

The risk guru: the instruments are not the problem; it's the use we make of them.

The Nobel: "A new bubble? Only in the real estate market"

Robert Merton: it makes no sense to blame derivatives. "Innovation, even in the financial sector, is never negative".

From our correspondent in New York

Massimo Gaggi

The danger of new bubbles? I can only see a real estate market bubble, but other bubbles are very difficult to identify let alone remedy. You can't take a surgeon's knife to them without creating collateral effects. Too much liquidity? Should the Fed curb money supply while unemployment rises? We must not forget the accusations levelled at the Central Bank, 80 years ago, that it was responsible for the Great Depression by squeezing money supply at the wrong time"

Robert Merton, the famous economist who will be in Trieste next week for the *Nobels' colloquia*, replies patiently and meticulously to our questions on the crisis and the impact of derivatives, the instruments whose use grew enormously thanks also to the algorithms that he created together with Myron Scholes and Fisher Black. This was the mathematical work that earned Merton and Scholes (Black died in the meantime) the Nobel for Economics in 1997. The award was conferred upon them by the Stockholm Academy in recognition of their having "created a new method of valuation", of innovative financial instruments and "of the risks connected to their use and extensively used by credit institutes". The reasons for awarding them the Nobel Prize also went on to say that "they were able to reduce exposure to risk in the markets".

Acclaimed for many years - even after the failure of Long Term Capital Management in 1998, the private equity fund co-directed by the two economists – Merton and Scholes have been attacked by thousands of critics 2008 in the wake of the financial crisis, triggered off by the reckless use made of financial products based upon real estate mortgages and by a derivative market whose spiralling growth could no longer be controlled. Now Merton immediately shrugs off these accusations: "the new financial instruments were not the cause of the crisis, innovation is never negative".

You cannot blame an algorithm for the crisis. Yet public opinion tends to see the origin of the crisis in the spread of little-understood innovative financial instruments, the derivatives. And when people hear about new bubbles they fear that the lesson has not been learned.

Understanding what mechanisms can generate a crisis and averting it is by no means an easy task. In recent years the USA exhibited three phenomena: an increase in the value of real estate, a strong reduction in the cost of money to sustain an economy reeling under the psychological impact of 11 September and a more

efficient and convenient system for refinancing mortgages. Taken one by one they were and are intrinsically good news, for both the economy and the consumers. But taken together they became the detonator of the crisis. But who could have understood this and taken the responsibility for interrupting growth? In any case we are dealing with very sophisticated analyses and this is a job for the best experts. And the best costs a lot. Instead the public sector offers very little by way of remuneration, even to those occupying top positions. Thus, be careful not to be fooled by overly-simple explanations – or remedies. And this also applies to financial products: they should be used better, not burnt at the stake. Their use is beyond question.

Does this also apply to credit default swaps? The cds were issued in enormous numbers and often by companies that were unable to handle the relative risks. Such risks were evidently not so limited.

Look, putting the blame on derivatives doesn't make much sense. The word itself means very little. It only means a set of contracts – from futures to options – used to transfer credit risk, which is an absolutely essential function. The crisis began as a credit crisis, which, in turn, made a serious impact on the cds, but other parts of the market continued to function regularly. In any case the problem is not the instruments but the way they are being used. If you build a train that can travel 300 miles an hour – the innovative instruments – it should run on the right kind of rails. If nobody bothers to provide them then you risk accidents. It is not right to blame the locomotive builders. And the solution is not to let the super-train travel at ordinary speeds, because you would lose all the benefits of the innovation.

Innovation, therefore, to be tamed not demonised. Even if it spreads everywhere, without limits...?

It is not ubiquity that makes innovation dangerous. For example, the cds are to be found everywhere but our judgement needs not be negative. They are instruments that made it possible to improve the management of risk. Certainly, there were excesses in the use of these instruments; and this is the real cause of the crisis: too many operators, the lack of effective controls by the watchdogs, a certain degree of ignorance as to the nature of these instruments on the part of the persons involved and a misguided system of incentives.

More rules therefore..

I would, first and foremost, say better interpreted and better enforced rules. In the past, too, the Fed had enormous powers at its command. They should have been used better. The rules must certainly be reviewed but now we risk a surfeit of rules and laws. In the field of financial innovation it is neither possible nor desirable to regulate everything."

In short rather than proposing incisive measures you would caution against excessive interventionism as this could only wreak further damage?

“I realise that the media and the politicians want a scapegoat. However, in this field both causes and solutions are very complex. And we must never forget that the crisis was not caused by derivatives but by the repo or repurchasing agreement market. The major losses on house mortgages and corporate loans commenced here. However, while all of this had a knock-on effect for the credit markets, including commercial paper, it should also be remembered that many other markets – from future to equity markets – continued to operate well”

From 2 to 3 December 2009 the 9th edition of Nobels Colloquia will be held in Trieste, an event promoted by Promostudio and the Province of Trieste. Erik Makin, Robert Engle, Robert Solow, Robert Merton, Arrigo Sadun, Dennis Snower and Philip Lane, together with Giulio Tremonti and Guido Rossi will debate the strategies for recovery. The United States of Barack Obama and Europe: economic policies, investments, credit and market regulation will all be analysed and discussed by these leading economic and financial experts.

[Didascalia foto:]

The roots of the crisis - Robert Merton, Nobel for Economics in 1997 with Black and Scholes