Pentti Hakkarainen: All you need is trust – reflections on a good society

Key talking points by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Royal Society of Arts Leadership Seminar "Looking for the Good Society", Helsinki, 31 January 2014.

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Accompanying slides can be found on the Bank of Finlands' website: Slides (PDF).

In the following I will present some reflections on what is a good society. The thoughts and this text are based on Dr Antti Suvanto's[1] Work on the issue and a preliminary paper he has prepared and will publish in the near future. In addressing these issues I must be humble. I am a banker, a central banker, a man of practice rather than a scholar.

Nevertheless, I find the topic extremely fascinating. In the following I will share with you my and Antti Suvanto's thoughts about the characteristics of a good society. One of the key characteristics, in my opinion, is trust. Therefore, I will spend some time to discuss the role of trust in the society, and in finance, in particular.

Let me make it very clear in the beginning that, in my opinion a good society is by no means a perfect society. I am realist. Therefore, my starting point is that even the best societies have defects, but good societies are capable of correcting them. Furthermore, societies are evolving and dynamic. The future will always bring about surprises. Good societies are capable to adjust to changing circumstances. Finally, a good society is not a utopia. Historical attempts to build utopian societies have all failed, some with disastrous consequences.

What is a good society?

What is a good society? This is a question that has been discussed by generations of philosophers, sociologists, political scientists, historians and economists. Even so, there is no generally-accepted definition of the good society.

Superficially the answer should be straightforward. The phrase good society describes *"the kind of society in which we should aspire to live; it is usually an egalitarian society where all people respect and appreciate each other".*[2] Few of us would disagree with this definition put forward, by the way, by Robert Shiller, one of the three Nobel-prize winners in economics in 2013.

This definition, however, raises more questions than it answers. For example, what is the society? Does it refer to a nation, a region, a tribe or a global community? What kind a society is an *egalitarian* society? Does it imply that all people should be equal in terms of fundamental human rights? Or, does it refer to the equality in opportunity or the equality of outcome?

Few of us would disagree with the claim that one of characteristic to a good society is that it aims to improve the *well-being* of its members. Again a multitude of new questions arise. What is *well-being?* Does it refer to the material well-being of the member of the society? Does it matter how the material wealth has been created and how it is distributed? Or, does it refer to welfare states?

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[2] Robert Shiller, Finance and Good Society, Princeton University Press 2012, p. 1.

Similarly, one is tempted to agree with the claim that a key characteristic of a good society is the *happiness* of its members. Recall that happiness was mentioned in the United States Declaration of Independence drafted by Thomas Jefferson: *"We hold these truths to be sacred and undeniable; that all men are created equal and independent, that from that equal creation they derive rights inherent and inalienable, among which are the preservation of life, and liberty, and the pursuit of happiness; ...".*

The above list of characteristics goes a long way to outline the main features of a good society. A good society is one in which people are free from coercion, free to make choices, free to make own decisions in order to *pursuit happiness.*

Trust

What about the *respect and appreciation* of other people?

According to neuroscientists and psychologists individuals are by born social. Evolution has forced women to give birth before the baby could possibly survive by himself, since the big brains of humans mean that any more time in the womb the baby's head could not get out.[3] This is the root cause for the fact that social interaction is vital for all individuals from cradle to grave.

There is, however, one important reservation.[4] This dispositional tendency to social interaction and cooperation applies to the members of a tribe, but not necessarily beyond that. Tribal organization helps individuals to solve the problem of *"Me versus Us";* that is, to define an individual's role in the group.

The biggest problem in our societies, however, is *"Us versus Them";* that is, to define the role of my group in relation to other groups. As Harvard professor of psychology Joshua Greene says: *"Our moral brains evolved for co-operation* within groups *but they did not evolve for co-operation* between groups".

We tend to respect and appreciate people whom we *trust*. While trust may be a dispositional propensity of individuals within a small community, a tribe, it is not obvious in more complex societies consisting of individuals representing a variety of different backgrounds.

What then is trust? A standard definition is something as follows: Trust is a feeling that you (the trustor) can rely on another person (the trustee); that is, you believe that the other person does not betray or disappoint you.

Trust is important for any society. Trust makes social and economic life predictable. Trust makes it easier for people to work together. Trustful relationships lead to interactions where both parties benefit. In today's language these are called win-win situations.

Trust reduces transaction costs. Without trust many transactions would become prohibitively expensive. One should enter in complicated arrangements in order to secure the counterparty to the deal fulfils his obligations.

Trust requires reciprocity. The other person (trustee) must by trustworthy. But we know that this is not always the case. We know that there is clear asymmetry in the building of trust versus the destruction of it. Once trust is lost, it is very hard to regain.

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[3] Matthew Lieberman, Social: Why Our Brains Are Wired to Connect, Oxford University Press 2012. Reviewed by Julian Baggini in Financial Times, January 3, 2014.

[4] Joshua Greene, Moral Tribes: Emotion, Reason and the Gap between Us and Them, Penguin Press 2012. Reviewed by Julian Baggini in Financial Times, January 3, 2014.

Some ten years ago an American political scientist Francis Fukuyama published a book titled *Trust: The Social Virtues and the Creation of Prosperity.*[5] His main argument was that the level of trust is the most pervasive cultural characteristic influencing a nation's prosperity.

In low-trust societies people and businesses need to negotiate and often litigate rules and regulations. Fukuyma listed China, Korea, France and Italy as examples of low-trust societies, whereas Japan and Germany represented high-trust societies. He also argued that the United States has been a high-trust society historically, although this status had started to erode more recently.

As indicated above, trust is not secured in societies beyond a simple tribal community. In more complex societies there is a need for rules and institutions that reduce the probability of an individual being cheated by another person.

For these we need governments who define the rules and set up agencies to enforce legal and property rights, as well as to enforce contracts between contracting parties. People need be secure that if they own something it cannot be arbitrarily confiscated. They also need to be secure that cheating and stealing will not get unpunished.

But how do we know that the rules will be applied and the institutions will function as intended? Are the institutions themselves trustworthy? We know that very often this is not the case.

This brings me to my main point. The essence of a good society is that the rules are the properly designed and institutions are trustworthy. A precondition for this is that those who define and implement the rules themselves respect the rules. In other words, they should be free from corruption.

Inclusive versus extractive institutions

Paying attention to trust and the trustworthiness of institution shifts the discussion on the goodness of a society to the quality of its institutions.

Daron Acemoglu and James Robinson make a distinction between *inclusive* and *extractive* institutions. Inclusive *economic* institutions enforce property rights, create a level playing field, and encourage investment in new skills and technologies. Extractive economic institutions, in contrast, are structured to extract resources from the few.

Inclusive economic institutions, in turn, support and are supported by inclusive *political* institutions. These institutions include citizens by distributing political power in a pluralistic and sufficiently centralized manner so as to be able to establish the law and order and secure property rights. Extractive political institutions, in contrast, tend to concentrate power in the hands of a few reinforcing extractive economic institutions to hold power.

The distinction between inclusive and extractive institutions is the key concept in a monumental book *Why Nations Fail?*[6] It is not the culture, weather or geography which explains why some societies become rich and others remain poor. Instead, it is man-made political and economic institutions that underlie economic success or the lack of it.

A closer look at Europe

The inclusiveness of economic and political institutions is not a matter of on-off. It is a matter of degree. In Western Europe the institutions are predominantly inclusive almost by

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5 Free Press, New York 1995.

6 Daran Acemoglu ja James Robinson, Why Nations Fail? The Origins of Power, Prosperity and Poverty,Crown Publishers, New York 2012. Finnish translation (Kimmo Pietiläinen), Miksi maat kaatuvat. Vallan, vaurauden ja varattomuuden synty, Terra Cognita, Helsinki 2013.

definition, because pluralistic democracy, property rights and the market economy is well-established and secured by constitution. Despite this, there are interesting differences even between the developed European countries regarding the ways institutions function and how they are trusted in.

The following diagrams illustrate some of these differences. The left-hand panel of the first diagram (Exhibit 1) exhibits the ranking of fourteen member states of the European Union with respect to the economic freedom prevailing in the country and perceived life satisfaction of its citizens. The sample includes eleven members of the euro area (EU12 except Luxemburg) plus Denmark, Sweden and the United Kingdom.

The further to the right the country is located in the diagram the greater is the economic freedom enjoyed by the citizens and businesses of the country. The economic freedom is the average ranking of the country in terms of four different measurements of economic freedom.[7] The vertical axis ranks the countries according to the life satisfaction expressed by the citizens in the latest *Eurobarometer* poll (Autumn 2013).[8]

The right hand panel exhibits the ranking between life satisfaction and the trust in institutions. The ranking of countries with regard to trust is calculated as the average ranking of the trust in political parties, national parliament, national government and the European Union as measured by the latest *Eurobarometer* survey.[9] The trust in political institutions can be interpreted as a rough measure of the inclusiveness of political institutions.

More or less similar picture emerges when one compares perceived corruption and democracy with life satisfaction. This is depicted in the following diagram (Exhibit 2). The higher to the right in the diagram a country is located the lower is perceived corruption and the stronger are its democratic institutions. The measure for corruption is taken from *Transparency International* and the measure for the strength of democracy is constructed by the *Economist Intelligence Unit.*

The main picture emerging from these diagrams, however, is robust. The Nordics seem to be high-trust and economically inclusive countries with the citizens enjoying high life satisfaction. The Nordics are also high-tax countries. So far high taxes have been willingly paid, because the middle classes feel that they have benefited from the welfare state. The socio-economic position of the middle classes is currently threatened which may reduce the willingness to pay taxes implying a deterioration of trust in the process.

The Southern European countries, in turn, seem to be low-trust, economically less-inclusive countries with citizens enjoying a comparatively low life satisfaction. This result can be interpreted positively. Implementing structural reforms in order to make the economies more competitive, improving the governance and the quality of institutions, and reducing corruption would help to build up trust and, over time, improve life satisfaction.

It is of course true that these kinds of comparisons may suffer from a number of caveats. For example, the selection of countries, indicators and time periods may be arbitrary.

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7 The OECD index of Product Market Regulation, the OECD index of Employment Protection Legislation, The Fraser Institute Index for Economic Freedom and the KOF Index of Globalization. These four indicators are highly correlated.

8 The Eurobarometer survey is conducted by the European Commission twice a year. The face-to-face interviews are made on a randomly selected population of around 1000 persons in each country. The results should be statistically significant.

9 The correlation between these four indicators for trust in political institutions is high.

Trust, finance, and good society

Let me now turn to my final theme; that is, the role of finance in a good society. Some of you may wonder what in earth has finance to do with a good society, especially now when we all are witnessing the huge damage caused by the global financial crisis over the past few.

The connecting factor between finance and the good society is trust. The whole monetary and financial system is based on trust.

Trust is the foundation for monetary exchange, and monetary exchange is the foundation of a market economy. Paper money has value only as long as the money holders can be secure that all others believe that the money can be used for transactions at a future date. The emergence of the universally accepted means of payment, in turn, was precondition for multilateral exchange and thereby for the distribution of labour.

The origin of the term *credit* word is a Latin word *credo*, translated "I believe". This illustrates the intimate relationship between trust and finance. No bank can operate if the depositors do not trust that money deposited at the bank can be withdrawn at a later date. A bank, in turn, must be reasonable confident that a borrower will pay back the loan at a future date.

The emergence of banking made possible the separation of investment from saving. Credit made possible that talented individuals without any inherited wealth could invest in producing goods and services and employ people to invest and employ. Investment financed by credit, based on trust, was, and still is, a precondition for economic progress.

The worst situation a bank could meet is the loss of confidence on the part of depositors. Any bank will fall, if a sufficiently large number of depositors arrive simultaneously to withdraw their deposits. This can happen even when the banker has in all respects behaved prudently. Sometimes a mere rumour can trigger a bank run.

Any kind of business activity, including banking, is dealing with risks. Without risk taking there would be no economic growth, no increase in prosperity. Extending credit to customers implies credit risk. Liquidity or refinancing risk arises from the so called maturity transformation where the long-term lending is financed by deposits or other types of short-term borrowing. Interest rates, exchange rates and asset prices tend to fluctuate in an unpredictable manner making banks vulnerable to price risks.

Risks cannot be avoided, but they can be managed. Risks are managed, first, by maintaining sufficient buffers and reserves for a "rainy day". The owners of the bank need to secure the solvency of the bank in order to minimize the risk of default. In addition to capital buffers there is a multitude of methods to manage risks by using different kinds of financial instruments, including derivatives. These are helpful as long as the markets function properly and the counterparties are trustworthy.

Of course, the same instruments that are used to hedge against certain types of risks can be used in a speculative way, which actually increases the risk. Excessive risk taking and herd behaviour are not unknown in finance. Sometimes excessive risk taking has been encouraged by short-term remuneration schemes.

While trust is the foundation of money and finance, it is true the history of money and finance is full of stories about how the trust has been betrayed. Fraud and betrayal have surrounded banking and finance throughout the history. No wonder that bankers' reputation has from time to time been lost.

In old days the rulers used to finance warfare by impairing the gold contents of coins. In the time of paper money, the same outcome was achieved by issuing money into circulation by greater amounts than was needed to normal flow of transactions. The resulting inflation was effectively a form of taxation transferring resources from money-holders to the hands of rulers to be used for extravagant consumption or warfare.

It is not difficult to find examples of financial fraud or misconduct in a more recent history. Some sorts of financial crimes are reported in the press almost weekly. These are typically crimes against property, attempts to converse ownership of assets to one's personal benefits. The list of acts is long, ranging from stock manipulation and insider trading to credit card fraud and counterfeiting.

These headlines should not mislead us to regard all bankers as gangsters (*banksters*). After all, the number of the acts of fraud is very small compared to millions of honest transactions conducted each day.

More importantly, we shall not forget the significant role financial markets have played in economic development. The benefits brought about by the financial markets cannot be assigned only to particular persons or businesses. They also bring about systemic benefits what the economists called positive network externalities. For example, I benefit from using a payments system only because I know that many others are using it as well. I trust a bank when I know that others trust it as well.

Similarly, if the financial markets cease to function properly, be it because of unexpected events, excessive risk taking or misconduct, everybody is bound to lose. The negative externalities of a banking crisis can be huge, as we all well know.

Therefore it is a in the public interest to design the regulatory framework and set up institutions, which reduce the probability of systemic crises. Needless to say, the regulations need to be of good quality, which means, *inter alia*, being not biased toward any vested interests. Similarly, the institutions must be trustworthy, which means, *inter alia*, being impartial and free from corruption. What is needed, in addition, is the set of institutions that take care that fraud and wrongdoing in finance, whenever it occurs, do not get unpunished.

To sum up. The role of trust in finance is the same as the role of trust in a good society in general. It may not be enough to say that "all you need is trust". You also need trustworthy institutions.