How to Restore Trust in the US Financial System? Prosecute Wall Street Fraud…

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Top Economists: Trust is Necessary for a Stable Economy … But Trust Won't Be Restored Until We Prosecute Wall Street Fraud

Most policy makers still don't understand the urgent need to restore trust in our financial system, or the need to prosecute Wall Street executives for fraud and other criminal wrongdoing.

But top economists have been saying for well over a decade that trust is necessary for a stable economy, and that prosecuting the criminals Is necessary to restore trust.

Trust is Necessary for a Stable Economy

In his influential 1993 book *Making Democracy Work*, Robert Putnam showed how civic attitudes and trust could account for differences in the economic and government performance between northern and southern Italy.

Political economist Francis Fukiyama wrote a book called Trust in 1995, arguing that the most pervasive cultural characteristic influencing a nation's prosperity and ability to compete is the level of trust or cooperative behavior based upon shared norms. He stated that the United States, like Japan and Germany, has been a high-trust society historically but that this status has eroded in recent years.

In 1998, Paul Zak (Professor of Economics and Department Chair, as well as the founding Director of the Center for Neuroeconomics Studies at Claremont Graduate University, Professor of Neurology at Loma Linda University Medical Center, and a senior researcher at UCLA) and Stephen Knack (a Lead Economist in the World Bank's Research Department and Public Sector Governance Department) wrote a paper called Trust and Growth, arguing:

> Adam Smith (1997 [1766]) observed notable differences across nations in the 'probity' and 'punctuality' of their populations. For example, the Dutch 'are the most faithful to their word.'John Stuart Mill wrote: 'There are countries in Europe . . . where the most serious impediment to conducting business concerns on a large scale, is the rarity of persons who are supposed fit to be trusted with the receipt and expenditure of large sums of money' (Mill, 1848, p. 132).
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> Enormous differences across countries in the propensity to trust others survive

> today.
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> Trust is higher in ‘fair’ societies.
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> High trust societies produce more output than low trust societies. A fortiori, a sufficient amount of trust may be crucial to successful development. Douglass North (1990, p. 54) writes,
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>> The inability of societies to develop effective, lowcost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.
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> If trust is too low in a society, savings will be insufficient to sustain positive output growth. Such a poverty trap is more likely when institutions – both formal and informal – which punish cheaters are weak.

Heap, Tan and Zizzo and others have come to similar conclusions.

In 2001, Zak and Knack showed that “strengthening the rule of law, reducing inequality, and by facilitating interpersonal understanding” all increase trust. They conclude:

> Our analysis shows that trust can be raised directly by increasing communication and education, and indirectly by strengthening formal institutions that enforce contracts and by reducing income inequality. Among the policies that impact these factors, only education, redistributive transfers, and freedom satisfy the efficiency criterion which compares the cost of policies with the benefits citizens receive in terms of higher living standards. Further, our analysis suggests that good policy initiates a virtuous circle: policies that raise trust efficiently, improve living standards, raise civil liberties, enhance institutions, and reduce corruption, further raising trust. Trust, democracy, and the rule of law are thus the foundation of abiding prosperity.

“Enforcing contracts”, “raising civil liberties”, and “reducing corruption” and “democracy” all have to do with the rule of law, which – as discussed below – in turn, means prosecuting violations of the law. Likewise, by “enhancing institutions”, they mean regulatory and justice systems which enforce contracts and prosecute cheaters.

And while Zak and Knack appear to favor redistribution of wealth, fighting inequality does not have to offend conservative values. As I recently pointed out, conservatives are against rampant inequality, and prosecuting fraud is the best way to reduce inequality:

> Robert Shiller [one of the top housing economists in the United States] said in 2009:
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>> And it’s not like we want to level income. I’m not saying spread

> the wealth around, which got Obama in trouble. But I think, I would hope that this would be a time for a national consideration about policies that would focus on restraining any possible further increases in inequality.

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If we stop bailing out the fraudsters and financial gamblers, the big banks would focus more on traditional lending and less on speculative plays which only make the rich richer and the poor poorer, and which guarantee future economic crises (which hurt the poor more than the rich).

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Moreover, both conservatives and liberals agree that we need to prosecute financial fraud. As I've previously noted, fraud disproportionally benefits the big players, makes boom-bust cycles more severe, and otherwise harms the economy – all of which increase inequality and warp the market.

So once again, we are back to the importance of prosecuting fraud.

A 2005 letter in premier scientific journal Nature reviewed 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.
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> 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.
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> "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.
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> Above all, trust enables people to do business with each other. Doing business

is what creates wealth.

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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.

In 2007, Yann Algan (Professor of Economics at Paris School of Economics and University Paris East) and Pierre Cahuc (Professor of Economics at the Ecole Polytechnique (Paris)) reported:

> We find a significant impact of trust on income per capita for 30 countries over the period 1949-2003.

Similarly, market psychologists Richard L. Peterson M.D. and Frank Murtha, PhD noted in 2008

> Trust is the oil in the engine of capitalism, without it, the engine seizes up.
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> Confidence is like the gasoline, without it the machine won't move.
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> 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).

In 2009, Paola Sapienza (ssociate professor of finance and the Zell Center Faculty Fellow at Northwestern University) and Luigi Zingales (Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business) pointed out:

> 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.
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> 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.

In 2009, Time Magazine pointed out:

> 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, and thus the broader economy.

In 2010, a distinguished international group of economists (Giancarlo Corsetti, Michael P. Devereux, Luigi Guiso, John Hassler, Gilles Saint-Paul, Hans-Werner Sinn, Jan-Egbert Sturm and Xavier Vives) wrote:

> Public distrust of bankers and financial markets has risen dramatically with the financial crisis. This column argues that this loss of trust in the financial system played a critical role in the collapse of economic activity that followed. To undo the damage, financial regulation needs to focus on restoring that trust.

They noted:

> Trust is crucial in many transactions and certainly in those involving financial exchanges. The massive drop in trust associated with this crisis will therefore have important implications for the future of financial markets. Data show that in the late 1970s, the percentage of people who reported having full trust in banks, brokers, mutual funds or the stock market was around 40%; it had sunk to around 30% just before the crisis hit, and collapsed to barely 5% afterwards. It is now even lower than the trust people have in other people (randomly selected of course).

Prosecuting the Criminals Is Necessary to Restore Trust

Nobel prize winning economist Joseph Stiglitz says that we have to prosecute fraud or else the economy won't recover:

> The legal system is supposed to be the codification of our norms and beliefs, things that we need to make our system work. If the legal system is seen as exploitative, then confidence in our whole system starts eroding. And that's really the problem that's going on.
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> I think we ought to go do what we did in the S&L [crisis] and actually put many of these guys in prison. Absolutely. These are not just white-collar crimes or little accidents. There were victims. That's the point. There were victims all over the world.
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> Economists focus on the whole notion of incentives. People have an incentive sometimes to behave badly, because they can make more money if they can cheat. If our economic system is going to work then we have to make sure that what they gain when they cheat is offset by a system of penalties.

Robert Shiller said recently that failing to address the legal issues will cause Americans to lose faith in business and the government:

> Shiller said the danger of foreclosuregate — the scandal in which it has come to light that the biggest banks have routinely mishandled homeownership documents, putting the legality of foreclosures and related sales in doubt — is a replay of the 1930s, when Americans lost faith that institutions such as business and government were dealing fairly.

Economists such as William Black and James Galbraith agree. Galbraith says:

> There will have to be full-scale investigation and cleaning up of the residue of that, before you can have, I think, a return of confidence in the financial sector. And that's a process which needs to get underway.

Galbraith also says that economists should move into the background, and "criminologists to the forefront".

Government regulators know this – or at least pay lip service to it – as well. For example, as the Director of the Securities and Exchange Commission's enforcement division told Congress:

> Recovery from the fallout of the financial crisis requires important efforts on various fronts, and vigorous enforcement is an essential component, as aggressive and even-handed enforcement will meet the public's fair expectation that those whose violations of the law caused severe loss and hardship will be held accountable. And vigorous law enforcement efforts will help vindicate the principles that are fundamental to the fair and proper functioning of our markets: that no one should have an unjust advantage in our markets; that investors have a right to disclosure that complies with the

> federal securities laws; and that there is a level playing field for all investors.

Nobel prize winning economist George Akerlof has demonstrated that failure to punish white collar criminals – and instead bailing them out- creates incentives for more economic crimes and further destruction of the economy in the future. Indeed, William Black notes that we've known of this dynamic for "hundreds of years". And see this, this, this and this.

Of course, it's not just economists saying this.

One of the leading business schools in America – the Wharton School of Business – published an essay by a psychologist on the 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."
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> 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.
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> 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.
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> "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."
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> 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.

As Wall Street insider and New York Times columnist Andrew Ross Sorkin writes:

> "They will pick on minor misdemeanors by individual market participants," said David Einhorn, the hedge fund manager who was among the Cassandras before the financial crisis. To Mr. Einhorn, the government is "not willing to take on significant misbehavior by sizable" firms. "But since there have been almost no big prosecutions, there's very little evidence that it has stopped bad actors from behaving badly."
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> Fraud at big corporations surely dwarfs by orders of magnitude the shareholders' losses of $8 billion that Mr. Holder highlighted. If the government spent half the time trying to ferret out fraud at major companies that it does tracking pump-and-dump schemes, we might have been able to stop the financial crisis, or at least we'd have a fighting chance at stopping the next one.

And as a former congressional aide recently said in some of the most colorful language to date:

> "You put Lloyd Blankfein in pound-me-in-the-ass prison for one six-month term, and all this bullshit would stop, all over Wall Street," says a former congressional aide. "That's all it would take. Just once."

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