

Rebuilding the economy on ethical grounds

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As the 2007-08 financial crisis gets relegated to history, one is left to ponder whether the right lessons have actually been learned. Have the major flaws in the global financial system been remedied, or have we merely postponed another, potentially much larger crisis?

In his [latest paper](#), IESE Prof. [Antonio Argandoña](#) asserts that the financial crisis can be attributed, in large part, to ethical failings at the personal, organizational and societal level.

As is now common knowledge, organizations and their representatives, particularly at the board and senior management levels, got involved in some highly dubious, and in some cases downright illegal, financial practices.

But all of this happened against a backdrop of broad social acquiescence. Governments, central banks and regulatory bodies were completely disinterested or incapable of applying the legal, institutional and social mechanisms that, in other circumstances, may have helped to stem the damage.

Morally questionable behavior

We often hear about the greed and irresponsibility on Wall Street that triggered the near collapse of the global financial system. Yet we hear much less about the cowardice and lack of moral fiber of managers who chose not to speak out for fear of jeopardizing their careers

and/or remuneration.

At the same time, the level of arrogance and hubris among financiers, economists, regulators and government officials was at an all-time high at the peak of the housing boom.

The crisis clearly has a moral dimension, Argandoña says. However, moral decline cannot be the sole reason, as many of these failings have been present throughout human civilization. So, why did the crisis happen now instead of at some other point in time?

One of the main reasons is regulatory failure. The rise of unethical or fraudulent behavior in the financial sector coincided with the paring down of the usual protective mechanisms that society employs to counter the effects of immoral behavior.

In effect, our legal and regulatory institutions went from punishing corrupt behavior to encouraging or even rewarding it.

Corporate governance crisis

The financial crisis is also frequently referred to as a crisis of leadership or governance. Across a broad spectrum of organizations — from commercial and investment banks, to rating agencies, central banks and governments — financial malpractice was commonplace.

This explosion in financial chicanery coincided with the rise of a perverse system of incentives, which produced highly undesirable results that often went unforeseen.

A faulty model

However, the failures of financial institutions, regulators and governments prior to the crisis were not isolated events. Instead, they reflect flaws in the economic, anthropological and ethical models that have had a dominant influence over Western economic and business practice.

Models based on flawed assumptions led to the rise of dangerous incentive systems and weak monitoring, financial reporting and accounting, which poisoned the entire organizational culture.

The anthropological model that inspired neoclassical economics says that, if the market is properly self-regulating, then individual actions, regulated by ethical values, become irrelevant, since the market will always produce socially optimal outcomes.

Needless to say, this belief in self-sufficient and self-regulating economic systems has suffered a serious setback in the aftermath of the crisis.

The obvious solution, says Argandoña, is regulation: The state must intervene to limit market abuses. And it must do so not only out of technical necessity, but as a moral responsibility. After all, a country's citizens entrust their governments to protect their economic and social rights.

That said, regulation is not always enough, and at times may even exacerbate the very problems it aims to solve, says Argandoña.

The necessity of ethics

Solving these problems requires the rebuilding of a system of ethics that looks far beyond the current obsession with short-term results and compensation.

According to Argandoña, ethics creates an equilibrium among individuals, organizations and societies. There should not be different ethics for each of these realms. In fact, ethics should be a vital part of politics and management practice.

Any purely economic interpretation of the crisis, while not necessarily wrong, is incomplete, says Argandoña. Our response to the crisis should target all three levels of ethics: People should be ethical, organizations should be set up ethically and society should function in an ethical way.

In short, ethics is key, not only to understand why the crisis happened, but also to prevent a recurrence.

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