

Financial Crises and Trust: Emerging Markets Perspective

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Secretary-General Angel Gurría of OECD is perhaps one of the earliest to have formally flagged building trust as an imperative in the early stages of the recent crises. The OECD, as a pioneering think-tank, had indeed organised the first-of-its-kind Workshop on Rebuilding Trust as part of its annual forum in May of this year. I could not avail of the kind invitation to this “idea factory” as I felt challenged, among others, with a gush of questioning thoughts that I share here. More importantly, I wondered if we would be whistling for order while the storm is not fully abated.

Trust has been described variously: as the spinal cord of economics; as the critical ingredient for financial markets which deal with exchange of promises; as the *essential oil* for all social transactions and economic dealings. It is common knowledge that trust reduces transaction costs immensely. A deficit therein delays, defers and reduces exchanges while creating vacuums. It increases search costs and creates overall economic inefficiencies. In the context of the global financial / banking crises, academics have noted eloquently that trust has been broken – though one is not sure if the break was before the crisis, after or both. Any case, we deal very well with the post-mortem so we know what to fix after it was broken soundly. Or do we?

For instance, how do we distinguish the desirable trust from blind faith all fraudsters seek so as to sell snake oil again? Every financial scam, be that of John Law, Charles Ponzi or a “Made-off”, requires rebuilding lost trust. It was indeed rebuilt in a short time! Politicians that won elections at such times called

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passionately for trust, baited and then switched to accommodate big corporate interests. They allowed themselves to be lobbied, sang tutored songs promising sugar-candy mountains and then rued the ensuing crises and trust deficit. There is comfort for many that historically public memories are short and sentiments even shorter.

But as a socio-anthropological idea, trust once broken is difficult to fix – whatever be the effort, the patch would show. For genuine rebuilding, the key players must change, justice must be seen and felt by the victims, and new behaviours must be evident and sustained for some length of time. Understandably, the socio-anthropological idea of trust entered economic theory when the positive benefits became obvious. It is natural now that trust must venture into the public policy domain because of its serious implications on democratic institutions and markets. But perhaps the socio-anthropological idea is different from the economic-polity one. Trust appears to have a different characteristic when human beings deal with inanimate systems, schemes, institutions – it appears by historical counts that trust in such cases can be easily rebuilt even through symbolism and stoked up by herd behaviour.

This, perhaps, is where trust can be distinguished from confidence. Trust can be irrational and suffer from biases of positive stereotyping, halo effects and feel-goodness. Confidence, on the other hand, is expected to be a rational process, however imprecise, estimating information, risks and consequences. Confidence and “big boy” arguments go together. Trust and the gullible appear to associate better. But then policy makers and academicians have used the terms interchangeably. Perhaps while confidence is what has in effect been lost after the crises, blind trust is what we want?

Is it easy to rebuild lost trust and arrest the diminishing faith in democracy, institutions and markets by a plan? Under normal conditions, changes in belief systems and institutions take a long time as institutional economists have noted and policy makers are beginning to appreciate. Rebuilding trust by plan requires multi-dimensional actions that all notice and feel clearly. It must be sustained over a long-enough period and prove to stakeholders that it is no symbolism one more time. This is a hard task and wait for the impatient politician and the financial intermediary who would rather hope for a “quickenning agent” that could ignite the irrational exuberance rapidly.

There is however, another way of rebuilding trust in a relatively shorter time in emerging market economies where there appears to be greater confidence in an imperfect State (with humongous corruption and inefficiency) than in

imperfect markets (where cronyism is more glaring than perfect competition). Bring in harsher regulation and demonstrably effective and efficient State intervention. It would be traumatic for the free-wheeling market participants but may quickly demonstrate strengthened resolve for stronger institutions to the general public. That would indeed be invoking a mild trauma in the hope of cancelling the after-effects of the previous crisis that was harsh on the entire world. The idea may not be a bad one, as the last financial crisis has shaken blind faith in market mechanisms and lazy regulators. Incidentally, the crises may also have shaken up hypotheses such as high-trust societies are where market mechanisms work well, big corporations thrive and high economic growth occurs. While trust was broken by big corporations in a couple of major economies (USA and UK), high-trust and big corporations belied the expectations of growth in others (Japan).

There is indeed a third option in dealing with trust these times, apart from signalling for an order and dirigisme discussed above. No action, as the next cycle / tide will take care of the trust deficit. History shows that trusting behaviours vis-à-vis markets also go through the same cycles as economies. There will be trust-splurging along with irrational exuberance when the music starts playing again. This will be in contrast to the deep distrust along with disproportionate weighing-in of recent losses when the tide goes down post-crises.

But this time round, the cycle and depth of distrust can be long and steep as the system hasn't played fair at all. Many are appalled by the unfair advantage the perpetrators enjoyed even as the public was made to hold the can helplessly. Examining justice post-crisis, Kara Tan Bhala (who migrated from Wall Street to ethics discourse and founding The Seven Pillars Institute) seems to conclude that there was hardly any pinch for the financial giants that brought these owes on the common public. There was very little *compensatory justice* as Banks were allowed to pay relatively small fines from corporate coffers to the government without having to accept any guilt. There was little *distributive justice* as the Bank honchos continued to get their millions in salary and bonuses (with passionate pleas that the apologies and remorse be ended) even as the public were made poorer. *Retributive or corrective justice* was given a go by with hardly any criminal charges framed against the perpetrators on both sides of the Atlantic. Perhaps, the snake-oil got mixed even as policy makers were earnestly trying to make that trust oil? This and other events, across many troubled emerging market economies, may validate Rawls theory that the long term stability of a society depends on how the public feels about just treatments. That could be the key criterion for determining how ephemeral the next cycle of trust and exuberance would be.