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COMMENTS ON PROFESSOR PARTHA DASGUPTA'S PAPER 'FINANCIAL CRISES AND THE WORLD'S POOR'

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Professor Dasgupta has written a very important paper on the importance of trust for the economy. Trust is not only vital for the functioning of the economy, but also for politics and life in society in general. This is commonsensical, for how can one conduct any kind of complex interaction unless there is trust in others? Yet the concept of trust is not paid much attention to in discussions of the financial crisis.

One might say that there are two different views of man, one derived from Aristotelianism where the postulate is that man is rational, implying created with an ethical sense, hence being able to live well with others with the *summum bonum* as a goal. On this view, good societies may be achieved. The alternative view is rather Nietszchean: man seeks power and must be strong to survive and dominate others. Such men will only cooperate if they can control that no one cheats. Life is a struggle among beasts, and the state must be a Leviathan. But even in Hobbesian society, enforcement can create a system that can work. A police state is also a state, and a state is better than anarchy. In societies with much trust, there is little need for enforcement, and vice versa.

Professor Dasgupta does not speak about anthropology, but is concerned with the key question of how a functioning financial system can be designed. Starting with some telling statistics about how the financial crisis affects the world's poor, we learn with disconcerting clarity that there is no justice in the world: Sub-Saharan Africa's growth has declined very much due to the crisis, and with its population growth, there is in fact now a *decrease* in growth for these states: 'The poor, as always, have had to carry a proportionate burden of the folly of the rich' (*ibid.*, p. 5).

'Greed is Good'?

There is no doubt that the market-liberal model can bring growth and prosperity to developing countries – development economics has many examples of this. Indeed, the incentives of the market are necessary and useful for all societies. There is no better alternative. But it is quite surprising that there is such a belief in the almost total freedom of market systems when in fact human beings are not perfect, but in need of some kind of regulation because temptation to abuse a system for power and/or money is always there.

In politics, therefore, we have many rules that purport to discourage politicians from power abuse. They cannot enrich themselves, provide favours to friends, deviate from the rules, etc. without being found out and punished. Clearly we understand that power carries with it the temptation of corruption.

Likewise, we are as citizens under the rule of law in all aspects of society – we have freedom, but we are also regulated in what we can do. We can be creative and manage our own lives, but the law of the land regulates the outer limits of our behaviour. We obey the law partly because we think it is the done thing – it is normal to be law-abiding – and partly because we will be punished if we break it.

As politicians and as citizens – as well as in our private lives – we think about what is right and wrong, about ethics. Not only the law and its limits form the boundaries of our behaviour, but also norms of ethics. The law is not enough; there is more demanded of us in our private and professional lives as well as in our civic lives: we feel, rightly so, that we must exercise ethical judgement about how we live and conduct our affairs: did I act according to proper professional norms towards my colleague? Did I live up to the standards of the profession? Note that this is not equivalent to saying: did I break the rules that my profession has put in writing and adopted? Ethical demands concern more than that which is covered by positive rules and regulations. Ethical dilemmas and concerns would not arise if rules covered them already.

Likewise, in my private life I must adjust my behaviour for the better from time to time, because I tend to forget to be considerate, think of others, etc. I know what is ethically best and yet do not follow that insight always.

The point here is simple: we are expected to be both law-abiding as well as ethical in all our walks of life. Like the professor or medical doctor who asks himself whether he acts in accordance with general as well as professional ethical standards, so we should expect the financial manager to do the same. The banker should ask himself: 'Do I have the best interest of my client in mind when I manage his money?' 'Am I frank about the risks?' 'Is my bonus reasonable, given the job I do?'

It is however clear that these questions have not been standard in the financial sector. I am among the many ordinary bank customers that have been utterly shocked by the revelations of greed and dishonesty in this sector. Bonuses have been unrelated to risk, customers have been sold so-called 'investment products' that have been extremely risky, and when banks have been on the brink of bankruptcy, they have asked for government assistance and received it.

Professor Dasgupta advocates that the client-banker relationship should resemble that of the patient-doctor: like the patient trusts the medical expert, the client puts his trust in the financial expert. Like the doctor charges a fee that is regulated by the authorities, so the banker should also have his fees regulated. Like the doctor is regulated by clear professional rules set by the his government, so the financial manager should be regulated by his government.

Yet this is not at all the case. 'Greed is good' has largely become the accepted standard, and it is as if we have become accustomed to a double standard of ethics: one for us, but with an exception for the financial sector. When I grew up in my little hometown in Southern Norway, my family trusted the banker like they trusted the doctor. This was normal there, and there is of course no reason why it should not be.

IN TRUST WE TRUST

Professor Dasgupta therefore analyses the over-arching importance of trust: the financial market is of course different from medicine in terms of risk – the trader or banker should earn more when taking more risk, but the client should always know what risk entails, and the trader or banker should not cash in the bonus at once – it should be related to the risk at hand over time. Today the trader is rewarded for short-term success or even for just selling the 'product'. The client assumes the long-term risk alone. This system has obviously benefited the banker or trader and not the client.

In the Norwegian press we just learnt that parking companies that were privatized issued parking tickets even when there was no reason to. There was an enormous incentive to do so because wages for the parking inspectors are related to 'performance', i.e. they get paid more when they issue more tickets. Furthermore, car owners seldomly protest because it is so very hard to get through the cumbersome system of complaining, and even if they do, it is hard to prove that they had a paid ticket in the car window. There is a power asymmetry between the parking company and the lone car owner.

This story is analogous to many stories from the banking sector in recent years: the client has been told by his banker that this or that 'product' is good for investing his savings in, while the banker's motive has been related to his bonus, often a percentage of the amount invested. The trust has been one-sided, from the client only. An infamous story from Norway concerns municipalities that were persuaded to invest in American derivatives by an investment company, Terra Securities. Terra derived enormous profit whereas the municipalities suffered almost total loss of the money that in fact belonged to their citizens. They went to court on the charge that they had been deliberately misled by the investment company.

Professor Dasgupta is therefore right in pointing to the importance of trust. If now clients have learnt from cases like the above to distrust bankers and investors, we have arrived at a so-called Nash equilibrium, a situation where all actors share the same assumption, viz. that no one dealing with investment can be trusted. The system then becomes self-enforcing in the sense that no one trusts each other, and as such, it breaks down. The client will perhaps put his money in real estate or revert to a barter economy, whereas the banker and investor are out of a job very soon. If no one has any reason to trust the other actors, we have a malign situation where everyone is worse off than if they co-operated. If both clients and bankers lose trust in each other, we are in a situation like the famous Prisoner's Dilemma where both detainees get outcomes that are worse than if they had co-operated.

In the financial crisis, we have had and still have a situation where largely clients have been fooled by bankers and investors; the trust has been one-sided. There has not been a Nash-equilibrium, and by now clients have learnt that they have little or no reason to trust banks. They therefore alter their behaviour if they can, but banks are more powerful and are saved by governments and therefore 'rewarded' for their unethical behaviour. The problem of 'moral hazard' has not been solved and explains why the system can continue even now.

There is clear need for regulation. But regulation at only the national level will not do. There must be international regulation of financial markets if they are to function, but governments are only 'valid' as law givers in their own territory. They are only responsible to their own citizens. But bankers and investors are global actors that can 'defect' from a given state if they want to. This enhances their power vis-à-vis both clients and governments. They can demand to be saved because of their clients in their home state, but can 'defect' when that becomes advantageous. There is a need for punishment for breaking the rules, but how can this be realised?

As Professor Dasgupta writes, 'trust is maintained by the threat of punishment' (p. 15). This is because actors in a market do not trust each other because they belong to the same family or are friends, but because they believe that in general, one obeys the law and places trust in legal institutions and in society. In many societies there is no trust at all, and then enforcement also fails because it cannot oversee all activity. But in most societies trust is the normal condition – I buy something and I pay for it later when I am billed – I know that unless I pay, there will be rules enforced. The seller also knows this. He trusts me with the commodity I buy and that he will get paid later. Usually legal enforcement is unnecessary, but it acts like a guarantee.

In the financial markets, there is no such enforcement. In addition they are global. We are faced with a very complex problem. Reputation, which is an incentive to be honest and keep promises, may not work in a global system. In a small town a firm's reputation acts as an enforcer of a social norm: in my hometown we know that the plumber and the carpenter will do solid work, because if they don't, the whole town will be informed very soon. They will be shamed, their reputation destroyed, and they will lose customers. The social norm that they do good work is therefore extremely strong. They also take professional pride in this and have never reflected on the 'usefulness' or even 'utility' of being trustworthy. However, if I have to call a plumber or carpenter in Oslo, the capital, I cannot expect this kind of professional ethics at all. I expect to be over-charged; I do not have any reason to trust the company and have to get references and ask around for information. There is in other words total trust in my hometown's carpenter, and very little trust in one from the capital. This example underlines how fantastic trust is for the functioning of en economy or society – it reduces all transaction costs to the minimum. Things function and things are also ethically sound. But when trust is lacking, all sorts of other problems arise.

In game theory we have models that are concerned with 'iteration' and have long 'shadows of the future'. This is how a society is – we live together and interact for a life-time. We meet as citizens, not only as professionals. Therefore the maximation of self-interested behaviour may pay off only once, in a game that is not iterated. In the normal state of affairs, such selfish behaviour is punished by others by loss of your reputation and trust in you. If you cheat on your fellows, you must leave town afterwards or live with a tarnished reputation.

The problem with the financial crisis is as said, ethical to the core. But it is very difficult to envision a solution to this problem as long as the financial sector is global. It 'belongs' to a given state only when it needs money from the state; otherwise its actors can move freely and are not obliged to have a reciprocal relationship with their state's clients. How can such an unequal system be regulated and enforced? How can trust be cultivated when the system can be exited by one set of actors? Trust in small communities where we all know each other is possible, but it seems that the nation-state is the upper limit of trust. Outside the state there is no enforcement and no trust.