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Trust, Confidence and Economic Crisis

This article explores the role of trust and confidence in economic life, and their relevance to the current financial crisis. It outlines a recent history of research and debate on the relationship between social trust and economic prosperity, before introducing more recent data on trust against the backdrop of the financial downturn. It goes on to distinguish the informal and social bases of trust from three key formal mechanisms of economic confidence (information, contract, regulation), linking this distinction to Akerlof and Shiller's revival of Keynes' discussion of the "animal spirits" that animate economic behaviour. Finally the policy dimensions are considered.

Explaining the current financial crisis can be a complicated science. Clearly the meltdown that took place from the autumn of 2007 represents market failure on a major scale. Financial markets failed in their twin tasks of managing and distributing risk, and effectively allocating capital for investment. Governments and other regulatory agents failed in their responsibility to monitor and steer such financial activities. Outside the instrumental complexities of collateralised debt obligations, the policy origins in the repeal of Glass-Steagall, or macro-analysis of global imbalances in levels of savings and investment, certain prominent voices have settled on a simpler and more unified account. For these commentators, the crisis involves a massive failure of trust and confidence. This goes beyond a crisis in investor trust or investor confidence. Nobel economist Joseph Stiglitz has contended that the "present financial crisis springs from a catastrophic collapse in confidence".¹ If it is more accurate to say that the latter is an effect, rather than the cause, of the initial financial collapse, it is nonetheless arguable that it is this erosion of confidence that has ensured the depth and the longevity of the crisis. Stiglitz puts it simply: "Financial markets hinge on trust, and that trust has eroded."² In his analysis of the problems besetting the financial markets, former US Labour Secretary Robert Reich argues that the "fundamental problem isn't lack of capital. It's lack of trust. And without trust, Wall Street might as well fold up its fancy tents."³ And in his keynote address to the 2009 BIAC Business Roundtable, OECD Secretary-General Angel Gurría stated: "The global financial and economic crisis has done a lot of harm to the public trust in the institutions, the principles and the concept itself of the market economy. It is also eroding public trust in corporations... This feeling of deception is dangerous."⁴

In the discussion that follows I explore the role of trust and confidence in economic life, and their relevance to

the current financial crisis. The first part of the discussion outlines a recent history of research and debate on the relationship between social trust and economic prosperity, before introducing more recent data on trust against the backdrop of the financial downturn. I go on to distinguish the informal and social bases of trust from three key formal mechanisms of economic confidence (information, contract, regulation), linking this distinction to Akerlof and Shiller's revival of Keynes' discussion of the "animal spirits" that animate economic behaviour. The final section considers the policy dimensions of this problematic, as government and other regulatory actors seek to develop measures that might re-build and sustain economic confidence.

Trust in the Economy

For Angel Gurría, "Trust is the spinal cord of economics." Institutional economists, economic sociologists, political economists and others concerned with the social organisation of economic life have long maintained that trust and confidence are crucial to effective economic functioning, not only in underwriting specific exchanges between particular agents, but in terms of a generalised foundation of trust that underpins a wider socio-economic system. In instrumental terms, resources of trust promote economic efficiency by reducing the transaction costs of economic exchange, on the assumption that others will behave according to common norms of economic conduct. It may be possible to transact without such an underpinning of trust – in contexts where cheating, fraud or corruption are

¹ J. E. Stiglitz: The fruit of hypocrisy, *Guardian*, 16 September 2008, <http://www.guardian.co.uk/commentisfree/2008/sep/16/economics.wallstreet>.

² Ibid.

³ R. Reich: Government needs to rebuild trust in markets, in: *US News and World Report*, 16 September 2008, <http://www.usnews.com/articles/opinion/2008/09/16/robert-reich-government-needs-to-rebuild-trust-in-the-markets.html>.

⁴ A. Gurría: Responding to the global economic crisis – OECD's role in promoting open markets and job creation, 21 May 2009, <http://www.oecd.org>.

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rife – but the risks and associated costs of doing so are much higher than where individuals have a reasonable expectation that others will deal plainly. In formal economies, law tends to formalise trust relations; if someone cheats me on an agreed contract, I have legal recourse. But such resort to law is costly – transaction costs are minimised when ordinary economic business is done under an implicit rather than an explicit contract, without complicated legal forms to govern each agreement. This opens onto the more fundamental sense in which trust matters for economic life, in the tacit assumptions we make that others share our understanding of an exchange, are operating according to common social norms: trust mediates the risk of socio-economic interaction. The reduction of economic uncertainty, the “oiling” of exchange relations, the management of risk, can be seen to foster economic efficiency at a macro-economic level as well as within any given exchange. Trust leads a double life as both a social value and an economic resource; as such, it is a critical concept for linking social arrangements with economic outcomes.

A number of researchers have explored the relationship between social trust and economic prosperity, with a broad consensus on the positive association between levels of trust and levels of national wealth.⁵ Individuals in wealthier economies are more likely to express trust in others (interpersonal trust) and also in economic and political institutions (systemic trust). Trust appears as a correlate of economic well-being at both ends of the wealth spectrum: levels of trust have been seen as crucial factors in the economics of transition and development, as well as for rich economies.⁶ Moreover there is evidence to suggest that it is not only wealth but its distribution that is relevant, with trust linked not only to higher GDP per capita but to lower levels of income inequality.⁷ In an important early study, Knack and Keefer

observe that “... trust and civic norms are stronger in nations with higher and more equal incomes.”⁸ In a more recent, large cross-sectional study, Delhey and Newton note the significance of cultural and political determinants of trust, but argue that the marked relationships between wealth, income inequality and trust suggest that “money matters for trust more than most things.”⁹ In a European context, national income measures are consistently linked to resources of social trust. Successive waves of data from the European Social Survey show that respondents in the wealthiest economies report higher levels of interpersonal as well as institutional or systemic trust. Finland and Denmark, for instance, score highest in measures of systemic trust, while transitional economies with comparatively low measures of GDP per capita, such as Poland, Hungary and the Czech Republic, report the lowest levels of systemic trust in Europe.

Financial markets capture the relationship between particular exchanges and a larger economic system very well. Indeed the financial crisis could be a perfect illustration of the trust thesis, as specific exchanges (lending or investment) are paralysed as part of a larger crisis of trust. Historically, trust relations have been crucial to the development of financial markets, most classically in the old City of London culture in which a broker’s word was his “bond”.¹⁰ The importance of trust, however, is not confined to gentlemanly deals between City traders. A recent paper by Guiso, Sapienza and Zingales addresses everyday investment activity explicitly in terms of “trusting the stock market”. As the authors put it: “The decision to invest in stocks requires not only an assessment of the risk-return trade-off given the existing data, but also an act of faith (trust) that the data in our possession are reliable and that the overall system is fair.”¹¹ Unreliable information or corporate malfeasance “may change not only the distribution of expected payoffs, but also the fundamental trust in the system that delivers those payoffs.” Their analysis, based on survey data from the Netherlands and Italy, shows a marked difference in levels of investment between more and less trusting respondents. Individuals who reported higher levels of trust were significantly more likely to buy stocks, and to commit a higher share of their personal wealth to such investments, leading

⁵ S. Beugelsdijk, H. L. F. de Groot, A. B. T. M. van Schaik: Trust and economic growth: a robustness analysis, in: Oxford Economic Paper, No. 56, 2004, pp. 118-134; R. Inglehart: Culture Shift, Princeton: Princeton University Press, 1990; S. Knack, P. Keefer: Does social capital have an economic payoff? A cross-country investigation, in: Quarterly Journal of Economics, No. 112, 1997, pp. 1251-1288; P. F. Whiteley: Economic growth and social capital, in: Political Studies, No. 48, 2000, pp. 443-466; P. J. Zak, S. Knack: Trust and growth, in: Economic Journal, No. 111, 2001, pp. 295-321; E. Uslaner: The Moral Foundation of Trust, Cambridge 2002, Cambridge University Press.

⁶ S. Knack, P. Keefer, op. cit.; P. F. Whiteley, op. cit.; M. Woolcock: Social capital and economic development: toward a theoretical synthesis and policy framework, in: Theory and Society, No. 27, 1998, pp. 151-208; M. Woolcock: The place of social capital in understanding social and economic outcomes, in: ISUMA – Canadian Journal of Policy Research, No. 2, 2001, pp. 12-22; P. J. Zak, S. Knack, op. cit.

⁷ E. Uslaner, op. cit.; B. Rothstein, E. Uslaner: All for all: equality and social trust, in: LSE Health and Social Care Discussion Paper, Number 15, 2005, London: School of Economics and Political Science.

⁸ S. Knack, P. Keefer, op. cit., p. 1251.

⁹ J. Delhey, K. Newton: Predicting cross-national levels of social trust: global pattern or Nordic exceptionalism? in: European Sociological Review, No. 21/4, 2005, pp. 311-327.

¹⁰ Cf. C. Mayer: Trust in financial markets, in: European Financial Management, Vol. 14, No. 4, 2008, pp. 617-32.

¹¹ L. Guiso, P. Sapienza, L. Zingales: Trusting the stock market, in: The Journal of Finance, Vol. LXIII, No. 6, 2005, pp. 2557-2600.

the authors to propose "that trust has a positive and large effect on stock market participation as well as on the share invested in stocks."¹²

As financial markets have grown more complex, and exchanges within them distanced and depersonalised via electronic communications, the problem of trust has become more acute. Systemic risk requires systemic trust, and the ways in which risk has been distributed across the system via complicated and often opaque instruments has tested systemic resources of trust to breaking-point. The choking up of different kinds of lending – inter-bank, business and mortgage lending – is a signal example of a crisis in confidence inside the financial system. The inability of banks to assess the creditworthiness of their partners in a context of toxic assets and byzantine debt obligations makes the risks of lending simply too high for trust to mitigate. There are clear problems of "external" or investor confidence too, visible in falling stock prices and depressed stock market activity. And it is also arguable that the crisis in the markets may have impacted on individuals' confidence in a wider economic and political system – in Angel Gurría's words: "Trust in governments and regulations, in banks and corporations, in open markets and globalization as a whole."¹³ In this issue of *Intereconomics*, Felix Roth¹⁴ presents data showing significant declines in expressed levels of public trust in the key European institutions, and notably the European Central Bank, together with 2008 survey data from Germany in which almost half the respondents described the social market economy as socially unjust, while almost three-quarters saw the distribution of income in the German economy as unfair.

Distinguishing Trust and Confidence

Research data such as these can be framed in terms of wider economic discourse concerning the role of trust and confidence in economic life. Notable here is the recent effort of George Akerlof and Robert Shiller to revive the Keynesian notion of "animal spirits" for the study of global capitalism. For Akerlof and Shiller¹⁵ animal spirits refer to the non-rational dimensions of economic behaviour. These tend to be seen as "psychological" – but there is good reason to extend this to a broader understanding of social relations and social norms, not simply aspects of psychology. Akerlof and Shiller address five,

more or less distinct, animal spirits: confidence; concern for fairness; corruption or other anti-social behaviour; money illusion; and the role of "stories" in shaping economic behaviour. Each of these has an explanatory role in respect of the current crisis, but my particular focus here is on confidence. This, the authors contend, is the "first and most crucial of our animal spirits" when it comes to economic behaviour. Such an assertion is in line with a view that economic relations are only possible on the basis of shared expectations regarding the conduct of economic exchange. But they suggest that the term itself implies "behaviour that goes beyond a rational approach to decision making".¹⁶ I disagree; but to stay for a moment with Akerlof and Shiller:

"Economists have only partly captured what is meant by trust and belief. Their view suggests that confidence is rational: people use the information at hand to make rational predictions. Certainly people often do make decisions, confidently, in this way. But there is more to the notion of confidence. The very meaning of trust is that we go beyond the rational. Indeed the truly trusting person often discards or discounts certain information. She may not even process the information that is available to her rationally; even if she has processed it rationally, she still may not act on it rationally. She acts according to what she trusts to be true."

The authors tend to use the concepts of trust and confidence interchangeably. It can be helpful, I would argue, to distinguish between trust and confidence in definitional terms. This is a distinction that can seem so-phistic, but is analytically useful. The seizing up of inter-bank lending is not so much a failure of trust but a crisis of confidence. If banks lack solid information regarding the value of other banks' assets and liabilities, and therefore their credit risk, they lack a basis on which to make rationally weighed decisions about lending; in the absence of reliable information, they cannot have confidence that the borrower is in a position to repay the loan. If, in contrast, banks suspect that their partners in these exchanges are, or might be, dissimulating or lying about their capital reserves or asset values, then this represents a failure of trust. Similarly, if I decide to invest in a company's stocks on the basis of their performance over time, their current stock position, and their market strategy, then I am acting on the basis of confidence. If I decide to put capital into a start-up based on my analysis of the market, and the firm's business and investment plan, I am acting (if more riskily) on the basis of confidence. But if I put capital into a start-up because I met the budding entrepreneur at a friend's party and liked him, then I am really riding on trust. It seems that

¹² Ibid. p. 2559.

¹³ A. Gurría, op. cit.

¹⁴ F. Roth: The Effect of the Financial Crisis on Systemic Trust, in: *INTERECONOMICS*, Vol. 44, No. 4, 2009, pp. 203-208.

¹⁵ G. A. Akerlof, R. J. Shiller: *Animal Spirits: how human psychology drives the economy, and why it matters for global capitalism*, Princeton 2009, NJ: Princeton University Press.

¹⁶ Ibid. p. 13.

at least some of Bernie Madoff's clients trusted him as a person. The basis on which more expert investors and brokers could have had confidence in his funds' sustained out-performance of the market over time, however, is not only a matter of serious question but of possible criminal investigation. Of course there is a large shaded area between these two categories but, in short, relations of confidence tend towards the side of objective information, external regulations over conduct, contractual agreements, rational and informed decisions; while relations of trust tend towards subjective perceptions, moral sanctions, gentlemen's agreements, non-rational choices. In the absence of mechanisms of confidence (information, law, contracts), one must fall back on trust (perception, moral obligation, social bonds) – it is under the latter conditions that "she acts according to what she trusts to be true".

In the absence or failure of reliable mechanisms of confidence, one resorts to trust in order to make decisions and in an attempt to deal with risk. The crisis of the financial system has involved precisely the breakdown of such mechanisms of confidence: the failure or distortion of information, contract and regulation. These are "the channels through which a stock market crisis becomes a trust crisis".¹⁷ In each case, elements of Akerlof and Shiller's animal spirits are in evidence.

Information

The primary financial market failure has been one of information. Various key information signals have proved false, wrong or absent. Chief among these is the specious information provided by the complex financial instruments that took an increasingly large market share. The pricing of credit derivatives was often too complicated and insufficiently transparent to allow for the reliable assessment of risk. Collateralised debt obligations systemically obscured the value of underlying debt. Off-balance-sheet accounting meant that the extent of banks' exposure to these credit instruments was not disclosed, and it seems was not always evident to the banks themselves. There is a deep irony in the fact that financial instruments originally conceived to manage and distribute risk more efficiently worked in such a way as to make risk almost impossible to calculate. The Bank of International Settlements, among others, issued repeated warnings over time that financial markets were not adequately reflecting risk, but it seems that many in the markets preferred to believe the economic "story" that the securitisation of finance had dealt effectively with risk.

Another critical economic story playing on animal spirits was that house prices would continue to rise, fuelling property booms in Spain, the United Kingdom and the United States that in the latter case outstripped the market in credible buyers, with the ripple of consequences we have seen across the international economy. Over-valued house prices are an instance of the "money illusion" to which Akerlof and Shiller refer, in which inflationary price movements fail to reflect asset values. Perhaps most questionable of all in respect of market information was the complicity of auditors with accounting practices that buried extensive risk in structured investment vehicles or other subsidiaries, or of rating agencies in telling reassuring stories about the creditworthiness of the same firms that paid them to issue such assessments.

False or misleading price signals represent a significant distortion of information in a market context. As Robert Reich expresses it: "Financial markets trade in promises – that assets have a certain value, that numbers on a balance sheet are accurate, that a loan carries a limited risk. If investors stop trusting the promises, financial markets can't function."¹⁸ In the autumn of 2008, finance markets effectively stopped functioning.

Contracts

The second crucial mechanism of economic confidence is contract. The making of contracts provides security in economic transactions, managing the terms of exchange and offsetting the risk that one or the other side will cheat. Contracts are designed to make economic relations transparent, to protect different parties' interests, and to reflect the rational agreement of all actors. The failure of this second mechanism of confidence was especially evident in the collapse of the sub-prime mortgage market in the United States and elsewhere. There is always a level of mortgage default in housing markets, but the contagion of broken contracts in the sub-prime sector vastly exceeded the level of default the market could bear. Three issues are relevant here. The first is that sub-prime contracts were often poorly understood by those buyers entering into them. Sharply escalating repayments may have been stated in the contract terms, but were not fully accounted by borrowers. It follows, secondly, that the most important part of sub-prime contracts was contained, to all intents and purposes, in the "small print". Thirdly, the information on which these contracts were based was often absent or wishful – absent in the case of no-document loans, wishful in the assumption that continuously rising house prices would offset the high credit risk. The contracts that secured sub-prime mortgages may

¹⁷ P. Saprenza, L. Zingales: A trust crisis, http://faculty.chicago-booth.edu/luigi.zingales/research/papers/trust_crisis.pdf, 2009, p. 6.

¹⁸ R. Reich, *op. cit.*

have been freely entered, but were not clearly based on transparency, rational agreement, or any balanced share of reliable information between parties. Contracts that are opaque, deceptive, or poorly understood raise issues of unequal power in market exchange that the contract form is itself supposed to mitigate.

Regulation

The contract is the basic regulatory form in market economies. This is the third sphere in which the financial crisis can be understood in terms of the failure of mechanisms of confidence. Market systems depend on regulation to function effectively: they are, as Karl Polanyi put it, "instituted" through legal, organisational and contractual means, at different degrees of formality. In this sense, the light touch previously espoused by the US Federal Reserve or the UK's Financial Services Authority does not represent de-regulation so much as mis-regulation – producing the regulatory environment which allowed for both the explosion of credit risk and the absence of systems to render such risk calculable. The Federal Reserve recognised but did not advise investors that the US mortgage industry was dealing in securities that could not be effectively priced. The lack of transparency surrounding its decisions on interest rates was consistent with a kind of "money illusion" that abstracted inflationary or deflationary movements in the short-term lending rate from underlying economic conditions. The Bank of England was more vocal about the markets' failure to properly value risk and the associated threat to financial stability, but the Financial Services Authority did not move until the spring of 2009 to regulate the proliferation of innovative instruments, adequately oversee banks' risk assessments and business models, or require that they held sufficient capital to off-set risky market activity. Market regulation, of course, is not only the remit of public authorities. Public and private agents of market governance – Treasury officials, central bankers, securities and exchange commissioners, but also pension fund managers, corporate boards, auditors and ratings agencies – are active in instituting markets in particular ways. The choice in this context is not whether or not to regulate markets: the institution of the financial sector as a highly de-regulated market is itself a regulatory strategy.

Trust, Confidence and Economic Regulation

It is such mechanisms of confidence – information, contract, regulation – that enable people to place their "trust" in specific institutions or in wider economic and political systems. Beyond the failure of these formal devices, however, lies another key factor in the crisis: the moral agency of individuals. In the most recent survey round for their Financial Trust Index, Sapienza and Zin-

gales found that the largest single cause to which their US respondents attributed the 2008 financial crisis was "managers' greed" (33%) – more than twice as many as attributed the crisis to "poor corporate governance" or "lack of regulation".¹⁹ This draws out the contrast between formal, and impersonal, mechanisms of confidence, and the social or moral bases of trust. Moral sanction clearly does not work in respect of corporate bonuses and pay-outs – and what are neatly called "pensions", although they do not work in the way that most employees would understand the notion of a pension. The difference between trust and confidence was clearly on display in cases where public and political outrage demanded the return of bonuses by employees of heavily subsidised banks. Many of the latter, it seemed, did not recognise the moral basis of a demand that – the lawyers could confirm – would not be legally enforceable. Substantial injections of public funds into practically insolvent institutions that then paid out large bonuses to a small number of their employees exemplified a financial system in which gains were privatised and losses socialised. The payment of bonuses against a backdrop of economic downturn and job losses in the real economy offended against that "concern for fairness" which Akerlof and Shiller identify as the second of the animal spirits, even if it did not shade into the third – corruption. The brokers may have been contractually entitled to hand-outs, but the public perception was that they did not deserve them. The bonus culture was more properly a free-for-some than a free-for-all, with traders' bonuses justified on the basis that these employees were generating wealth, when in fact they were generating value.

The concern for fairness puts into question the moral character of individuals who had not behaved illegally, who were indeed performing (whether more or less well) their job. In a speech in March 2009, the Chief Executive of Britain's Financial Services Authority professed his faith in the moral foundations of the City of London: "I continue to believe", H. Sants said, "the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles."²⁰ He is right. The personal decency of any banker or broker should be of little public concern if their performance is effectively regulated to ensure legality, efficiency and a prudential approach to risk. The problem is that it was his own organisation that was tasked with such regulation in the period when

¹⁹ P. Sapienza, L. Zingales, *op. cit.*, p. 6.

²⁰ H. Sants: Delivering intensive supervision and credible deterrence, speech to the Reuters Newsmakers Event, London, 12 March 2009, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml.

excessive risks were being taken, it seems, by any number of "decent people". The light touch regime created severe moral hazard in allowing for drastic over-leveraging, bonus-driven remuneration, and a fetish for financial innovation that calibrated risk in terms of various novel instruments, loans and swaps but included no serious consideration of overall systemic risk.

Governments (at least in democracies) cannot legislate for moral feeling, but there is a central regulatory role to be played in restoring public confidence in the integrity and efficiency of institutions whose purpose, after all, is not primarily to enrich individuals but to allocate investment across the economy. The inefficiency with which financial markets are performing this basic function – as share trading drags, business lending dries up, bankruptcies rise and productive output declines – is compounded by the sector's increasing cost to the economy over time, as OECD figures show financial services taking, from the mid-late 1980s, an increasing share of aggregate income and corporate profits in many of the world's largest economies – United States and Japan, Britain, France and Germany – even before one factors in the costs of recent bail-outs. As a mechanism for allocating productive investment efficiently and economically, the global financial system might currently bear comparison with Soviet central planning. There is no serious argument to replace market actors with government actors in this allocative role, but the latter do have an important part to play in ensuring the financial sector performs its economic function effectively, and in promoting wider confidence in the system. This will involve, to be sure, an appeal to animal spirits as well as formal mechanisms, but the balance between the two is in need of redress. Economic confidence during the credit bubble was premised on stories that were as attractive to government actors as to citizens – of the "Great Moderation" of low and stable interest rates, of rising tides and floating boats – and on trust in a "feel-good factor" which indeed felt too good really to be true.

Robert Reich suggests that: "If what's lacking is trust rather than capital, the most important steps policymakers can take would be to rebuild trust. And the best way to do that is through regulations that require financial players to stand behind their promises and tell the truth, together with strict oversight to make sure they do."²¹ It is difficult to argue with this view, but also difficult for policymakers to perform this role credibly so long as their interests are not clearly distinct from those of the financial players they are bound to oversee. The independence of central banks from political interests

has become an article of economic faith, but the independence of political actors from private economic interests is of at least comparable importance. As many people (40% in each case) responding to Sapienza and Zingales' 2009 survey on financial trust believed that the primary motivation for the rescue plan developed under Treasury Secretary Henry Paulson was in "the interest of Goldman Sachs" as believed it was in "the interest of the country." If it was once possible to think that what was good for General Motors was good for the country, it is not obvious that this could plausibly be said of Goldman Sachs. Nor is it obvious that the threat to free markets from government ownership of major corporations is a more clear and present danger than "the perception that the government is captured by big business".²²

Reich's position is complicated by the fact that the crisis of public trust extends beyond financial markets and market actors to policymakers themselves, as part of what Joseph Stiglitz refers to as a "global mistrust of government experts".²³ This is the spectre that the OECD Secretary-General fears: a collapse in "trust in governments and regulations, in banks and corporations, in open markets and globalization as a whole".²⁴ The rhetoric is somewhat overdone. I may or may not trust my stockbroker, who is handling my money in transactions that I do not personally monitor. At a stretch I might be said to trust the government: that is, to trust policymakers to act with probity, or the governing party to act in line with my interests. It makes less sense, however, to think about trust in such abstractions as "open markets" or "globalization as a whole". Where Gurria's line does resonate is with that foundational sense of trust as the pre-condition for an economic system as well as for any specific exchange within it, the social norms that allow individuals to transact with others on the basis of shared, and tacit, assumptions about conduct: trust, as he puts it, as the "spinal cord" of the economy.

What, then, are the mechanisms through which economic trust and confidence might be eroded or enhanced? We can think about this question in relation to the "animal spirits" identified by Akerlof and Shiller. The "first and most crucial" of these – and the heart of Keynes' use of the term – is confidence. Confidence can be built through informational resources and institutional measures that are generally taken to be reliable, transparent, and subject to appropriate scrutiny. Akerlof and

²¹ R. Reich, *op. cit.*

²² P. Sapienza, L. Zingales, *op. cit.*, p. 9.

²³ J. E. Stiglitz, *op. cit.*

²⁴ A. Gurria, *op. cit.*

Shiller recognise as much when they advocate government targets for credit alongside the setting of fiscal targets – managing levels of borrowing and spending in a manner analogous to using monetary policy to manage inflation. Indeed this steering of credit in the economy is already happening, through forms of re-discounting or economic stimulus designed to get banks lending or businesses borrowing. The question remains as to how these temporary measures might relate to a longer-term government oversight of levels of credit in the economy. Part of the answer will involve finding ways to ensure banks act like banks – assessing risk and creditworthiness in a prudential fashion, and allocating capital accordingly – rather than like high-stakes gamblers. This will involve increased banking regulation: in particular insuring against over-leveraging by requiring banks to hold substantial capital against their exposure to risk. It should also mean regulating in a similar way the various forms of non-bank creditors and investors: hedge funds, private equity funds, insurance companies, structured investment vehicles. In this sphere, the April 2009 draft EU directive on Alternative Investment Fund Managers is a concrete instance of a regulatory measure that promises to promote confidence through better oversight and greater transparency. The directive would allow non-EU hedge funds or private equity funds to operate in European markets on the condition that they met European standards of supervision, including controls over leverage and enhanced requirements for disclosure. Such measures, disagreeable as they might be to hedge fund and private equity managers, provide the basis for other actors to make rational decisions about investment with a greater degree of confidence.

Government and other regulators can also respond to the concern for fairness, and the antipathy for anti-social behaviour, that animates or erodes economic trust. In a macro-economic context, such a concern with fairness may be embedded in the observation that countries with more equal income distribution report higher levels of interpersonal trust. In relation to financial markets, there is a strong argument from fairness for the reform of structures of remuneration. The accelerated share of economic activity taken by financial services since the mid-late 1980s went together with the over-valuing of certain jobs in this sector, creating disparities both between different functions within the industry and between employees in this sector and those in other parts of the private sector.²⁹ In spite

of the public discontent with inflated salary and bonus packages in conditions of corporate failure, however, there is little to suggest that there is any real appetite on the part of either public (government) or private (board-member or major shareholder) actors to regulate private sector arrangements of this kind.

I have suggested that there are no serious arguments for government actors taking over from financial markets the function of allocating investment capital. This is not strictly true. Bail-out monies on both sides of the Atlantic are precisely attempts to stimulate and to steer flows of investment capital, whether through banks and other financial institutions, or directly to producers – as in rescue plans for the auto industry. It would be difficult to find a policy-oriented economist who would argue against the economic necessity of such measures: indeed the argument of such figures as Robert Shiller or Paul Krugman has been that the level of government stimulus has been too *low*. Government actors are market actors. They represent, or should represent, public rather than private interests, but nonetheless they are key market actors, whether as lenders, borrowers, investors or regulators. On the other hand, I would suggest that a crucial element of the public opposition to bail-out packages for the financial sector derives from the way that the core function of these institutions – the allocation of capital to businesses, public bodies and households – has been obscured by the perception (not a false one) that the chief business of banks and the like has become that of generating money from money, while charging an excessively high price for doing so. The Edelman Trust Barometer 2009³⁰ reports that 62% of respondents in a twenty-country sample state that their trust in corporations is lower than it was in the previous year, while 65% overall agreed that their governments should exercise tighter regulation over businesses in all sectors. A critical reason why the massive financial market failure has proved so difficult to resolve is the associated collapse of trust as a foundation for economic action and a means of mediating risk. Trust cannot easily be restored once it has eroded, but more formal means of securing confidence through credible sources of information, fair forms of contract, and disinterested forms of regulation provide reliable conditions for economic behaviour. Arguments from within the financial sector against the regulatory turn are growing: the chief policy error would be to allow those sectoral interests to outweigh the more basic requirements for formal mechanisms to build economic confidence.

²⁹ Cf. T. Philippon, A. Reshef: Wages and human capital in the U.S. financial industry: 1909-2006, in: NBER Working Paper, No. W 14644, 2009, <http://ssrn.com>.

³⁰ Edelman Trust Barometer, <http://www.edelman.co.uk/files/trust-barometer-2009.pdf>.