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 collaterised 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

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2 Ibid.
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. 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. 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. In an important early study, Knack and Keefer observe that “... trust and civic norms are stronger in nations with higher and more equal incomes.” 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.” 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”. The importance of trust, however, is not confined to gentlemanly deals between City traders. A recent paper by Guioso, 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.” 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

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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.
