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20 Trust and the global financial crisis

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Trust is crucial for the economic system. However, trust in the financial system to be efficient, self-regulating and ultimately beneficial for all has been massively undermined by the global financial crisis. As Nobel Prize laureate in Economics Joseph Stiglitz underlined,

Even in a market economy, trust is the grease that makes society function. In the current crisis, bankers lost our trust, and lost trust in each other. Economic historians have emphasized the role that trust played in the development of trade and banking. The big lesson of this crisis is that despite all the changes in the last few centuries, our complex financial sector was still dependent on trust. When trust broke down, our financial system froze. (2010: 289)

It is no exaggeration to say that human societies rest upon mutual trust to keep them together. People need to trust others not to deliberately harm them and to behave reliably. In the absence of a breach, we mostly do not think about this. We continue to pursue our goals, assuming all will go well provided we put in the effort, intelligence and resources. But we depend upon the underlying system to be sound. Normally, we proceed on the assumptions of confidence that the earth will not give way or that we will not be hit by a large wave from out of the blue. We make similar assumptions about the economic system not collapsing. Generally, we need to trust our systems, which is another way of saying that we have confidence in them not to betray us.

Although a significant part of the recent global financial crisis (GFC) is a crisis of loss of confidence and trust, there are also some further characteristics. The current crisis is unprecedented in size, depth and scope, extending to institutional defaults and sovereign debt. It has impacted at lightning speed in financially advanced countries around the world. For many, following the boom of 2002-7 the GFC came unexpectedly as if a visitation from out of the blue – from outer space. Actually, it was correctly predicted, but not by the right kind of people; those mainstream economists central to the running the US economy. Stiglitz recalled his experience at an economics conference after the bubble had burst in 2008 when a chorus of central bankers told him that nobody had predicted the collapse. Despite the fact that Stiglitz and others at the conference were on record as predicting it, Stiglitz realized that what the central bankers meant was that “nobody with credibility” had predicted it. So, this should be seen in terms of the roles of the central institutions of economic power and theory on which they are based.

For mainstream economic leaders, it was as though there were no real imminent root causes that produced what they thought of as a “once-in-a-career event” at most. There seemed no systemic causes. Yet many others panicked, seeing that the system was not sufficiently stable to guarantee their investments. The mathematical, scientific economic modelling of efficiency theory that excluded human motivations and responses failed to support the centre of the system or forestall the collapse of pivotal icons of economic faith and stability. As Stiglitz discovered in the research for which he was awarded his Nobel Prize, although the neoclassical models assume the efficiency of markets except in particular instances of market failure, the opposite is the case. Models may assume perfect information and rationality from which to generalize but in reality the information is imperfect because workers, products, resources and situations differ in qualitative as well as quantitative ways. Because a world with perfect information differs markedly from a world with imperfect information, the former was not a viable model for the latter (Stiglitz 2010: 239-42).

Invariably, model makers miss critical conditions that occur only rarely but do in fact occur. Rarely are the users of the model aware of all the conditions tested or of the rare conditions under which the model creates disasters, as in the case of the BP Deep Horizon well of 20 April 2010. Although economic models give a seemingly positive answer, such a calculation, in reality they provide only hypotheses created by earlier observations of specific conditions, actions, reactions, tested in a variety of environments to determine conditions under which the hypothesis may or may not be true. Today, many answers are model driven. However, a model should not be confused with an answer. Such confusion lies at the heart of the kind of thinking that has got us to where we are today! It seems that mainstream economists have assigned robotic characteristics to those who are the ‘market’. They have pigeon-holed human characteristics based on false or incomplete information about populations of flesh-and-blood humans. Many other aspects of humanness operating in social systems have not been included in those models.

One such operating component of humans is the human capability for problem solving and creating entirely new future conditions at rapid rates (Jacques and Caso 1984). Today those creations move through the global network in nanoseconds - no wires attached! By missing key assumptions, such as the importance of non-economic factors, or by making erroneous assumptions, such as perfect information or rationality, they bring about wrong and harmful results. The internet allows such rapid communication and dissemination of information that the psychological factors of euphoria, mania, fear and panic are not contained and spread swiftly, ‘calming’ or ‘exciting’ the market.
Because the market is not simply a mathematical entity, both economic and non-economic factors make an impact. An important non-economic component is what John Maynard Keynes labelled ‘animal spirits’. In its original Medieval Latin sense it meant ‘of the mind’ but has become transformed to mean what Akoff and Shiller in their recent book, titled Animal Spirits, call ‘a restless and inconsistent element in the economy. It refers to our peculiar relationship with ambiguity or uncertainty. Sometimes we are paralysed by it. Yet at other times it refreshes and energizes us, overcoming our fears and indecisions’ (2009: 3-4).

As Shiller (2009) commented elsewhere, ‘it refers also to the sense of trust we have in each other, our sense of fairness in economic dealings, and our sense of the extent of corruption and bad faith’. Trust, which dismissed doubts about others, was crucial to animal spirits.

Keynes sought to convey the message that swings in confidence are not always logical. The business cycle is in good part driven by animal spirits. There are good times when people have substantial trust and associated feelings that contribute to an environment of confidence. They make decisions spontaneously. They believe instinctively that they will be successful, and they suspend their suspicions. As long as large groups of people remain trusting, people’s somewhat rash, impulsive decision-making is not discovered.

Unfortunately, we have just passed through a period in which confidence was blind. It was not based on rational evidence. The trust in our mortgage and housing markets that drove real-estate prices to unsustainable heights is one of the most dramatic examples of unbridled animal spirits we have ever seen. (Shiller 2009)

Shiller adds another important factor related to trust. The new, far more complex system of granting credit meant more intermediation in the markets, more complex arrangements with innovations in housing mortgages, securitization and derivatives, including the shadow banking sector.

The more complex the transaction the more trust is needed to sustain the transaction...

The trust in the innovative lending practices was excessive; now that trust is replaced by deep mistrust. The wreckage of formerly towering financial institutions is all around us. (Ibid.)

Trust is dependent on psychological factors. Indeed, psychology plays a key role in the work and direction of economies. Psychological confidence is essential to the functioning of the market. Consumers and investors behave differently depending on their confidence or concern.

In the GFC, as Stiglitz stated, ‘the trust and confidence that underlie the banking sector evaporated’ (2010: 3). Confidence, trust and faith in the system are crucial to understanding waves of euphoria and mania, which push the markets upwards, and the panic and fear that bring them down. The past few years of easy credit have allowed Ponzi schemes to rise to immense proportions and then collapse like houses of cards around the world. Faith in the financial institutions has been too great to the point of illusion or delusion, while scepticism and panic can cause collapse. The central importance of psychology is underlined by the way self-fulfilling prophecies can pull the market down through initial panic, leading to increasing panic. In boom times, when the economic system seems to produce ongoing growth and development, the psychology is hidden or muted; the market then seems to have an inevitable upward dynamic all of its own. It is then that many people simply assume that things will continuously improve and pay little attention to the market except to reap their profits. It is seen simply as a taken-for-granted fact of life that needs little explanation, certainly not a psychological one. The bubble may not look like a bubble in an economy on the rise when economic rationalism and economic greed seem sufficient to explain increasing euphoria. Yet this assumption requires explanation, if only because there are busts as well as booms.

When things go well, the system seems to be producing results on its own, akin to what Adam Smith called the ‘invisible hand’ of the market in his classic work of 1776, The Wealth of Nations. All that was required was a free market in which each would pursue his or her own ends, which ipso facto would also produce the best for the whole community. This concept of the coincidence of individual and social aims formed the basis for the value of self-regulation of the market under laissez-faire capitalism. However, people lose faith in this invisible hand when there are busts, or after bubbles such as the recent credit bubble. Belief in the stability of the system that has been taken for granted is vital when the system seems under threat. Our psychological attitude, best defined by whether or not consumers and investors basically trust the system to be safe and secure, has consequences. Crises are not mainly the result of purely economic factors. As Akoff and Shiller assert,

The idea that economic crises, like the current financial and housing crisis, are mainly caused by changing thought patterns goes against standard economic thinking. But the current crisis bears witness to the role of such changes in thinking. It was caused precisely by our changing confidence, temptations, envy, resentment, and illusions – and especially by changing stories about the nature of the economy. (2009: 4)

Banks were regarded as the most robust part of the system before they went beyond their traditional roles and became clearly involved in easy credit schemes. The necessity for trust was such that governments needed to intervene to guarantee banks. If there is not some fundamental guarantee that banks can be trusted in difficult times, then consumers will shift their money away.
Our attitude or approach towards the economy is fundamental to its functioning. As Bob Reisch, chief investigator for the US Senate Committee investigating the collapse of Goldman Sachs, put it, we need a system that will operate far differently, 'because in the end people have to have faith that the system will work for everybody, not just for a group of insiders. And if that faith and confidence isn't restored, we're going to have a lot of problems' (Australian Broadcasting Corporation 2010).

Taxpayers and consumers need to feel assured that guarantees of bailouts do not gravely impact on the real wider economic system in which they have a major stake. This means that if governments, and therefore taxpayers, need to guarantee the banking system with possible bailouts, then governments have an appropriate major role in regulating that system. Stiglitz notes the irony that 'the way the model of American individualism worked was that people took responsibility for successes but showed little sense of accountability, or responsibility for the failures or the costs imposed on others' (2010: 282). This is far from a trust-inducing situation, which requires taking responsibility for all outcomes. Moreover, there is a fiduciary relationship between investment banks and their investors that requires oversight through laws and regulations. As Akerlof and Shiller conclude about the role of regulation in capitalism,

We had forgotten the hard-earned lesson of the 1930s: that capitalism can give us the best of all possible worlds, but it does so only on a playing field where the government sets the rules and acts as a referee. Yet we are currently not really in a crisis for capitalism. We must merely recognize that capitalism must live within certain rules. Indeed our whole view of the economy, with all of these animal spirits, indicates why the government must set those rules. (2009: 173)

The behaviour of the financial industry and institutions itself affects the financial and economic system and demonstrates the need for external regulation. Government or collective action has significant characteristics. Hurd mentality, identification with leaders, regression, splitting, projection and behaviour are par for the course in groups and organizations. The implementation of policies or aims is often at considerable odds with the laudable aims of many institutions, such as the Church, the United Nations or corporations (Long 2003). Self-evidently, trustworthy institutions cannot allow systematic fraud and corruption to rule, and therefore need transparent structures, regulations and oversight to prevent this.

The financial system has shown that it cannot be relied upon to regulate and prevent fraud and that the required faith and confidence of investors to keep that system going means government involvement to assure trustworthy institutions. The financial system, including banks, can no longer be detached from the economic system (if ever it should have been), especially given the limited data upon which the models that have propped up the financial system have been based. As Akerlof and Shiller observe,

in their attempts to clean up macroeconomics and make it more scientific, the standard macroeconomists have imposed research structure and discipline by focusing on how the economy would behave if people had only economic motives and if they were also fully rational. (2009: 168)

These economic models assume that people always act rationally and from only economic motives, and that therefore the financial system should be self-regulating. However, if the models took psychological factors into account, there would need to be government intervention and regulation (ibid.: 173). As Gillian Tett observes, the financial system itself has many silos within it. Different departments of banks vie with each other with little oversight, and regulators themselves have many silos within their organizations. The connection with reality was both tenuous and tendentious: 'The chain that linked a synthetic CDO [collateralized debt obligation] of ABS [asset-backed security], say, with a "real" person was so convoluted, it was almost impossible to fit that into a single cognitive map - be they anthropologist, economist or credit whizz.' This disconnect was not noticed because credit was considered to be so technical that only experts could deal with it, and it was 'a classic area of social silence' (Tett 2009: 293).

This area of social silence illuminates how far illusion replaced reality in the financial system. Many bought the illusion that it was axiomatic that the new financial instruments would of themselves contribute to stability and growth. But far from adding to the stability of the system, the new financial instruments contributed to the illusion of the financial alchemy that the compound of infinite market liquidity and continuous market innovation would keep wealth increasing (Nesvetailova 2010: 145). Stiglitz also uses the alchemical metaphor: 'Modern alchemy entailed the transformation of risky sub-prime mortgages into AAA-rated products safe enough to be held by pension funds. And the rating agencies blessed what the banks had done.' The banks then became gamblers. Thinking they had passed on the risky assets they held, they were 'caught off guard' when the market collapsed (Stiglitz 2010: 6).

One major form of illusion in the financial system has been that peculiar combination of knowing and not knowing: 'turning a blind eye' to what was going on. Many, both within and outside the financial system, had turned a blind eye to what was going on. It is a dim awareness that is dimmed by an awareness of the displeasure involved in facing it, and an attitude that can only engender mistrust. British psychocritique John Steiner focused on the idea of having insight but at the same time turning away from it and misinterpreting it. Steiner discussed the mechanism of turning a blind eye, which occurs when 'we seem to have access to reality but choose to ignore it because it proves convenient to do so' (1985: 161). According to Steiner, this conveys the right kind of ambiguity about how conscious and unconscious the knowledge is:

At one extreme we are dealing with simple fraud where all the facts are not only accessible but have led to a conclusion which is then knowingly
that we need to be realistic about what is normal: succumbing neither to panic nor to euphoria, either in life or in the market. This is what Freud termed the ‘reality principle’, which served the pleasure principle but often not in the short term. In Beyond the Pleasure Principle (1920/1955), Freud suggested that the pleasure principle, which holds that we seek the immediate gratification of our drives, must be modified with the advent of civilization by the reality principle, which involves the subservience of the pleasure principle to the demands of reality. This is demonstrated in the development from the immediate satisfaction of childhood immaturity to the delayed satisfaction or resignation of adult maturity.

Freud is often regarded as being solely focused on the mental life of the individual, but this is mistaken. Freud saw an inseparable link between individual and the collective: individual psychology was at the same time ‘social psychology as well’ (Freud 1921/1955: 69). Reality contrasts with illusion and fantasy, and involves social bonding. For Freud, turning away from reality defines neurosis, which has collective as well as individual significance. Freud notes that neurosis involves not just withdrawal from reality but withdrawal from society. Reality involves being social, living together with others in the human community; and neurosis involves cutting the bond with society:

The social nature of neuroses has its genetic origin in their most fundamental purpose, which is to take flight from an unsatisfying reality into a more pleasurable world of fantasy. The real world, which is avoided in this way by neurotics, is under the sway of human society and of the institutions collectively created by it. To turn away from reality is at the same time to withdraw from the community of man.

(1913/1955a: 74)

The neurotic personality utilizes illusion or fantasy with its hallucinatory pleasure, and numbing of the pain involved in confronting what is really going on. According to Freud, this is not a simple misperception to be corrected by pointing to the facts. There is a pay-off in keeping away from reality; the fulfillment of a wish in fantasy, an investment in this pleasure. Freud’s work The Future of an Illusion (1927/1961a) was a trenchant critique of religion as a major form of wish fulfillment that kept us from confronting and dealing with reality. For Freud, the religious worldview, built on wish and illusion, had its basis in the springs of childhood emotion, which he contrasted with a scientific approach built upon real issues and how best to deal with them. Past decades have seen a denial of reality in the financial system which has significantly undermined trust. After the 1987 stock market crash, I wrote an article on the role of illusion and other psychoanalytic aspects, including splitting, projections and manic denial (Kinsler 1990). Recently, Morante summarized his argument that

an important psychological factor underpinning the crisis was the collective need to escape the reality of an increasingly complex and vulnerable global
world and find an illusory refuge in the ownership of money and property. On the trail of a favorable economic cycle, financial operators, regulatory authorities and the public collided in the illusion, which eventually developed into something akin to a psychic retreat, that financial markets would provide effortless and everlasting wealth and home ownership to an increasing number of people. The paper considers how omnipotence, illusion and the absence of the father/authority figure as the psychic representative of reality fostered a manic wave of rampant optimism, greed and overconfident investors. (2010: 4)

The recent denial of reality that undermined trust included the self-serving fraud of using easy credit and new financial instruments as a means of, for example, bundling junk assets with real assets; unquestioned faith in economic efficiency models of the market which proclaimed that it would sort itself out through self-regulation; and faith in the world of derivatives in failed attempts to postpone any rendezvous with reality into the indefinite future.

The scope of these recent temptations to deny reality is enhanced and magnified by the socio-economic context of the contemporary post-industrial world. Accelerated technological and social change has led to vast and fast interconnections, with decreasing time for reflection and thought about such immense changes and their consequences. This involves reconfiguring how the economic system operates, with the largest, very diverse world economies coming together as G2, G8 and G20 in attempts to deal with common global financial issues. There have been immense shifts in production from the West to developing countries such as China and India, making the world ‘flat’, as Thomas Friedman (2007) argues. The system became global, with a number of centres such as China and the European Union, instead of being unequal with the United States as central. A significant factor that has promoted illusion is the emergence of a major driver of the world economy: a new chimeric entity designated by economic historian Niall Ferguson and economist Mortiz Schularick (2007) as ‘Chimerica’. Ferguson explains: the most important thing to understand about the world economy over the past decade has been the relationship between China and America. If you think of it as one economy called Chimerica, that relationship accounts for around 13 per cent of the world’s land surface, a quarter of its population, about a third of its gross domestic product, and somewhere over half of the global economic growth of the past six years (Ferguson 2009). Although this ‘symbiotic relationship’ appeared as a ‘marriage made in heaven’, since one half saved while the other half spent, it was based on shaky assumptions that should lead to impending divorce. China promoted its competitiveness by artificially keeping its currency from appreciating by acquiring a large dollar reserve, and has successfully encouraged saving. Conversely, US consumers massively overspent with easy credit, including new financial instruments that bundled together junk and real assets and passed the debt down the line until it could be postponed no more, leading to defaults...

(2002b: 251)

Economists have only partly captured what is meant by ‘trust’ or ‘belief’. Their view suggests that confidence is rational: people use the information at hand...
to make rational predictions; they then make a rational decision based on those 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 disregards 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.

(2009: 12)

The GFC has been traumatic for a large range of people on whom it has impacted in terms of loss of property, jobs, income and security. The effect is not just physical but psychological. A sense of some control over the main direction of one’s life is important to a sense of identity and optimism about the future. But the failure of trust has been especially dramatic in the GFC. As Burkard Sievers argues, trust involves vulnerability. “The greater the risk trust has to ‘absorb’ the greater the capacity required to cope with the loss when one’s trust is violated” (2003: 31).

The disassociation of the broader economic system from the financial system is, especially in boom times, an illusion that feeds an inevitable fall at the end of the bubble. Galbraith (1987a) explains that in a stock market, real estate or art boom,

[there is increasing participation by institutions and people who are attracted by the thought that they can take an upward ride with the prices and get out before the eventual fall. This participation, needless to say, drives up prices. And the prices so achieved no longer have any relation to underlying circumstance. Justifying causes for the increases will, also needlessly to say, be cited by the vastly vulnerable financial analysts and commentators and, alas, the often vulnerable business press. This will persuade yet other innocents to come in for the loss that awaits all so persuaded. For the loss will come. The market at this stage is inherently unstable. At some point something – no one can ever know when or what – will trigger a decision by some to get out. The initial fall will persuade others that the time has come, and then yet others, and then the greater fall will come. Once the purely speculative component has been built into the structure, the eventual result is, to repeat, inevitable.

Apart from its socio-economic structure, the market is, importantly, a repository of our wishes. Nine months before the 1987 stock market crash, John Kenneth Galbraith observed, in an article published in January 1987 about parallel circumstances with the 1929 crash, “There is a compelling vested interest in euphoria, even, or perhaps especially, when it perverts, as in 1929, on insanity. Anyone who speaks or writes on current tendencies in financial markets should feel duly warned” (1987a: 62). Galbraith also notes that, throughout history,

[nothing so gives the illusion of intelligence as personal association with large sums of money. It is, alas, an illusion. The mergers, acquisitions, takeovers, leveraged buy-outs, their presumed contribution to economic success and market values, and the burden of debt that they incur are the current form of that illusion.

(ibid.: 65)

According to Galbraith, nothing is really new in the world of finance, and the controlling fact is ‘the shortness of the public memory, especially when it contends with a euphoric desire to forget’ (ibid.: 68). If he were with us today, I imagine he would be signally unimpressed by the financial instruments of the New Economy which have helped to delude investors about the galloping distance from ‘underlying circumstances’. Trust in any trust in the system would be absent.

Just after the 1987 stock market crash, Galbraith suggested that recent years had seen an outbreak of ‘financial dementia’ in Wall Street, with the lessons of the past going unheeded.

People and institutions were in the stock market in these last five years, some in the belief that it would go up for ever, some in the equally innocent conviction that their own peculiar financial genius would allow them to get out before the fall. This is the pure speculative situation. Anything, or even nothing, can trigger the eventual, inevitable and very rude wake to get out.

(1987b)

Galbraith would have agreed with George W. Bush’s assertion in July 2008, ‘Wall Street got drunk’ (Doyle 2008).

The close connection between society and the financial system needs to be acknowledged so that the self-validating economic models are based on realities rather than carefully restricted theories based upon limited criteria. A widespread sense of basic trust goes beyond the necessary recognition of flawed assumptions involving the autonomy and self-correcting nature of the free market into trusting the wide range of factors involving trust between Wall Street and society.

This chapter has focused on the centrality of trust and trust-inducing institutions in the foundations of the economic and financial systems in societies. The situation facing the world at the GFC raises some fundamental issues about how to erect and maintain a secure foundation of trustworthy institutions. Many of the old divisions of left and right have disappeared, as it is now indisputable that the state needs to be involved with regulating the economic system. What is the relation between economy and the state and what are the future optimal roles of the national state and combinations of states? The answer is not so much in the proportion of state versus market but the foundation of what will promote mutual trust, human bonding and progress. What kinds of codes are optimal to be trust-inducing across societies? The recipe involves a spectrum where creativity is
encouraged together with respect and a sense of fairness. A multidisciplinary approach to understanding the future economic system needs to go beyond economic models and other silos. At the very least, trustworthy institutions prevent deliberate harm – they would target fraud and manifest unfairness. These past years have seen not only gigantic fraud on the part of companies such as Enron and pyramid sellers such as Madoff, but also immense compensation for executives involved with corporate failure in the first place. People are prepared to accept genuine mistakes and accidental harm but their sense of fairness is offended when leaders profit from their own bad actions. It also requires greater complexity in going beyond the national level to trustworthy agreements between nations that are sustainable. As Stiglitz recently concluded,

An environment of bitterness and anger, of fear and mistrust, is hardly the best one in which to begin the long and hard task of reconstruction. But we have no choice: if we are to restore sustained prosperity, we need a new set of social contracts based on trust between all the elements of our society, between citizens and government, between this generation and the future.

(2010: 208–9)

References


