Economic Crisis, Trust and Socio-Economic Aspects of Sustainable Development

Kryzys ekonomiczny, kryzys zaufania a społeczno-ekonomiczne aspekty zrównoważonego rozwoju

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Abstract

Authors described the relationships between economic crisis and a crisis of trust. This study identifies key elements that play significant role in trust building and destruction. The consequences of behavioral factors of the market players are discussed. Relationships between social status, higher acceptance of risk and decrease of trust in the economic system are analyzed. The importance of trust and intergenerational justice as a base factor for long-term socio-economic growth are also highlighted.

Key words: sustainable development, trust, crisis, economy, financial markets, intergenerational justice

Streszczenie

W artykule podjęto tematykę relacji pomiędzy kryzysem ekonomicznym i kryzysem zaufania. Omówiono elementy kreiujące i destruktywne w procesie budowy zaufania w gospodarce. Przedstawiono konsekwencje wynikające z zachowań uczestników procesów ekonomicznych oraz relacji zachodzące między stanem materialnym inwestorów, a akceptowaniem przez nich wyższego poziomu ryzyka i spadkiem zaufania do systemu ekonomicznego. Wskazano istotność zaufania do systemu ekonomicznego oraz sprawiedliwości międzypokoleniowej jako podstawa zrównoważonego, trwałego, długoterminowego rozwoju społeczno-ekonomicznego.

Słowa kluczowe: rozwój zrównoważony, zaufanie, kryzys, ekonomia, rynki finansowe, sprawiedliwość międzypokoleniowa

Introduction

The development of neo-liberal economic thought, together with massive successes by Margaret Thatcher’s cabinet in the UK and two decades of growth in USA, brought a deeper belief in economic development being understood as a growth of economic indicators. This included the matter of entrepreneurship being positively measured by increased profits. This is commonly known under the phrase greed is good. This decreased the perceived importance of research in the field of welfare, replacing it with counting Gross Domestic Product as somehow a basic measure of development. It was strengthened by a basic rule of liberal capitalism – grow or die (Pawlowski, 2010; Fotopoulos, 2007). Unfortunately, this was accompanied by the slow disappearance of traditional market values, especially trust. It also lessened the importance of increasing socio-economic and ecological risks that resulted from this growth model. Belief in the free market as the best possible mechanism leading to optimal solutions oversaw important behavioral aspects of its players. The free market is driven by human behaviors and they quite often follow instincts rather than knowledge. It was forgotten that people change their behaviors depending on their economic status, and this may lead...
to irrational, risky market decisions. This was brutally reinforced by the financial crisis of 2008. The rapid spread of so called turbo capitalism resulted in the division of global society into a tiny elite of winners, who struggled only a little during the last crisis, and a constantly growing number of others experiencing structural unemployment, especially young people, who feel forgotten and lost. Capitalism without ethical and moral boundaries leads to degradation and exhaustion of natural and social resources (Ikerd, 2008). Its growth is connected with a shortening of the planning horizon, and results in not taking proper account of many long-term threats. 

In this study, reflections on these observations and factors are presented. Trust and boundaries seem to be irreplaceable in building and sustaining socio-economic growth.

**Market Growth Factors Before the 2008 Financial Crisis**

The economy grows in cycles and follows turns in growth and decline that can be observed. Its current state is reflected in stock markets, where stocks rise up in the long term but face short-term pitfalls as well. This mechanism may be illustrated by a pendulum, which is shifting one way and shifting the opposite later on. Stock market shifts depend in great measure on investors’ moods. Prices increase when greed wins and they decrease when fear wins (Kossecki, 2011). Long-term sustainable development derives from the perception of common interest by society’s members (Fiut, 2007); greed comes from selfishness.

The two decades before the 2008 economic crisis were a time of unprecedented, long-term economic growth and a period of bonanza on financial markets. It was supported in the last decade of the 20th century by IT technologies development, as well as by a decrease in IT hardware and telecommunication services prices. The primary source of this economic growth was in the decrease in prices of semi-conductors. It indirectly influenced other sectors of the economy as well (Jorgenson, 2001). According to economists, basics of the new economy in the USA were created by:

- re-birth of productivity increases in American companies after 1995;
- IT technologies development, which led to increased productivity in other market sectors;
- organizational changes in companies forced by the necessity of incorporating digital economy rules.

The scale of these changes made many economists judge that basic economic laws were changed (Bryson, 2005). Development in IT technologies enabled unprecedented growth on financial markets. Investments became far easier and available to many new players (quite often to people not really wealthy) who haven’t the necessary knowledge on how financial markets work. Meanwhile, the markets developed many financial instruments that from beginning were bringing enormous gains, but even their creators had no clue on the risks they brought. The other important factor was a boom in the real estate market, which gained strength in the middle of the 1990’s. People who rarely purchased flats were becoming investors. Many people started to buy estates not for living in them, but on a speculative basis. One may ask: what were their goals?

**Behavioral Mechanisms of Investing on Financial Markets and Investment Rules**

According to the behavioral portfolio theory, people when investing are driven by two emotions: fear and greed (Shefrin, Statman 2000; Szyszka, 2009). Greed makes investors hoping to gain high returns, but accepting relatively high risks, turning investing into a kind of a lottery. On the other hand, fear drives one to keep part of assets in secure investments, bringing low returns but guarantying real value. In these terms, fear comes from being afraid of a decreasing level of consumption while greed comes from a hope for immediate increase (Szyszka, 2009).

The wide spread of investing and gaining high returns brought a belief that welfare levels comes not from work, but from capital investments where risk seemed to be low. In consequence, big financial players begun to rank the financial dimension of investments as the most important, or even the only one (Puls Biznesu, 2011). Meanwhile, the turn in market trends brought a decrease of purchasing power to many people in society. This can be illustrated by the quite massive trust in derivatives that as came out later, were bound to a high investment risk of loss. This risk was however very difficult to observe by common investors due to the complication of these instruments. At the same time, investors were experiencing unprecedented high returns on these instruments for a longer time.

In October 2010 at Leon Koźmiński Academy, Prof. Kołodko said at the conference Report on Management that the main reason for the last crisis was the greed of investors. In his opinion, with acceptable levels of risk, it is possible to expect a long-term return at the level of 8-10%. Meanwhile investors had gotten used to return levels of about 20-30%. Such levels must relate to high risk, as traditional investments and the economy simply can’t generate and sustain gains at that level. Therefore in the long term, greed and demand for such high returns had to drive into crisis, leading to the mechanism of a speculative bubble. Speculative bubbles are created when the market price of an asset becomes to be calculated on the change in its level predicted for the future. In such
cases, everybody starts to buy because it will be more expensive later, which drives to a self-realizing prophecy and a risk of losing its fundamental value. Such a market is usually very sensitive to all negative information, which as time passes is more and more likely to drive a crash. The more speculative prices are, the worse the crash is. In this case, it is easily illustrated using a pendulum. With such a mechanism, one could see it in the real estate markets before the crisis of 2008.

The beginning of the 2008 crisis had prior scandals but symbolically began with the bankruptcy of Lehman Brothers, which was one of the oldest investment banks. It caused an almost complete freezing of the interbank market as banks lost trust to their partners. Many institutions faced liquidity problems and deposit rates dramatically rose. On the stock markets, fear appeared and lack of trust, one of the basic values underlying normal functioning of the financial markets, was lost.

**Role of Trust in Markets and the Economic System**

Trust is one of the terms that is intuitively understood but very difficult to define. Usually people state easily if they trust another person or institution. On the contrary, it is not easy to explain what factors influence these opinions. This is partially caused by the fact that some people use rational indicators, while other use highly subjective ones. This may be because trust is being built by objective facts (keeping promises, professional service, office in a good place) as well as by subjective ones like non-verbal communication and way of speaking.

Interpersonal trust is very important in social life and seems to be one of the factors regulating social relations (Markowa-Gorki, 1990). Increasing trust allows decreased control; it is seen to be one of the key organizational factors (Mayer, Davis, Schoorman, 1995). Interpersonal trust may be observed in relation to people and institutions as well.

Another important type of trust one can distinguish is trust in a system. It is a belief that non-personal (usually social) structures are able to guarantee a good (perceived safe) future (Lewis, Weigert, 1985). Such non-personal structures may use different means of protection such as regulations (e.g. legal regulations), guarantees, and contracts. The term system trust is always used in a specific situation and specific context. It is usually connected with so-called normality (Baier, 1995), right order of things (Lewis, Weigert, 1985) and structural safety. For instance, a company undertaking construction, which consists of parts measured in the metric system, trusts that participants all use the same metric system; hence it is a commonly used and officially recognized standard (Mc Knight, 1996).

An interesting illustration of this problem may be the case of bankruptcy and misleading bookkeeping in Enron, an American corporation discovered in 2001, as well as in similar following scandals like the WorldCom bankruptcy in 2002. This result in a decrease in trust towards Arthur Andersen (Enron’s auditor) and in general to leading audit companies, or even to all institutions connected with the New York Stock Exchange (The Economist, 2002). George Bush, the President of the USA, stated in one of his speeches that basic rules underlying capitalism have been denied (Węglarczczyk, 2002). But leaders hadn’t learned the lesson, and the next crisis to a great extent was caused by inadequacy in financial reporting and not informing about the level of risk that had been taken by companies.

According to some economists, the series of accounting scandals has destroyed trust and endangered the fundamentals of the free-market economy. R. Skidelsky, a member of British Parliament, said that the global crisis resulted from abnormality, i.e. errors in asset pricing by banks and rating agencies (Skidelsky, 2011). J. Stiglitz claimed that one of the reasons for the last crisis had been a moral deficit, which resulted in common use of creative bookkeeping as well as irrationally risky activities in the financial sector (Stiglitz, 2010). The financial sector time after time crossed the thin line between creative bookkeeping and book deception. The crisis itself brought a dramatic correction in real estate and financial instrument prices.

Baier claims that a system creates trust when everyone performs their work and duties accordingly (Baier, 1995). System trust, especially in initial relations, positively influences interpersonal trust creation (Mc Knight, 1996). Trust is built over a very long time, but is easy to quickly destroy. According to M. Deutsch, one has trust of an event when he or she expects it, which leads to behaviors perceived by that person as having bigger negative consequences when it fails than the positive consequences in the opposite situation. This causes an asymmetry of award and punishment connected with trust (Deutsch, 1958).

Lack of trust results in decreased comfort as well as usually higher costs. This is due to the necessity of checking each partner, collecting information, and safeguarding for the situation where partners don’t keep their commitments. When one does not trust people, quite often the joy of life is lost as well. One has to check workers and friends and turns suspicious. When people don’t trust economic development, usually they withdraw assets from markets and exchange them for so-called safe assets, such as noble metals. The economy shrinks. Expenses were then cut in programs, as recommended by international institutions in countries like Greece, which brought further economic shrinkage. One may connect this to a decrease of optimism and trust towards the economic order in these coun-
tries. People and entrepreneurs stopped trusting the system, which deepened the shrinkage effect in economies.

The recovery process is connected on the other hand with an increase in optimism among economic parties, and a belief that the situation is going back to normal, i.e. a growth trend. This will mean that investments are to bring positive returns. Consequently, it should become unnecessary to pay extra costs for safeguarding trust, which additionally raises the benefits by a positive multiplier effect.

Trust plays a crucial role in each transaction even though it isn’t an integral part. Any person deciding to sign a contract is in a situation that is somehow risky, i.e. a situation in which after a decision is made, the result to be achieved is not definite (Encyklopedia psychologii, 1978). In many crises, one could identify the events that undermined trust in the economic system, just like the Lehman Brothers bankruptcy. Decrease in trust causes an additional necessity in checking partners and institutions and quite often results in finding that some parties cannot be trusted. This results in a general decrease in the level of trust between entities in the economy, which is reflected in economic indicators.

**Material Status as a Determinant of Risk Taking and Entrepreneurship**

Most investors see a decreasing marginal usability of goods, which may be reflected in their attitudes towards risk taking. They feel stronger negative emotional feelings from losing a currency unit than positive feelings from gaining one (Zarzecki, 1999). Poor and rich people, just like poor and rich countries, have different attitudes towards risk taking. A rich one, that already achieved a certain level of consumption, is afraid to lose it. A poor one is dreaming of a possible consumption increase. This is the reason that he or she is willing to take a much high risk. This may be an explanation to the phenomena of an enormous popularity of lotteries in developing countries. Lotteries are a way of selling dreams, emotions and hopes for a better tomorrow, such as gains in consumption. On the other hand, the rich have less unfulfilled dreams, especially those that may be bought with money. Instead, they are afraid of losing what they already have.

Poor people and poor countries dream of having more and having a higher rate of return, they often accept disproportionate increases in risk taking. This can be illustrated by the fact that in poor countries, it is possible to find so many poor and desperate people that are willing to take a part in drug smuggling. This is a way for earning easy money, but requires taking an enormous risk of destruction of one’s own life. Similarly, poor countries quite often seem to take on too many public debts.

Before the 2008 crisis, investing in the real estate market were encouraged for relatively poor people. They were urged to start buying houses and flats with credit to increase their standard of life. They believed that they were making wise investments. In parallel, more small investors begun to invest in derivatives, not being aware of the risks they bring. The crisis brought verification of these investment risks, which led to impoverishment of the lower class (which was unable to pay mortgages) and of fresh investors from the middle class.

The world seems to be dividing more and more along this line, and the last crisis made this division even bigger. So-called aid programs, that were run during crises in different parts of the globe, were set up to help large international financial institutions, that had miscalculated risks in their own investments and may lose their own assets.

The aid program offered to Greece has been aimed to decrease the losses of big European banks. Those banks were not able to properly assess risks related to their bond investments. In the USA, huge funds have been raised for helping bankrupt big investment banks, but citizens having problems with paying their mortgages have been largely left on their own.

In a society, economic relations are being regulated by many contracts that are important for its proper running. For financial institutions and international capital, the most important would be the ones for paying debts to lenders, as their frauds or bankruptcies undermines trust in such capital entities in the financial market. This is why international institutions help countries experiencing problems, delivering billions of dollars for borrowers to pay debts on-time. On the other hand for the common people, more importance seems to be placed on social contracts for basic social and economic security of citizens and on pensions. Undermining these social contracts quite often leads to street protests, which reflects later on the nature and level of the economic climate.

**Sustainable Social Development as an Economic Dimension**

The present generation in Poland and in other European countries is living on the cost of future generations. For instance, this relates to their pension systems. Today’s retired pensions are paid for by working people’s contributions, which are becoming higher and higher while the retirement age is being increased. At the same time, it is predicted that the future pensions for people that work nowadays will be drastically lower. Symptomatic of this is the decreasing Demographic Reserve Fund, which in Poland is a kind of social retirement insurance for future generations. In 2010, it went down 7.5 billion PLN and in 2011 dropped another 4 billion PLN. In addition, the Social Insurance Institution (ZUS) is being financed from the current
budget and in 2011 received 37.1 billion PLN from public money (Gazeta Prawna, 2011).

One may add, that discussions on extending the working time before retirement are not supplement-
ed by any discussions on ways how to promote having more children in families. This might be a simple way of reducing the consequences of changes in the age structure of polish society. Meanwhile, in newspapers, one can read calculations on how high is the cost of child raising in Poland. This is still unresolved, which is a problem because intergenerational justice is a cardinal rule of sustainable development (Pawłowski, 2010). The present generation, and especially its narrow establishment, is living on the credit of future generations.

In the USA, the 2008 crisis has deepened differences between rich and poor people. During the years of the Bush presidency, taxation of dividends and capital gains was cut. Between 1980 and 2010, the incomes of 90% of American society significantly shrunk. Meanwhile, between 1980 and 2006, the share in total incomes of the 1% of the richest Americans grew from 10 to 25%. Average young Americans are less educated, earn less money and have worse educational possibilities than their parents. At the same time, 400 of the richest in the Forbes annual list gained more than 60% of all Americans (Zawadzki, 2011).

Earnings of CEOs in American corporations grew 4 times in real terms since the 1970s. During the same period, earnings of the average worker in real terms slipped by 10% (Lubowski, 2011). An extreme illustration of this might be the earnings of Richard Fuld, CEO of Lehman Brothers, which during the 8 years before its bankruptcy totaled $300-$485 million USD (Wikipedia, 2012). Similarly, $47 million USD was paid to Martin Sullivan, CEO of AIG at the moment of his resignation in 2008 (CNBC, 2008). The bankruptcy of Lehman Brothers, the biggest one in US history, was one of the main reasons for the problems of giant insurance company AIG, which received $115 billion USD of public aid during the crisis. A year later in 2009, the same company announced its willingness to pay $165 million USD in benefits to its managing directors.

Growing social disproportions have already been pointed to as one of the most important disorders of the neoliberal economic system. They cause growth of structural unemployment and concentration of the world’s capital in hands of only a few entities, which enforce their vision of economic order on others (Gawor, 2006).

Constantly richer elites are alienating themselves from the rest of society. At the same time, the tax system burdens mostly touch the people who earn little or average amounts, who are paying relatively high income and social taxes as well as indirect taxes. At the same time, people who earn the most may avoid paying taxes, for instance by using so-called tax heavens. The Cayman Islands, a British territory, have 580 registered banks and the value of assets and holdings registered there is about $500 billion USD. There is also registered about 2,200 investment funds, 500 insurance companies and 40,000 off-shore companies. In Lichtenstein, another tax heaven, there are about 75,000 off-shore companies (Gontarczyk, 2010).

In the developed countries, corporations are paying lower and lower taxes. Corporate income tax, as a percentage of total US federal tax income, fell from 32.1% in 1952 to 11.5% in 1998 (Klein, 2004). Nowadays, fiscal policy tightening is done in most countries by raising indirect taxes and social expenditures cuts, and not by raising capital taxation, especially on derivative markets. Introduction of even small taxation on derivatives dealing would highlight its effects and limit natural adjustment to the real economy size. More and more fortunes are being created separately from the actual production processes. At the same time, there was introduced some financial markets deregulation, which enabled creation of many market bubbles – Internet, real estate, food, and energy. Those bubbles influenced the living levels of common citizens that now have to face rising prices of gasoline, energy, food or mortgages.

Another factor is the running out of natural energy carriers. Current estimates show that at a constant power consumption level, all oil resources will dry up in about 40-50 years, natural gas in 60-70 years, and coal in 140-150 years (Pawłowski, 2010). At the same time, one can observe the growing influence of power supply companies on the political establishment, which can be seen in both underdeveloped and developed countries. Large international energy companies hurt natural resources (Gawor, 2006). However, the energy lobby has only a minor interest in alternative energy development and production.

The current investment bubble in energy markets is mainly caused by transactions on the derivative markets, which are only loosely connected with real energy demand. In 2008, 71% of future oil contracts were traded by financial investors (Kublik, 2008).

Low wages, especially among young people, lead to shrinking of the middle class and is dividing society. The number of millionaires grows along with the number of poor people. Children of middle class parents have small chances to achieve a similar to their parents material status. Thanks to this, big corporations, especially in services, have lower personnel costs. Specialists have had to accept constantly deflating wages, which may not secure their living conditions above a social minimum.

The middle class is living in constant uncertainty and frustrations are growing. Social division causes a drop in social trust of the economic system. The young generation is losing its hope for a better
future. The recent crisis led to breaking the social status-quo, which brought social deviations, criminality, terrorism and other dangerous effects (Maćzyńska, 2011). Stiglitz has been pointing that neoliberal globalization and lack of social security will lead to growing brutality all over the world (Stiglitz, 2004).

Ensuring mutual trust and taking into account a longer planning horizon are basic requirements towards fighting the current crisis and securing long-term, sustainable development. During a meeting with members of the Rome Society of Industry and Finance Specialists, Pope Benedict XVI stated: 

*the most certain way of fighting against the fall of entrepreneurship is set on a net of contacts with other social subjects, investing in research and innovations, not running towards unfair competition between companies, not running away from own social duties and securing high productivity, which would answer real human needs. The company may (...) produce ’social goods’ when only finance officers and managers will follow the long term vision, which brings long-term gains over speculative incomes, which promote innovations instead of collecting richness* (Benedict XVI, 2009).

The Pope also sees the problem of unemployment among youth: *following steps of my predecessors, I stressed that facing the unemployment rise, especially among young people, economic poverty of many workers and discovering new forms of slavery, and equal access to decent work is a matter of a top priority* (Benedict XVI, 2009).

These problems may be observed in Poland as well. According to research of the Public Opinion Research Center (CBOS), 74% of Poles regard that equality is more important than economic growth. Poles prefer slower, but equitable, improvement for all. According to 37% of respondents, justice in society means that all have a similar level of living and that there are neither very poor nor very rich ones (CBOS, 2012). Increased disproportionate conditions, that accompany economic crises, are undermining trust in society towards the economic system. Therefore, gaining huge individual richness should be considered as a threat to long-term, sustainable development.

### Conclusions

The financial crisis of 2008 painfully reminded everyone that sustainable development is a base for national wealth. Its creation is not possible with financial speculation and risk over-acceptance. Economic thinking cannot be separated from traditional values of the classic capitalist growth economic model, in which one of the basic wealth creation factors is human work, that should allow a decent level of life without having to take unnecessary risk. The paradigms, that were functioning during the prior decades, caused a situation in which growth couldn’t be sustained, which finally brought on the latest crisis.

One of the basic rules of sustainable growth is inter-generational justice, which allows future generations to have their needs satisfied, and which has been disturbed. Blind greed of some present leaders may threaten the lives of future generations.

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