them, though I am sure that most of you are familiar with the rhetoric of this discourse.

Liquid financial markets would favor the funneling towards financial markets of a massive amount of savings. Liquidity was perceived as the best way to make savings converge towards the markets. Moreover, liquidity was seen as the best way to allow markets themselves to perform their function of allocating savings towards the best, the most productive investments, thereby yielding the macroeconomic advantage of enhancing growth globally.

So the liquidity of markets was seen actually as a vehicle for growth, for innovation, for prosperity. At the same time – and I will only hint to the aspects that are more linked to accounting because, of course, this is not my task and I do not have the knowledge to go deeper in this subject, but it will be taken up by other participants – liquidity of the markets was seen as a condition not only to ensure the financing of enterprise but to ensure an adequate evaluation of the firms through the principles of fair-value and mark-to-market. The idea that the correct and appropriate evaluation of businesses was reflected in the market value of their assets rested upon the implicit assumption of the existence of liquid markets.

And at the same time, the shift towards fair value accounting was accompanied by transformations within the banking industries specifically, that brought banks more and more to focus and concentrate on liquid assets through various forms of financial innovations such as securitization and the increase of leverage in various forms. I will not insist on this because I am sure that you can think various other aspects in which liquidity has permeated the functioning of the financial system.
I will however suggest that already before the outbreak of the crisis, at least to the most acute observers, it was clear that liquidity had drawbacks as well as advantages, that liquidity was a double-edged sword which produced a new form of artificial precariousness in the financial system while attempting to cure the natural precariousness of financial relationships which is intrinsically tied to the uncertainty of the future.

By stressing the ambiguity of liquidity, of course – as certainly students will have understood and possibly other participants – I am referring, first and foremost to the work of J.M. Keynes, starting already from the early 1930s. Let me quote a passage of *The General Theory*, with which many of you will be familiar, that suggests the critical attitude that Keynes had towards liquidity as a fundamental feature of the financial system. It is a very famous quote in which Keynes says:

> Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of “liquid” securities. It forgets that there is no such thing as liquidity of investment for the community as a whole.\(^4\)

This is a very severe critique against liquidity, which has found echoes also in other observers more linked to the current practice of finance. I will just recall a remark by the chief economist of Goldman Sachs, Jim O’Neill, just before the crisis broke out: “Liquidity is there until it is not. That is the reality of modern financial markets”. Since the outbreak of the subprime crisis we have had compelling evidence of the fact that liquidity is indeed elusive. The liquidity of assets on financial markets made their actual liquidation possible. Thanks to liquidity there were rapid flows of money from one sector to the other of the financial markets, and from one country to the other. This resulted in an increased volatility of stock prices and in a sudden widening of the spreads on sovereign bonds. At the same time, the liquidity of investments implied that the money invested on financial markets could leave them just as easily as it had arrived on those markets, and even faster.

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This, in turn, produced further evil consequences throughout the entire financial and economic system: the losses on portfolio investments obliged financial institutions to restrict credit conditions for businesses; the hoarding of idle monetary balances produced deflationary pressures; on the other hand, the flowing of money to other sectors of the economy, such as foodstuffs and raw materials, caused a hike in commodity prices and inflationary pressures. The coexistence of such contrasting tendencies contributed to exasperate the sense of uncertainty. But the problems hit even more directly the accounting practices themselves. Fair value accounting in the wake of the crisis proved to be a problem. Not only was it counterproductive, being pro-cyclical and accelerating the negative impact of the crisis, as Mr. Rector recalled in his opening remarks. In certain extreme cases it proved also to be altogether impracticable, because the principle of mark-to-market could not be carried out in absence of an active market in certain sections of the system. Liquidity also proved to be a problem for the banking system. Even here, what was initially perceived as a blessing, eventually proved to be a curse.

The paradigm shift in banking from originate and hold to originate and liquidate – let me rephrase in these terms what is usually called originate and distribute – resulted equally pro-cyclical because it systematically underestimated risk on the upward swing and systematically overestimated risk and restrained credit on the downside.

Now, the question at this point is to understand the nature of the problem, to which the credit crunch and the crisis bear witness. There are two alternative hypotheses: the first is to assume that the crisis is caused simply by a lack of liquidity. The second assumption is to believe that the root of the problem is liquidity itself as a building block of the financial system. Quite clearly the policy response to the crisis has followed the first assumption, according to which the problem was merely a lack of liquidity. Accordingly, policy responses, particularly in terms of monetary policy, were intended primarily to restore liquidity.

The “quantitative easing”, which was inaugurated in the immediate aftermath of the crisis and is now at its third stage, represents the most obvious response in this respect. You need to reflate the economy by producing more liquidity in order to contrast the draining up of liquidity on the markets. The side-effects of such policies are possibly even more dangerous than the evils that they were intended to cure. Quantitative easing produces quite clearly moral hazard: both creditors and debtors get accustomed to bailouts and hence have less incentives to guard creditworthiness. Quantitative easing also produces inflationary threats, even if it does not immediately produce inflation, since the all the money that is issued by central banks and that has been hitherto mostly hoarded may sooner or later be put back in circulation and will at that point prove to be out of proportion with the goods available for purchase. In the meantime, on the other hand, monetary expansion is not proving to be effective in bringing out the expansionary effects that it was intended to produce.
Another reaction on the part of policy makers was to increase liquidity, not in the market, but on the balance sheet of the most fragile elements of the financial system starting from the banks. And here I refer, for example, to the principles of Basel III that were evoked even by professor Sironi just some minutes ago: the liquidity coverage ratio and the increased liquidity requirements for the banks. Even here, with negative side-effects. The more money is required to be on the balance sheet of the banks the less money is available for businesses.

A reaction was necessary also in the field of accounting. Again, here I am not an expert but I would just mention some possible ways of countervailing the shortfalls of fair-value accounting by restricting the scope of mark-to-market and making recourse, for example – as has been done for certain instruments – to a different principle of mark-to-model. And here it really reminds me of the famous joke about how economists solve the problem of opening a can when you don’t have a can opener, by simply assuming that you do have a can opener. It is quite literally a similar situation. You don’t have liquidity and, by making recourse to the models, you simply assume the problem away, since the fundamental assumption for the working of these models is that you have indeed efficient and liquid markets. So that is quite clearly a way of assuming away the problem.

The second possible way around the evil effects of fair value accounting is to expand the scope of its application by including in the principles of mark-to-market not only assets but also liabilities. This has been proposed, I don’t know how far it has been pushed in terms of practices, but it is, I think, equally dangerous in weakening the principle of prudence in accounting.

So I come to my conclusions that intend to open a different perspective, which is in fact – and I will insist on this – a perspective that in my view is more closely related to Keynes’s proposals. The countermeasures that I have described so far, especially the expansionary monetary policies, are frequently described as Keynesian policies. In fact, they are a very superficial reading of Keynes’s recommendations. Keynes’s way of getting out of the problem of liquidity was much more radical: it did not imply merely a change in policy, but it required a radical reform, with the purpose of removing liquidity as the main building block of the financial system. What do I mean by that?
Let me take another couple of minutes in order to illustrate what it would mean to build the monetary system and the financial system on principles that are not based on liquidity. I will have to quote further from Keynes in order to do that. Here is the continuation of the analysis of chapter 12 of *The General Theory*. After the critique comes the proposal. Keynes says:

*The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only.*

You can see here that Keynes proposes in fact to put the financial system upside down. Not liquid investments but in fact illiquid investments, indissoluble investments, permanent like marriage. Perhaps today we should say: “More than marriage”. And, of course, Keynes is not unaware of the counter-effects of this. He says: “Of course if we make investments permanent and fixed this may attract less savings towards productive investments”. But here is the interesting point. I will skip directly to the crucial statement:

*If individual purchases of investments were rendered illiquid, this might seriously impede new investments, so long as alternative ways in which to hold his savings are available to the individual.*

This is the point: The liquidity of investments relies, in fact, on the liquidity of money itself. Illiquidity will represent an impediment and an obstacle to investment only as long as there is the possibility for investors to retain their savings in liquid form, in money, in hoards of cash. And this is basically where we stand today in 2013: the possibility of holding savings in the form of money is a major obstacle towards productive investments. And the radical cure to this is to introduce a reform at the same time in the monetary system and in the financial system.

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5 Ibidem, p. 160.
6 Ibidem.
On the financial system you want to encourage long-term investments in the form of, for example, of venture capital and long-term investments according to the principle of participation in profits and losses. And, at the same time, you want the monetary system not to afford this easy way of escape, this easy refuge against uncertainty, which is represented by liquidity in the sense of ready cash. So the issue here, in terms of the monetary system, is to deprive money of its character of a store of value, of liquidity.

Let me give you an example here that has been mentioned recently in order to go in this direction in Europe. We know that one of the problems is that the European central bank has created massive amounts of liquidity that in fact do not circulate because they are re-deposited by the banks back at the ECB. Now, one possibility that has been proposed by Massimo Amato and myself, but also by others, is to tax excess reserves of commercial banks with the European central bank in order to encourage these reserves to be put into circulation. This is one way of reminding that there is no easy escape from the need to make liquidity actually flow through the system.

Another proposal which is, of course, of Keynesian origin and that we want to put on the table for the discussion today is to encourage – for the purpose of providing circulating capital, short-term credit to businesses – the adoption of clearing systems between businesses according to the model of the Clearing Union proposed by Keynes as an international monetary system. This model, if adopted by banks as a way of funding private businesses, could in fact reduce their liquidity requirements because it would allow them not to keep money on their balance sheets for the purpose of funding current business. But I am sure we can discuss this during the debate. It was just to raise the issue at the beginning of this workshop, since this is what we will actually discuss about today: what kind of monetary, banking and accounting systems can be conceived that do not need to rely on liquidity as their basic concept? I will conclude here, I am sorry if I was a bit too long, and I thank you for your attention.

**Moderator Yuri Biondi**

Thank you, Luca. Let me just recall a practice recently introduced by UBS (and Credit Suisse). If a financial institution deposits money at UBS, the private Swiss bank, on a cash clearing account, then it may have to face a charge for its credit balances. This policy is adopted nowadays by private banks precisely in order to avoid excess deposits held in Swiss francs by overseas institutions.7 So perhaps central banks could do the same. I will leave the floor to Gennaro Zezza, who will take a macroeconomic perspective on the monetary system.

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7 Financial Times (2011), « UBS introduces fees on franc deposits », by Alice Ross, December 11.
Gennaro Zezza

An international Clearing Union to address global imbalances?

Thank you, Luca, for inviting me here. I hope I will be on topic with the main theme of this workshop by discussing possible alternatives to the organization of the monetary system from various perspectives. I will focus on the international monetary system, which is a topic on which I have been working for some time, and on which I am still working.

The real trouble with the current international monetary system of payments, both at the world level and at the Eurozone level, is related to ‘global imbalances’, that is to say the persistent deficits of some countries, notably the Unites States, which are matched by persistent surpluses by other countries, now notably China. In the Eurozone we have a similar imbalance with Germany and other core-countries running persistent trade surpluses vis-à-vis the other Eurozone partners in the periphery. The trouble with the institutional setting both at the world level and at the Eurozone level is that there is an intrinsic ‘deflationary bias’ towards addressing these imbalances, meaning that – as Keynes pointed out in all the documents preparing for the Bretton Woods conference – the system is built in such a way that only deficit countries are responsible for addressing the imbalances, and they do this by deflating their economy. This implies a recession; which spills over to other countries.

Figure 1 shows the imbalances at the world level according to projections by the IMF. You can see that, with the great recession starting in 2006, the imbalances were reduced, but they are projected to stay with us. The persistence of imbalances has started and then revamped the discussion on how to reform the system.
When I was preparing my talk for this workshop I started from previous slides I prepared some months ago, which focused only on the world situation, and I was making references only to the literature on the international monetary system at the world level, where the US dollar is the predominant reserve currency and there are some countries which are pursuing export-led growth – notably China – by trying to manage their exchange rate and by accumulating US financial assets. As I updated my slides, I realized that there are striking similarities between the global scene and the current Eurozone setting.

Figure 1. Current account imbalances
The point is that, in this kind of system, we can have stability for a very long time. There are some countries, say China, which are successfully implementing an export-led growth strategy, where strong demand for their goods translates into rapid growth in their industry, rapid growth in employment and so on. And another country, in this case the United States, is buying goods in exchange for pieces of paper. So, apparently everybody’s happy: the Americans are enjoying what we may call excessive consumption, while the Chinese are creating jobs and income. The trouble is that the process is intrinsically unstable because, as the debt of the United States piles up, there is a possibility that the dollar could devalue, and if it devalues, China will suffer capital losses on the large amount of dollar-denominated reserves that she has accumulated. The situation in the Eurozone is similar, even though we have a common currency: one or more countries are relying on exports for growth and they are willing to, or they have been willing to, lend to their trading partners in order for their trading partners to buy more of their goods. So the process had been stable for a long time until the crisis started, of course – as Luca was pointing out: ‘liquidity is there until we find it is not there any longer’. The point is that you cannot have export-led growth for one country without some other countries accumulating debt. It is impossible – as it has been suggested – that the end of the Eurozone crisis is for all Eurozone countries to adopt an export-led strategy because this would imply by definition that some other country is willing to hold an increasing number of liabilities – if all are pursuing export-led growth, who remains, who is willing to borrow?

The mirror image of the trade imbalance is that an export-led country is accumulating claims on other trading partners and they are not willing to spend these claims. I think that this is very close, if not exactly the same thing, as the problem of missing liquidity that Luca was pointing out earlier and that is actually showing up in the Eurozone’s accounts.

The situation was revealed by the explosion of the public debt, but basically both at the world level and at the Eurozone level the explosion of public debts is just the continuation of an unstable situation which pre-existed but has more or less the same characteristics. So, one way out of this, if we do not want to reform the financial system, is to allow countries to run a deficit if you want to have some countries which pursue trade or current account surplus.

We need to have some stable willingness to accumulate financial liabilities as well as financial assets.
The trouble is that there will be intrinsic instability processes in this system. As pointed out already, some of these problems at the Eurozone level are revealed by the TARGET2 system in the European central banks. And, as I was pointing out earlier, if we let the system continue then we could go on for many years – and we have been going on for many years – but at some point in Europe someone will suddenly stop playing the game.

This happened in Greece, when the Greek government revealed that the deficit was excessive, and immediately the markets became illiquid and there was no more willingness to lend either to Greece or to other countries running deficits; and these countries were forced to adjust their government deficits through austerity measures. So the countries that were already in a troubled situation, with large foreign debt and large foreign interest payments, had also to implement austerity measures, which we later found had perverse effects on their income and therefore on their ability to raise taxes and to pay back the debt. And this is bringing down the whole system to a crisis.

The trouble in the Eurozone is that the system has been designed to be, in a sense, a closed system, where the ECB is not allowed to provide additional liquidity when liquidity dries up. And here I would like to comment on what Luca was saying before about the quantitative easing measures that have been taken. Similar measures have been implemented by the ECB, which put on its balance sheet a lot of financial instruments that were usually not allowed as collateral. But the trouble is, in my view, that this is only shifting assets in the balance sheet of the central bank and of the banking system. If instead the ECB were allowed to finance directly government debts, since the government deficit is incurred because the government is actually spending more money than it is collecting through taxation, this would imply an immediate increase in the liquidity of the private sector, which is not necessarily the case if liquidity is provided to the banking sector which may decide to keep it as a reserve for insurance purposes. So, I think that a necessary shift requires that the ECB abandon one of its features, which is its impossibility of directly refinancing government deficits. Of course, this may cause moral hazard problems – as
Luca was pointing out – but we have to pay some price.

I don’t know how much time I have left, but I want to say also some words on some methodologies that we are adopting to try to address this issue in a systematic way. We started working at the international level from ideas that were revamped by the governor of the Bank of China which called attention again to the Keynes’s plan for Bretton Woods, and proposed either to change the rules governing the World Bank and the IMF, or to create a new international institution which would act as a Clearing Union in the spirit of Keynes. We are trying to address this with the so-called stock-flow consistent approach, which was initiated by Wynne Godley in Cambridge in the 70s and by James Tobin more or less at the same time in the US. The main feature of this approach, which is a macroeconomic approach based on national accounting, is that any macroeconomic model should have an explicit representation of the accumulation of financial assets for each institutional sector which comes out basically from the saving of each sector (so the saving of household, firms, banks, government and the rest of the world). And each of these savings implies a change in net financial assets, either an increase in net assets or a decrease in net liabilities or the other way round. Model consistency requires having an explicit representation of the implications of the accumulation of these stocks on future decisions. An accumulation of debt has to imply future interest payments, and our accounting system has to specify what are the implications for aggregate demand and the distribution of income of these interest payments both domestically and at the international level.

We started to lay down a model of the world as it is today, with the dollar as reserve currency, and then we tried to lay down in detail, on the basis of Keynes and other authors who elaborated on that, how a Clearing Union could be implemented.
Our model relates to monetary payments at the international level, but there are many similarities with proposals for reforming the Euro and transforming the euro into a common currency for trade or a unit of exchange, and it also has similar features with the introduction of a Clearing Union at the local level. So, if you introduce an institution which clears accounts by a new money, which Keynes called Bancor (which is just a unit of account), the first problem is: how is this money introduced? I have seen very different proposals: for instance, that each country which wanted to adhere to the system should get its quota of Bancor at the Clearing Union in exchange for gold. And I don’t really see why this should be necessary, because in principle the Clearing Union would work only with a system of fiat money where, when a country is selling goods to a different country, its Bancor account at the Clearing Union is credited and the Bancor account of the debtor country registers an increase in its debt. Most transactions will clear out, and at the end of any accounting period there will be countries with a deficit and countries with a surplus. Mechanisms for automatic readjustments have to be put in place. One of these mechanisms is exchange rate realignment; and the other adjustment mechanism will be interest payments which should be debited both to the debtor countries and to the creditor countries, so that we introduce a symmetry in the adjustment towards a stable configuration of trade. This should provide less incentive for a country to push an export-led growth, but may cause problems: if the only cost that we incur by importing more than we are selling abroad is to have an increase in our Bancor deficit position at the Clearing Union, this may look like a free lunch. So, there may be some problems if all countries try to pursue a free lunch approach. I guess that the same problem will apply at the local level if you want to introduce a clearing system between firms, workers and banks in a given region and you introduce a new currency which can be used for clearing. How much can we trust this currency? Can it be convertible or not? For instance, Keynes proposed a convertibility in one way so that we can get Bancor in exchange for gold but we cannot get gold in exchange for Bancor. So, the rules of the game must be laid down quite clearly.

And the other question – possibly the last thing I wanted to say – is that: will this end the desire to hoard money? We introduce a new currency, which is just a unit of exchange and does not serve as a reserve asset. Will this end the desire of countries to insure against future circumstances? Or will this shift the hoarding process to some other assets? I understand Luca’s proposal of trying to solve the liquidity problem by making it impossible to hoard liquid assets. But if there is a legitimate instance for hoarding assets for insurance against future losses in income or whatever, this may just shift the problem from one financial market to the other, or possibly to markets for real assets.
The other possible problem of a new financial system at the international level, of a Clearing Union, is: will we allow portfolio investments if we introduce the Clearing Union for regulating international trade? Because if we don’t, then the Clearing Union and the Bancor, even if they are well designed, may not end the problem of trade imbalances, because if a country wants to keep its exchange rate undervalued, it can purchase an increasing amount of foreign assets, or make the opposite operation to try to manage its exchange rate at different levels from what would be required for trade balances. So, any change in the rules governing the monetary market may have implications for the international mobility of capital.

In our simulations the model shows that, indeed, if we introduce a system based on the Clearing Union and the Bancor, it will reduce global imbalances and provide the path towards stability. It also shows that we have to design quite carefully how the parameters of the system are set because if interest rates are not set at the appropriate level, or if the proceeds of the Clearing Union (which gets interest payment and therefore has some money to spend by transferring Bancor balances to some country) are not designed carefully, then the system may not be so stable.

The real trouble is: is all this feasible? Because the benefits of changes in the rules of the game may not be so obvious to the countries which are now benefiting the most from the current system. So, in a sense the United States at the world level, Germany and the other core-countries at the Eurozone level. Possibly the benefits are becoming more evident now, with the crisis. In the end, any unsustainable set of institutional arrangements generates crises, and when crises hit, all countries in the system are worse off.

**Moderator Yuri Biondi**

Thank you, Gennaro, for having introduced us to a simulation approach, which tries to identify various variables of the monetary system and describe the management of this new kind of monetary system. And thank you also for raising some underlying issues at the political-economic level. I now give the floor to Jean-Luc, who will further address them from, I suppose, an industrial and political-economic perspective.
Jean-Luc Gréau

Instability out of control. Thirty years of financial liberalization

Good morning to everyone. I am very pleased to be here, invited by Massimo Amato and Luca Fantacci, and by Bocconi University that I know by reputation but not visually since it is the first time I come here.

I would start from a political observation. Our managers, politicians, economists, policy-makers, journalists, they all believe to know what money is. But myself after fifty-two years of being an economist I do not know what money really is. The classical definition of money as a store of value, a unit of account and a means of payment is a schizophrenic definition. There is a violent contradiction between the function of store of value and the function of means of payment. I will move from the position of Keynes that does not solve the issue but allows to state it explicitly, and according to which money is the most liquid asset. It is from this prospective that I will attempt tell you the story of the past thirty years of financial liberalization.

But before proceeding I should remind you that money can be affected by two different forms of disease: deflation and hyper-inflation. Deflation is characterized by the so-called liquidity trap, a situation in which economic actors prefer to maintain their wealth in liquid form. Hyper-inflation is characterized by the opposite situation, where there is literally an escape from money in order to invest one’s wealth in real goods. Every time I think about monetary issues I keep in mind these two extremes as reference points for my understanding.

I will now try to say what is the central point that characterizes the experience of the past thirty years of financial liberalization. This experience, this attempt of liberalization, can be summed up in the goal of transforming financial assets and real estate in a liquid form comparable to that of money. In this sense it is an anti-Keynesian attempt. We would have to describe three major transformations that have occurred over the past thirty years and with which you are all familiar.
The first is securitization or ‘titrisation’ in French. Starting from the 1980s banks have increasingly tried to put on the market the huge majority of the loans that they had issued to their customers. I saw this problem working with the CNPF (which is called today MEDEF), the employers’ organization in France, when French banks established a working group to study securitization. This transformation has deeply affected the nature of that peculiar commodity which is a loan. The loan is a peculiar product in so far as it is produced both by the lender and by the borrower on one side and the other. As a consequence of securitization the responsibility of banks as lenders was reduced. Certain categories of loans were securitized at 100 per cent. It is also important to underline that the governments have, without exclusion, given their blessing to this practice. So banks have abandoned their original function of lenders to take up the rather different function of brokers.

The second issue is collateral. “Collateral damage” was the title of an article published on the Financial Times on the 25th October 2012. It is a pun: the fact of adopting a collateral (guarantee) turned into a damage. It is the capacity to create a collateral that creates the possibility of issuing a loan. What are the different types of collateral that can be given? The first is stocks, the second is warrants, and the third is mortgages. I will insist on mortgages since they are at the basis of the crisis of 2007. It is not an English word, it is a French word. Mortgage is the *gage saisi sur la mort*, namely the guarantee on the death, and it comes from a medieval expression in French. So, a mortgage is conceived in view of facing a situation of force majeure.

Now we are not in the Middle Age and mortgage has a very different meaning. I will not insist on the various types of securitization, CDOs and CDS, but I will underline the fact the mortgages are a pro-cyclical element in the financial system. There is an apparent virtuous circle: the volume of credit increases, the price of real estates increases and the price of the securitized mortgages also increases. Up to the moment when the crisis breaks out, when exactly the opposite occurs. This is precisely what happened in the United States, in the United Kingdom, in Spain, Ireland, Australia, Hungary, Canada, Sweden and the Netherlands.

I will take as an example the clear illustration given by Spain. Once you securitize mortgages, these can be easily sold on international financial markets. And this is the reason why Spain between 1997 and 2007 was one of the countries where banks made less recourse to central bank lending. In Spain banks issued twice as much credit compared to the European partners but they asked half the amount of money from the European Central Bank, since their primary source of funding was the international financial market.
So I come to the third major transformation with which you are all familiar: the independence of central banks. And I arrive at the following observation as a form of conclusion. Today central banks and commercial banks form a united whole (un ensemble solidaire). What I mean by this is that central banks cannot perform their monetary policy autonomously because they have to continuously help commercial banks and bail them out. I will give two illustrations referring to the monetary policies of Ben Bernanke and Mario Draghi.

The first is known under the name of quantitative easing. What is quantitative easing? I would try to explain it in an original manner compared to what you read in financial papers. Quantitative easing brings us in the middle of the issue of liquidity. With quantitative easing the central bank takes out of the market public and private credits and puts back into the market liquidity. There are less assets on one side and more money on the other.

The second example is the injection of 1,000 billion euros by Mario Draghi between December 2011 and February 2012. The central bank did this in order to afford sufficient credit to financial intermediaries through the Eurozone and beyond in order to allow them to face their commitments. If the central bank had done this directly for the benefit of the firms you would have said that it had done this as a form of an undue help.

I arrive to three conclusions.

The first consequence of all this was an increase in instability, in uncertainty and hence in insecurity. Financial crises repeat themselves, they continue and tend to become more and more frequent. The crisis in South-East Asia in 1997-98, the crisis in the United States in 2001, and the crisis both in America and in Europe in 2007-10.

With my second conclusion I arrive to a point that was also made by Gennaro Zezza. The great monetary zones are no longer closed. In 2008-2009, the American banks brought several hundred billions dollars in assets to the ECB and received money in exchange; and European banks did the same at the Federal Reserve. This shows the contagion of the financial instability from one side to the other of the Atlantic. This also exists within Europe itself.

The third and last conclusion is that central banks are put in a corner. As remarked by Luca Fantacci in his own presentation, by making quantitative easing and helping private banks, central banks have arrived to reduce interest rates to zero. What else can they do now? The issue is quite simple. Businesses have an accounting which is primarily an accounting of flows and subordinately an accounting of stocks. For banks it is the opposite. Today the banking system has a huge amount of credits the value of which depends on the low interest rate. Once the interest rate decreases the value of credits increases and vice-versa. If central banks should increase interest rates by two points in England, United States and Europe, they would run the risk of making the entire financial system collapse.
Moderator Yuri Biondi

Thank you, Jean-Luc, for having stressed some monetary issues that lay behind the problems we are discussing. We open now the discussion to the audience. If you have some comments, remarks or questions to our speakers, they are welcome.

Discussion

Question. Daniel Sacerdoti (Student, Bocconi University)

A topic that I think is very important and that has never been directly touched upon is the political willingness to change the financial system and somehow to abandon the idea of liquidity that shapes the entire system. What is your opinion about this?

Luca Fantacci. I believe that it is not so much that there is no political willingness to address these issues but that there is no clear idea of how to get out of these problems. This is the reason why I it is important to work out a theory, which is capable of understanding at what level the problem actually is. Otherwise, even if you do have the political willingness, this willingness eventually bumps into vested interests and into the impossibility – as Mr. Rector was saying at the beginning of the workshop – of changing a piece of the financial system without changing the rest. So really the precondition is not a political willingness, but a view of the financial system as a whole, in order to try to change it coherently and consistently.

Gennaro Zezza. I think it is a very delicate topic because the political willingness depends on the current conditions of power. So, as it has been pointed out, there are some social groups that are getting benefits from the current situation and in many cases they are supporting the government not to change the course of the events. And therefore the political willingness for such a change requires a shift in the electorate towards governments that are willing to address these issues. Not everybody agrees that these are the problems and these are the solutions. The current state of the events is clearly making some social groups gain and these are winning so far.
Jean-Luc Gréau. There is a point, which is not clearly seen by all those who talk about reforming banking. It is the banks that underwrite the loans to governments according to the procedure that was established thirty years ago of primary dealers. This has worked extraordinary well. States could be mismanaged with the approval of the banks. Now we have an appointment with history. And the banks require a drastic change in the way states are managed in a moment when we are already in a recession. These were the conditions that were attached to saving the states within the Eurozone. In May 2010 there were various possibilities like restructuring deeply the Greek debt and maybe organizing the exit of Greece from the Eurozone. The French president advocated a different solution, which consisted in saving Greece in order to save Greece’s creditors, namely the French banks and the German banks. I have nothing else to add.

**QUESTION.**

Massimo Amato (Associate Professor, Bocconi University)

I have a question for Gennaro Zezza. You raise a problem concerning the abolition of the store of value suggesting that if we abolish totally the store of value we have a problem of insurance, if I understand. Don’t you see a difference between a reserve assets and a store of value?

I mean, every reserve asset is an insurance, but it does not imply the abolition of risk. It is itself risky in a sense. While the store of value is the dream of abolishing every risk for the owner of the store of value. Do you agree with this distinction? And, if you do, what are the implications for your points.

Gennaro Zezza. I think I agree with you. I am not sure about the implications. But in a sense we can set up, as I see it, a mechanism for transferring purchasing power into the future which does not need to be liquid. But I guess this implies a very strong formal trust upon the institutional mechanism which guarantees this. Think of the pension system. I can do without liquid assets if the pension system is such as to guarantee my purchasing power in the retirement. If I don’t trust the institutional setting, then I will want to have some hoarding as a guarantee. I don’t know if this answers your question.
Don’t you think that this idea of ensuring purchasing power in time is the very reason for the asymmetry in the adjustment between debtors and creditors? If you imagine that the owner of the store of value has the absolute right to see preserved his purchasing power over time, implicitly you see the creditor as having the right to keep his position and to shift the burden of adjustment on the debtor. This is the technical point. If you advocate symmetry in adjustment in restructuring you have in a sense to put into question the structure of the store of value.

Luca Fantacci. Just to follow up on this with a question for our experts in accounting, I wonder: even from the point of view of accounting, I would assume, it is quite different to have an asset in the form of money strictly speaking, a legal tender, a store of value, and some other kind of asset which might be a precaution, which might be a form of a store of value like gold or diamonds or something else, but it does not have a fixed value in terms of the unit of account. So, what actually characterizes money, I would say in this respect, is the fact of being legal tender. Something that you know in advance that it gives you the possibility of paying any kind of debt at a predetermined value. And that is peculiar to money. And if you take that away of course you can save something else but no one has the possibility of preserving value *stricto sensu*. You preserve always a thing, some kind of asset, but not value in itself. And this, I think, would have implications, even in terms of how record are kept, and accounting works, and hence business behave.

**QUESTION.**

Yuri Biondi I have a question to the three speakers. Do you think that debts should be repaid?

Jean-Luc Gréau. It is simple. In Europe almost all countries are insolvent. Finland is solvent, Luxembourg is solvent, maybe Germany is solvent. Once you have passed a certain threshold – the concept of threshold is crucial in economics – once you have passed the threshold, you cannot manage to reverse the situation, not even with a good management of public finances. But the peculiarity of Europe is the fact that the greater part of these public debts lies on the balance sheets of banks, of insurance companies and of pension funds. And they are not on the balance sheets of the households. Because if this were the case, the partial bankruptcy of states would be obvious. The states would be saved and we would be paying for that.
Gennaro Zezza. Any debt is a means of transferring income and wealth. Any debtor has a creditor, so if you want not to repay the debt you also want the creditor to lose his assets. So if you are happy with this, it is ok. Somebody for Greece said: “Well, the creditors of Greece are German and French banks and there are no Greeks who are creditors of their own government, so let’s default on the debt and let the Germans and the French bear the cost and Greece will be ok”. It is not so clear that this is the situation, as I understand it. First of all there is a sizeable portion of Greek debt, which is held domestically and there is another sizable portion which they cannot default on. For Italy, I would say, it is not the case to default on the debt because it is true that the pension funds are holding public debt, but if a pension fund goes bankrupt then the retired people who should get their pension from it would lose their income. So, this is not something that I am looking forward to. What I think is a completely different story: who should set the interest rate on government debt? Because the trouble we have in Italy is that we are paying a “spread” because of a political decision not to have the central bank financing the government. If this political decision were changed we would reduce by 80 billion euro a year in interest payments, the government would be in a surplus and we should not worry about the repayment of debt. So we would be better off.

Luca Fantacci. I think that you, Yuri, raised the crucial issue by asking whether debts should be paid or not. I would perhaps rephrase the question in these terms. The fundamental issue for the financial system is whether debts should be made payable or not. Of course, contingently we have the problem of deciding whether specific debts, public or private, should be paid out or not – the case of Greece. But before you arrive at that point the question is: do we issue within our financial systems debts that are intended to be paid out or not? And in this case public debts are quite clearly an example of debts that are originally issued without even envisaging the need for those debts to be paid out. It is not even in the cards. It is not discussed at the European level – or anywhere, for that matter – whether governments should pay out their debts, whether they should get back to zero. The furthest you go is that they stop accumulating debts or they go back to some sort of threshold of 60% of GDP. But that’s not paying out your debt. And of course I am not saying that they should be paid out. I am saying that we should question a system where it is a fundamental feature of certain debts to be simply floated.
The public debts, like the debts of central banks, are liabilities that are simply issued in order to be circulated and not to be paid out. It seems obvious for us. If we take the model of money creation that Gennaro described before, this is not the case. In the Clearing Union money is created in the perspective of being destroyed or reabsorbed. And this is a change in paradigm that we should keep in mind because there is a reason why Keynes called this money bancor. That’s because he was inspired by the functioning of banks. This is how banks actually work and create money, by giving anticipations in view of reabsorbing these anticipation. And this is crucial because if this is managed appropriately I think it really sets the monetary system and the credit system back on its feet. Because it tells you that from the perspective of the economic system as a whole the prudence, meaning the precautionary motive, is satisfied not by the accumulation of money but by the presence of actual goods.

From the perspective of the economic system as a whole it is obvious: the only precaution is having some kind of good - investment goods, consumption goods, commodities, raw materials, whatever you want. This means that when it comes to individuals you can always provide money that you need to spend unexpectedly by a sort of anticipation. So even in this case, if you look from the individual point of view, what you need is not money but credit. My question is: what are we doing with all this money around, if it is not in the interest of the individuals nor in the interest of the economic system as a whole? It’s the other face of payable debts. I mean, there is so much money which is not spent because there are so many debts that are not paid out, and vice-versa. They are two faces of the same problem.

**QUESTION.**

Andrea Papetti (Student, Bocconi University)

A crucial issue that has been raised more or less implicitly is that the central bank needs to be a lender or market maker of last resort. A quite radical way to derogate from the liquidity principle is to think of the central bank as a market maker from the very beginning. Indeed, I think that Gennaro Zezza tried to do this with his stock-flow consistent model. We can think of central bank as a market maker à la Keynes as a Clearing Union. And then the question is, and professor Zezza raised it, what is the role of portfolio investments in this case? I would like professor Zezza to elaborate on this. I think that portfolio investments are the core of current-day finance. So the question is: can we derogate from the principle of liquidity by making the central bank work like a Clearing Union without eliminating portfolio investments? What is the trade-off that you faced in modeling the Clearing Union with stock-flow consistent models?
Gennaro Zezza. When I mentioned portfolio investments I was thinking of, say, the central bank of China, or Japan, buying US treasury securities. I was not thinking of individual investors buying stocks on the market. They are two completely different things.

We had capital controls at the international level for many decades and this helped prevent crisis. On the other hand they did not prevent investors in the domestic markets to purchase whatever form of assets they wished to. I think that Keynes also suggested that finance should be local rather than international, because it is true that if you let capital move around you increase the possibility of financing investments, but it is also true that you increase the risk of the funding being withdrawn, generating a crisis. The price of eliminating again international capital mobility is a price we can pay for the elimination of international financial crises. We have indeed to pay this price.

Luca Fantacci. Just following up on this. When we talk about capital controls and restrictions I think we should bear in mind that we are not talking about prohibiting capital movements altogether, we are just talking about restrictions on short-term portfolio movement. This allows full scope for long-term investments like foreign direct investments, which were indeed included in Keynes’s vision of the post-war world. We are not saying no financial relation altogether. Just some specific type of financial relations.

Yuri Biondi. Just to mention the fact that the International Monetary Fund has recently reintroduced the possibility of capital controls because of challenges associated with rapid capital inflow surges (including those targeting real estate) or disruptive capital outflows which are endangering macroeconomic and financial stability of the monetary system.8

QUESTION.

Unidentified student.

One question to Monsieur Gréau. What are the origins and the causes of securitization, let’s say in 2004-06, when the cost of money was already low, i.e. the need to put more money inside the system and to make the credit at the end even less expensive?

Jean-Luc Gréau. I think I can say that the origin of securitization was the high inflation of the 1970s. The 1970s represent a phase without precedents in recent economic history. A strong inflation, but not hyper-inflation. A reduced growth, but still a growth. And of course the end of the Bretton Woods system that caused an instability and an insecurity that did not exist before. It is important to note that in the post-war years of sustained growth, banks consistently accompanied this process of economic growth. In the 1970s banks had to face the new conditions, and most of all the risk represented by big businesses, whose liabilities were assumed by the banks themselves. The banks tried to reduce their dependence from these customers represented by big businesses.

This lead to a major intellectual overturn that questioned the approach that had been undertaken in the post-world war. We have to bear in mind that the 1970s even public opinion rejected inflation. This is the way in which Mrs. Margaret Thatcher arrived to power. It was clear at that point that the post-war economic system had come to an end and we had to find a way out in one way or another.

Jérôme Haas. All this is true, and on top of it banks continue to make money. Especially when interest rates are low you have to invent something else to make money, and this proved to be the beginning of this alchemic invention that helped financial markets to develop and to become the gold mine that we were not even dreaming of.

Luca Fantacci. If I may add another element, I think that there was an interest, for all these reasons, for banks to securitize and put on the market these products. But there was another element: they knew that they could find a demand for these products. And they could find a demand because there was already a world-wide inflation of money, of liquidity. So, liquidity was searching for different outlets and it was willing to invest in more risky products.

Yuri Biondi. Probably I have some bad frequentations: I have been working with lawyers and sometimes I can say that the reverse is true. Economists always struggle with finding bottom-up explanations. All occurs as if a spontaneous order is the sole order in place. However, concerning the monetary system, it is much more a matter of regulatory reform and top-down artificial design. Policy-makers decided to give up the gold-exchange standard (on August 15, 1971, US President Richard Nixon issued Executive Order 11615, pursuant to the Economic Stabilization Act of 1970, (Pub. L. 91–379 - 84 Stat. 799), which "closed the gold window", ending convertibility between U.S. dollars and gold), dismantling the Bretton Woods system.
This move actually provoked an instability in the exchange system because creditor countries holding reserves, especially oil reserves, aimed then to protect the value of their credits and reserves relatively to the dollar which was expected to devaluate because of that move. Inflation occurred as a consequence of a sequential strategic game triggered by that move. And that move factually introduced a breach in the regulatory financial architecture, which policy-makers decided voluntarily to replace with market-based financial regulation, which is a non-sense because no such a thing as one ‘global financial market’ exists. Sorry to be quick and crude.

Panel 2 Accounting

Moderator Luca Fantacci
We are ready for the second session of our workshop which is more strictly focused on accounting issues and the first contributor to the session is Shyam Sunder at Yale, so we will see him and listen to him from Yale, from the video.

Shyam Sunder

Accounting Antecedents of the Financial Crisis

Thank you, Luca, Yuri and Jérôme. I apologize for speaking to you through video connection from long distance and I appreciate your willingness to accommodate me. In these few minutes, I’d like to talk about some accounting antecedents of the financial crisis.

First, the previous major financial crisis in the United States and in a large part of the rest of the world in the 1930s gave rise to new laws, regulations and attempts to fix financial reporting. Since then we have seen continual growth of written standards of financial reporting. Compared to the pre-1930 era, in which, at least in the United States, financial reporting was based on what was called the “generally accepted accounting principle” (GAAP), practice of accounting has become increasingly dependent on written rules.
The GAAP was a social-norms concept, which meant that with few written standards, accountants and managers used their professional judgment to decide on treatment of transactions and to prepare financial reports. That applied not only to the banks and financial services industry, but also to the other industries. That has changed gradually since 1930s and by now, 75 years later, we have come to depend significantly on standards written by national authorities in various part of the world. In the last decade, in many countries of the world, especially in Europe, this has meant reliance on standard written by the International Accounting Standards Board (IASB). I shall argue that this growth and dependence on written standards of financial reporting is an important element of our recent and current problems.

Second, written standards make financial reporting susceptible to mathematical financial engineering. Developed over the last 30-40 years, financial engineering has created a situation, which enables experts to design new transactions, new securities and even new kinds of organizational forms to defeat the purpose of financial reporting standards and regulations. Teachers of accounting, who try to get the students to learn how to prepare good financial reports, cohabit in business schools with our colleagues who teach them techniques of financial engineering to avoid the consequences of financial reporting standards. Financial engineering techniques are directed to finding ways of not showing liabilities on balance sheets, making income statements look better. Some of these methods have acquired familiar labels such as off-balance-sheet financing.

What is off-balance-sheet financing? It is to take off from the balance sheet things that should have been there as liabilities. With such goals, financial engineering stands in direct conflict to financial reporting. I mention it here because, as the accountants increase their dependence on written financial standards, they unwittingly make it easier for financial engineers to evade the intent, and reduce the effectiveness of financial reporting standards.

When we dispense with social norms, or reduce the scope of professional judgment, or create an environment in which exercise of proper professional judgment becomes less likely, we become more susceptible to financial engineering. I shall argue that a major aspect of the financial crisis had to do with this interplay of financial reporting and financial engineering.
I should point out that it takes many months, even years in some cases, for the bodies writing standards of financial reporting to write a new rules. Yet it probably takes mere hours or minutes for engineers to devise a way around them. This means that written financial reporting standards are almost guaranteed to lose in their battle against financial engineering. And the more financial reporting depends on written standards, the more prone it becomes.

Third, traditionally, and in most walks of our lives, when asked: “What do you understand by risk?” The common sense meaning of risk in most domains of our lives is the possibility of harm, injury or loss. That is true in medicine, sports, engineering, insurance, credit, or regulation. When a creditor mentions risk, it is the risk of default or the chances that the debtor will not pay the creditor. In sports, it is the risk of injury. In insurance, it is the risk of an accident or fire, for which the insurance company may have to pay a claim from the policyholder.

In 1952, Harry Markowitz suggested a new definition of risk based on the dispersion of outcomes. Under this definition, the further apart the various outcomes of an uncertain process are, the more risky the process is supposed to be. Markowitz himself had doubts about whether it is a better concept of risk. But his variance concept of risk has been widely adopted in the equity part of financial literature and in certain branches of economics, in spite of the fact that in insurance and credit markets it’s the tail risk—the risk of loss—that matters. This displacement of risk-as-harm to risk-as-dispersion-of-outcomes has had consequences. One of the consequences is that accountants abandoned prudence. Prudence was the protection against tail risks—the risk of loss, injury or harm. The way the prudence criterion in accounting tried to protect against tail risks was to tell the accountants and managers of corporations not to overstate their revenue, income or assets. When uncertain, they were supposed to err on the side of understating their revenue, income and assets, and overstating their liabilities. The prudence criterion was applied to try to control the exposure to risk of those who relied on financial reports. This is the well-known principle of conservatism in financial reporting.

Equity part of the finance literature switched to the dispersion measure of risk leaving little room for prudence to fit in because prudence meant a downward bias. So logically, prudence went out of the window. Indeed, following the recommendations of the Financial Accounting Standards Board and the International Accounting Standards Boards, accountants dispensed with prudence and conservatism as the criteria to be applied in financial reporting, and claimed to have rendered the financial reports unbiased. Over the recent 15-20 years, this approach has remained largely unchallenged.
Once they abandoned the prudence criterion, accountants joined the bankers to worship at the altar of liquidity. Liquidity became the new god, and market value became the criterion by which accountants were to prepare the financial reports. This was achieved through an old rhetorical trick. With market values relabeled as “fair values”, any criticism of market value accounting was made to appear an argument for unfair value accounting! The rhetorical trick worked, and had its consequences.

One of the consequences of accountants using market values—pro-cyclicity—has already been mentioned in the morning session, and need not be repeated. Second, it shifted the focus of accounting from being for the markets to from the markets. I always thought that accounting was, is, and should be, for markets. It should be a source of data and information on which investors and markets can rely to form market prices. So accounting has to be a determinant of market prices. The market value accounting amounted to accounting from markets not for markets. We know markets hardly need accountants to tell them what the market prices are. You don’t have to wait for the annual report of a bank in March next year to find out the market values; they are available easily on computers at any time, often second by second. Accountants gave up their prudence-based historical cost system in favor of market value accounting. This happened under considerable pressure from the financial services industry, because, in a rising market, bank executives found it attractive to be able to report income on the basis of market values and be compensated accordingly.

A large number of derivative securities are actually offsprings of written accounting standards. As I mentioned earlier, they are financial engineering products, which are designed to bypass accounting standards. Take lease accounting as an example.

Accounting standard setters have struggled with lease accounting for more than forty years. They hardly finish writing any rule for capitalization of leases before financial engineers design new kinds of leases to effectively bypass that rule.

Liquidity of the markets in which these securities are traded, are at least in part controlled by the issuers of the securities. The amount of money that the issuers/market-makers of derivative securities earn depends on the market being sufficiently illiquid, but not too illiquid. Profit is the product of the bid-ask spread in the market for derivatives times the volume of trading. If the volume of trading becomes very large and the bid-ask spread very narrow, the product of the two is small. Also, if the bid-ask spread is large and the volume is small, their product is small. They maximize their profits at an intermediate level of bid-ask spread and volume. When the market becomes too liquid, they issue new derivative securities—CDS, followed by CDS-1, CD-2, and CDS-3, etc.—to control the liquidity and maximize their profits.
To summarize, we have talked briefly about four issues. First, the increasing dependence of financial reporting on written rules, moving away from social norms and professional judgment. Second, is the intensive gaming between written financial reporting rules and financial engineering which the former is guaranteed to lose through creation of new transactions and derivative securities by the latter. Third, the consequences of the dispersion concept of risk displacing loss concept for accounting in the form of rejection of conservatism in favor of “unbiased” market values under the guise of “fair value” accounting. Fourth is the endogeneity of liquidity of derivative markets (which are engineered financial products), because it is managed to maximize the profits from issuance and making markets for these securities.

It is interesting to note that little has been done to date by way of reforms to address any of these four issues. To the extent the recent crisis involved these four elements, we have done little to prevent their continuation or reoccurrence in the future. I believe we need to do some re-thinking about our financial reporting system. I think we could allow more room for professional judgment and social norms to reduce our dependence on written standards. We also need to specify strict limits on what the banks with access to the public money are allowed to do.

Good accounting and good finance, like good plumbing and electrical wiring, are boring and low-paid businesses. When they are functioning well, we rarely think about them, taking them for granted. Banking and accounting should not be exciting like fire-fighting or skiing. When they become exciting and highly paid, we get into trouble. I will end by showing a chart from a paper by Philippon and Reshef (Figure 2). This is a figure about the relative wage and education in financial services industry over the last hundred years.

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You see what happened to the wages and education in the financial industry. Look at 1910, 1920, 1930. Wages rose and a lot of talented people came into the business. There was a huge market crash, a new system was put in place, new regulations was put in place, including Glass-Steagall Act in the U.S. And for the next 40 years banking became a low-paid, boring business. You see the trough from about 1940 to about 1980. Then the financial industry was deregulated, wages started rising, and as wages rose the financial industry attracted more and more talented and educated people. And this chart goes up to about 2007-08. I don’t need to tell you what happened. There have been two times when wages and financial industry talents were high. We had a crash and serious malfunctioning of the financial system. When wages are low, not very smart people go into the industry and things functioned much better.

Figure 2. Relative wage and education in the financial industry

Notes: Fins. includes finance and insurance. Our concept of education is the share of employees with (strictly) more than high school education. Education (1910-2000) is computed from U.S. Census data, and from the Current Population Survey. Relative education is the difference in educated shares between Finance (Fins.) and the Non-Farms Private sector. Wages (1909-2006) are computed from the Industry Accounts of the U.S., Kuznets (1941) and Martin (1939). The relative wage is the ratio of wages in Finance (Fins.) to Non-Farm Private wages.
Thank you, Shyam, I will immediately give the floor to our next contributor Jérôme Haas, from the Authority for Accounting Norms in France.

**Jérôme Haas**

*The fantasy of being almighty. The abolition of time in market-based accounting*

Good afternoon, everyone. I would really like to start from what Luca told us about liquidity, not because I want to be a good student or nice to him but because I am really convinced that liquidity is a very good starting point to discuss what has happened during the financial crisis and introduce what role accounting standards have played in this financial crisis and continue to play today.

So I will not repeat everything that was said about the increase of the amounts of liquidity in the system, although I would have really liked to start from there and to insist on something that is so obvious that we don’t see it or say it: the amounts of liquidity, in terms of dollars or euros, that are today on the balance sheet of big companies (not only banks but also businesses in all other segments of the economy), are of a magnitude that has never been heard of in the whole history of our economy of our planet. These amounts are absolutely out of proportion with anything that we can say about the real economy, that is to say: what people earn when they produce something and sell it and get money for it and invest, etc. The amounts of liquidity to be found in what I call the financial sphere, the size of the “financial sphere”, is really not commensurate with the rest of the economy. And I would say it does not have even any link with the rest of the economy – Jean-Luc Gréau and others earlier today have explained that very well, for example through the notion of loan, which has totally disappeared. That’s what I really want to talk about: the financial sphere, with its huge size, disconnected from the rest of the economy but that very much exists. I would suggest to refer to a very important word that was used by the G-20, in their first communiqué, as early as November 2008 in Washington where, in the very first line in the very first communiqué of the G-20, it spoke of “excesses”. There were excesses everywhere. This notion of excess is very well materialized by the description I have just made of this huge financial sphere disconnected from the rest of the economy.
Basically, to use another word, I am speaking of financial markets, and I want to highlight that you cannot substitute “financial markets” for “banks” in a very generic manner. For example, when we speak of banks, I think that banks in France and banks in Italy cannot at all be portrayed as actors in the financial markets like investment banks in the City of London or banks in Wall Street. It is absolutely true that major French and Italian banks, for example, have a very important share of their activities that is linked to financial markets. And that they make a lot of profit out of it. But obviously it is managed in such a way and done in such a fashion that – sorry to say – but it has not put their existence at risk, never in the past ten years, throughout the worst financial crisis of all times. There must be a reason. And that’s because it relies on a different business model.

So, I am not speaking of French banks or Italian banks. I am speaking of the people who are the real risk takers within this financial sphere and live from it, that make it grow and that are really at the core of the financial markets. It is true that some of them are maybe employed in some of the French and Italian banks and that makes the whole issue more complicated and difficult. I don’t want to enter into that debate.

Rather I want to really focus on a certain way of behaving in the economy of today, characterized by this huge financial sphere where you have financial market actors who use this liquidity, which is the very “fuel” with which they work. What do you do when you work in a financial market? You are paid to make money exactly as if you were a plumber, but you are supposed to make money with a very strange input that had never been understood to be an input on that scale before: with money itself. So you work with money and you create money and you do that, totally separately from everything else. That is what I want to discuss with you, because the size of this sphere where people make money with money has become the driving force in the economy, in regulation to a large extent, finally in accounting standards, in accounting standard-setting, as well. Because this is where money is. So this is where a certain type of power is – and I am not speaking of intellectual or whatever power, I am speaking of the power of size and the power that derives from the size of such pot of money.
So, for many reasons that have been discussed earlier, liquidity has been brought to restore growth after growth was broken by the burst of a financial bubble, by the financial crisis. I am not going to tell you again a story that you know perfectly well. But bringing more liquidity to people who work with liquidity is exactly the same as to give drugs to a drug-addict. He/she loves it. And, of course, that only lets the financial sphere become bigger and bigger and of course more and more dangerous. We will see that. That’s really where I want to take you.

Let us get back to our participant in financial markets. What does he or she do? Let’s over simplify and call him “the trader”, in the middle of this financial sphere. He is trying to make money out of money, here and now. This is an experience of absolute power, alchemic certainly and almost mystic, in a way. He/she becomes a magician, a rainmaker, almost a god. What can be more pleasing, more rewarding? I think that what he/she is trying to do with all that liquidity is really to maximise this reward and the pleasure associated, in other words he/she has no other goal than his/her maximum pleasure and regardless of anything else. I mean, it is the quest for absolute pleasure. This is about the fantasy of being almighty. Forget about everything else. Please recall: this financial sphere is disconnected from the rest of the world and from the rest of the economy.

I have come to this idea that I submit to you but now I shall take us on earth and explain very boring accounting things. Before that let me mention that what our traders have been tempted to do is that they have tried to do two things, which I would say are two “sins”. In the Roman-catholic sense of sin. One is to try and forget that we were ignorant, that there are a lot of things that we don’t know. The other one is to try and forget that there exists something called time, rather than just instantaneous pleasure and happiness. And I will try to explain this to you through some reflections about accounting standards, but I won’t be long.

What do I mean by “forgetting that we were ignorant”? Basically, our traders, and the accounting standards that they are using, rely on one key assumption, which is: everything is in the price. The price tells you all. I was so struck the first time when I learnt about that. I had this young fellow working with me and lecturing me about it, and I was thinking: “He is young and modern and I am not”, because when I was a student I was not taught about financial markets, whereas he knows everything about financial markets.
So I asked him: “What can you teach me about the financial market?” He said: “It is very simple: the past and present and future are in the price”. The price tells you everything. Of course, it is not true. The price of sub-prime credits did not tell you anything about the value of sub-prime credit – John Paulson, the famous trader, as you know, made 3 billion dollars just because he worked a little bit more than others, actually much more, and he found out that the price was wrong.

The price of CDOs, which were not traded, was not telling you anything about the underlying layers of risk in the CDOs. The price in the secondary market for the Greek debt did not tell you anything about the situation of Greece. And if you take those examples you will see to what extent the “belief” in price can lead to mistakes and how also it can lead people to be tempted to manipulate price - because price is something you can manipulate, which can make it even more wrong sometimes.

My first two examples (sub-primes and CDOs) tell the story of a bubble bursting that led where we are today; the third one (Greek debt) is the history of a self-fulfilling prophecy where the markets said: “Greece should be traded at 25% only of its value”. Why 25%? Nobody knows. In the end they made what we call a self-fulfilling prophecy: in the end the market went down to 25%. It did not mean anything rational. I have been involved in negotiating the external debt of developing countries for years and I know exactly how you do that in a professional way. It is typically a boring job, as Shyam just said. You look at the balance sheet, you make assumptions, you look at the balance of payments, you discuss with many people ten times; you make assumptions and you do your job as a good orthodox, nice finance guy and that’s terribly boring, but it has nothing to do with what the price is supposed to say about things on the market.

What has happened since the crisis? Basically, the essential belief that the price tells you everything has not at all disappeared, it has not changed. People continue to believe that the price will tell you everything so that the new accounting standard, - IFRS 9 is its name - which has been produced by the international standard setter, basically continues to state that, as a matter of principle, the value of the financial instrument is its market price, “by default” as they say. In some exceptional cases, which are enumerated in a limited list, maybe you can account for financial instruments in a different manner.
And that shows that this line of thinking has not changed since the crisis. So the standard-setters have also asked banks to give a lot more information (IFRS 13), in order for people who read the financial statement of banks to supposedly better understand what the price of every single instrument that they hold is and possibly, in pure theoretical terms, how the price may change in this or that instance. But this does not tell you anything about the value of what they have in their portfolio, it just gives you some theoretical indications. And the reality is that in the financial statement of the banks, the price of financial instruments, which we have seen is most of the time not relevant, continues to be the measure of the financial situation of a bank, and that’s a critical issue.

I come to the second sin that I wanted to flag and discuss which is that my famous trader friend tried to forget that there is such a thing as time. By the way, he also forgets about space, because he thinks that the planet is flat and, you know, when you are in a trading room frankly you can be in Singapore or in Tokyo or wherever. It is the famous anecdote, by the way, where the British banks repeat to the British government: “If you continue to raise tax, we go to Singapore”. And, together with sane British friends, I always say to these gentlemen: “Have you thought about the time difference between Singapore and London and, since a lot of people will definitely stay in London where are their needs and activities, are you ready to stay up all night in Singapore, to trade with your friends in London? Or do you want to only trade with one another in Singapore?” I often realize that they behave as if they thought that the earth was flat – that is why I say that for them, unconsciously, there is no time and there is no space either.

Let’s focus on time. Basically our traders are only interested in value, established as the price. And the price is something that is instantaneous. It is where demand meets supply, at a given point in time. But, before, a lot of things happen, as in life, which starts with movement, not from a fixed datum. And that is how the accounting standards have walked in sync with the financial sphere. Basically when you start reading from the first line of what we call the “conceptual framework”, these accounting standards tell you, like in the “genesis” of accounting, so to speak, that you have two things: assets and liabilities. I thought you had expenses and revenues.
If at the end of the year I have spent 100 and I have received 200, I have a profit of 100. That’s something I understand. But the instantaneous value of things, the photography at the end of the period, how does it help me to understand whether I perform or not, whether I make money or not? It tells me what I have. They are thinking in terms of stocks and not flows. That’s a big problem. And there is a lot of ideology in it.

I was told, for example, that within what is probably the best and oldest institutionalized accounting standard setter in the world, the FASB, a discussion arose: half of the board held the view that you have to think in terms of assets and liabilities, the other half of the board claimed that you have to think in terms of revenues and expenses. So, I am not trying to be ideological but my problem is: you have to balance the two. With current international accounting standards you essentially look at things from the assets and liabilities side and you forget about the rest. So you focus on a picture, you don’t look at the film and you thus forget about... time. Yet the one thing that is very critical to understand is that, if you focus on a photograph, it is true in the moment when you take it, but it is wrong the day after. If I show you a picture of you at the beginning of the year and of you at the end of the same year it won’t tell you what happened in between. You lack critical information and that’s something that we need to have.

Has this been changed? No. What do we miss? There is a concept that we have developed to express what is missing when you only look at the photograph and not at the film. The concept that we have developed is the concept of “business model”. It is very simple. It is essentially the description and the understanding of what happens in the time-span during which you accumulate cash-flow. It is very important. It tells you where you are buying things, what you do with them, how much you spend, how you manage to transform them into something new that you sell, making money out of it and what you do with it. The cash-flow accumulation is the central information that you miss if you only look at a company through one angle, which is, once again, the instant picture. You don’t know about the “how”. And why is it critical?
Let’s take an illustrative example. The longest-term business model in the economy is the insurance sector. They work and develop products to cover against risk over a very long period of time and to insure you. And if you measure the financial health of an insurance company by taking the picture every quarter, you understand nothing about how the dynamics and the economics of that company work. You don’t understand what the management does, if it is successful or not. What you see is basically the reflection of market prices because they hold a lot of assets to cover the risks in the future. But you don’t understand anything about the boring truth that an insurance business is something that you run over the long term. So, it is extremely dangerous just to make that confusion between the picture and the film, the fixed photograph and the mobility of time.

So, what can we do? We have to discuss among ourselves, change concepts, change standards, change a lot of policies, probably do more in terms of education. That is quite a challenge. In fact, the debate is not about the shock of ideologies but about restoring the balance between, as you have understood, the two ways with which you look at things in a business, an economic entity, a company.

To conclude, let’s come back to our trader. We have left him or her swimming in an ocean of liquidity, in perfect happiness, as if in paradise. No time, no space; pure happiness, liquidity. Let us be Freudian: he or she is like a baby in his or her mother’s womb, free from any constraint, as if almighty.

And it is critical to think in those terms. Because one of the most promising reflections, I think, about what has happened throughout the thirty years, that Shyam showed us on the famous curve by Thomas Philippon (income in the financial industry), concerns the behavior of people. So what I am trying to bring here is also a contribution about how much the behavior of people who are within that financial sphere is peculiar - excessive, to use the G-20 word.
And, indirectly, it includes accountants and accounting standard-setters. Because the standards - willingly or unwillingly, it doesn’t matter, but that’s a fact - are creating a lot of danger as they are disconnected from the rest of the economy. International accounting standard-setters refuse to consider the impact of their standards on the economy, in the name of their self-proclaimed independance. In the rest on the economy, believe it or not, you have time, you are ignorant, there are many things that you don’t know. So that you will have to learn to show things as they are. You have to separate the past, which is sure, from the future about which you have to recognize your ignorance. You will have to present facts in a certain way that will no doubt be boring.

So do we need a new wisdom and where is it going to come from? It is not clear – hence all the debate about the financial crisis more generally, to which I will not come. The question was raised by one of you: will it come from the street, from the politicians, from the bankers, from the regulators? That’s a good debate that I think we can have after we speak.

I would just finish with two simple ideas. One is that I think there is more resemblance between our perceptions and our economies in France and Italy than, let’s say, in the UK and in the US. And secondly, when I was a student I didn’t hear anything about what we are now discussing, the word “financial markets” was not even pronounced and I am not so old. You are lucky enough to listen to us today talking about that matter and about these biased behaviors, which consist of ignoring that we are ignorant, ignoring time and space. With all that you should be equipped to spot future crisis and adopt bitter behaviors, if you will sometimes work in the financial sphere or somehow in relation to the financial sphere. This is why I ales. I am calling especially for accounting, on more boring standards and activities, as Shyam said: maybe that will make us, I mean the rest of the economy, safer.

**Moderator Luca Fantacci**

Thank you Jérôme for this very stimulating and rich contribution. We are running a bit late on schedule. I take responsibility for that since I am the moderator, but I think it was a good opportunity to listen to both contributions and I also invite the other contributors to take their time, I will reduce the time of the discussion, since we have envisaged plenty of time for that. So I will give immediately the floor to Angelo Casò.
Angelo Casò

Back to business. From assets and liabilities to profits and losses accounting

It is easy for me to speak after Jérôme because I am in full agreement with him. We both chair a European National Standard setter, so the starting point of our contribution is the same. Generally in the recent discussion we are always in agreement, when we have to discuss with the IASB. Probably, I’ll repeat some important input given by him.

One of the most important changes that we have had in these last years in the financial statement is the increasing importance of assets and liabilities compared to profits and losses paper. In our mind financial reporting is based on two papers: asset and liabilities and profits and losses account. During the last years, the assets and liabilities approach has become more and more important. Why does this happen?

Probably because of two reasons. The first is inflation. Inflation has increased the role of the assets and liabilities aspect. This occurred because costs and revenues in a situation of high level of inflation are less important. What is important is to have knowledge each time of the value of your assets and the value of your debts. The debts are devaluated by inflation, the assets are revaluated. And for this reason the attention of preparers and users of financial statements began to be more and more addressed to the assets and liabilities instead of the profits and losses account.

Another input came from regulators. Regulators are certainly more interested in having an inventory of the legal entity regulated instead of having a good knowledge of its performance. Why? Because for them it is easier to understand what is the risk of having an insolvency, a disaster, if you have a clear and complete knowledge of assets and liabilities. Performance is a less important matter for regulators. What is important for a regulator is to have a clear understanding of the amount of assets and of their liquidity.
In order to evaluate a risk of insolvency, it is important to answer a question: what is the amount of assets that can be easily realized? What is the amount of debt that it is possible to control? For this reason we have more and more detailed rules accounting concerning the way to evaluate the real value of assets and the capacity to realize them rapidly, on one side. On the side of debts, the relevant issue is the quality of debt. How can you manage the debts in a difficult situation? If you have a look at the debt sector, you see that it is increasingly difficult to distinguish between certain debts and equity. For regulators it is important to have a good knowledge about debts that you may manage in a crisis, in a difficult situation. A real debt is difficult to manage. You have to pay it. Subordinate debts, semi-equity, any kind of subordinate bond are debts that you can manage; in other terms, restructure. This produces a strange consequence. I read, Yuri, your article. You have a strange situation in which if you reduce your debt through an agreement with your creditor you have a profit. So it is better to have bad debts instead of good debts. And this is very strange. This is something that we have to think strongly about.

For these reasons the profits and losses approach has been increasingly left in a corner. The cost was left in a corner. Why? The cost is important if you have to understand your performance. What is important for you? What you have paid, not what its value is. What is important for a businessman who tries to create value? The cost of the goods, the process of production, how the product can be sold on the market. For this reason the cost was the traditional figure of profits and losses account and not the traditional means for evaluating an asset. When you have to evaluate a performance, prudence is fundamental. When you look at the profits and losses account what is important? To avoid to have profits that are not realized. The idea of ‘realizing’ belongs to the realm of profits and losses not to the realm of assets. In the realm of assets, the “fair value” is important: the value that you can realize immediately or in future through the discounted cash flow. But it is not so easy to identify the “fair value” if you do not have a market. If liquidity disappears, securities no longer have an active market of reference to quote and liquidate them: the cash-flow of reference is then something that you can no longer easily identify. Following this market-based approach, financial statements become more and more subjective, more and more in the hands of financial engineering. This is the big change that we have witnessed over the last years. This is something we have to reflect on. Jérôme contrasted the photograph and the film, the profits and losses account and the inventory. How can we go in the right direction?
Traditionally, the IASB approach remained based on the inventory. Regulators are very fond of the photograph of assets and liabilities. So it is not easy to find a solution, by giving more importance to the profits and losses account. But something is moving. We have seen that Integrated Reporting is becoming something more and more important. We started to understand that to have only the knowledge of the inventory of assets and liabilities does not provide complete information.

It is generally accepted that managers have to be paid also on the basis of the performance of the business and not only on the basis of the change in the value of the assets.

I am a member of the board of a bank. In the last two-three years, the financial statements of banks have been completely influenced by the change of asset values and not by the difference between the cost of money for the bank and the revenue from money given by the bank to its clients (industries) to develop their businesses. If you try to read the profits and losses account of a bank you may find it difficult to understand. You always have to rewrite the profits and losses account, you have to take out the change of value of assets and to put in the cost of money paid and the revenues coming from the sale of money. The role of a bank is to buy money and to give money, not to wait for the change of value of assets. This is not the traditional business of a bank. We have a lot of work to do in this area.

I think that something is on the table. As European National Standards Setters, we are discussing in these weeks, in these months, about the re-edition by IASB of the Conceptual Framework. It is necessary to go back to the big principles and to forget for a moment the detailed rules that we use for financial statements. We have to go back to a principles-based approach. And there we have to try to study how to give more information about the performance of the business. A first possible approach is to give this information through the disclosure. This is an easier way. In these last years, more and more additional disclosures are asked by regulators (“explain this through the disclosures” “give us a lot of information adding it in the financial statements”). This is a starting point that is acceptable because we have to do something, we need to have a starting point. But it is also a dangerous starting point because we have to remember that additional disclosure cannot take the place of the financial statements. Since information should be mainly delivered through the profits and losses account that constitutes the main accounting information.

Something is arising from the OCI (Other Comprehensive Income) approach. A kind of third paper is added after the assets and liabilities and before the profits and losses account. A third document through which you may try to read the profits and losses account that is polluted by the change of value of assets and liabilities. This is something that is on the table.
What is the meaning of this thinking by national standards setters in Europe? It is that we have to go back to the real economy. How are debts to be repaid? Debts may be repaid if we go back to business, to real economy, producing goods, we have to produce wealth, to produce goods, and not to work always and only around the money. We have also to remember that if we do not produce something we don’t know how to buy something. The problems are how to exchange goods for products that are necessary for the development of the economy. We cannot stay all the time around a computer trying to understand what the value of some financial instrument or the value of money is. At the end, if you have to eat something, you cannot eat money. If you have to clothe yourself, you cannot wear money. This is the message that a National Standard Setter leaves you and it is a message that comes from European National Standard Setters belonging to Central Europe. When we discuss these matters, France and Italy have the same feeling and the same approach.

**Moderator Luca Fantacci**

Thank you very much. I think that especially these last sentences capture the spirit of this initiative, which indeed underlies many of our contributions. We have arrived to the last contribution of our panel by Yuri Biondi.

**Yuri Biondi**

*Liquidity and Prudence: Perspectives from Accounting and Valuation*

It was a long afternoon but insightful and suggestive. When we arranged the program, I was supposed to give you a concluding speech, coupling my thoughts with a summary of previous interventions. Actually, this may be done through my own thoughts alone. Mr. Rector stressed a critical point: prudential accounting today no longer exists, because when prudential authorities propose pro-cyclical reserve provisioning by banks, which seems a simple and quite orthodox reaction to a global financial and banking crisis, Mr. Rector stressed that both fiscal authorities and accounting standards-setting bodies oppose the proposal. So, accounting standards-setting bodies factually oppose prudential regulation. Surprised, I suddenly realized: “sure, those accounting standards-setting bodies do, actually”. Indeed the accounting standards-setting bodies we are confronting nowadays, I guess, are no longer accountants. They are not doing accounting, they are doing something else.
They do something they believe to be accounting, which is in fact a quite peculiar way of doing accounting, because they assume that market pricing is the cornerstone of the accounting system. They do accounting from the markets, as Shyam Sunder has stressed. They take the fair-value accounting approach that is even different from the static patrimonial approach widespread in the 19th century. Because at least, under the static patrimonial approach (an inventory approach), you put the asset side at current value while the liability side remains at the nominal value. This is a liquidation approach, which could be prudent to some extent if you do it properly. This approach is inappropriate for business and for economic purposes – i.e., it is not good for the real economy, to represent and govern the production cycle – but still it may be prudent under certain conditions.

When you consider fair-value accounting instead, you take both sides of the balance sheet at their current values, preferably mark-to-market values. This leads to inflate the asset side and to reduce the liability side, relatively to historical cost accounting. This accounts for the differentials, which are the ‘profits for traders’ that Jérôme Haas was speaking about. It is definitely not accounting in its historical sense, because accounting used to be accounting for ongoing businesses, for enterprises. As a matter of fact, banking was generally special and kept apart, because somehow the general interest mission embedded in banking, insurance and the pension system made accounting different for those fields, before the recent move towards sector-neutral international accounting standards. Therefore, leading accounting regulatory bodies have been fostering an ‘accounting revolution’ in fundamental accounting principles, moving toward a fair value basis of accounting, where accounting systems strive to replicate the market price system and current market prices become the cornerstone of accounting. The traditional focus on accountability of enterprise entities to their stakeholders (including shareholders) and the public interest is then displaced.

I shall illustrate this drift by taking the Greek case – Jérôme Haas already spoke about it. Beginning 2011, a quarrel occurred concerning accounting for the distressed Greek sovereign debt. IASB (International Accounting Standards Board, which is a private accounting standards-setting body which issues international financial reporting standards called IAS/IFRS, which are endorsed by the European Union – so these standards are our European accounting rules today) really insisted in having a fair-value approach, meaning a mark-to-market evaluation of those distressed securities. In particular, IASB addressed an open letter to the European Securities Market Authority (ESMA) on 4 August 2011.

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This letter was an implicit critique of some bankers in Europe, who, in the middle of a critical off-market negotiation of Greek debt, decided not to go with the market prices to account for it. This accounting choice was legitimate from a technical viewpoint but made the IASB upset. This case just shows how strongly and fiercely the latter believes in its market credo for preparing financial statements.

I want also to stress that this letter constituted an institutional abuse, because we are also discussing here about regulation. And regulation should be submitted to what we call the institutional setting of it because we are in a Republican order, we are supposed to be in a democracy. I don’t see why the international accounting standards-setting body takes issue about how we apply European accounting standards, because it is not a European institutional regulatory body. IASB has no power or right to supervise implementation and application of accounting standards in Europe. So it should not speak up about them. It has no right or authority to do that. This fact just highlights some issues about the current political situation in Europe.

I don’t think IASB had any legitimacy in taking issue of current accounting practice in Europe. In fact, it is surprising that the European Union outsourced its accounting standards-setting, renouncing indeed to its accounting sovereignty and deciding then by law that: “We cannot decide about how to do accounting in Europe”. It is another very strange institutional move. Sorry to be crude and candid so far.

Several issues arise from this Greek accounting problem. The first issue is that the IASB has a market credo but there are many other credos actually. When they came to putting this credo into practice, they got into trouble, as it is always the case. You can believe in God. This may be a very important choice for your soul, for your life after life. But if you really try to play God here, among humans, it could be dangerous and difficult to manage. So, a huge problem occurred when the application of fair-value measurements was suspended in the aftermath of the global financial crisis. This was done by both the US accounting standards-setting body and the International accounting standards-setting body (IASB) – the latter being also the European body, for some strange historical accident. Both bodies suspended the application of fair-value. This move has created a new regulatory ruling, because preparers of financial statements are now granted with a sort of authorization to interpret the notion of “active market”.

What is an active market indeed? How should a market be defined in a standard, enforceable way? An ‘active market’ is not defined by the IASB’s conceptual framework and today it is at issue. Preparers can and should decide whenever they prepare financial statements if active markets exist. And this is a very serious problem because, when you have an accounting conceptual framework, which is based upon the idea that markets should be taken as reference, you should do accounting according to those markets. However, if you allow preparers to decide when markets are ‘active’, you are evidently allowing them to put numbers at will in their financial statements. This is definitely not prudent and probably even worse.

So the problem was and still is that markets, including those for the Greek debt, are fragmented and volatile. Actually, primary issuance of Greek debt has been off-market since the outbreak of the crisis, and it is not expected to be restored soon. Throughout the global financial crisis since the summer of 2007, huge troubles occurred with interbank loans and refinancing, involving a lack of “liquidity” which is fundamental in a market-based financial system and regulation. This liquidity shortage was really puzzling and it has occurred again in further occasions. Trade volumes on secondary markets disappeared for the Greek debt in particular. So it was simply reasonable not to apply mark-to-market accounting to that debt because some critical conditions for an “active market” were not fulfilled. But distressed market prices still existed. This involves a huge technical problem because if you decide to apply mark-to-market accounting, you must decide case by case if an active market exists. This could involve a very sensitive affair to deal with. As a matter of fact, markets do not even exist for some assets and liabilities, indeed for most of them. To apply mark-to-market accounting, mark-to-model methods should be invented and enforced, involving more and more complex accounting rules to decide in absence of (active) markets. There is already a problem because you should define when you trust a market to be active and, if the market does not exist at all, the problem becomes even worse.

Following this market-based accounting approach, a further quite neglected point is that mark-to-model valuation may involve even greater pro-cyclicality because it includes estimation of discount rates, margins and durations of assets and liabilities in order to apply mark-to-model accounting for them. So, if you try to invent a price, accounting figures are subject to changing discount rates, margins and duration over time, at least. Altogether, this market-based regulatory move results in abolishing accounting, which has been probably the very purpose since the beginning. At the end, you get a lot of valuation and no longer accounting to be reported.
Mark-to-market involves a further fundamental theoretical problem: advocates of this approach believe in markets, in market pricing, at the point that they do try to invent a market pricing even when the market price does not exist. This credo involves a circular reference. Since you are supposed to be able to do market without accounting (which has been abolished, as I explained before), you have to deal with a system which is completely self-referential. So, if everybody in the market decides to trade according to the idea that a borrower will go bankrupt, she will actually go bankrupt. Decreasing market prices will drive increasing borrowing rates and debt burden, triggering the borrower’s default. This is a simple mechanism based on self-fulfilling expectations, which underlie any market trading. In this way, we lose all possibility to recognize the actual condition of the borrower and to trade on the basis of this condition, because no autonomous source of information enables us to know about the borrower’s condition independently from the market. In sum, you assume that the market is already (and always) true, but the market is supposed to know it from nowhere. It implies a very problematic situation. In particular, the most problematic part concerns potential losses. If accounting for liabilities is done at the market pricing, actual profits are recognized whenever potential capital losses occur on the liability side. If market value of liabilities goes down, the accounting entity is supposed to realize a potential profit ‘as if’ it held and liquidated that liability at its current market price.

In sum, generally speaking, this market-based accounting approach leads to measure profits and losses, which are not realized today and which may never be realized in the future – it is based upon just an estimation of them. This approach leads to tune the ongoing process of the accounting entity on those market-based estimations. The accounting entity may even fail because it follows those estimations, in a self-fulfilling prophecy based on accounting, since actual enforceable accounting profits and losses are determined according to mere estimations. If value estimations for assets in portfolio go down, the entity measures accounting losses and is then forced to respond to them, triggering failure threats and actual distress. The market solution should be to further measure liabilities at current prices: you put both assets and liabilities at their market prices, making market-based estimations of profits and losses symmetrical, so at least you don’t go bankrupt because of ‘accounting mismatch’. However, you do not and can no longer know whether you are supposed to go bankrupt or not. You cannot have information about the actual condition of the ongoing accounting entity. This unbearable situation recalls the case of Lehman Brothers which had a perfect balance sheet with huge profits and went bankrupt one day, while accountants did not help to discover or alert on it. This was also the case for Enron.
These case studies raise a further issue with accounting perimeter. Accounting entities increasingly manage not to put the underlying positions and the actual profits and losses on their balance sheet; however, they still incur them somewhere outside the accounting light, because they go on doing banking, they still run businesses and they don’t have any nirvana (beyond time and space) to live in. So, they still take business risks and hold financial positions over time; they still run ongoing business activities but they don’t report about them. This is a huge accounting problem, concerning not only recognition and measurement, but also accounting entity perimeter, revenue recognition and timing.  

Generally speaking, all these problems come from having established an accounting system, which depends not only on the liquidity but also on the very existence of markets. Accounting may be done for markets, not from markets, as Shyam Sunder said before. This used to be the case before the recent drift into market-based accounting regulation. I am pretty convinced that if we come back to that old-fashioned autonomous role of accounting, we can maintain an ‘accounting lighthouse’, acting as a device providing common knowledge, which is informative about the borrower’s financial position and performance, including solvency, independently from the markets. This ‘accounting lighthouse’ may help to have a better market pricing indeed. This led me to speak about banking because banks, i.e. financial institutions, were the most exposed to the fair-value accounting approach. Even leading accounting regulatory bodies can acknowledge that, for some business activities, it could be hard to apply a full fair-value accounting approach, because most of their assets and liabilities are not listed, among other difficulties. But especially for financial institutions, those bodies were really convinced that their full fair-value approach should be retained and applied. Those bodies actually issued standards, which allowed those institutions to do full fair-value accounting for financial instruments. So the full fair-value option for financial assets and liabilities was allowed and applied especially in the US and also by the international regulatory body after a few years. It is still a valid option since then. Fair-value was suspended in the aftermath of the global financial crisis but not so much has been done to amend it in any fundamental way. The existing accounting regulatory regime is still based upon the market reference as it was before the global financial crisis.

Therefore, accounting regulatory bodies still believe that a bank can be managed, or at least accounted for ‘as if’ it were a perfect portfolio of liquid assets and liabilities, which are supposed by definition to be under threat to be liquidated out of the entity’s balance sheet at every instant of time. This view constitutes the benchmark of originate-to-liquidate mentioned by Luca Fantacci. Actually we can do this, as it has been done, but we can also say that banks are not a portfolio of liquid assets and liabilities. It used to be the European view on banking. This has been the case for government bonds: they can be kept until maturity. So, you don’t need to look at changes in their market pricing to account for them on the bank’s balance sheet. This definitely constitutes one viable possibility. The bank holds some potential profits and losses somewhere outside the entity perimeter but, if it does not realize them, that is, if the bank management decides not to realize them while running its business, this bank does not have to account for those potential profits and losses, or change its reserves or shareholders’ equity because of them. At the end of the story, this bank realizes actual profits and losses according to the underlying contracts, not current market pricing. This is the case in general for banking: you can have a representation of banks, which is independent from market conditions (as can be done for other accounting entities). Of course, if banks are much more dependent on external markets, this dependency will appear in their representation through time in the banks’ accounting reports. However, in this entity-based accounting regime, accounting rules do not force them to mark-to-market at every time, at every instant, because if banks have a recurrent relationship with markets, it will appear progressively as realized profits and losses over time, instead of as measurements of (unrealized) current values on the balance sheet at one arbitrary point in time.

This entity-specific accounting regime seems especially suitable because accounting for banking at ever changing market prices may prompt short-term strategies, excess leverage, distribution of fictitious profits and enhanced financial instability, actually not the most suitable results for protection of investors (and depositors) that have committed their funds to the bank as well as for society at large. This regime should track cash flows and funds over time through entity perimeter under control, while establishing some conventional methods for non-cash items including commitments.
This leads me to recall that liquidity is not the only way to organize the overall financial system created by banking. Liquidity points to a dependence on the market, or the idea that the whole financial system is or should be a market. Actually, as I provocatively mentioned before, no such thing as ‘one financial market’ exists. Relationships with banks and among banks are not necessarily market relationships. A financial system involves market and non-market links with and among banks. So you can define this whole network of links as a dynamic system and look at how this system is organized and what kind of layers and devices are put in place, addressing its financial architecture, as we call it.

This systemic perspective should especially distinguish between money as a measure of value and a permanent store of value, and some other monetary functions (as Luca Fantacci mentioned before), which are more related to flows, payments, debts and financing production.\(^\text{15}\) This enables giving up the idea of having an almighty market, since we don’t need that God at least. Laplace renounced to the notion of God in his representation of nature; even economists might perhaps renounce to that idea of market which is a surrogate of God in their representation of society. However, whether they believe in markets or not, economists should not neglect to address the institutional foundation of markets. The latter would be simply a bad epistemological move. We can discuss about the scope of markets in our society, but we should never forget that markets exist because some overarching institutional conditions exist: especially (i) the debt-credit nexus that has been stressed and is required to establish a market; and (ii) the existence of an accounting system which constitutes another precondition.

I will conclude by giving you some points by Schumpeter (which is my favorite classic as Keynes is for Luca Fantacci)\(^\text{16}\). Schumpeter says that even if banks cannot create legal tender and cannot create machines, they can still issue \textit{ex nihilo} money, which may at the end enable the creation of material goods and services which would not be created without this banking practice. He also insists in the same paragraph about the fact that the bank credit has nothing to do with the fact we have savings, owners and other preconditions which actually depend on money as a commodity. He takes definitely an institutional economic perspective of the supply of credit, which cannot be seen as a ‘supply’ because it is no longer based upon a money market. Schumpeter is considered a liberal economist. We should definitely read again all the classics because, until the 1940s at least, even leading liberal economists were really careful about not thinking banking as a market activity. Accordingly, reserves, provisions, bank equity, any kind of prudential regulation for banking are understood as controlling devices of the monetary system. And accounting is an integral part of this system.


Just to conclude, let me summarize three basic messages underpinning this talk. My first message is to think about the financial system, and particularly the monetary system and its institutional architecture, with a view to enhance and enforce financial fairness and financial stability, or prudence if you want.

The second message is that markets cannot be and have never been auto-regulated. They could be actually self-referential, but this is a danger, not a virtue. Some institutional foundation is always behind markets by nature.

The third message, which is my favorite (because I am quite passionate about accounting), is to give up fair-value accounting, which is simply not accounting, and imagine and establish a proper representation of enterprises’ performance and solvency distinct from market pricing.

**Moderator Luca Fantacci**

Thank you, Yuri, I think it was a splendid way to conclude the panel. We still have about thirty minutes left. If you still have some energy left, I believe you have questions and remarks.

**DISCUSSION**

**Question. Massimo Amato**

I would like to talk about the ideological base of the debate. When you, Jérôme, speak about the ignorance of future and the question of time, you touch a relevant theology even when theology does not deal with God, but there’s an idea of omniscience, of almightiness in knowledge. Then Yuri pointed out the idea that markets can give through prices the entire representation of the entire life of a business or of an investment. I would like to read simply a quote by Francesco Ferrara (from *Della moneta e de’ suoi surrogati*), an economist of the 19th century, who says something really surprising, because we normally think of economists as sober people. In this case the tone is visionary:

*Credit destroys the obstacle of time. To activate the faculty of production of inert value, to multiply operations, to accelerate savings; what is all this? It is to win time, to conquer the future. Expand this faculty, this potential in mankind; give him the possibility to reunite in one single point the full disposition over all future values; and he will have the power to dominate eternity and to recreate the world from scratch.*

When your colleague, Jérôme, said that price is present, past and future he said, *de facto*, that price is eternity.
Jérôme Haas. Yes, but what I heard very clearly is something totally different and maybe wrong. Francesco Ferrara is describing the act of extending a loan, of granting credit. When you give credit you don’t do finance, you finance an activity. It is totally different. I mean, finance is not the end, it is the means. Today instead, it is like operating from the market for the market. Of course, there is something that I witnessed disappear - although, as I said, I am very young ! I am talking about the job of extending credit. I mean, the people who were the kings in the banks were the big bankers who were making credits up until the 60s and 70s. It is true. Banking was much more modest and dull than it is today and it was very low paid. Nevertheless, these guys had a job, which was to understand the business model and to finance it. This was a very important job because they would be the link between the present and the future. And that was the nobility for bankers to do that job. That’s why we associate a number of big bankers’ name to the history of the industrial revolution, of the conquest of the Far-West in the United States, etc.

And immediately after both the industrial revolutions in the various European countries, and when it comes to develop in the Unites States, at some point it is followed by a period of incredible speculation, as the ordinary word goes. That’s because you cross a sort of red line, which takes you from “useful finance” to “excess finance”. And I myself spent hours with colleagues, including professors and academicians, back in the years 2008-09-10, discussing how we could draw the red line between good derivatives and bad derivatives. And that was the subject. There is no contradiction. What Ferrara is describing – to use another word that was used by Adair Turner, the chairman of the Financial Services Authority in the UK – “it is a socially useful finance”. An idea which I fully accept. I would follow Ferrara if that’s what he means. But I may totally misunderstand Ferrara.

Luca Fantacci. To have a hint of what Ferrara means it is perhaps useful to look at the title of his book: “Of money and its surrogates”. This is really the concept of liquidity. Ferrara is one of the first to introduce the concept of indifference between credit and money.

Massimo Amato. This is the same thing that Jean-Luc Gréau was suggesting when he said: what this financial system is trying to do is to eliminate the difference between money and assets. This is the final point of Ferrara. That is to say, the threshold between good and bad finance is impossible to draw. All is good and all is bad in the eternity, in the night of the absolute black (“the night in which all cows are black” – G.W.F. Hegel).
Question. Unidentified student.

Maybe my knowledge is not enough to understand everything in the debate. I would like to understand a very simple thing: what is the advice that you deem appropriate to give to students attending your course? I have started reading your book [The End of Finance, by Massimo Amato and Luca Fantacci]. Here you have tried to shift the accent from the phenomenology of the crisis to the inner causes, the philosophical foundation, of the crisis. According to your view, the financial markets, as we intend them, are completely wrong. Today I see a kind of marriage between this philosophical foundation and the accounting misconceptions that are based on these foundations.

The question is: what are our possible actions? Do we have to get something back on its feet, which is now totally sick but can be healed? Or do we have to create from scratch something totally new, destroying what is there now? Do we have to introduce new rules that are not based on this wrong concept of liquidity anymore? Or do we have to imagine a totally new finance?

Jérôme Haas. I just want to say one word in response to you. Technically if you take the example of accounting standards – but you can take the example of banking regulations or many things, many segments of financial regulation – technically what you have to do is very limited: you can have more or less regulation, change some articles if you will, almost some words or lines, or sentences, not much. But the hurdle is considerable because you have to go over and change behaviors, attitudes, beliefs that are so deeply engrained in people’s minds, and that is very very hard to do. So you have two routes. One is to change technically, but it needs huge efforts; and maybe another promising way is to try and develop something from scratch, from a different angle that would lead you to the type of equilibrium that you want to reach. I don’t have a definitive answer.
Is there a big role for universities? I mean, I study finance. I have great professors in these schools. But the underlying logic is always that of trying to teach us how to become good dealers, or maybe good croupiers. At least until we become so good that we are able to run the casino. I think this is the point... But maybe I am just jealous of my mates that are in London.

Shyam Sunder. Let me go back to the question whether we should modify the system or start afresh. It seems to me that as long as there is trust, in the world, if I trust you, that means that I have an anticipation of the future and trust immediately creates of money. Creation of money is not a policy decision in society. If two persons live on an island and one catches two fish and gives one to the other with the anticipation that the other person will share the next day what they will catch, here you have essentially created money. It seems to me, for what little I understand of money and credit, that: to the extent anticipation of future is a part of our faculties, of our brain, then through those faculties we develop the capacity to create money. It is not a natural state of society to decide how much money is created. Of course, states and society and regulators can facilitate the creation of money or put limitations on the creation of money, but money will be created and has been created without any participation or control by the state.

State’s policy actions are not necessary. Babies have been born long before doctors and hospitals arrived. Money has been around for a long time, and will continue to be around, whether the government does something for that or not.

Jérôme Haas. You used the word “limitation” and that’s the point. I fully agree with you in the description of the spontaneous creation of money. But perhaps you would agree that, since we do not live on an island, at some point you have to recognize that there is society and therefore there must be some limitations. That’s what I meant before when I suggested that there is a need to draw a red line. And if you agree that we must have a red line, which will really be a human artifact, a society’s creation, then it all starts from here and you have to reflect about where to put it. But we need it, obviously.
Shyam Sunder. I agree, thank you.

Luca Fantacci. I want to share with you a thought that occurred to me while I was listening to your previous contributions, particularly by Angelo Casò, concerning the prevalence of assets and liabilities approach over profits and losses. The thought concerns, in fact, monetary creation. At least since 1971 money is an accounting entity, purely: it is nothing else but something written on an account of the central bank or of the commercial banks. But I believe there are two ways to create money as an accounting entity, which are very different.

The way we are used to money creation in fact contradicts Shyam’s intuition. Because we do have a centralized entity called central bank that issues money in arbitrary quantities – and we have seen how far over the past five years – and also imposes rules on how much this almightiness can be shared by commercial banks establishing liquidity ratios for the creation of bank money and a series of accessory laws that make bank money legal tender, as we have witnessed recently. This is a way of creating money directly in the perspective of assets and liabilities. It is a money created at the same time as a liability of the central bank, as Jean-Luc Gréau was saying today, to enhance the liquidity of other assets and to substitute other assets on the markets. But this is not the only way to produce money as an accounting entity, because Gennaro told us a completely different way.

Bancor is not fiat money in this sense. Bancor is the opposite. It is the result of profits and losses. If you look at the balance sheet of individual members of the Clearing Union, whether they are states or they are businesses, you only create money as a result of profits and losses or deficits and surpluses of the participating member. And it is completely different. Because in this case the creation of money is subordinated to economic activity. It is closely linked to real economic activity and that’s where, Shyam, your remarks come back in and become not just an intuition or wishful thinking but something that actually corresponds to what is happening. If we had a system working like the Clearing Union then the anecdote you were telling – about money as the creation of trust between people or countries or businesses – would be true. But until we have this system of fiat money, legal tender and everything that follows, we are stuck in a financial system that creates at the same time debts and the money to buy those debts, and hence determines the price of those debts. And even if we like to call that price “fair”, it is in fact a price which is biased upward artificially by all the money created to buy those assets.
**Shyam Sunder.** I think this is a very good clarification, Luca. If I may add one more thing here... In your second example, consider a car manufacturer who generates profit. Even though that profit may be measured in units of money, the existence of that profit lies really in the existence of real commodities and real goods. When they say that Volkswagen has made a billion euros of profit this year, what do they mean? My understanding of that would be that Volkswagen used some real resources in making cars and in exchange for the cars it sold it obtained some real resources. If you convert those real resources in monetary terms, you just see those profits in terms of units of money.

But those profits, don’t they exist in terms of real commodities, of real stuff, rather than just in terms of money? We state them in terms of money, in accounting, but profits are real, right?

**Luca Fantacci.** I would answer in these terms, if I follow your line of reasoning. I would simplify further the example, if profits are the result of a commercial activity selling more than you are buying, having a value in excess (of what you put on the market over what you take from the market), this means that profit is a credit you have towards the market which is real in the sense that the only way to pay this credit is with actual goods and services. Eventually, they have to be transformed into demand for other businesses’ goods and services. If you put into there fiat money, then you alter the picture.

**Jérôme Haas.** I would just add that the profit Volkswagen is making really is a payment for their ability to do more than just taking inputs and producing an output. And the value that you are ready to pay to have that Volkswagen is something more, therefore you give them a profit. So the price is definitely paying for something else and this something else is not material, it is not tangible. And that’s where it becomes tricky because you have started, whether you like it or not, to introduce a sort of gap between something that has started as a pure material, tangible story and something which goes into the direction of something intangible and that’s the beginning of the problem.
**Yuri Biondi.** This intangible story points to a vertical dimension that was early stressed by Schumpeter in his ‘Theory of Economic Development’. Schumpeter states that financing comes into enterprises that are actually organized by an entrepreneurial spirit which belongs to this vertical dimension: to create something new, which triggers the economic development, which involves also the dynamics and which generates the business profits creation. Schumpeter stressed that profits come from dynamic processes, which do not exist in the statics. This enterprise process points to an intangible dimension.  

**Jérôme Haas.** And it is qualitative not only quantitative, this is what makes it complicated.

**Angelo Casò.** We have solved all the problems of the world.

**Luca Fantacci.** I am afraid, we have raised all the problems of the world, perhaps not solved them, but we can be satisfied with that. Thank you very much to all participants.

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