The 'Credit Crunch' and Trust

Professor Geoffrey Hosking FBA *examines the role of trust in our financial systems, and argues that we need a fundamental rethink.*

THE 'CREDIT CRUNCH' which began in the summer of 2007 seems to be evolving into something even more sinister, with banks reluctant to lend to their potential customers or even to each other. It begins to look like not just a temporary crisis of liquidity, but something much deeper. The economic commentator Stephen King put his finger on it: 'We are witnessing a breakdown of trust on a scale that doesn't lend itself to easy answers.'[1]

Money is the paramount symbol of trust in modern society. It enables us in normal times to obtain goods and services from people we do not know, have no other grounds for trusting, and are never likely to meet again.

But money is complex and many-layered, and in each layer trust is at work. Much of the money that most of us possess takes the form of an entry in electronic account records. Behind that is paper money, which most people would accept as 'real money', but only because they are trusting. Each note bears a statement that the Bank of England 'Promises to pay on demand the sum of' ten pounds, or whatever it is. That promise refers to reserves of gold that the Bank of England holds – except that the Bank does not hold anything like enough of it to cover all the banknotes in circulation, and anyway it long ago cancelled its obligation to offer gold in return for notes. Even if it still did, what can you do with gold? You can't eat it, or wear it, or warm yourself with it. So money is not a real 'good' or benefit, just a symbol of entitlement to a benefit, a symbol that society trusts, yet one that is at least one stage removed from that benefit. The current voracious demand for gold shows that in uncertain times we feel safer descending several storeys in what begins to look like a rickety structure.

Modern financial systems, and their intimate link with politics, originated with the late seventeenth century revolution in England. After the overthrow of the Stuarts, through the Bill of Rights of 1689 the great landowners and London merchants bound the new monarch, William III, to constitutional rule: he had to share with parliament his power over the state budget and over the army and navy. He could not raise taxes or float loans without the consent of parliament. In return the landowners and merchants consented to being seriously taxed: this was their down-payment for gaining new powers.

All this was going on when war was threatening with France, a war which turned out to be extremely expensive, and which demanded effective mobilisation of the nation's resources. To cope with those expenses, the monarchy had to borrow huge sums of money. It floated new loans, and these were guaranteed by parliament in the form of the national debt. Those who bought Treasury bonds would receive guaranteed annuities for life, or for a stipulated period. Since parliament was elected, had decisive powers and represented the real wealth of the country, those bonds were as trustworthy as any investment can be. They became very popular, and the national debt actually became an engine for raising revenue.

It was crucial also that this settlement was guaranteed by a national bank. In 1694 the Bank of England was set up with two main functions: (1) it managed the government's debt; (2) it guaranteed the value of the pound sterling. It was able to issue paper money, backed by the authority of the English monarchy and parliament and hence by the trust people placed in them. Again, this greatly expanded the potentiality of the economy. Wealthy people gained far more confidence in investing their money, not only in the Bank itself, but in the economy generally. It became much easier to establish insurance companies, which not only augment people's confidence in the future, but also generate funds that can be used for investment. Later there followed institutions like joint-stock companies and the stock exchange, which also arose to facilitate collective economic enterprise and to give wealthy people confidence in investing their money. Taken together, these were powerful motors for wealth-creation, based on trust.

What was this wealth used for? At first mostly for war. The result was what the historian John Brewer has called the 'military-fiscal state', far more efficient than Britain's great rival France at raising both taxes and loans, so that with more modest resources it was able to mobilise much greater economic power for war-making purposes.[2] Later on this formidable money-making machine would be deployed for investment in the world's first 'industrial revolution'.

In a sense this was a great success story. But there were two serious problems. The first was that the new financial instruments added an extra layer to the trust already embodied in money. In modern parlance, the whole system was 'leveraged'. That meant that in a crisis it was liable to more abrupt and cumulative seizures of distrust than money itself. The first example of this ailment was the 'South Sea Bubble'. The South Sea Company was essentially a 'pyramid scheme', of the kind we saw in Russia and Albania in the 1990s, no longer paying dividends out of real profits, but using recent investments to pay off obligations to somewhat older investors. Eventually it became clear what was happening, and in September 1720 the 'bubble' burst. Dividends ceased, South Sea shares became almost worthless, and many investors faced ruin.

I mention this example to suggest that the capitalist economy, based on ever more complex layers of trust, is liable to panics and crashes. When trust breaks down, it does so abruptly and cumulatively. On the whole, over time, we become better at dealing with those crises, but we can never entirely

Figure 1: *Customers wait in line to remove their savings from a branch of the Northern Rock bank on 17 September 2007. (Peter Macdiarmid/Getty Images)*

overcome them, as the Northern Rock episode in September 2007 illustrated (Fig. 1).

The other major drawback of the new financial system was that it was very hard on the poor. Interest on the national debt was paid partly out of the highest tax rates in Europe, most of which were indirect and so inflicted the greatest hardship on the poorest people. Besides, to obtain secure collateral for raising loans, landowners would clear tenants with undocumented or short-term tenure off their lands, to become agricultural wage-labourers, to go into the towns to seek employment, and not infrequently to end in the workhouse. It took a political struggle lasting more than two centuries for some of the wealth of the rich and of the exchequer to be channelled into providing for social security, health and education for the great mass of the British people. Once that happened, though, the nation-state became the most effective instrument yet devised for spreading risk and redistributing benefits, and it thus became a very powerful repository of trust.

As a result, where in traditional societies people looked to family, friends, local community or religious institutions to help them face life's risks, nowadays most of us place our trust in state welfare systems, savings banks, insurance policies and pension funds – all of which require economic growth to operate effectively. As Robert Samuelson has remarked, 'The triumphant religion of the twentieth century was not Christianity or Islam but economic growth.'[3] Investment in economic growth became a panacea for all ills. In recent decades this has worked pretty reliably, but it has also erected a new storey – in fact several new storeys – on to the already highly leveraged edifice of trust on which we base our lives.

Since the massive deregulation of financial systems of the 1980s, even more layers have been added to the sprawling ziggurats of trust that already sheltered us. Banks and building societies have been advancing their customers more and more credit (the financial term for trust) on easy terms. They have been able to do this partly because prevailing interest rates were low, but partly because they no longer had to keep the accruing liabilities on their books: they split them up, repackaged them and offered them as securities for other banks to buy. Since these 'securitised' packages were apparently too complex for most dealers to understand, the resulting deals were based largely on trust. House prices rose steeply, so houseowners had greater assets to offer as collateral to raise further loans. Non-houseowners, though, unless they could acquire sub-prime mortgages, saw the possibility of buying a house recede further and further into the distance. Nearly everyone took on more and more debt, supported or unsupported. In this way a world of socially divisive make-believe – or, if you prefer, deceptive trust – was created.

Meanwhile, the funds in which we place our trust have been investing their resources all over the world to bring in a better return on our behalf. Today we have to all intents and purposes one single global financial system. Over the last twenty years most of us have – in many cases without even realising it – been investing in countries we have never visited and know nothing about. As Jeffry Frieden has pointed out, 'Mutual funds, investment trusts, and banks in the rich countries [have] brought small investors, retirees, union pension funds – anyone with even modest savings – into direct contact with stocks and bonds from Bangkok to Budapest to Buenos Aires, from Seoul to St Petersburg to Sao Paulo.'[4] Insurance companies have done the same. Between 1980 and 1995 investments from mutual funds, insurance funds, pension funds and such like grew tenfold, and much of this is foreign investment, which often offers better returns.[5] Such investments have enabled us to feel confident in our own future, to feel assured that in case of disaster – fire, storm damage, a serious illness – we would be able to cope, and that when we get too old to work we shall be able still to lead a decent existence.

All this is right and proper, but it too has a downside. We have invested mainly in order to trust our own futures, and in doing so have ensured that most of the benefits of worldwide trade accrue not to the people who need them most, but to the citizens of the relatively wealthy countries. It is not just governments and multi-national companies that are to blame. We are all responsible, since we use the proceeds to insure against risk and provide for our own futures in the ways I have indicated above.

Even when it functions well, then, the present international financial system creates huge and ultimately unsustainable distortions, which are especially damaging to the poor. At the moment, moreover, it is not even functioning well, and many of the rich can no longer feel secure. So the system needs repairing, and while doing so we should endeavour to eliminate its underlying defects. I have been working on the history of structures of trust in various past societies.[6] My findings suggest that, when there is a real crisis of trust, the best way to tackle it is to both *broaden* and *democratise* trust.

Today's globalisation is potentially very beneficial, because it can help to spread risk more widely than ever before, and thus broaden trust. The richer countries are in a position to share the risks of those living in the poorer countries. For this to work, however, it needs to be *real* globalisation, from which people all over the world can benefit.

The international financial institutions set up after 1945, which once promoted stability and reduced poverty, are no longer doing so. By and large they are run by the USA and the wealthy western (in part east Asian) countries. And, as Joseph Stiglitz has shown, the way they are operated reflects the interests of those countries. Developed countries protect their own agriculture and ailing industries in a way that impedes the access poorer countries have to their markets. Developed countries ensure that capital flows are liberalised, since they make money from them, but that labour flows are not, though they would help poorer countries to earn money in their own way. Intellectual property rights obstruct the delivery of lifesaving generic medicines to those in poorer countries who need them and cannot pay first-world prices.[7] And so on. We are repeating the mistakes of the eighteenth and nineteenth centuries, and metaphorically consigning the world's 'bottom billion' to the workhouse.

All these defects intensify the instability of the whole international economy, and they also generate powerful resentment and distrust. Contemporary Islamist terrorism has many roots, but one of them is certainly extreme distrust of the west, directed against the way western economies have exploited non-western peoples and compelled them to adopt aspects of a secular, materialist life-style without gaining the benefits of it. Many Muslims, not only the terrorists, are rejecting Samuelson's 'triumphant religion of the twentieth century'.

Like all crises, the present 'credit crunch' gives us the opportunity to undertake a fundamental rethink and to reconfigure our international economic institutions so that they are both more equitable and more open to the input of the poorer countries. The key is to broaden and equalise the foundations of trust in the globalised world, so that the generally beneficial effects of money in its modern guises can be restored.[8]

Figure 2: *The trading floor of the Hong Kong Stock Exchange on 11 February 2008, a day when share prices opened lower amid fears of a global slowdown and bigger losses from the subprime mortgage crisis. (Mike Clark/AFP/Getty Images)*

Notes

1 *The Independent*, 17 March 2008, 50.

2 John Brewer, *The Sinews of Power: war, money and the English state, 1688–1783*, London: Unwin Hyman, 1989.

3 Robert J. Samuelson, 'The spirit of capitalism', *Foreign Affairs*, vol 80, no 1 (Jan/Feb 2001), 205.

4 Jeffry A. Frieden, *Global Capitalism: its fall and rise in the twentieth century*, New York: Norton, 2006, 386.

5 Robert Gilpin, *The Challenge of Global Capitalism: the world economy in the 21st century*, Princeton University Press, 2000.

6 See my 'Trust and distrust: a suitable theme for historians?' *Transactions of the Royal Historical Society* (6th series), vol 16 (2006), 95–116.

7 Joseph E. Stiglitz, *Making Globalization Work*, New York: Norton & Co, 2006, especially 77–9.

8 I must record my gratitude to the Institute for Advanced Study, Princeton, where I worked on the history of trust during the academic year 2006–07.

Geoffrey Hosking is Emeritus Professor of Russian History, University College London.