

recession, as happened in Mercosur countries. Therefore, we cannot have a doctrinaire approach and say that regional trade agreements are beneficial or detrimental to global trade. Each regional trade agreement will have to be assessed individually in terms of its impact on trade creation, trade diversion, employment opportunities, economies of scale etc.

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Economies of Trust and the Financial Crisis

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Trust makes the world go round. It is the most pervasive cultural characteristic influencing a nation's prosperity and its ability to compete. Trust enables people to do business with one another, which in turn creates wealth. Trust and growth are positively related and are mutually

reinforcing in nature. If the society's levels of confidence and trust are low, it leads to inefficiency of markets and institutions, causing the economy to settle in an inefficient equilibrium in a multiple equilibria model of growth.

As critical as trust in both government and business is for our political and economic system, faith in other people maybe more important. Trust in other people, or generalized trust, is a central factor in shaping both social cohesion and institutions that function well. The roots of generalized trust and confidence in institutions are not the same. Confidence in institutions largely reflects current performance of the economy. Moreover, confidence is less variable than trust in government.

A crisis of confidence portends a loss of public trust, and there is no better example of this than the American banking industry that bred the global financial crisis of 2008. The financial crisis, originating from monetary excesses, caused a housing boom followed by a bust which eventually threatened the total collapse of financial institutions. Banks ultimately had to be bailed out by national governments. Stock markets around the world also witnessed a downturn.

From 2000, the Federal Reserve started easing the lending standards and held its target interest rates well below monetary guidelines. The Federal Funds rate fell by 11 times, from 6.5% in May 2000 to 1.75% in December 2001. This created a flood of liquidity in the economy. It was cheap money which was easy prey for restless bankers and borrowers who had no income, jobs or assets. The complex interplay of subprime lending and adjustable-mortgage lending lead to exuberant risk taking due to

availability of loans at low interest rates without any down payment. The environment of easy credit coupled with a large demand for houses led to the appreciation of home prices. This upward spiral in prices made investments look like a new rush for gold. The Fed, too, continued slashing interest rates (in June 2003, the Fed lowered interest rates to 1%, the lowest rate in 45 years). To make things merrier, in October 2004, the Securities Exchange Commission (SEC) relaxed the net capital requirement for five investment banks (Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns and Morgan Stanley), which allowed them to leverage credit up to 30 or even 40 times their initial investment.

Trouble soon began as interest rates started rising and the demand for home ownership reached its saturation point. The Fed started raising the funds rate, and by June 2006, it had reached 5.25%. Incentives for investment in housing soon dried up, and this led to a fall in housing prices. The U.S. Home Construction Index declined in 2006 by 40%. Not only were new homes being affected, but many subprime borrowers could not withstand the higher interest rates. They started defaulting on their loans and filed for bankruptcy.

It became apparent in August 2007 that the financial market could not resolve the subprime crisis on its own. The financial crisis became acute and interest rates rose dramatically. Policy makers misdiagnosed the crisis as one of liquidity rather than of counterparty risk. The Economic Stimulus Act of 2008 was introduced, whereby a package of cash totalling over a \$ 100 billion was given to individuals and families with the aim of jump-starting consumption, and by extension, the economy. But this failed too. The Fed started slashing the discount rate as well as the funds rate, but bad news

continued to pour in from all sides. Lehman Brothers filed for bankruptcy, Indymac bank collapsed, Bear Stearns was acquired by JP Morgan Chase, Merrill Lynch was sold to Bank of America, and Fannie Mae and Freddie Mac were put under the control of the U.S. federal government. The crisis was now being aggravated by governance failure: political governance by regulators and legislators, corporate governance by firms and executives, and personal governance by individuals.

The consequences of the crisis

The crisis resulted in either people losing their homes or the value of their houses sinking below the mortgage they were paying. A household's expectation of potential earning power declined substantially. The number of unemployed climbed to 14.7 million over the course of the recession, peaking at 10 percent of the nation's labour force in October 2009. The ranks of the underemployed (those who want a job but can only find part-time work) and frustrated job seekers (those who become discouraged and give up looking for work) rose to 12 million, a 94 percent increase. In July 2013, four years after the recession is deemed to have ended, labour underutilization remains intractably high: 11.5 million people are unemployed and an additional 10.6 million are underemployed or frustrated.

The crisis also resulted in a significant loss of trust in government institutions and the U.S. capitalist economic system. Saving the system from complete collapse, especially with extraordinary government assistance, including bailouts to a handful of giant financial institutions, reinforced the perception that public support exists primarily for large, interconnected and complex financial entities. Deemed "too big

to fail,” these financial intermediaries lacked discipline, accountability and transparency, and proved largely immune to the downside of their excessive risk taking.

People also felt betrayed by businesses that they saw as playing fast and loose with financial instruments that few seemed to understand. Investment firms took excessive risks using resources that either had deteriorated greatly in value or had never existed at all.

The fact that financial markets could come so close to collapsing has given citizens a glimpse of the fragility of modern finance and its strong dependence on mutual trust. For any economy to function, the participants must trust that the system is reasonably fair. Trust between individuals is a reciprocal behaviour. The system would fail to function if there is a lack of trust on either side.

Hence, a question now arises as to how the financial industry can rebuild its image. Building institutional and industrial trust is not easy. One way to do so is through performance. Once investors begin to recoup their losses and the market rebounds, any concern or hostility towards the industry will likely dissipate, at least temporarily. In fact, we are already seeing evidence of the beginning of this process. However, relying solely on performance to build and sustain public trust can be risky, as industrial performance is often cyclical, and in a downturn, the chance of losing the public's confidence can be high.

For the financial industry to be perceived as trustworthy, ethical and high performing, especially in light of the financial crisis, it must develop the capacity to respond to and learn from experience and generate positive

outcomes. The financial system must act in accordance with a set of core values and beliefs, which should be aligned within and across firms. Another critical component in the trust rebuilding process is creating a sense of positive intent towards the stakeholders of the industry. Positive intent requires that the industry should be clear in its motives and communicate the same to its shareholders. When there are common values and goals, customers and clients are more willing to believe that a firm or industry has their best interest at heart. When there are no mutually held values or expectations, there is a perception of imbalance in power, along with greater risk and vulnerability, which prevents trust from flourishing. The financial industry needs to focus on these aspects and regain the people's trust quickly, so that it can contribute to greater growth.

Developing Real Economies in Synthetic Worlds

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“In the cyber universe, though the worlds are synthetic, the economies are real. Cyberspace is ruled by the law of supply and demand, which quantifies prices exactly as happens in the real world,” observes the Italian economist Loretta Napoleoni, known primarily for her analysis of terrorism finance networks. In her book *Rogue Economics*, she turns her attention to Chinese counterfeiters, Russian oligarchs, Congolese slave traders and other