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On the Atrophy of Moral Reasoning in the Global Financial Crisis

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On the Atrophy of Moral Reasoning in the Global Financial Crisis

Cover Page Footnote

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INTRODUCTION

Financial crises occur more frequently than is commonly thought. Although major pandemic episodes may only number a dozen or two, history is littered with hundreds of financial crises.¹ The US Government's response to the latest crisis, for instance, involves the second major US taxpayer bailout in the space of twenty years, the other resulting from the Savings and Loans crisis in the 1980s. By the same token, previous banking crises do not compare to the Global Financial Crisis (GFC) of 2008, which is in a class of its own (although even the GFC is not another Great Depression), in terms of both the magnitude of the event itself, and its subsequent domino effect.

Within the GFC, there are many individual financial crises. The sub-prime crisis, for instance, is different from others in that for the first time in decades, probably since the student unrest of the 1960s, there is a simmering sense of angst in society at large about the socioeconomic system. Although the crisis originated in the banking sector, its effects spread surprisingly quickly to the entire economy, giving rise to what has been dubbed the Great Recession. In the US the jobless rate climbed to over 10 percent. Many lost their homes through foreclosures, and bank customers everywhere were adversely impacted as credit lines dried up and macroeconomic conditions deteriorated into recession. Two years after the crisis, long term unemployment remained at record levels in the United States, with some 1.4 million out of work for 99 weeks or more, their unemployment insurance benefits expired. The harmful effects, so evident in domestic economies, also spilled out internationally, with many reverberations, including a consequential rise in global poverty: the GFC pushed the ranks of the world's hungry to a record high of one billion people, or one in six persons, according to the United Nations Food and Agriculture Organisation.² A lethal mix of the global economic slowdown combined with high food prices in many countries saw the number of people in chronic hunger and poverty top 100 million, according to FAO Director-General Jacques Diouf. Clearly, the adverse human fallout from the credit crunch in terms of personal and social hardship was – and continues to be – profound.

The economic disparities flowing from the GFC have earned the public's ire, we suggest, not only on account of the economic cost but also because of the moral chasm that has been exposed, between financiers on the one hand and

¹ Charles Kindleberger and Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: John Wiley & Sons, 2005).

² United Nations, "One Sixth of Humanity Undernourished – More than Ever Before," *Media release* (June 19, 2009), <http://www.fao.org/news/story/en/item/20568/icode> (accessed July 1, 2009).

public opinion on the other. A perceived decline in banker scruples, aided in part by the excessive avarice of some individuals at the expense of others, has caused some to question faith in the market system and renew talk about economic 'justice'. For example, the gap between the wages of ordinary workers and the bonuses paid to those on Wall Street or the City of London, who presided over the crisis, has provoked strong community reaction³. In response, the community has found ways to express its disapproval. The spontaneous TEA parties in the United States are a good example, involving demonstrations by taxpayers aggrieved that they have been called upon to underwrite the bailout of big banks and who feel they are Taxed Enough Already, evidence of a groundswell of ill-feeling⁴. Community resentment also boiled over in Europe in the aftermath of the meltdown, in some cases to the point of vandalism of high-paid executives' property, which has prompted some captains of industry to surrender their golden handshakes and pension plans.⁵ Echoing concerns in the community, religious leaders such as Anglican Archbishop Williams and Pope Benedict XVI have called for greater attention to what God has to say about economic and social relationships.⁶

That the implications of the GFC go beyond economic mechanics, to deep issues of social cohesion and public belief, is the subject of this essay. We live in a society, not an economy. Complex societies are built on interdependence and require trust, a precious communal intangible, yet there is a palpable sense in the community that the GFC raises serious questions about the fairness of markets, and that addressing these adequately will be essential to the long-term health of

³ This is not the first time the matter has provoked concern; indeed it has a long history, including among Catholic social statements. In *Casti Connubii*, it was detailed that workers should be paid sufficient wages to support their families, and this ideal was developed in *On the Condition of Workers* and *Quadragesimo Anno*. This may be contrasted to the immense bonuses paid to the leading executives. See also *Mater et Magistra* for a thorough treatment of vast disparities in wealth, and *Laborem Exercens* (Rome: Vatican, 1981), a treatment by John Paul II on just wages.

⁴ If the justice principle in Biblical thought (in the New Testament, see for example James 5:1-5) is applied with respect to taxes, private wealth should not be exhausted through taxation by the State, which reduces the ability of a given wage level to support the family.

⁵ Julia Werdigier, "Bank's former chief agrees to pension cut," *New York Times* (June 19, 2009).

⁶ Lecture in Cardiff by the Most Rev. Rowan Williams, Archbishop of Canterbury, 2009. *Caritas in Veritate*, Papal Encyclical of Benedict XVI (Rome: Vatican, 2009). Note: Archbishops' tomes and Papal writings can be viewed as learned commentaries, taking their place among the broader body of scholarly literature on a given topic. That they are written from a perspective of faith that seeks to evaluate carefully the normative content of economic analysis and consider the theological framework of the economic system, need not alter their academic value. For discussion of Papal encyclicals on the economy see Andrew Yuengert, "The Use of Economics in Papal Encyclicals," in *Religion and Economics: Normative Social Theory*, ed. J. Dean and A. Waterman (Boston: Kluwer, 1999).

the socio-economy. Rather than just one or two rotten apples, the GFC seems different because of the widespread sense that the entire system may be flawed. In response, a range of commentators including politicians, media and bloggers have claimed this is ‘the end of capitalism as we know it’.⁷ If classic socialism died in 1989, perhaps we are now witnessing the demise of classic capitalism since 2009, to be replaced by Capitalism 2.0, they say. While premature and certainly overstated, these and similar sentiments telegraph the severity of this history-making episode. While reverting to a wholesale centralist approach is not generally favored by most, including prominent religious figures,⁸ there is nevertheless a growing sense of a serious disconnect between business and the common good. These sentiments clearly symbolize the need for business leaders and policy makers to better understand the influence that collective moral responsibility can have over aggregate market outcomes.

For economists the GFC presents an analytical challenge to the presumed efficacy of markets. Every episode of financial chaos raises broader questions about the functional integrity of markets. In the long run, we are sympathetic to the view that the effect of markets is to improve morality, because consumers will eventually penalize firms that engage in unethical behavior.⁹ Yet in the short run there are sometimes serious exceptions to this market discipline principle. Under certain conditions, as evident in the GFC, moral misalignment of markets can and does occur. In the long run the market may well foster morality, but if the time it takes for consumers to ‘eventually’ discipline rogue firms is so long that the collateral damage of the inevitable market correction is of the order seen in the GFC, then the adjustment lag itself becomes an important issue and cyclical episodes of moral atrophy cannot easily be swept under the carpet.

⁷ G. Ruddick, “Capitalism at ‘turning point’ claims Lord Mandelson,” *Daily Telegraph* London, (May 14, 2009).

⁸ Though a range of viewpoints exists among Christians on the issue of capitalism and the role of government, there is a general consensus that favors private business working for the common good, over state-dominated centralism. In *Rerum Novarum*, Leo XIII said socialism was an illegitimate approach to solving the great social upheaval and heightening tensions of his time. In Protestant thought, a predominantly private business economy with decisions being made with a mind to God’s Kingdom is typically preferred. See for instance Jeff Van Duzer and Tim Dearborn, “The Profit of God,” *Christianity Today* (2003).

⁹ Rachel Kotkin, Joshua Hall and Scott Beaulier, “The Virtue of Business: How Markets Encourage Ethical Behavior.” *Journal of Markets and Morality* (2010): 45-58. See also Timothy Lane, “Market Discipline,” *IMF Staff Papers* (1993): 53-88; and Franco Bruni and Francesco Paterno, “Market discipline of banks’ riskiness: a study of selected issues.” *Journal of Financial Services Research* (2005): 303-325.

This paper is motivated by questions raised by the global credit crisis about the human condition and the moral ecology of markets. We first provide an explanation of the sub-prime crisis in terms of a shared failure of virtue, by advancing the notion of an endemic moral bubble involving a contagion, and by placing the GFC experience in theological perspective. The discussion then seeks to understand why moral atrophy spread virally prior to the GFC blowout: taking the father of market economics Adam Smith as a starting point, we note that his idea of social custom crystallized as professional practice provides a useful window into moral contagions, and that a nexus exists between virtue and market stability. The paper then asks how we can better immunize the market system against short run but highly damaging moral epidemics like the GFC. Here we evaluate Smith's notion of 'sympathy' and the importance of seeing exchanges as a marketplace of moral goods, not just common goods and services. Accordingly, the paper emphasizes the vital necessity of maintaining the ethical integrity of markets, and connects this thought with pro-actively and publically fostering a sense of commercial virtue, and even spiritual vitality.

THE GLOBAL FINANCIAL CRISIS AS SHARED MORAL FAILURE

An interesting question arises when many individuals in a profession or industry seemingly collaborate in a collective lapse in integrity, as apparently occurred in the GFC. This phenomenon seems pivotal to explaining the financial Frankenstein monster that the GFC became.

The dislocation from the financial earthquake to the macroeconomic system upon which so many depend for their livelihood was of history-making proportions. Housing markets went into a deep slump, and stock markets dived, shrinking the life savings and 401(k) pensions of millions. The largest banks in the United States, United Kingdom and continental Europe found themselves in serious trouble. Some financial firms in those countries merged or were sold, and others filed for bankruptcy, starting with the failure of the two largest US mortgage corporations, Fannie Mae and Freddie Mac, and of Wall Street stalwart Lehman Brothers. The big four investment banks on Wall Street were shut down (Lehman), sold off (Merrill Lynch) or turned into bank holding companies (Morgan Stanley, Goldman Sachs). During the period of greatest intensity in the crisis between August and November 2008, central banks supplied emergency liquidity and national economic authorities arranged injections of taxpayer-funded capital ('bail-outs') for institutions under stress. Assessing the UK bailout package, the Bank of England said it represented 'the largest UK government intervention in financial markets since the outbreak of the First World War'.¹⁰

¹⁰ Bank of England, *Financial Stability Report*. (Number 24, October, UK Government: London,

What really went wrong to cause the Global Financial Crisis? On one level is the technical explanation. Macroeconomic imbalances were worsening in the years leading up to 2008, especially between interest rates and asset prices, and between the US and China. To a significant degree, these imbalances were exacerbated by poor economic policy decisions. Interest rates were allowed to sit too low by the Fed and many other central banks, resulting in excessively growth in mortgages, leading to unsustainable asset price appreciation.¹¹ China's fixed *renminbi* exchange rate policy contributed to the US balance of payments deficit and saw a massive two trillion dollar build-up in China's foreign reserves (a fact eventually acknowledged by China's landmark decision in May 2010 to finally allow the previously pegged *yuan* to begin appreciating against the dollar). This occurred against a broader background, over a decade or more, following the fall of the Berlin Wall and Soviet system in 1989, and of the opening up of the Indian and Chinese economies which saw some two billion consumers enter the world market on a scale not seen previously.

It is also true that a succession of government structural policies (notably in the US) in the years leading up to the credit crisis blurred the separation of commercial banking from social assistance measures. A few examples make the point. The 1986 Tax Reform Act included the Real Estate Mortgage Investment Conduit (REMIC), rules that almost certainly made mortgage securitization more lucrative, by allowing financial firms to issue multiple-class pass-through securities without an entity-level tax. The 1995 Community Reinvestment Act (CRA), seeking to get banks to offer more credit to at-risk small businesses and low-income earners, while an admirable objective, nevertheless required private commercial banks to devote a certain proportion of their excess reserves to sub-prime loans. In 2004, the Securities and Exchange Commission (SEC) allowed securities firms to raise their leverage sharply, from the traditionally accepted ratio of 12-to-1 to a new standard as high as 33-to-1, probably encouraging imprudent balance sheet growth and greatly increasing the exposure of firms to minor declines in asset values. The Bush Administration's 2004 *American Dream* package of housing measures that sought to assist low-income groups through zero equity lending, despite its noble intentions, may have fueled the flow of sub-prime mortgages that stoked the subsequent lending frenzy and house price bubble. According to the OECD, the American Dream initiative was a key driver in the run-up to the crisis, and a core reason why the toxic activities that led to the meltdown were so much stronger in the US than elsewhere.¹²

2008): 32.

¹¹ David Gross, *Dumb Money: How our Greatest Financial Minds Bankrupted the Nation* (New York: Free Press, 2009).

¹² Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, "The current financial crisis: causes and policy issues." *Financial Market Trends* (Paris: Organisation for Economic Cooperation and

In combination, these and other policy steps no doubt altered the incentives of US banking firms, toward stimulating the over-production of sub-prime mortgages and encouraging the growth of a shadow banking system. Without denying the relevance of economic and legislative causes, we propose that the well-documented catalog of technical factors alone is insufficient to explain the GFC. On a deeper level, the crisis needs to also be understood in terms of collective character. We see this as a two-way street: the application of a decision-making framework is an ethically significant act, and equally the adoption of a moral code is an economic decision. There are two reasons why the moral dimension of the GFC is worth investigating. From the perspective of economic stability, such enquiry may prove to be useful in preventing such damaging crises from being repeated in the future, for the good of all concerned. From a religious, particularly Christian perspective, the matter of moral integrity looms large for a different reason: a society that is materially prosperous yet economical with the truth does not bode well for the human condition. 'Before you enquire, blame no man'¹³, yet to the believer, understanding exceeds riches in importance (Proverbs 16:16). To the religious professional, and a Christian economist in particular, fresh economic insights may be gleaned from theology: just as a correct and thorough understand of economics is essential to informed judgment about social ethics, so too theology may prove to be a boon to informed judgment about economies.¹⁴ On this view, we might seek not only to understand and fix the problems of the economic crisis, but also to learn from its commentary on the spiritual condition of mankind. To do so one must therefore seek a holistic analysis of its causes.

Did an erosion of morality contribute to the crisis? The epicenter of the crisis was the United States subprime mortgage market, and the seeds of the debacle lay in the accumulation of junk assets, especially securitized and residential mortgage-backed loans, that were sub-prime: their liquidity and credit quality were riskier than usual. Despite their long held consensus about the prudential superiority of traditional intermediation banking, senior bankers allowed a shift to a revised version of the originate-and-distribute model in which securitization became a mantra, particularly in mortgage lending. This meant that incentives and risk-taking were de-coupled at the coalface and loan volumes expanded without paying adequate attention to risk. The tried-and-true prime lending focus of banking increasingly took a back seat to non-conforming housing

Development, 2008).

¹³ We are aware of the need for humility and moderation in our enquiry (Matthew 7:1; John 8:7). Not being fit to cast the first stone, yet we offer this essay in the interests of the common good.

¹⁴ Anthony Waterman, "Social Thinking in Established Protestant Churches," in *Religion and Economics: Normative Social Theory*, ed. J. Dean and A. Waterman (Boston: Kluwer, 1999).

loan business, which grew to an unsustainable 12 per cent in the US industry. Standards of prudent loan assessment were frequently abandoned, for example through the acceptance of so-called ‘liar’ or low-doc (little or no paperwork) loans and ‘ninja’ (no income-no job) mortgages, banks perilously liberalized once-rigorous assessments of customers’ capacity-to-pay, evidenced by the overwhelming number of loan delinquencies post-crisis. Bankers accepted more no-deposit loans and became more willing to lend up to the full value of a property, so-called ‘one hundred percent loans’. This imparted an unusually speculative tone to the business of banking.¹⁵

From a faith perspective, this evolution in the business model of banks provides much food for thought. While we cannot be certain of others’ motives, bankers may have been induced by less-than-worthy motivations to seek unsustainable profits. Making just profit from a loan is no sin, and those who take loans for just reasons with the intent to repay also do no wrong in the Christian perspective.¹⁶ Indeed in many cases bankers may well have acted with good intentions. Yet the shift in judgment described above put the lending institutions into an increasingly dangerous position through imprudent loan growth that, like a sand castle, was in peril of being destroyed by the waves of the oncoming financial tsunami. One church leader, the Primate of the Church of England, commented this way: ‘The move away from a realistic focus on scarcity and productivity/added value and towards the virtualized economy of money transactions has been deeply seductive, and, over a limited time-frame, spectacularly successful in generating purchasing power’.¹⁷ The Anglican Archbishop’s argument is that because credit is not something that is naturally scarce in precisely the same sense that material resources are (a proposition most economists would dispute), inadequate regulation can foster the illusion that the money market is effectively risk-free, that ‘money can generate money without constraint’. The problem comes when massively inflated credit is called in: ‘when the disproportion between actual, measurable material security and what is

¹⁵ Pope Benedict XVI, wrote of this in the encyclical *Caritas in Veritate* (Rome: Vatican, 2009) in which he decried bad speculative financial decisions.

¹⁶ Elaboration is available in *Vix Pervenit*. Benedict XIV. The GFC was a two-way street: not only banks, but also their customers may share some of the blame, as there is a Christian obligation to repay one’s debts. There are two sides to a lending contract from a Christian perspective: while the lender has a moral obligation not to place an unrealistic burden on the customer, the borrower has an obligation not to abuse the loan of money that was given and must honor their promise to repay. Although some customers may not have foreseen the potential downside to subprime loans despite their best diligence, others may have knowingly not fulfilled their obligation and may have lightly taken advantage of easy credit before the GFC, effectively ended up stealing from their bank. This, in turn, harms others who may justly borrow from the banks, as it reduces the banks’ ability to loan further funds.

¹⁷ Lecture in Cardiff by the Most Rev. Rowan Williams, Archbishop of Canterbury, 2009.

being claimed and traded on the market is so great that confidence in the institutions involved collapses', argues Williams. Because of this loss of proportion, the Archbishop of Canterbury called for a 're-establishment of patience and trust in economic processes'.¹⁸

Clearly, bankers made business mistakes. Yet it also seems at least plausible that the moral compass of many influential bankers went awry. Theologically speaking, lenders have a duty of care in the lender-lendee relationship. While the borrower has an obligation to repay the debt in accordance with the agreements, the lender has an obligation not just to treat the debtor justly, but also to work for the common good (Leviticus 19:36, Galatians 5:14). 'The current crisis is not caused by sub-prime mortgages, credit default swaps, or failed economic policies: the root cause is failed leadership' said Bill George, professor of management at Harvard Business School. The Archbishop goes further and openly calls the crisis the fault of an 'underlying sense of greed'.¹⁹ Greed is a recurring villain in both secular and Biblical thought.²⁰ Fifty years before Smith wrote, the Papal encyclical *Vix Pervenit* detailed the greed of creditors and dishonest contracts, and Benedict XIV wrote shortly thereafter of how some individuals persuade themselves that such actions are legitimate.

Equally, as the broader community reaction by people from all walks of life demonstrates, one does not need to be religious to take umbrage at the apparent opportunism evident in the GFC. While some may be unaccustomed to talking about the notion of a place for higher beliefs in business, many in society's mainstream accept there is a universal values dimension to the lending culture that developed in the period between 2001 and 2007. That loans were made to customers who could not demonstrate the ability to service the loan sustainably, and that these effectively necessitated bankers bypassing the accepted standards of their profession, placing their bank and their clients in jeopardy, is now established in the public record. The Securities and Exchange Commission (SEC) decided to levy a record-breaking \$550 billion fine against market leader Goldman Sachs in July 2010, to settle federal claims that the investment bank misled investors in sub-prime mortgages.

On top of the charge of misinformation, many see another layer of guile in the GFC: opacity. The deterioration in the quality of the loan book was not adequately revealed to stakeholders until it was far too late. Citigroup, for example, finally outlined its accounting oversights publically for the first time in

¹⁸ Breach of trust brings into play the Biblical command, 'you shall not commit murder' which carries the implication that we should take care of the well-being of our neighbor (Matthew 5:21-26).

¹⁹ Lecture at the University of Cambridge by the Archbishop of Canterbury, 2008.

²⁰ Hebrews 13:5, Christians are exhorted to be content with what they have. See also Proverbs 15:27, Luke 12:15.

July 2010, two years after the crisis. Some might even go so far as to say that the financial industry concealed the truth from stockholders, bond investors and regulators alike. The Securities and Exchange Commission has officially taken this position, fining Citigroup \$75 million in July 2010 for lack of disclosure of subprime risks to bank shareholders, with the S.E.C. enforcement director stating that ‘the rules of financial disclosure are simple; if you choose to speak, speak in full and not in half-truths’.²¹ In moral philosophy, deception does not require outright lying: silence about material facts or dissembling also amounts to forms of falsehood, and imply an unfair contract.²² The New York Times drew a parallel with the junk bond scam of the 1980s: ‘By persuading the markets that the bonds defaulted at a rate substantially less than the real rate, the sellers of the junk could demand and receive a higher price for several years. When the real default rate became known, as it inevitably did, the bonds collapsed in value. The subprime crisis was essentially the old junk bond scam on super-steroids, with nuclear weapons thrown in’.²³ Credit rating agencies, which operate under a potential conflict of interest in their relationship to banks, did not sound the alarm. By such action, they become part of the problem.

Transparency and sound corporate governance are matters of moral turpitude. In Biblical terms, Proverbs teaches that ‘he that hides his sins does not prosper’.²⁴ A recent analysis by the OECD pinpoints corporate transparency and honesty as critical to the strength and safety of financial institutions, finding that in many instances of systemic instability banks themselves have been at the core of difficulties, often related to ‘inadequate disclosure and lack of transparency’.²⁵ In the context of the 2008 crisis, this lack of disclosure was telling. One commentator laments that ‘if Wall Streeters can fudge numbers and get very rich from that fudging, some may do it’.²⁶ This is a character issue: ‘fudging numbers’ amounts to a form of cheating, and legitimizes a culture in which individuals and firms feel less obligation to honor business agreements, to do unjust damage to others, or having caused harm to repair the damage as much as they can. This becomes a market in which signals are mixed and incentives are distorted. When the incentives are flawed, an environment is established in which violations of the

²¹ *New York Times* (July 30, 2010).

²² In *Vix Pervenit*, Benedict XIV wrote in 1745 against dishonest profits and immoral contracts, where a fair contract is one generally considered acceptable and compatible with Christian ethics.

²³ Ben Stein, “Dad’s Reminders Never Grow Old.” *New York Times* (June 21, 2009).

²⁴ Proverbs 28:13

²⁵ Stephen Lumpkin, “Resolutions of Weak Institutions: Lessons Learned from Previous Crises,” *Financial Market Trends* (Paris: Organisation for Economic Cooperation and Development, 2008).

²⁶ Ben Stein, *op cit*.

common good become easy and, more insidious, easy to rationalize.²⁷ This exemplifies how markets and morality interact.

It is difficult to avoid the impression that an extraordinary and collegial deterioration in moral governance in the banking sector played a key part in the crisis, by allowing a flexibility in business values to develop unchecked.²⁸ The verdict of Gillian Tett in her book *Fool's Gold* is that the US\$2 trillion losses from the crisis were self-inflicted, and unlike many banking crises, 'not triggered by war, a widespread recession, or any external shock', but rather 'the entire financial system went wrong as a result of flawed incentives within banks and investment funds, as well as the ratings agencies'.²⁹ It was, in other words, a matter of market culture.

Significantly, the path to moral atrophy in the credit crisis was within legal bounds, and, generally speaking, was not illegal. The GFC lay within the zone of moral ambiguity. Avoidance of moral responsibility was the problem, not outright criminal evasion. This gray area has been nicknamed 'avoision'. We are not dealing here with the Enrons or Worldcoms of this world, where the actions in question were illicit, legally speaking, and where the fallout was mostly restricted to those directly connected with the individual firm concerned. By contrast, unlike the junk bonds scandals of the 1980s, there have been no courtroom prosecutions arising directly from the GFC. The atrophy of character in the latest episode was not ostensibly criminal. This makes it harder to address. Rather than outright fraud, the GFC has to do with a losing sight of the common good, with unprincipled conduct that is nevertheless legal. Yet faiths such as Christianity teach that life is not about expediency. From a theological perspective, unethical choices hiding behind the veil of legality are nonetheless unethical, and equally capable of leading to problems such as those witnessed in the GFC. Legality allows rationalization, and rationalization allows unethical customs to flourish.

Critical to understanding all this is the fraternal dimension. This is what makes the GFC such a powerful challenge to the long run assumption that the market will discipline unethical behavior. Greed has been around for thousands of

²⁷ The OT commandment against stealing (Exodus 20) has the implication that, in business, all participants behave with respect toward others for the benefit of the common good. Flawed incentives make this outcome difficult to achieve. See also Leviticus 19:35-36 and Proverbs 16:8.

²⁸ The 'flexibility' displayed by bankers is consistent with recent research on executive behavior patterns by Finkelstein and others suggesting that business leaders make fatal mistakes because personal will competes with rationality. All of us operate according to self-interest, which imparts bias and creates blind spots. We are not always aware that our sub-conscious is often driving our decision-making. The Bible says there is a deadly self-centeredness in us all (2 Timothy 3:2-4).

²⁹ Gillian Tett, *Fool's Gold: How the Bold Dream of a Small Tribe at JP Morgan was Corrupted by Wall Street Greed and Unleashed a Catastrophe* (New York: Free Press, 2009).

years, and has caused many individuals and firms to stumble, but usually as isolated cases and in an uncoordinated fashion. Yet apparently the particular yeast that caused the GFC cake to rise was the industry-wide and cohort-condoned nature of the problem. Amidst the overheated economic environment in the years immediately preceding the GFC, it appears that the industry collectively reached – or was striving for - a kind of Wall Street alchemy, an attempt to manufacture banking gold out of lesser metals. By means of some dubious financial metallurgy, the greater part of the profession gained or sought too much too quickly and lost all sense of proportion, exceeding a critical threshold of excessive seeking success-at-any-cost. There was a collegial effect at work: when a critical mass of people forms a wave of excessive avarice, there exists the potential for an epidemic.³⁰ Society can be said to have reached its threshold of excessive ‘affluenza’ when, for whatever reason, the associated avarice stimulates changes in behavior *en masse*, away from norms of decency and the greater good. The follow-on result from this obsessive private devotion to affluence can be a decline in corporate character, especially in matters of character.³¹ If there are many such individuals across an industry or an economy, if society as a whole turns away from common principle in its business dealings, then the macroeconomic results can be devastating, as illustrated by the GFC.³² Such loss of faith is not usually sudden. It is more typically a gradual process that is encouraged by peer group moral migration toward expediency. Competitive pressure, usually such a positive force in the economic production process, can become a negative factor in this environment, when it provokes players to increasingly outdo each other in cutting moral corners to win the next deal. One piece of rationalization leads to another, and as virtue atrophies away, there is less of a safeguard preventing further rationalization of wrong practices. It is not surprising that the change towards irresponsible lending was a glacial process that began back in the 1990s (or earlier), before eventually coming to a head in 2008.

In summary, it seems certain that the Global Financial Crisis can be attributed, at least in part, not simply to technical factors but also to the human condition, and that the dereliction of duty underlying the GFC systematically ballooned beyond a few isolated cases to become an epidemic. The episode can be

³⁰ Note that it is not mammon *per se* that is responsible: money itself is not evil, rather the New Testament tells us the *love* of money is the root of all kinds of evil. Instead, money is simply a tool that can empower various behaviors, both good and bad. See 1 Timothy 6:10.

³¹ Ian Harper and Eric Jones, “Treating ‘Affluenza’: The Moral Challenge of Affluence,” in *Christian Theology and Market Economics*, ed. I. Harper and E. Jones (Cheltenham: Edward Elgar, 2008)

³² Rutherford Johnson, “A Theological and Mathematical Model of the Loss of Religious Values following ‘Excessive Affluence’ and its Potential contribution to an Economic Crisis.” (Paper presented to American Economics Association annual meeting, Atlanta, 2010).

thought of as a *moral bubble*, akin to an asset price bubble where the quantities involved are moral rather than monetary. The GFC reminds us that markets, in general, have both a hard infrastructure (goods, services, price signals) and a soft infrastructure consisting in their moral fabric (trust, prudence, transparency). Though less quantifiable in its dimensions, the latter is equally important to the long-term sustainability of any given market. In terms of economic theory, the GFC was a cyclical episode in which the soft infrastructure of markets – usually kept robust by the threat of market discipline on bad behavior – broke down for a significant period. From a spiritual perspective, the GFC again raises age-old moral-philosophical questions about human nature, and what kind of society we are becoming.

Two questions, in particular, are of interest. By what process or force does moral atrophy tend to spread in markets? And - given that we live in a pluralist society – how can our secular market system be encouraged to retain the norms needed to guide and constrain economic conduct, for the common good?

HOW MORAL ATROPHY SPREADS: ADAM SMITH'S *THEORY OF MORAL SENTIMENTS*

With capitalism under intense pressure, it is appropriate to re-visit the views of Adam Smith, the pioneer economist and moral philosopher who is regarded (rightly or wrongly) as the father of modern market economics. In addition to launching the classical engineering view of markets with *The Wealth of Nations* published in 1776, Smith also had much to say on the role of morality in the economy, notably in his *Theory of Moral Sentiments*. Indeed, the ethical shortcomings highlighted by the GFC may have come as no surprise to him. In this section we will show that Smith certainly appreciated the importance of the connection between markets and morality, an observation attested by the fact that he kept working on the *Theory*, first published in 1759, right up until his death in 1790, revising the work some six times. By the same token, the *Theory* was written before *Wealth* and supplied the ethical, philosophical, psychological foundations for the later, better-known work.

This nuanced and integrated view of Smith, regrettably, has not always been fully appreciated. Over time, arguably, advocates of the free market have tended to lose sight of the philosophical side of Smith's work. Some have concluded that the *Theory*, with its emphasis on altruism, contradicts Smith's other work on markets and impartial exchange that seems to preach self-interest, (a view known as the 'Adam Smith problem'). In his famous pin factory illustration in *Wealth* Smith seems to argue that the public interest is best served by each person pursuing his own private gain, whereas in the *Theory* he suggests that instead of simply pursuing expediency, economic players need also to display congruity with their fellow man. It is fair to say that the predominant discourse

about Adam Smith in the twentieth century favored the first over the second: it was very much a product of the prevalence of neoclassical economics, and tended to paint an overly amoral and individualistic picture of markets. ‘Modern economists tend to build a Smith in their own image by quoting very selectively from the relatively infrequent but hugely influential passages in the *Wealth of Nations*’.³³

This reduction of Smith’s thought has been incomplete, and misleading. As a polymath and professor of moral philosophy, Adam Smith understood there are diverse sets of values affecting economic actors besides mere price, including psychological motivation such as greed, sociological factors such as religion, emotional loyalty to a firm, and so on. Though it is more evident in the *Theory* than in the *Wealth of Nations*, looking into human nature was highly relevant to Smith and if we restrict ourselves to an overly mechanistic-individualistic reading of his more famous tome, we risk missing the socio-behavioral aspects of his message. A model of a mechanical market mechanism is one thing, but the reality of human actions is another matter entirely, and Smith was not naïve about this fact.

In particular, the *Theory* and *Wealth* need not necessarily be seen as contradictory. Smith’s self interest is the notion of enlightened self-interest, that each person’s best interests are bound up with those of his customers, workers, and so on.³⁴ By exercising solidarity with trading partners, the Smithian individual will indirectly enhance his own prospects. Smith’s suggestion is that as economic players engage in an examination of conscience, asking if they have done their duties as citizens by promoting justice and safeguarding the welfare of the community at large, then paradoxically - more often than not – this will be good for business. In keeping with this, contemporary scholarly literature is increasingly revising the more jaundiced dualistic view of Smith.³⁵ Recent interpreters, noting the apparent disagreement between that monochrome view of human nature in *Wealth of Nations* and the more complex, multi-layered understanding in *Theory*, have pointed to various principles as a way of reconciling the two. For instance, Otteson develops the notion of familiarity, which refers to the social distance between two people, how well they know each

³³ Richard Bronk, *The Romantic Economist* (Cambridge: Cambridge University Press, 2009): 61.

³⁴ This ironic conception of self-interest was Smith’s great insight. Although traces of the enlightened view arguably can be found prior to Smith, he crystallized it most effectively. Pierre Force, *Self-interest before Adam Smith: A Genealogy of Economic Science* (Cambridge: Cambridge University Press, 2003).

³⁵ Examples are Sam Fleischacker, *On Adam Smith’s Wealth of Nations: A Philosophical Companion* (Princeton: Princeton University Press, 2008), or Leonides Montes, *Adam Smith in Context: A Critical Reassessment of some Central Components of his Thought* (London: Palgrave Macmillan, 2004).

other.³⁶ He argues that while familiarity is only implicit in *Wealth*, it was central in the *Theory*, and clearly important to Smith in both works because it acts as a unifying thread. In order for markets to function well, Smith believed that the individual best improved their own condition by looking to that of others. This is why principled conduct is desirable in the Smithian marketplace of morals.

An important section in the *Theory* in this respect is Part V: ‘On the Influence of Custom and Fashion Upon the Moral Sentiments of Mortal Approbation and Disapprobation’.³⁷ Smith begins by saying there are ‘other principles’ (besides sympathy) which have a considerable influence on the moral sentiments of mankind (Part V, Chapter I). These principles are ‘custom and fashion’. He develops an argument based on how the human mind tends toward association. Speaking of how we judge beauty, Smith writes that ‘when two objects have frequently been seen together, the imagination acquires a habit of passing easily from the one to the other’. If the first appears, we lay mental odds that the second will follow. And we do this despite the fact that ‘independent of custom, there should be no real beauty in their union’, yet when custom has so connected them together, we feel ‘an impropriety in their separation’. In turn this can alter our standards: ‘those who have been accustomed to slovenly disorder lose all sense of neatness or elegance’. Over time, this human propensity has the consequence of generating instability in our moral sentiments, because social custom and fashion are continually evolving. This may not be a message we find easy to accept. ‘Few men’, writes the philosopher, ‘are willing to allow that custom or fashion have much influence on their judgments’, yet a moment’s reflection ‘may convince them of the contrary’.

Having proposed the idea in respect of our sentiments towards beauty, Smith then takes this peer culture axiom - which is very much like the modern-day behavioral heuristic³⁸ of representativeness - and applies it to our moral judgments, in Chapter II of Part V. By way of illustration, he notes that in the reign of Charles II a degree of licentiousness was ‘connected, according to the notions of those times, with generosity, sincerity, magnanimity, loyalty, and

³⁶ James Otteson, *Adam Smith’s Marketplace of Life* (Cambridge: Cambridge University Press, 2002).

³⁷ Adam Smith, *The Theory of Moral Sentiments* (New York: Dover Philosophical Classics, 1759; 6th edition 1790).

³⁸ A heuristic is a short cut or rule of thumb used for approximate decision-making. For instance, in a game of pool a player does not use a calculator or perform a trigonometric calculation before each shot, but instead simply sizes up the situation and uses ‘feel’ and experience to hit the ball. In banking, a trader may observe that stock prices have fallen on four successive days, and from this choose to believe prices will rise on the fifth day based on the law of averages, even though the odds remain 50:50 and logic does not warrant such optimism (an example of ‘gambler’s fallacy’).

proved that a person who acted in this manner was a gentleman and not a puritan' while 'severity of manners and regularity of conduct, on the other hand, were altogether unfashionable, and were connected in the imagination of the age, with cant, cunning, hypocrisy and low manners'. Likewise, the degree of frugality, which in a Polish nobleman would be considered as excessive parsimony, would be regarded as extravagance in a citizen of Amsterdam. In particular, argues Smith, this tendency toward jumping on the bandwagon applies notably within a given trade or market circle: 'the objects in which men in the different professions and states of life are conversant being very different, and habituating them to very different passions, naturally form in them very different characters and manners'. In theory, the propriety of a person's actions should be independent of any one circumstance of his situation, and should instead be justified by appeal to timeless principles, whatever the situation. But the 'peculiar character and manners which we are led by custom to appropriate to each rank and profession' and 'the different situations of different ages' are apt to 'give different characters to the generality of those who live in them'.

This supplies helpful insight into how moral atrophy can spread within markets. Immoral sentiments, what Smith terms 'habits of falsehood and dissimulation' (and theologians call sin), can tend to be contagious within a certain industry or among a given group of artisans, as shared sentiments about virtue (and vice) 'naturally become habitual to them'. The moral ecology of financial markets, in other words, is highly social.³⁹ Smith seems fully aware we are social beings, and accordingly we are apt to adopt norms that are influenced by contemporary mores, the crowd, accepted language, common representation, and so on. Human ethical misconduct and collective expediency – not in the ideal but in observed practice - will therefore often exhibit a viral nature.

From our discussion of the GFC, the evidence suggests that bankers almost certainly experienced moral contagion, telling themselves that 'everybody is doing it' (making unwarranted sub-prime loans). Chuck Prince, CEO of Citibank, has been quoted as saying that 'when the music is playing, you need to keep dancing', suggesting that on Wall Street peer pressure is a powerful driver, imparting a bandwagon bias to moral judgments such that they become heavily influenced by a reference group. We suggest in the build-up years to the GFC, the creeping presence of an influential reference group of unethical managers began to infect the rest of the market, starting a moral contagion. This is consistent with work by economists Noe and Rebello who model the agency relationship between managers and investors and argue that while some ethical managers develop internalized norms through socialization that prevent them from acting

³⁹ Karin Cetina and Alex Preda, *The Sociology of Financial Markets* (Oxford: Oxford University Press, 2006).

opportunistically, other unethical managers lack these norms.⁴⁰ The authors find that boom conditions magnify the effect: the higher the economic activity increases, the greater are opportunities to profit from unethical behavior, increasing the influence of the unethical managers and eroding ethical standards over the long run. This is also consistent with the work of Basu who shows that while the ‘right to give up rights’ (which is akin to Smith’s notion of sympathy) is an important ingredient in the economic welfare of the individual, an agent’s decision to waive their rights depends on how others waive their rights. That is, the behavior of the one player affects another.⁴¹

We pause to summarize the argument so far. From Smith we learn that markets always and everywhere act as trading exchanges in not one but two commodities simultaneously – money and morals. From our analysis of the GFC debacle, we observe that the first can drive out the second. Individual participants, faced with commercial pressures (which are urgent and visible), feel a temptation to cut corners on ethics (which appear to be less urgent and less tangible, and thus less costly). The sacrifice ratio between the two, based on relative consequences, can seem to favor monetary considerations over moral, at least in the short term. This is especially significant under conditions where peer customs begins to create a viral ‘permission’ effect within a given market toward relaxing standards: this has the effect of altering the relative cost ratio for the individual by placing a lower premium on virtue considerations and a higher premium on the need to succeed. Yet Smith’s point – that there is an interconnectedness in any given market between its monetary trading and its moral quality – means that any regress toward moral atrophy will eventually have negative consequences for economic trade itself, inevitably leading to atrophy not only of ethical standards but of the monetary efficacy of the market as a whole. Market forces, in this instance, crowded out morals. The GFC vividly demonstrates the effect, and shows that the true calculus for the ultimate good of the market system is jointly monetary and moral.

That moral contagion – both positive and negative - looms large in the operation of markets, yet arguably remains under appreciated by modern economists, is an idea that has been hinted at from time to time by some prominent economists during the past half century. Hayek, for instance, spoke of a ‘fatal conceit’ that afflicts human beings and observed that ‘one should never suppose that our reason is in the higher critical position and that only those moral rules are valid that reason endorses’.⁴² Though the actors in the market tend to

⁴⁰ Thomas Noe and Michael Rebellio, “The Dynamics of Business Ethics and Economic Activity,” *American Economic Review* (1994): 531-547.

⁴¹ Kaushik Basu, “The right to give up rights,” *Economica* (1984): 413-22.

⁴² Frederick Hayek, *The Fatal Conceit* (Chicago: University of Chicago Press, 1988): 21.

dislike these norms of character and may fail to understand their validity, agents unintentionally conform to certain traditional practices and patterns of virtue, Hayek argued, as a matter of expediency. He concluded that these norms spread ‘fairly rapidly’. Nobel prize winner Vernon Smith, one of the pioneers of the application of market theory to the field of behavioural economics, voices similar sentiments in his *Cato Journal* paper reflecting on fifty years as a student of human behavior.⁴³ He argues that markets are essentially the product of underlying moral norms, without which they could not exist.

MINIMIZING CYCLICAL DEVIATIONS IN THE VIRTUE OF MARKETS

Moral atrophy across a market has tangible economic costs. Noe and Rebello demonstrate in theory – and the GFC shows it empirically – that higher ethical standards on the part of managers increase economic activity, and vice versa. Any tendency of markets toward viral moral atrophy therefore presents society as a whole with a significant problem: if markets, for all their proven efficiency at producing goods, contain within themselves an ability to fall into ethical atrophy from time to time, in turn threatening their very efficiency, then how can the system be better immunized to prevent this?

Smith’s remedy in the *Theory* is couched in terms of a system in which a principled ‘sympathy’ with one’s fellows plays a pivotal role. Smith proposes the role of mutual sympathy because he must solve the apparent tension between a cohesive society and the self-interested pursuit of commerce. Smith observed in his famous economic treatise that ‘the private interests and prejudices of particular orders of men’ have expressed themselves without calculating the consequences of their actions ‘upon the general welfare of society’. Smith’s solution to this dilemma is to put forward a scheme whereby the pursuit of private interest is coupled with the cultivation of public spirit, which he terms benevolence. He emphasized the role of mutual sympathy and moral conscience in creating a stable polity, such that in his overall vision, moral-philosophical pillars and socialized sentiments underpin the economic judgments that help lead to a cohesive society under a market regime.

This idea, that mutual public sympathy is an essential adjunct to private competitive markets, gained added force for the architect of market-based economics with Smith’s sixth edition of his *Theory*. His revisions in 1790 heighten the contrast between mere beneficence and true justice (note especially Part II, Section II, Chapter I). The first is ornamental only, while the second is fundamental. Beneficence is a weaker form of sympathy that consists in voluntary

⁴³ Vernon Smith, “Reflections on Human Action after 50 years,” *Cato Journal* (1996): 195-209.

benevolence and which the lack of 'is no positive evil'. The mere want of beneficence, says Smith, 'seems to merit no punishment from equals'. Justice, by contrast, is mandatory and a much stronger duty, the violation of which is injury. Smith observes that 'somehow or other, we feel ourselves to be in a peculiar manner tied, bound and obliged to the observation of justice'. By this second form of moral duty, Smith is then moved to declare that 'there can be no proper motive for hurting our neighbour' (Chapter II) and 'though it may be true, therefore, that every individual, in his own breast, naturally prefers himself to all mankind, yet he dares not look mankind in the face and avow that he acts according to this principle'.

Here Smith's *Theory* offers an important insight into dealing with the GFC and its aftermath, by helping us understand how to combat moral atrophy in a secular society and its tendency to become epidemic. In the subprime crisis, if the economic actors who made those unethical choices because of vice contagion could have appreciated that the very market upon which they depend for their own livelihood is not only a place where goods are traded but also a framework of mutual trust, and that the two are intertwined for the greater good, then they may have employed a different type of calculus. Values such as human dignity, solidarity and fair play would have had a better chance of retaining a real role in decision-making, and themselves been part of a positive viral outworking. (The viral effect can operate for good as well as ill.) Based on Smith's notion of moral sympathy, the market might have been more likely to agree on norms to restrain and guide the economic system through the difficult ethical choices faced in the years 2001-2006, when the seeds of the crisis were sown. To the extent that such civic sentiment gained credence in the public sphere, it would have been self-enforcing, because in each profession the prevailing ethical sentiments (in Smith's words) 'become habitual to them'.

For instance, the collective attitude of bankers toward risk and toward balance sheet prudence is a case in point. A post-crisis official report from the OECD concludes that faced with competitive pressures, 'the corporate governance and risk control functions in many firms will adjust to accommodate strategy'.⁴⁴ In effect, to maintain market share and return short-term profits to shareholders, bankers stepped up their off-balance sheet mortgage securitization to reckless levels in order to maximize revenue streams. The result was a marked acceleration in subprime leverage over time, beyond the normal limits of prudent balance sheet management. An alternative scenario might have gone as follows: prudently anticipating that commercial financial organizations are sustainable only when they are constrained by prudential limits, and acknowledging that there

⁴⁴ Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, "The current financial crisis: causes and policy issues." *Financial Market Trends* (Paris: Organisation for Economic Cooperation and Development, 2008).

is a difference between reasonable risk-taking and gambling, and despite the fact that ramping up sub-prime loans would increase profits in the short term, management might have anticipated there would likely be a heavy price to pay in the long term. In order to avoid the large write-downs that such a strategy would inevitably lead to, bankers as a profession might have thus exercised their duty of care and agreed to maintain certain limits on junk lending, for the good of the industry. This, despite the personal cost to them in the short term of reduced bonuses or profit reports.

From a purely mercenary point-of-view, this may not sound persuasive. Yet Smith's theory suggests that in fact it pays to be nice, and research has shown that mutual cooperation is better for both parties than mutual defection.⁴⁵ This is because any short run gains from selfish choices will be outweighed by long run costs. That said, perhaps some may still wish to object that the above counterfactual scenario is unrealistic, on the grounds that commercial pressure leaves individual bankers with little choice but to jump on the bandwagon. In reply, we note that customers regard a working moral compass is an essential part of this thing economists call 'the market', and therefore reputation needs to be factored in as an intangible business asset, one that should not be jettisoned, even under duress. This intangible asset was undervalued by bankers involved in the GFC. In the years prior to the crisis, the OECD argues that the US business model for bankers moved too far toward an 'equity culture' with a focus on faster share price growth and earnings expansion.⁴⁶ The previous 'credit model' of banking, based on balance sheets and old-fashioned spreads on loans, was not conducive to banks becoming growth stocks. So, the strategy switched more toward fees via securitization, which enabled bankers to grow their earnings while at the same time economizing on capital under the Basel system. The consequence was a significant crash in the value of the firms concerned. The reason? Corporate character is a form of 'social capital' that has a dollar market value. Ironically, Catholic social thought predicts this: it has generally been suspicious of purely materialistic theories in business.⁴⁷ Likewise evangelicals urge listeners to regard the pursuit of money as secondary to seeking first the kingdom and the eternal salvation that Jesus came to accomplish.⁴⁸

Were bankers aware of the direction in which they were drifting? It is now

⁴⁵ Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984)

⁴⁶ Sebastian Schich, "Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects," *Financial Market Trends* (Paris: Organisation for Economic Cooperation and Development, 2008).

⁴⁷ Andrew Yuengert, "The Use of Economics in Papal Encyclicals," in *Religion and Economics: Normative Social Theory*, ed. J. Dean and A. Waterman (Boston: Kluwer, 1999).

⁴⁸ Kim Hawtrey, "Economics and Evangelicalism," in *Religion and Economics: Normative Social Theory*, ed. J. Dean and A. Waterman (Boston: Kluwer, 1999).

a documented fact that Goldman Sachs (and others) created certain securities, packaged and sold them to clients, and then bet against those very same securities, cynically predicting their clients would lose money on the products Goldman had sold to them. In other words, it was a conscious choice. Despite the competitive and policy forces bearing down upon them, lenders arguably had a choice how to respond⁴⁹. They did not need to bet against their own clients. They did not need to over-react to the housing market imbalances and the stimulatory policies of government in a manner that had the effect of making matters worse. Rather than allowing traditional distinctions between different financial activities (banking, securities dealing, asset management etc) to become even more blurred financial firms could have maintained time-honored firewalls of their profession. The conventional approach, after all, has served well as a business strategy for many decades.

Where were the captains of industry in all this? The role of CEOs and of others in prominent positions raises the question of opinion leadership if markets are to be continually renewed. To the extent that market players base their customs partly on that of their peers, as Smith proposed, then leaders play an important role in setting the tone and direction. The ‘social proof’ heuristic (in the terminology of modern behavioral theory) is a phenomenon that occurs in ambiguous situations when people are unable to determine the appropriate mode of behavior: making the assumption that surrounding people possess more knowledge about the situation, players may deem the moral behavior of others as a guide, by assuming it is better informed. What one does affects the other, and a moral-laden choice by one member of an industry or profession can have a negative effect on the ethical position of another member, creating a domino effect.

These observations argue the need for market leaders to fully appreciate the influence that collective moral tone can have over aggregate market outcomes. When those in authority abdicate their responsibility for values leadership, then the ethical chasm that has been opened may continue to widen to increasingly dangerous levels.⁵⁰ Hawtrey and Dullard argue that those in positions of influence in business have an obligation to care for the codified integrity of their industry

⁴⁹ Theologically, those in authority have a duty to work for the common good. Profit in the short-run at the expense of long-run problems for more people may be considered to be a violation of these principles. For discussion, see *Catechismus Meridionalis-Occidentalis* No. 245-249.

⁵⁰ An examination of conscience says that those in positions of authority should ask themselves if they use their authority ‘...for [their] own advantage or for the good of others, in a spirit of service’ (*Manual of Prayers*, compiled by J. Watkins, Pontifical North American College, Rome).

and to promote corporate virtue, which takes a certain amount of valor.⁵¹ It takes courage to lean against the wind when everyone else is bending with it. As General George S. Patton, Jr. was known to say, “moral courage is the most valuable and usually the most absent characteristic in men”.⁵² A comprehensive understanding of leadership by key opinion-makers within and outside the industry (which can and should include not just bankers but also journalists, clergy, professors and the like) requires decision-shapers to proactively shape the values and culture of markets, not just the technical coefficients of production and exchange. This involves developing an agreed-upon language of moral sentiments, a shared public narrative, and a cohesive community vision of corporate character. The GFC has shown that all economics is faith-based, and vividly highlighted the importance of restoring public trust in the system, a leadership task that is ultimately about truth, beliefs, virtues, and norms.

Here again, Smith is helpful. He argues that ‘a superior may, indeed, sometimes, with universal approbation, oblige those under his jurisdiction to behave ... with a certain degree of propriety to one another’. That is, the civil authorities have an important role to play in safeguarding the moral fabric of markets:

The civil magistrate is entrusted with the power not only of preserving the public peace by restraining injustice, but of promoting the prosperity of the commonwealth, by establishing good discipline, and by discouraging every sort of vice and impropriety; he may prescribe rules, therefore, which not only prohibit mutual injuries among fellow citizens, but command mutual good offices to a certain degree.

Applied to banking in the wake of the GFC, market leaders – and legislators - should have played a more constructive role in setting moral norms, by proactively helping to answer the values questions periodically thrown up by the market. What might so-called ‘high-standard’ market trading look like? Should the bonus and incentive culture on Wall Street be immune from community opinion (and what does the theory of the just wage have to teach us about CEO salaries⁵³)? Credit derivatives are complex instruments involving risk: should they be subject to standardized trading that enhances transparency to the community? Is it beneficial in the long run for banks to be allowed to grow ‘too big to fail’ (and is it desirable for governments to be running banks)? In an industry driven by

⁵¹ Kim Hawtrey and Stuart Dullard, “Corporate Virtue and the Joint-stock company,” *Journal of Markets and Morality* (2009):19-34.

⁵² Alan Axelrod, *Patton on Leadership: Strategic lessons for Corporate warfare* (New York: Prentice Hall, 1999).

⁵³ 1 Peter 2:16. For discussion: *Mater et Magistra*. Papal Encyclical. John XXIII. 1961.

debt, where are the prudent limits to borrowing?

Commercial leadership involves a certain amount of moral wisdom.⁵⁴ Positive consensus-building prior to the GFC would almost certainly have made a measurable difference to the outcome. There is evidence that peer pressure from inside the industry, as well as from outside voices (such as poets and preachers) works. To illustrate, consider the outbreak of transparency that has followed in the wake of the post-crisis G20 Summit in London in February 2009. Of an OECD blacklist of countries that have yet to implement internationally accepted standards of transparency on tax disclosure, a number agreed in the wake of the G20 meeting to relax banking secrecy laws, including Andorra, Monaco, Liechtenstein, Costa Rica, Malaysia, Philippines and Uruguay.

Legislators, for their part, can no doubt also influence the moral tone of markets. A recent case study will serve to illustrate, from Japan. In June 2009, Japanese regulators imposed sanctions on Citibank (suspension of advertising for one month) for failing to monitor suspicious transactions. The Financial Services Authority in that country highlighted fundamental problems with Citigroup's compliance and monitoring system, and noted that it had failed 'to make notification of suspicious transactions, including money laundering'. Citigroup issued an apology, and said it would comply with the regulator's order and would submit a revised business plan. Whatever economic structure is chosen by regulators, it should be for the well being of the population, as such structures are intended to be instruments not of oppression, but of human freedom.⁵⁵ The state has a duty to protect the rights of all people, and especially its weakest members.⁵⁶

CONCLUSION

We have advanced the proposition that the Global Financial Crisis reflects a moral bubble. Decision-making by market actors was influenced by "the crowd" in the years building up to the GFC, generating a tendency toward viral moral atrophy. Insight into this capacity for ethical toxicity in markets was sought by revisiting Adam Smith's *Theory of Moral Sentiments*. Given that Smith is considered the father of market economics, it is important to return to his writings for a reappraisal. We argue that Smith's system of mutual sympathy provides a helpful corrective by reminding us of the role that moral infrastructure plays in

⁵⁴ Thomas Jeannot, "Moral Leadership and Practical Wisdom." *International Journal of Social Economics*, (1989): 14-38.

⁵⁵ This idea can be read in *Populorum Progresso*, papal encyclical by Paul VI (Rome: Vatican, 1967).

⁵⁶ Romans 13:1-5; Deuteronomy 25:1. For discussion, see *Mater et Magistra*, John XXIII papal encyclical (Rome: Vatican, 1961).

the operation of markets. The two elements – markets and morality – must be held in dynamic tension together, but this principle was lost sight of in the GFC. The episode provides an important case study of how markets interact with morality, and supports a hypothesis that the operational functionality of markets - a necessary condition for the efficiency and equilibrium propositions of classical economics to be fully realized – can fail in the presence of imperfect integrity.

On the positive side, we see the GFC as a historical aberration. In the long run, markets probably tend to improve morality, because consumers will eventually impose sanctions firms that engage in poor conduct. Yet as we have argued in this paper, there are sometimes serious departures in the short run. These stem from market imperfections due to human nature, overlaid with viral group dynamics. It is tempting to dismiss the problem of episodic moral atrophy with a wave of the hand and belief that eventually, ‘the market will correct it’. Yet as the GFC shows, the risks of such an approach are not trivial: millions of people have paid a huge cost. On this occasion, the market took so long to detect and correct the imperfect behavior by firms that the economic casualties were immense. It is now exceedingly apparent that the willingness of stakeholders prior to the crisis to place an almost blind faith in the idea that a deregulated financial sector would regulate itself,⁵⁷ proved to be extremely costly. This cost itself constitutes a moral issue that cannot be ignored or downplayed. One thing is clear: if we look at the great credit meltdown only on a technical level, we will be hit by another crisis again one day. We need to see markets in terms of moral technology, not trading technology alone.

The GFC was distinctive not only because of the gigantic economic loss, but also because it set the business community on a collision course with the broader values of the community. The crisis ignited a debate over the common vision for society. When ‘the market’ is used to justify a sequence of events that - in hindsight - includes widespread behavior that most people agree is wrong, we have moved into the moral dimension of economics. We are not suggesting that morality can be legislated, although there is a role for legal sanctions. While there is now recognition, in the wake of the GFC, that the legal infrastructure of the market needs an overhaul - Washington made a significant statement to this effect by enacting the most far-reaching Financial Reform Bill in history, adopted by Congress in July 2010 - by the same token it remains clear to us that the issue is not legality *per se*. Nor do we believe that the answer is to teach ethics more in business schools, although there is a place for that too. In 1987 Harvard University received a gift of \$30 million and set out to use it to teach students that ‘ethics pays’. Yet two decades later, the ethical debacle of the GFC suggests that

⁵⁷ Robert Nelson, *Economics as Religion* (Philadelphia: Pennsylvania State University Press, 2008).

the impact felt from such programs may have fallen short of expectations.

The GFC is about more than law, and goes deeper than mere ethics. It involves belief. This essay has sought to demonstrate that the challenge of moral atrophy in markets is tied to the spiritual condition of the society in which markets are nested.⁵⁸ When the community is unsure of its religious faith, then the moral path can easily become a slippery slope. In response, the Christian faith calls us to believe in One greater than ourselves and the Scriptures remind us ‘what profit a man to gain the whole world, only to lose his soul?’⁵⁹ There is, in other words, a belief dimension to economic cycles that is bound up with the human condition: amidst the pressures of commercial survival it is easy to lose sight of what we are living for, and wake up one day to find the knowledge of God has been crowded out, with harmful results.

Ultimately it is not markets that atrophy morally, it is people. We believe that the issue of market integrity failure requires a reaffirmation of faith, which means hearing the Gospel afresh. Belief in a higher purpose is needed to bring about a true reformation of persons, who will in turn become agents for the kind of market character that will engender an economics for the common good.

⁵⁸ David Wells, *Losing our virtue* (Grand Rapids: Eerdmans, 1998).

⁵⁹ Matthew 16:26