The Economy Will Not Recover Until Trust is Restored

By Washington's Blog
Global Research, September 11, 2009
Washington's Blog 10 September 2009

Region: USA
Theme: Global Economy

A 2005 letter in premier scientific journal Nature reviews the research on trust and economics:

> Trust … plays a key role in economic exchange and politics. In the absence of trust among trading partners, market transactions break down. In the absence of trust in a country's institutions and leaders, political legitimacy breaks down. Much recent evidence indicates that trust contributes to economic, political and social success.

Forbes wrote an article in 2006 entitled "The Economics of Trust". The article summarizes the importance of trust in creating a healthy economy:

> Imagine going to the corner store to buy a carton of milk, only to find that the refrigerator is locked. When you've persuaded the shopkeeper to retrieve the milk, you then end up arguing over whether you're going to hand the money over first, or whether he is going to hand over the milk. Finally you manage to arrange an elaborate simultaneous exchange. A little taste of life in a world without trust–now imagine trying to arrange a mortgage.
>
> Being able to trust people might seem like a pleasant luxury, but economists are starting to believe that it's rather more important than that. Trust is about more than whether you can leave your house unlocked; it is responsible for the difference between the richest countries and the poorest.
>
> "If you take a broad enough definition of trust, then it would explain basically all the difference between the per capita income of the United States and Somalia," ventures Steve Knack, a senior economist at the World Bank who has been studying the economics of trust for over a decade. That suggests that trust is worth $12.4 trillion dollars a year to the U.S., which, in case you are wondering, is 99.5% of this country's income. ***
>
> Above all, trust enables people to do business with each other. Doing business is what creates wealth. ***
>
> Economists distinguish between the personal, informal trust that comes from being friendly with your neighbors and the impersonal, institutionalized trust that lets you give your credit card number out over the Internet.

Similarly, market psychologists Richard L. Peterson M.D. and Frank Murtha, Ph.D. wrote in October:

> Trust is the oil in the engine of capitalism, without it, the engine seizes up.
>
> Confidence is like the gasoline, without it the machine won't move.
>
> Trust is gone: there is no longer trust between counterparties in the financial system. Furthermore, confidence is at a low. Investors have lost their confidence in the ability of shares to provide decent returns (since they haven't).

And two professors of finance write:

> The drop in trust, we believe, is a major factor behind the deteriorating economic conditions. To demonstrate its importance, we launched the Chicago Booth/Kellogg School Financial Trust Index. Our first set of data—based on interviews conducted at the end of December 2008—shows that between September and December, 52 percent of Americans lost trust in the banks. Similarly, 65 percent lost trust in the stock market. A BBB/Gallup poll that surveyed a similar sample of Americans last April confirms this dramatic drop. At that time, 42 percent of Americans trusted financial institutions, versus 34 percent in our survey today, while 53 percent said they trusted U.S. companies, versus just 12 percent today.
>
> As trust declines, so does Americans' willingness to invest their money in the financial system. Our data show that trust in the stock market affects people's intention to buy stocks, even after accounting for expectations of future stock-market performance. Similarly, a person's trust in banks predicts the likelihood that he will make a run on his bank in a moment of crisis: 25 percent of those who don't trust banks withdrew their deposits and stored them as cash last fall, compared with only 3 percent of those who said they still trusted the banks. Thus, trust in financial institutions is a key factor for the smooth functioning of capital markets and, by extension, the economy. Changes in trust matter.

They quote a Nobel laureate economist on the subject:

> "Virtually every commercial transaction has within itself an element of trust," writes economist Kenneth Arrow, a Nobel laureate. When we deposit money in a bank, we trust that it's safe. When a company orders goods, it trusts its counterpart to deliver them in good faith. Trust facilitates transactions because it saves the costs of monitoring and screening; it is an essential lubricant that greases the wheels of the economic system.

Americans clearly don't trust the big banks and financial companies.

The Financial Giants Don't Trust Each Other, Either

Indeed, as leading economists have pointed out, the big financial institutions don't even trust each other, because they know that all of the other companies might have hidden toxic assets in SIVs, overvalued their assets, gamed their books, or otherwise tried to bury their problems.

For example, Anna Schwartz – co-author with Milton Friedman of the leading monetarist book on the Great Depression – told the Wall Street Journal:

> We now hear almost every day that banks will not lend to each other, or will do so only at punitive interest rates…This is not due to a lack of money available to lend, Ms. Schwartz says, but to a lack of faith in the ability of borrowers to repay their debts. "The Fed," she argues, "has gone about as if the problem is a shortage of liquidity. That is not the basic problem. The basic problem for the markets is that [uncertainty] that the balance sheets of financial firms are credible."
>
> So even though the Fed has flooded the credit markets with cash, spreads haven't budged because banks don't know who is still solvent and who is not. This uncertainty, says Ms. Schwartz, is "the basic problem in the credit market. Lending freezes up when lenders are uncertain that would-be borrowers have the resources to repay them. So to assume that the whole problem is inadequate liquidity bypasses the real issue"…
>
> In the 1930s, as Ms. Schwartz and Mr. Friedman argued in "A Monetary History," the country and the Federal Reserve were faced with a liquidity crisis in the banking sector…
>
> But "that's not what's going on in the market now," Ms. Schwartz says. Today, the banks have a problem on the asset side of their ledgers — "all these exotic securities that the market does not know how to value."
>
> "Why are they 'toxic'?" Ms. Schwartz asks. "They're toxic because you cannot sell them, you don't know what they're worth, your balance sheet is not credible and the whole market freezes up. We don't know whom to lend to because we don't know who is sound."

As financial writer Will Hutton says:

> "Such was the break down in trust and sense of panic that some of the most familiar names in British high street banking would not lend to each other at all or, at best, just overnight. Instead, the Bank of England had to supply tens of billions to banks who found the normal sources of funds blocked.
>
> ***
> Unless there is a radical and government-led change in ownership, structure, regulation and incentives so that the principles of fairness are put at the heart of the Anglo American financial system – proportionality of reward and fair distribution of risk – there is no chance of the return of trust and integrity upon which long-term recovery depends."

Princeton economist and former Secretary of Labor Robert Reich agrees that Wall Street's biggest problem right now is the collapse of trust:

> The problem is, government bailouts, subsidies, and insurance aren't really helping Wall Street. The Street's 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.

Reich also writes:

> Despite all the money going directly to the big banks, despite all the government guarantees and loans and special tax breaks, despite the shot-gun weddings and bank mergers, despite the willingness of the Treasury and the Fed to do almost whatever the banks have asked, the reality is that credit is

> not flowing.
>
> Why? Because the underlying problem isn't a liquidity problem. As I've noted elsewhere, the problem is that lenders and investors don't trust they'll get their money back because no one trusts that the numbers that purport to value securities are anything but wishful thinking. The trouble, in a nutshell, is that the financial entrepreneurship of recent years — the derivatives, credit default swaps, collateralized debt instruments, and so on — has undermined all notion of true value.
>
> Many of these fancy instruments became popular over recent years precisely because they circumvented financial regulations, especially rules on banks' capital adequacy. Big banks created all these off-balance-sheet vehicles because they allowed the big banks to carry less capital.

(For more on credit default swaps, see this).

In other words, I would argue that our economy is not fundamentally stabilizing (notwithstanding a couple of temporary "green shoots") because the government and the financial giants are taking actions and releasing data which encourage more distortion and less trust.

The crisis will deepen unless honest and transparent accounting is used, investments become transparent and understandable again, and the government stops gaming the system for the benefit of the big boys.

As John Carney writes:

> "We're probably making things worse. Allowing insolvent institutions to fail and requiring worthless and worth less assets to be fully written down would provide transparency to the market. Instead, we're dedicated to the post-Lehman proposition of "Never Again." The various programs of our government continue to obscure asset pricing and conceal insolvency. This means that you can't trust the market to tell you which firms are failing.
>
> Twisting the arms of bankers to lend to institutions that may be insolvent is a recipe for deepening the crisis. We've just been through a period of malinvestment–we spent too much borrowed money on junk. Borrowing more to spend on junk only digs us in deeper.
>
> Bank lending won't get going again until trust in the markets can be restored. Fighting a Great Depression era problem probably won't help. More transparency, which means more write-downs and failures, is probably necessary if we're going to get through this. Unfortunately, we're still sailing in the opposite direction."

(For more on allowing insolvent institutions to fail, see this)

Happy Talk: Then and Now

It is true that consumers and small investors drive a large portion of the economy. And it is true that consumers and small investors, in turn, are largely driven by their perception of what is happening.

But I would also argue that all of the happy talk in the world won't turn the economy around when the fundamentals of the economy are lousy, or there has been a giant bubble and vast overleveraging, or there has been massive fraud, or the government has gone so far into debt that it has formed a black hole.

Happy talk did not work during the first couple of years of the Great Depression, once the speculative bubble and leverage of the Roaring 20's burst, leading to the inevitable crash.

As economist Irving Fisher pointed out (as recounted by economist Steve Keen):

> Hobbled by this naive belief in equilibrium, the economics profession was as unprepared for today's crisis as it had been for the Great Depression. Now that the crisis is well and truly with us, all conventional "neoclassical" economists can offer is the hope that the crisis can be overcome by a good, strong dose of confidence.
>
> From [Irving] Fisher's point of view, such a belief is futile. In an economy with an excessive level of debt and low inflation, he argued that confidence was irrelevant–and in fact dangerously misleading, as he knew from painful personal experience.

University of Maryland professor economics professor and former Chief Economist at the U.S. International Trade Commission Peter Morici wrote in 2006:

> The speculative frenzy of recent years is causing a major adjustment, and the happy talk of realtors is prolonging the process. The absence of realistic analysis about the extent of overvaluation is characteristic in an industry that sees nothing but an upward progression for values, but houses like any other asset can be overpriced.
>
> Things are likely to get worse before they get better.

Morici was pointing out that there was a bubble in housing, and happy talk would not keep the bubble from bursting.

As Washington Post business writer Steven Pearlstein predicted in August 2007:

> Despite the happy talk from Washington and Wall Street investment houses — eerily reminiscent, by the way, of the early days of the savings-and-loan crisis of the late '80s — these shocks [the subprime and credit crises] will have serious consequences …

And economist James Galbraith is saying now (just as his father economist John Kenneth Galbraith said 50 years ago) – that "happy talk" won't solve the crisis.

Indeed, the chair of the congressional oversight committee of the bailouts (Elizabeth Warren) and the senior regulator during the S & L crisis (William Black) both say that hiding the true state of affairs and trying to put a happy face on an economic crisis just prolongs the length and severity of the crash

Donald W. Riegle Jr. – former chair of the Senate Banking Committee from 1989 to 1994 – wrote (along with the former CEO of AT&T Broadband and the international president of the

United Steelworkers union) wrote recently:

> It's almost as if the [Obama] administration is opting for a rose-colored-glasses PR strategy rather than taking a hard-nose look at actual consumer and employment figures and their trends, and modifying its economic policies accordingly.

In short, happy talk and fake confidence-building exercises (like the stress tests, which Time Magazine called a con game) don't work.

Efforts to Instill False Confidence Will Backfire

Indeed, I believe that trying to instill false confidence will actually backfire on Summers, Geithner, Bernanke and the boys and make the crisis worse.

Why?

Well, initially, as Yves Smith points out:

> Team Obama has made it clear that it sees restoring confidence as paramount, when anyone with consumer marketing experience will tell you that advertising campaigns that make exaggerated claims about the product often don't simply fail (as in customers see through the hype) but often backfire (buyers discount future ad messages about the product). The press has had a manipulated feel, with readers on sending news stories that have misleadingly positive stories with Panglossian headlines and upbeat initial paragraphs that are often undercut by other material in the same article.
>
> So in our new branding, "the economy is no longer in a freefall" has become "recovery." The self-congratulatory tone among US financial regulators (who should instead be engaging in serious self-recrimination for failing to foresee and prevent this crisis) is premature.

In addition, psychologists say that – until government and business leaders prove they can behave responsibly, and until the perpetrators of financial fraud are held accountable – real trust will not be restored and the economy will not recover

For example, one of the leading business schools in America – the Wharton School of Business – has written an essay on the psychological causes and solutions to the economic crisis. Wharton points out that restoring trust is the key to recovery, and that trust cannot be restored until wrongdoers are held accountable:

> According to David M. Sachs, a training and supervision analyst at the Psychoanalytic Center of Philadelphia, the crisis today is not one of confidence, but one of trust. "Abusive financial practices were unchecked by personal moral controls that prohibit individual criminal behavior, as in the case of [Bernard] Madoff, and by complex financial manipulations, as in the case of AIG." The public, expecting to be protected from such abuse, has suffered a trauma of loss similar to that after 9/11. "Normal expectations of what is safe and dependable were abruptly shattered," Sachs noted. "As is typical of post-traumatic states, planning for the future could not be based on old assumptions about what is safe and what is dangerous. A radical reversal of how to be gratified occurred."

> People now feel more gratified saving money than spending it, Sachs suggested. They have trouble trusting promises from the government because they feel the government has let them down.
>
> He framed his argument with a fictional patient named Betty Q. Public, a librarian with two teenage children and a husband, John, who had recently lost his job. "She felt betrayed because she and her husband had invested conservatively and were double-crossed by dishonest, greedy businessmen, and now she distrusted the government that had failed to protect them from corporate dishonesty. Not only that, but she had little trust in things turning around soon enough to enable her and her husband to accomplish their previous goals.
>
> "By no means a sophisticated economist, she knew … that some people had become fantastically wealthy by misusing other people's money — hers included," Sachs said. "In short, John and Betty had done everything right and were being punished, while the dishonest people were going unpunished."
>
> Helping an individual recover from a traumatic experience provides a useful analogy for understanding how to help the economy recover from its own traumatic experience, Sachs pointed out. The public will need to "hold the perpetrators of the economic disaster responsible and take what actions they can to prevent them from harming the economy again." In addition, the public will have to see proof that government and business leaders can behave responsibly before they will trust them again, he argued.

Note that Sachs urges "hold[ing] the perpetrators of the economic disaster responsible." In other words, just "looking forward" and promising to do things differently isn't enough.

Are the "perpetrators of the economic disaster" being held accountable?

So far, Obama, Summers, Geithner, Bernanke and the crew have tried to paper over the cause and severity of the financial crisis, instead of honestly addressing them. They haven't lifted a finger to hold anyone accountable (other than a Madoff or two), but have actually thrown billions of dollars at the perpetrators (or else appointed them to government posts).

Indeed, William Black says that "the [government's] entire strategy is to keep people from getting the facts".

Economist Dean Baker made a similar point, lambasting the Federal Reserve for blowing the bubble, and pointing out that those who caused the disaster are trying to shift the focus as fast as they can:

> The current craze in DC policy circles is to create a "systematic risk regulator" to make sure that the country never experiences another economic crisis like the current one. This push is part of a cover-up of what really went wrong and does absolutely nothing to address the underlying problem that led to this financial and economic collapse.
>
> The key fact that everyone must always remember is that the story of the collapse was not complex. We did not need great minds sifting through endless reams of data and running incredibly complex computer simulations to discover the underlying problem in the economy. We just needed some people who understood the sort of arithmetic that most of us learned in 3rd grade.
>
> If the people at the Fed, the Treasury, and in other key positions had mastered

> arithmetic, and were prepared to act on their knowledge, they would have taken steps to stem the growth of the housing bubble. They would have prevented the bubble from growing to the point where its inevitable collapse would bring down both the U.S. economy and the world economy…
>
> We didn't need some super-genius to solve the mystery. We just needed an economist who could breath and do arithmetic. But the DC policy crowd tells us that if only we had a systematic risk regulator this disaster could have been prevented.
>
> Okay, let's do a thought experiment. Suppose we had our systematic risk regulator in 2002. Would this person have stood up to Alan Greenspan and said that the country is facing a huge housing bubble the collapse of which will sink the economy?…
>
> Alan Greenspan said that there was no housing bubble; everything was just fine. Would our systematic risk regulator have said that Greenspan was nuts and that the whole economy was a house of cards waiting to collapse?
>
> Anyone who believes that a risk regulator would have challenged the great Greenspan knows nothing about the way Washington works. The government is run by people who first and foremost want to advance their careers.
>
> And, the best way to advance your career in Washington is to go along with what everyone else is saying. If that was not completely obvious before the collapse of the housing bubble, it certainly should be obvious now.
>
> How many people in government have lost their jobs because they failed to see the bubble? How many people even missed a promotion? In fact, the top financial officials in the Obama administration, without exception, completely missed the housing bubble. One might think it was a job requirement.
>
> This lack of accountability among economists and economic analysts is the core problem that must be tackled. Unless these people are held accountable for their failures in the same way as custodians and dishwashers, there will never be any incentive to buck the crowd and point out looming disasters like the housing bubble.
>
> The reality is that we have a systematic risk regulator. It is called the Federal Reserve Board. They blew it completely. We will do far more to prevent the next crisis by holding our current risk regulator accountable for its failure (fire people) than by pretending that we somehow had a gap in our regulatory structure and creating another worthless bureaucracy.

Remember also that the Wharton study pointed out that "the public, expecting to be protected from such abuse, has suffered a trauma of loss similar to that after 9/11."

Trying to put a happy face on a grim situation, continuing to do things which are transparent attempts to instill false confidence, and leaving in power the people who caused the crisis reinforces the market's convictions that (1) government and business leaders are behaving irresponsibly instead of addressing the fundamental problems and (2) there is no accountability.

So people's trust declines still further, thus substantially delaying any chance of a sustainable economic recovery. In other words, by trying too hard to instill confidence, the powers-that-be actually undermine it and exacerbate the financial crisis.

So What Will Help?

Keeping quiet about how bad things are won't help. As numerous leading independent economists and financial experts agree, the three things that will help are:

1. Honestly addressing the causes of the crisis;
2. Honestly addressing the necessary – if bitter – medicine needed to get out of the crisis; and
3. Holding responsible those who caused the crisis.

Postscript: Time Magazine notes:

> Traditionally, gold has been a store of value when citizens do not trust their government politically or economically.

In other words, the government's political actions affect investments, such as gold.

It is interesting to note that Americans no longer trust their politicians, the justice system, their ability to obtain liberty, or the media. Americans know that the boys launched the war in Iraq (which will end up costing $3-5 trillion dollars) based upon justifications which turned out to be untrue. Many Americans have read that the government imported communist Soviet Union torture techniques and then said "we don't torture". Many Americans also know that the government spied on American citizen (even before 9/11 … confirmed here and here) while saying "we don't spy", and that the government apparently planned both the Afghanistan war (see this and this) and the Iraq war before 9/11.

This is an economic, not a political, essay. But I think the lack of trust in government concerning political issues poses an interesting question. Specifically, is it possible that the American people's distrust of the government concerning the above-described issues also bleeds over into a lack of trust in the government's economic actions and statements? In other words, if people discover that a government is lying about political issues, do people trust the government's pronouncements about economic issues less?

I don't know the answer, but analyzing the possibility could provide a researcher with an interesting project (or a PhD candidate with a potential doctoral thesis).