Feature

Trust and the City

What did the financial crisis teach us about the failings of the market – and what implications does it have for the environmental crisis? **Adrian Henriques** explains.

Below left: The market price of coal does not reflect the social and environmental costs of coal mining or climate change. © Fair/Greenpeace

Below: Forest ecosystems are essential to climate stability © Greenpeace

It is dangerous to seek lessons from the colossal financial crisis which has overturned the world's markets before it has fully unfolded. But a far greater danger would be to fail to learn from it.

There are two aspects of the crisis: a credit crunch and a stock market crash. The credit crunch arose because house prices started to fall in the US. But this was compounded by several factors. Lending institutions had over-lent to borrowers who could not afford to take out a mortgage. Then the mortgages were mixed with other products and sold on to other banks. So those who had done the deal were no longer liable for anything if the house-owners defaulted. In the end no bank trusted or wanted to lend to any other, which affected businesses. This led to a fall in the stock prices of banks and in turn into a general stock market collapse.

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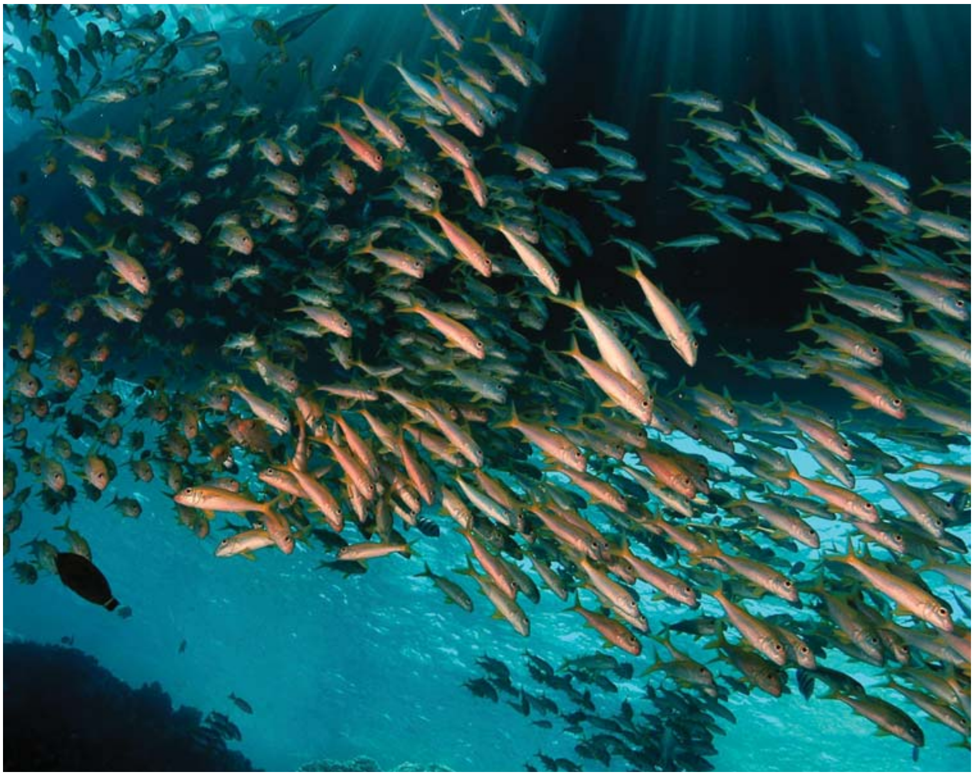
The current financial crisis has led people to understand how extensive their dependence on the financial system is. The total collapse of the financial system through failure to regulate it properly would have disastrous consequences for everyone not living by subsistence agriculture. There would be widespread business failure, unemployment and poverty.

Yet our dependence on the global ecosystem dwarfs our dependence on the financial system. Compared to the collapse of the ecosystem, that of the financial system will seem almost mild by comparison. This raises three crucial questions. Why has the free market failed to regulate itself? How does regulation work? And what sort of regulation is needed now to prevent the global ecosystem from going the same way as the global financial system?

Why has the market not regulated itself?

The free market is the most efficient engine of economic growth the world has ever seen. It is supposed to ensure that resources are allocated in the most efficient way to be economically productive. And it is supposed to



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be self-regulating. This is where the 'invisible hand', the great regulator in the sky, comes in. The problem is that it is very hard to point in reality to a free market. Markets are not 'free' because prices rarely factor in externalities. (An externality is something you don't pay for, but get anyway.) That means that the environmental, social and economic costs of transactions are not always reflected in the price paid. As prices are too low to reflect the cost of carbon damage, for example, too many transactions are done which cause climate change.

In general, prices should reflect the real value of what is bought and sold. But recent stock market behaviour did not follow that rule. If the price of a share falls dramatically – perhaps by 25% in a few minutes as happened in October – how could the market have been pricing stocks correctly? If it was right before the fall, it must have been wrong afterwards. Or perhaps it was the other way round.

When markets are not working, the orthodox economic response is regulation. Its purpose is to eliminate distortion and protect those who are affected adversely by markets; it is not primarily designed to help or to hinder business. Nevertheless, regulation is usually unpopular with businesses and regarded as a dangerous route to wasting money. The preferred approach, if there has to be one, is self-regulation.

In response to the financial crisis, it has become possible to talk about regulation more generally. George Osborne, the UK Conservative Shadow Chancellor has even declared that 'laissez-faire is dead.' We are in a situation where the nationalisation of entire banking industries is being carried out with hardly a cry of opposition. There is public anger at the way in which banks sold mortgages to people who essentially couldn't afford them. We can expect to see much tougher regulation of the provision of credit. There is also public rage at the bonus culture of the City and Wall Street. That people should prosper as a direct result of causing the crisis is regarded as unacceptable. Precisely how the City should be regulated is not easy to say, but it is likely some attempt will be made. It has also been suggested that the balance sheets of banks should be much more tightly controlled to prevent losing sight of risks created by new instruments such as mortgage-backed securities.

How does regulation work?

Regulation can work in two main ways: by prescribing precisely what should and should not be done, or by articulating general principles which should be followed. It is possible to regulate in this way either processes, such as lending procedures, or outcomes, such as who gets a mortgage. Regulation by prescription is difficult because it has to be very detailed to be effective, which makes it costly for business. It is also prone to unforeseen, and sometimes counter-productive, side effects. The alternative, principle-based approach can be much more flexible but it is also much more open to abuse. City remuneration, for example, has been regulated on a principles-based approach for some time now. This does not seem to have worked.

For regulation to work, it must target the right thing – not just what we think we want, but what we really need. In order to avoid the perverse effects of legislation it is important to control the right thing. This means that the intended end or outcome should be targeted, not the process, means or immediate outputs. The control of biofuels is a case in point. While the EU Directive aimed to limit the carbon impact on the environment of transport, it targeted fuel in a way which did not consider the wider impacts fuels have. The result is a law which is not only damaging in ways not even considered, but very likely counter-productive for its own purposes as well.

Over the last decade and a half, self-regulation has been the mainstay of CSR, or voluntary corporate social responsibility. In this time it has bolstered many a corporate reputation and has led to modest improvements in performance – both financial and non-financial. But there is no evidence that it has led to the scale of change necessary to protect society or the environment. The voluntary Banking Code, for example, states that banks and building societies 'will lend responsibly'. This piece of self-regulation has manifestly not led to appropriate limits on consumer debt. As we have seen, pumping up consumption in this way is one of the key factors that led to the financial crisis. It not only over-extends consumers, but from an environmental perspective it also magnifies the environmental impact of the economy.

So regulation is difficult. And because

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regulation is difficult, it must be accompanied by transparency in its implementation by business and also of the resulting performance. In fact, transparency itself provides a soft kind of regulation through the attempt to avoid shame. Transparency (over more than the narrow subject of regulation) also enables regulators to function more effectively. Overall transparency makes for a freer market – markets cannot function effectively if the participants are blindfolded. Transparency should be encouraged by legislation.

How can we regulate for ecosystem protection?

There are two main issues when we consider using regulation for ecological ends. First, does regulation deliver the kind of thing it is supposed to deliver? Second, does it deliver enough of it?

Self-regulation can be effective if: it is based on transparency and the involvement of stakeholders; if there is monitoring and verification; and if there is a link to consumers. A good example is the Forest Stewardship Council, which certifies sustainable and socially responsible forestry, and fulfils all these conditions. It is an example of where self-regulation has worked. But there are many examples of self-regulation which are simply lip service. The Banking Code appears to be an example of this. Perhaps the arrival of the EC Unfair Commercial Practices Directive will help to address the situation since it will mean that companies cannot claim to have signed up to codes they have not signed up to or claim to have complied with code provisions when they have not.

Of course, on the demand side, no-one has to buy FSC products. And on the supply side, a large number of companies either have a vested interest opposed to any regulation or just can't be bothered. In other words, not enough is happening. In these situations, formal legislation is needed. But not all companies oppose sensible regulation. Leading businesses, such as BT, Barratt and United Utilities, have realised that the issue of environmental impact is urgent. They are calling for more clarity, rigour and regulation on environmental issues. In such recognition lies some hope.

The law is not, unfortunately, a magic wand.

Opposite page: Marine ecosystems are under strain as fish stocks collapse due to global demand © Care/Greenpeace
Top right: Coal power is responsible for 50% of UK CO_2 emissions © Morgan/Greenpeace

Right: The market price of Compeq's electronics do not reflect the social and environmental costs of its contaminating this river in China © Greenpeace
Below: Environmentally and socially responsible forestry in Brazil is certified by the FSC © Greenpeace

While the law adds the power of enforcement, all regulation, (including soft, self-regulation) depends on underlying culture and values. One of these crucial values is a general respect for the law. China has laws against corruption and environmental damage, but these are widely ignored, with devastating results. In addition it is also necessary for there to be reasonably wide social acceptance not only of the underlying aims of the legislation but also of the behaviours required under it. So given that very few laws actually receive 100% enforcement, social acceptance is necessary if they are to be widely obeyed.

We must hope that in the new climate of openness to regulation, the real need for constructive regulation of companies' social and environmental impacts will be considered carefully – and acted upon.

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