CENTER FOR THE STUDY OF
Economy & Society

327 Uris Hall
Department of Sociology
Cornell University
Ithaca, NY 14853-7601

Tel: (607) 255-1506
Fax: (607) 255-8473
cses@cornell.edu
www.economyandsociety.org

CORNELL

CSES Working Paper Series

Paper #55

"The Role of Confidence in Finance"

May 5, 2010

by

Richard Swedberg
Cornell University

Forthcoming in Karin Knorr Cetina and Alex Preda (eds.),
Handbook of the Sociology of Finance, Oxford University Press

It has been realized for a long time by bankers and politicians that confidence plays an important role in finance. Economists, in contrast, have been slow to realize this. As a result there does not exist a strong tradition in the economics literature that discusses what confidence is and what role it plays. The main theoretical as well as empirical work in this area, in short, remains to be done. The same is also true for establishing what economists so far have said about the role of confidence in finance. Again, the result is a weak, close to non-existing understanding of what confidence is.

One may speculate why this is the case. One factor may be that mainstream economics focuses on a narrow set of factors that drive economic behavior, and confidence is not one of them. It is, for example, possible to argue that one can make good analyses without taking confidence into account. This is an argument that needs to be taken seriously; and those who advocate that there is a need for a better understanding of confidence in finance must be prepared to show how this will improve the analysis.

Another reason for the neglect of confidence in the analysis of finance has to do with the common conviction among economists that confidence belongs to the field of psychology, not economics. To this can be added that mainstream economics has by tradition not been very interested in psychology, including the field of economic psychology that was created by George Katona and others in the 1950s (e.g. Katona 1975). A more successful attempt to bring psychology and economics together can be found in behavioral economics, a topic to which I shall return later in this chapter.

Sociology has for natural reasons had even less to say about the role of confidence in finance. Economic sociology has only been around for a few decades and has not produced very many studies of finance. This is true even if we take into account the work by sociologists who are active in the field known as the social studies of finance (but see e.g. Pixley 2004; Knorr Cetina and Preda 2005).

Given the absence in economics as well as in sociology of a well-developed tradition that studies the role of confidence in finance, I will structure this chapter as follows. I will first introduce the main attempts so far to deal with this topic, in economics as well as in sociology. The reason for discussing the contribution by economists in a handbook of sociology is two. First, the economists have had much more to say about confidence in finance than sociologists. Second, and following Schumpeter's dictum that economic sociology consists of an area that is situated at the intersection of sociology and economics, it is natural for the study of confidence in finance to draw on both of these sciences (Schumpeter 1954:25-7).

Since there exist so few works on this topic, and so little consensus on the role of confidence in finance, it is also necessary to touch on a few related topics in this chapter. One of these has to do with the relationship between trust and confidence. According to the everyday use of these two terms, for example, they have related and partly overlapping meanings – but is this also the case for the way they are used in economics and sociology? It is clear as well that the role of confidence is not limited to the area of the economy, and in the economy, to the area of finance. What lessons can be learned from general discussions of confidence as well as from discussions of confidence in economic life in general. Addressing topics and questions of this type increases the difficulties in dealing with the topic of confidence in finance and takes it in divergent directions.

Part 1: Economists on the Role of Confidence and Trust

In order to give the reader a sense of how economists have looked at confidence, I will start out by presenting the content of one of the few overviews of this topic that exists (and perhaps even the only one). It is a brief article entitled "Confidence", which appeared in *The New Palgrave Dictionary of Money and Finance* (1992). It appeared in the early 1990s and is written by Alan Walters, a British expert on money and finance (Walters 1992).

Walters makes two major points in his article. The first is that confidence plays a very small role in modern economics. "Confidence…is largely ignored by modern theoretical economics" (Walters 1992:423). The second is that confidence is primarily a psychological phenomenon; and it is this fact that makes it so hard to for economists to deal with confidence. "Economists' tools and models", Walters says, show a distinct "inability" to analyze confidence, without resorting to "market psychology" (Walters 1992:424-25).

But even if there exists a basic incompatibility between economic theory and the psychological phenomenon of confidence, economists have for a long time nonetheless discussed various forms of confidence. According to Walters, their interest has taken three forms: they have developed surveys of confidence; they have looked at the role of confidence in the business cycle; and they have studied confidence and governmental policy.

Surveys of confidence include the famous surveys of consumer confidence that have been produced since the 1960s by the Conference Board and the Survey Research Center at the University of Michigan. But to Walters these surveys do not really address the issue of confidence, but what people think that the economy will be like in the future. He concludes: “it is doubtful if these surveys of confidence help in understanding the effects that confidence has on economic conditions” (Walters 1992:423).

Walters’ discussion of surveys of confidence is very brief; and it does not at any point address the issue of finance. His attitude to what he calls “business confidence” and its role in the business cycle is different. He devotes far more space to this topic, for one thing. He also notes that this topic includes finance, in the form of “financial panics”.

Walters centers his discussion of the role of confidence in the business cycle around a work that probably few people are familiar with – *The Trade Cycle* (1922) by Frederick Lavington. According to Lavington, businessmen make their decisions in a rational manner. At times, however, their decisions are colored by hope; and this results in “unduly high confidence or optimism” (Walters 1992:423). And sometimes their decisions are colored by apprehension; and this results in “unduly low confidence or pessimism”.

Lavington’s analysis makes us realize that the notion of confidence is linked to optimism and pessimism, even if it may be hard to pinpoint the exact difference between a strong sense of confidence or optimism, on the one hand, and between an absence of confidence and pessimism, on the other. Walters, in presenting Lavington to the reader, also introduces a few other concepts that are commonly found in discussions of confidence: *uncertainty* and *animal spirits*. If there is uncertainty, he suggests, there will e be room for the animal spirits. And depending on the strength of the animal spirits, there will be little or no confidence.

The concept of animal spirits comes from Keynes; and Walters several times refers to the British economist in his article. We are, for example, told that one can find a rudimentary form of confidence multiplier already in Lavington, and that the idea of surveys of confidence traces its origin to Keynes' work. And Keynes argued that confidence varies directly with the faith we have in our forecasts.

Walters also directs some criticism at Keynes, especially for not working out the effects of confidence on the business cycle. The reason for this omission, he says, is that Keynes felt that confidence "was mainly a matter for business psychology rather than for analytical economics" (Walters 1992:424).

The third topic that Walters surveys in his article is confidence and government policy. This type of confidence essentially deals with the type of confidence that the general public as well as business people have in the way the government handles the economy. Walters suggests that what is ultimately at issue here is consistency. In order to inspire confidence, government policy in economic affairs has to be credible; and for it to be credible, it has to be consistent.

An economic policy that is internally inconsistent will fail, according to Walters. As an example he mentions a situation in which the budget deficit is not properly aligned with the monetary policy or with the inflation rate. Walters also attacks Keynes' idea that the government should counter downturns in the business cycle, with the argument that this is very likely to erode confidence. The reason for this is that in the end a deficit always has to be paid off.

While Walters' article can serve as an introduction to the role of confidence in economics, it also needs to be complemented. One reason is that it is very short and fails to do justice to, say, the contribution of Keynes. Another reason is that quite a bit has happened with the analysis of confidence during the twenty years or so since Walters' article was written.

When did economists start looking at confidence? Histories of economics typically begin with *The Wealth of Nations* (1776), and one may therefore ask if its author had something to say on the topic. The answer is that the closest Adam Smith comes to a discussion of confidence is in his remarks on the role of a merchant's reputation. According to Smith, there is variation in the "character" displayed by merchants from different countries. The Dutch are "more faithful to their word" and better at "performing agreements" than say the English. And the English, in their turn, are more faithful and so on than the Scots. Adam Smith also notes that the more frequently people interact with one another, the more important it is for the actors to have "character". The reason for this, he suggests, has to do with "self-interest", which "leads men to act in a certain manner from views of advantage" (Smith [1766] 1997:17).

These remarks on reputation and character are not to be found in *The Wealth of Nations* but in *Lectures of Jurisprudence*, something that again alerts us to the fact that confidence is a topic that tends to lie outside the normal domain of the economist. And again we find a new topic – this time, *reputation* – that is close to and overlaps with confidence, without for that reason being identical to it. It should also be noted that by linking interest so closely to confidence, Adam Smith can be seen as an early proponent of the calculative view of confidence.

While an expert on the history 19th century economics might continue in this vein and point tome some minor statements on confidence in the works of Ricardo, Mill and so on, I shall limit myself to a discussion of a single work from this century. It is, however, a work that has much to say about the role of confidence in finance: *Lombard Street* (1873) by Walter Bagehot.

Keynes has called this book "one of the classics in Political Economy" (Keynes 1915:369). The main reason for singling it out for discussion in this chapter is that it is probably the most influential work ever written on the role of confidence in finance. It is in this work, more precisely, that the classical strategy for how a central bank can restore confidence in a financial crisis was first outlined. During the recent financial crisis, for example, Bernanke repeatedly referred to what Bagehot says in *Lombard Street* (e.g. Bernanke 2008, 2009).

Bagehot's purpose in writing Lombard Street was first and foremost to make the financial community in England realize that the Bank of England, which was a private bank at the time, must resume the kind of responsibilities that we today associate with a central bank. England was at the time the banker of the world; and the concentration of capital that could be found in the financial district of London well surpassed that of any other financial power. Banking was however also very vulnerable to crises – and unless certain measures were taken, Bagehot argued, one of them could destroy the English banks.

Confidence and trust (and Bagehot used the two terms interchangeably) stand at the very center of his analysis of the fragile nature of the banking system. "Credit means that a certain confidence is given, and a certain trust reposed", he writes (Bagehot [1873] 1922:22). "'Is the trust justified and is that confidence wise'? These are the cardinal questions".

What Bagehot refers to in this quote is the kind of confidence that a banker must have in the person to whom money is lent. But this is only side of the equation. The other side has to do with the confidence that the depositor has to have in the bank, in order to part with the money. In France, for example, Bagehot notes, many people do not trust the banks and therefore keep their money at home.

At both ends of the banking business, in other words, confidence is crucial. Or in Bagehot's words: "The peculiar essence of our banking system is an unprecedented trust between man and man" (Bagehot [1873] 1922: 151). This "*unprecedented trust*" also means that banker has to do anything he can to keep people calm and not to endanger confidence. One classical line in *Lombard Street* reads: "Adventure is the life of commerce, but caution, I had almost said timidity, is the life of banking" (Bagehot [1873] 1922: 220-21). Another related quote reads: "Every banker knows that if he has to *prove* that he is worthy of credit, however good may be his arguments, in fact his credit is gone" (Bagehot [1873] 1922: 68).

Panics, however, or sudden losses of confidence, do occur; and Bagehot devotes many pages to analyze how these can be triggered, and what can be done to stop them and restore confidence. Losses in the loan portfolio of banks are extra dangerous for precisely this reason. Especially when the losses are hidden and suddenly disclosed, the crisis can bring down the whole financial system.

The best way to stop a crisis and restore confidence, Bagehot famously says, is to "*lend freely*" (e.g. Bagehot [1873] 1922:48, 64; emphasis added). When a panic is on, the natural instinct for a banker is to hold tight to the money. In this situation, Bagehot argues, the central bank – the Bank of England – must behave differently. It must lend freely and, by giving the impression that it has confidence in the system, it will restore confidence.

It was earlier mentioned that Keynes regarded *Lombard Street* as a classic in economics. He especially praised Bagehot's gift for observing what was going on in real life. He, however, had less appreciation for Bagehot's analytical skills and basically felt that Bagehot was more of a psychologist than an economist. "*Lombard Street*", Keynes sums up, "is the Psychology of Finance, not the theory of it" (Keynes 1915:373). This is another instance, in short, of the view that confidence is important in real life – but that economics unfortunately cannot deal with it.

Next to Bagehot, Keynes is the economist who has made the most important contribution to the analysis of confidence. While Bagehot concentrated on the role of confidence in the banking system and how to handle its sudden disappearance in a crisis, Keynes was more interested in the role that confidence plays in the regular working of the economy and especially how it influenced investments. Keynes touches on confidence in many of his writings, but most importantly in *General Theory* (Keynes 1936; see also e.g. Keynes 1937).

The main question that Keynes raises in *General Theory* is how full employment and steady economic growth can be ensured in a society with a capitalist economy. His well-known answer is that the state has to intervene in order to increase demand and to steer investments in a productive direction. This is also the general picture into which Keynes fits confidence. The role of confidence, he argues, is crucial; and that is to help offset the uncertainty that inevitably is part the decision to make an investment. Investments cannot exclusively be made based on rational considerations; they also involve confidence.

Keynes' analysis of confidence can be found in the famous Chapter 12 in *General Theory*, which contains his most important contribution to the sociological analysis of the economy (Keynes 1936:147-64). Besides its analysis of confidence, this remarkable chapter (which deserves to be known as a classic in economic sociology) also introduces such well-known Keynesian notions as animal spirits and the stock market as a beauty contest. These two latter concepts are usually presented and discussed in their own right, but as we soon shall see they are closely linked to the phenomenon of confidence.

Keynes starts out from the idea that investment represents the key to production and economic growth. Investments, however, also depend on an evaluation of distant events and these are impossible to know. On this point Keynes refers to his own work on statistics and argues that probabilities simply do not apply to future events. Rational calculations cannot present a solution; and the only way you can proceed is with the help of confidence. Confidence, from this perspective, is defined as "how highly we rate the likelihood of our best forecast to be wrong" (Keynes 1936:148).

At this point of the argument in Chapter 12 Keynes stops and presents the reader with the fullest statement that can be found in his work on the role of confidence in economic life:

> The *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analyzed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its important influence on the schedule of the marginal efficiency of capital. There are not two separate factors affecting the rate of investment, namely the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand-schedule.
>
> There is, however, not much to be said about the state of confidence *a priori*. Our conclusions must mainly depend upon the actual observation of markets and business psychology. This is the reason why the ensuing digression is on a different level of abstraction from most of this book. (Keynes 1936:148-49)

Note that so far Keynes has argued that confidence is indispensable to the key problem of economics, namely production and economic growth. He has also stated that economists have ignored confidence and that it must be introduced into economic theory. But how does Keynes want to proceed from this point onwards? His answer, to repeat, is as follows: "Our conclusions must mainly depend upon the actual observation of markets and business psychology. This is the reason why the ensuing digression is on a different level of abstraction from most of this book".

Keynes, in other words, says that he will rely on precisely the two qualities that made it possible for Bagehot to deal with confidence: *observation* and *psychology*. But even if he will attempt to go beyond Bagehot and introduce confidence into economic theory, he also says that he will be unable to proceed in the same way as he does elsewhere in *General Theory*.

Keynes' answer to the question of how confidence helps actors to handle far-away events or to form long-term expectations is as follows. In the stock market actors not only make forecasts as best as they can, they also depend on "*conventions*", and this provides them with the confidence they need for their forecasts. In starting up and in running firms, businessmen have to make forecasts. And what gives them confidence, is something else: animal spirits.

On the stock market the private investor draws on a convention for how to evaluate the stocks; and to the extent that this is done, he or she is able to proceed with confidence. This type of confidence, however, is brittle in nature, since these conventions are based on superficial knowledge and are easily influenced by what other actors think. Since confidence on the stock market is structured in this particular way, it is inherently unstable.

Adding to the problem, from Keynes' perspective, is that professional investors do not have long-term productivity as their goal. What they try to do is essentially to figure out how the private investors view the market. This is where Keynes' famous theory of the stock market as a beauty contest comes into the picture. Professional investors try "to anticipate what average opinion expects the average opinion to be" (Keynes 1936:156). What happens on the stock market, according to Keynes, consequently depends on "the state of confidence of the speculator"; and the problem is that this type of confidence is based on conventions that have little to do with production (Keynes 1936:158).

Keynes also discusses the confidence of another key actor in the modern economy, namely the businessman; and this type of confidence differs in many ways from that of the speculator on the stock market. Instead of being based on inherently unstable conventions, it draws on animal spirits or the spontaneous urge that human beings have to act. This type of emotions especially dominated economic life before the separation of ownership and management of the firm, according to Keynes, but they are still operative in the modern economy.

The tendency is nonetheless for the activities on the stock market ("*speculation*") to be more important for the economy than those of individual businessmen ("*enterprise*"). This means that investments will be handled in a poor way and that the state has to intervene and assume some responsibility for investments. What consequences this will have for confidence, Keynes does not say. It would seem to entail a third type of confidence, however, namely confidence in the state as an economic actor.

After Keynes very little attention was paid to confidence in the economics literature till the 1970s. From this time onwards modern economics has become more pluralistic; and it has opened up to many new types of analyses such as game theory, behavioral economics, neuroeconomics and so on. In several of these new approaches one can find studies that deal with confidence. It is hard to generalize, but there seems to be a tendency to either use the term "confidence", and cast it as a psychological and non-rational phenomenon, or to use the term "trust", and see it in more structural and rational terms.

Behavioral economics draws on psychology to recast economic analysis and tends to use the term confidence. The most important stream of research in this type of approach is centered around the idea of *overconfidence* and has its origin in a pioneering study from 1992 by Dale Griffin and Amos Tversky (see also Pech and Milan 2009). Overconfidence is here interpreted to mean that "people are more confident in their judgments than is warranted by the facts" (Griffin and Tversky 1992:411). The article by Griffin and Tversky mainly uses examples that have nothing to do with finance, but the authors also note that overconfidence can lead to "regrettable financial investments" (Griffin and Tversky 1992:432).

Today's behavioral economics is very broad in scope and also has a macroeconomic branch, as exemplified most importantly by the work of Richard Shiller. Among Shiller's many attempts to take confidence into account, there is for example his work on investor confidence, including his Index of Investor Confidence (e.g. Shiller 1999, 2000:44-68). His most important attempt to outline a theory of confidence for macroeconomic analysis is however to be found in a recent book co-authored with George Akerlof, *Animal Spirits*.

In this study, the authors state that while most of economic life can be understood with the help of the concept of interest, along the lines first outlined by Adam Smith, there is also another part of economics that can only be explained by referring to man's "noneconomic motivations" or animal spirits (Akerlof and Shiller 2009:3). These animal spirits account in particular for two very important aspects of economic life: its variation and its sharp fluctuations.

While "animal spirits" is a term that comes from Keynes, Akerlof and Shiller have reinterpreted it for their own purposes. It no longer means man's spontaneous urge to action, but instead covers the following five phenomena: confidence, temptations, envy, resentment and illusions.

Akerlof and Shiller state that confidence represents "the corner stone of our theory", and that it should be used in a way that differs from how most economists currently use it (Akerlof and Shiller 2009:5). When economists have discussed confidence, they have mainly seen it in terms of a multiple equilibria analysis and/or as a bleak attitude to the future. The argument has been that without confidence, you may get stuck in an undesirable equilibrium; and with the help of confidence, you can move to a better economic future.

To Akerlof and Shiller this view of confidence is wrong since it "suggests that confidence is rational", while "the very meaning of trust is that we go beyond the rational" (Akerlof and Shiller 2009:12). As an example of how confidence (or rather its disappearance) can affect finance, they mention the collapse of Lehman Brothers in September 2008.

The main suggestion of Akerlof and Shiller for how to introduce confidence into economic theory has; however, to do with something they call *the confidence multiplier*. Drawing on Keynes' idea of the multiplier, they suggest that a confidence multiplier indicates "the change in income that results from a one-unit change in confidence – however it might be conceived or measured" (Akerlof and Shiller 2009:16).

If we now turn to the approaches in modern economics that prefer to use the term trust, and not confidence, we find that the emphasis is more on stability, rationality and the broadly social qualities of trust, than on irrationality and individual psychology. The tone of this line of research can be illustrated by a famous statement on the role of trust by Kenneth Arrow. In *The Limits of Organization*, he describes trust as "an important lubricant of a social system" (Arrow 1974:23; cf. Arrow 2009). The full quote reads as follows:

> Now trust has a very important pragmatic value, if nothing else. Trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair reliance on other people's word. (Arrow 1974:23)

From the characterization of trust as something efficient and stable, there is only a small step to what Oliver Williamson has called "*calculative trust*" (Williamson 1993:463-64; emphasis added). This approach is also often used in game theoretical analyses of trust. It similarly informs the increasing number of empirical studies of trusts that have been carried out by economists. Rafael La Porta and his co-authors show, for example, that there exists a relationship between the number of trusting people in a country and its level of inflation and GDP growth rate (La Porta et al 1997).

Neuroeconomists also seem to identify more with the view that is implicit in the concept of trust, than with the focus on uncertainty that can be found in the research on confidence (e.g. Fehr 2008). The main insight in neuroeconomics is that trust is linked to a hormone called oxytocin, which is related to the tendency of human beings to be social. Oxytocin has its origin in the brain and affects the organs through the bloodstream. In one of his experiments Ernst Fehr administered oxytocin to a number of students through a nasal spray and then told them to play a so-called trust game, which involved investing a sum of money. Students who received a dosis of oxytocin were more willing to trust their financial partners than those who did not receive the hormone (Angier 2009).

While economists who do work in finance have not shown much interest in trust, there exists today a small body of work also in this highly technical field (Sapienza 2009). What view of trust one can find in this type of economics can be gleaned from an article that was published in 2008 in the *Journal of Finance*, "Trust in the Stock Market" (Guiso, Sapienza and Zingales 2008). Its key argument is that trust can help to explain the puzzle why so few people invest in stocks. The more trust there is in a country, the more its citizens will invest in the stock market.

The authors define trust as “the subjective probability individuals attribute to the possibility of being cheated” (Guiso, Sapienza and Zingales 2008:2557). There exist “outer factors” that influence individuals to buy stocks (such as the quality of investor protection) as well as “interior factors” (such as their education and religion). The authors also refer to cross-country data. The conclusion of the study is that less trusting individuals are less likely to buy stocks; and if they do buy stocks, they buy less.

I earlier referred to Schumpeter’s statement that economic sociology is situated somewhere in the gray area between economics and sociology, and the sociological flavor of the study of trust and participation in the stock market is incontestable. This is also true for much of the other research on confidence and trust that has been discussed. Bagehot’s ideas on why confidence is particularly important in the banking business are, for example, easily cast in sociological terms. And even if Keynes always referred to psychology and never to sociology when he discussed confidence, there is a clear sociological dimension to his analysis.

Part 2: Sociologists on the Role of Confidence and Trust

While economists to some extent have theorized both the concept of trust and that of confidence, this is not the case with sociologists. Why sociologists have looked at trust but not at confidence is not clear. One clue, however, can be found in the one and only major study devoted to the phenomenon of confidence that a sociologist has carried out, namely a book with this title by Rosabeth Moss Kanter (2006). What Kanter means by confidence, it turns out, is a belief in oneself. Confidence, in other words, has probably been viewed by sociologists as a psychological phenomenon, just as in economics. And since Durkheim sociologists have tended to stay away from truly psychological phenomena and mainly focus on what takes place outside the individual, as opposed to what happens inside the mind of the individual actor.

But if sociologists do not use confidence as a distinct concept in its own right, this does not mean that they have a unitary concept of trust. As it turns out, modern sociologists have produced a bewildering number of theories of trust. Before addressing this issue and discussing what it entails for the analysis of confidence in finance, however, it is useful to look at some earlier contributions by sociologists to the understanding of trust.

Of the classics, it is especially Simmel and Weber who have written on trust. Weber did not develop a special concept of trust but used a variety of related and overlapping terms. His most successful analysis of trust is probably to be found in his analysis of political legitimation. Coercion is not enough to dominate a population in the long run, Weber argued; something else is needed to inspire trust in the ruler. The three different types of legitimation was his answer.

Weber also made some interesting contributions to the understanding of trust in economic life. One of these can be found in “The Protestant Sects and the Spirit of Capitalism”, in which it is noted people in the United States tended to trust individuals who were members of certain religious sects (Weber [1920] 1946). During his trip to the United States, Weber also says in this article, he ran into a person who wanted to become a banker and who therefore became a Baptist. He knew, Weber says, that by joining a sect people would have no difficulty in trusting him with their money (Weber [1920] 1946:304-05).

It can also be argued that Weber’s concept of rational capitalism has an important component of trust. What makes rational capitalism so superior to other forms of capitalism, according to Weber, is precisely its predictable nature. Merchants and other economic actors can trust that courts, the state and so on will act in a certain manner. Without this predictability or trust, Weber notes, it would not be possible to mobilize the huge sums of capital that are necessary in the modern economy.

Simmel discusses trust in *Philosophy of Money* as well as in his general sociology (Simmel [1907] 1978:178-79, 480; 1950:318-20, 345-48). In the former work he cites the inscription of a Corsican coin: *non aes sed fides* (“*Not money, but trust*”). Trust, Simmel explains, is crucial to the existence of money in two ways. First, you have to trust that a certain coin is worth a certain amount. And second, you have to trust that other people will accept the coin at its value.

Simmel discusses money and trust in *Philosophy of Money*, but he also touches on credit and trust. What he has in mind with credit, however, is personal credit and not the kind of credit that the banking system is based on. In general, it seems that Simmel knew very little about banking and the stock market.

Simmel was, however, very interested in trust as a general phenomenon, in society as well as in the economy, and also in different types of trust. On the one hand, he suggested, there exist a kind of trust that is based primarily on knowledge. If you know something completely, Simmel says, you do not need to trust. But if you do trust, there is always a chance that you may be wrong; "any trust always entails a risk" (Simmel [1907] 1978:480). A farmer, for example, typically trusts that there will be a harvest next year; and he bases this on empirical grounds.

Translators of Simmel's work into English often render the word *Vertrauen* in this type of context as "confidence". But Simmel also used this term for another type of trust; and here the translators use "trust". In the latter case there is something else involved besides knowledge. This something else, Simmel said, is "hard to define", but comes to its clearest expression in religious faith (Simmel [1907] 1978:178). His most precise attempt to define this element can be found in his description of it as an "element of social-psychological quasi-religious faith" (Simmel [1907] 1978:179). Simmel was clearly looking for a word to describe trust that had some elements in common with religious faith, but which also differed from it. Perhaps secular faith is close to what he had in mind with "quasi-religious faith".

Before leaving Simmel, it is important to note that he emphasizes the interactional dimension of trust and confidence more than its psychological and individual dimension. Trust and confidence, he says, are something that "people have in each other" (Simmel [1907] 1978:178). But the interaction involved is not the same for these two concepts. While confidence tends to be something you give, trust is something you tend to accept (Simmel 1950:348).

Just like the economists reacted to, and received important inspiration from, what happened during the Great Depression in the 1930s, so did the sociologists. Especially one analysis of the events during this period has become a sociological classic. This is Robert K. Merton's analysis of a run on a bank in his essay "The Self-Fulfilling Prophecy" (Merton [1948] 1968).

Merton mentions that in the early 1920s some six hundreds banks went silently bankrupt every year in the United States; and that this figure nearly quadrupled during the years before and after the Crash of 1929. The way that even a good bank could go bankrupt during these years inspired Merton to an ideal typical account of what happens during a run on a bank. He cast his analysis as a story about the fictional Last National Bank, set in the year of 1932. A rumor that this perfectly healthy bank was insolvent made depositors withdraw their money – and this pushed the bank into bankruptcy.

Merton explains what happened in the following way:

> The stable financial structure of the bank had depended upon one set of definitions of the situation: belief in the validity of the interlocking system of economic promises men live by. Once depositors had defined the situation otherwise, once they questioned the possibility of having these promises fulfilled, the consequences of this unreal definition were real enough. (Merton [1948] 1968:476)

While Merton speaks of changes in "beliefs" and "the fulfillment of promises" as the key mechanism involved, it is clear that these terms are very close to confidence or trust. And what Merton describes in terms of the Thomas Theorem and a self-fulfilling prophecy can equally well be presented as a classical run on bank caused by its depositors losing confidence. Merton also points out that this type of runs on banks can be blocked through "enacted institutional change" (Merton [1948] 1968:489). As we know, this came about through the creation of the Federal Deposit Insurance Corporation in 1933.

Since the 1980s two developments have occurred that are of importance to the discussion of how sociologists view the role of confidence in finance. One of these is the re-emergence of economic sociology and the related social studies of finance. The other is the huge attention that has been devoted to the concept of trust. The latter development has involved not only sociologists but social scientists in general.

As earlier mentioned, contemporary economic sociologists have had little to say about confidence and trust. While it is often pointed out that credit implies trust and that the term credit comes from the Latin *credere*, which means to trust, this is usually also where the analysis stops. There does however exist one major exception to this tendency, and this is the attempt to portray trust (and confidence) as an emotion.

The two proponents of this view are Jocelyn Pixley and Jack Barbalet, both of whom are influenced by Keynes's ideas about uncertainty and animal spirits. Barbalet is a pioneer in the sociology of emotions (as well as active in economic sociology); and his work is primarily relevant in this context for the interest that he has shown for the concept of confidence (Barbalet 1998:82-102; for a critique of Barbalet, see Dequech 2001). According to Barbalet, confidence as an emotion consists of two elements, one that is cognitive and another that is dispositional in nature. "The cognitive element of confidence involves images of projections of self and beliefs concerning the future. The dispositional aspect concerns inclinations to act on those images, projections, and beliefs" (Barbalet 1998:85).

Jocelyn Pixley's main contribution can be found in her monograph *Emotions in Finance* (2004), which is based on interviews with some forty people in finance, from central bankers to finance journalists. Her main thesis, inspired by Keynes, is that the future is unknowable and that the only way to proceed is to go beyond rational calculations.

Pixley argues that trust, confidence, credibility and similar phenomena are all emotions that must complement rational calculations, for forecasts or actions directed towards the future to be possible. The type of emotions involved, she says (and here she leaves Keynes), are social in nature and often carefully managed by central banks, private banks and some other actors. The main problem from Pixley's perspective is that the modern financial system is based on making short-term profits, and this means that the type of trust it produces is volatile in nature. The tendency in finance is also to deny the very existence of emotions and only to speak in terms of risk, something that adds to this volatility. The solution to the instability of modern finance, the author suggests, is caution and democracy.

Pixley primarily talks in terms of trust; and it is now time to take a brief look at the social science discussion of this concept that was begun in the 1980s and has become very vigorous. The first and perhaps also the most important fact about this discussion is that it has led to no consensus whatsoever about what is meant by trust (see e.g. Hardin

2001). Some scholars focus on its rational element, while others cast trust in terms of probability. There also exist a number of studies that portray trust as a very broad phenomenon that is closely related to the notion of social capital. One example of this is *Trust* by Francis Fukuyama, in which economic prosperity is closely linked to what the author defines as trust ("the expectation that arises within a community of regular, honest, and cooperative behavior, based on commonly shared norms, on the part of other members of that community" - Fukuyama 1995:26).

In most of the literature on trust, no particular attention is paid to the concept of confidence and the two terms are used interchangeably. There do exist a few exceptions, however, and one of these evokes the ideas of Simmel on trust as quasi-religious faith (see also e.g. Luhman 1988:97, Seligman 1997:25-6). This is in an essay by economic anthropologist Keith Hart, which can be found in the influential anthology on trust edited by Diego Gambetta (Hart 1988). Drawing on evidence in dictionaries, he points to the link that exists between religious faith and trust. "*Faith*", he writes, "is an emotionally charged unquestioning acceptance" (Hart 1988:187). "*Trust* implies depth and assurance of such feeling, with inconclusive evidence or proof. *Confidence* involves less intensity of feeling, being based often on good evidence for being sure".

Similar to Simmel, Hart views confidence as being more or less the same as trust, minus most of the quasi-religious element. Hart rejects the idea of a simple continuum, from faith over trust to confidence. While some kind of continuum is involved, the concept of trust contains elements of faith as well as evidence. Hart does not say if this is also true for confidence, but possibly this is the case even if the element of faith would be less than in trust.

Concluding Remarks: On Adding Signs to the Theory of Confidence in Finance

So far in this chapter I have presented and commented on contributions by economists and sociologists that in one way or another deal with confidence in general and confidence in finance. It is clear that there exists no consensus either in economics or in sociology when it comes to what confidence is and what role it plays in finance.

My own impression is also that such a consensus is not likely to emerge. And since this is the case for trust, it is even more so for confidence. What needs to be done is therefore to try to push ahead theoretically, to advance beyond the current discussion by putting forth new ideas on this topic.

This is what I have attempted to do in an analysis of the role of confidence in the current financial crises (Swedberg forthcoming b). I here suggest that confidence has a double structure, in the sense that we typically have confidence in something because there is something else we want to know but cannot know. We do not have full knowledge of this something else and therefore have to rely on some kind of substitute, in which we place our confidence. I may, for example, have confidence in that some bank will respond in some manner, because it has done so several times before. I may also have confidence in how a rating agency evaluates a bond issue, because I know that this agency has a good reputation.

Confidence, and here I think that Barbalet and Hart are correct, does not only have a cognitive dimension but also an emotional and more holistic one, involving the whole person and not only his or her calculative capacity (what Simmel attempts to capture through his expression "quasi-religious faith"). The reason for this has not only to do with the fact, I would argue, that one draws on confidence in situations where one lacks full knowledge; there also exists another and more important reason. This is that confidence is only fully manifested when some action is based on it, since this forces the actor to go beyond whatever knowledge he or she has and so-to-speak take a jump into the unknown.

Trust, I agree with Simmel and Hart, belongs to the same family of phenomena as confidence, but its element of quasi-religious faith is stronger. Confidence, I would argue, is more common in the area of the modern economy, where actors have to be very alert, than in such areas of life as religion, politics and family. In these latter areas, faith and loyalty are common as well as important.

A solid theory of confidence must also be capable of handling different types of actors. In discussions of confidence and trust, the actor is typically assumed to be an individual. The reason for this is probably that trust and confidence are seen as psychological in nature; and psychology deals with the individual. In the modern economy, however, the main actors are institutions; and trust and confidence have consequently to be theorized in such a way that they cover institutions as well as individuals.

What existing theories of trust and confidence do not take into account, I also would argue, is the existence of *signs* and their role more generally in society (for signaling and trust, see Bacharach and Gambetta 2001). In both trust and confidence, to repeat, you have to rely on something else than full knowledge; and this something else, I suggest, can be conceptualized as a sign.

The actor has to find a sign that he or she can rely on, which indicates that something really exists or will happen. If friends vouch for someone being honest, this is a sign; and if some person repeatedly has proven reliable, that is another sign. One may call this type of sign for a *proxy sign* since it stands in for something else, which we want to know but lack full knowledge of. In my own work on the economy, I especially draw on the work of American philosopher Charles Peirce, for the understanding of what a sign is and how it operates (e.g. Peirce 1991, Swedberg forthcoming a). Signs, according to Peirce, include words but cover a much wider range than so.

By introducing the idea of an intermediary layer of signs into the analysis between the actor and whatever he or she has confidence in, one also increases its accessibility to sociological analysis. There are actors who create signs as well as actors who interpret them; and both of these processes can easily be analyzed sociologically. There also exist different kinds of signs, all of which have a history that can be illuminated with the help of sociology.

The idea of signs may open up the analysis of confidence in finance to new conceptualizations. In Merton's run on the bank, for example, depositors read signs (rumors) and act on these. And according to Bagehot, bankers have to be extra vigilant in managing signs because of the peculiar role that confidence plays in deposit banking. Or, to take a recent example from the financial crisis: the rating agencies were much too lax in assigning evaluations to stocks and bonds, and the same was true for the investors who relied on these evaluations.

It would probably take another chapter to properly outline what role signs play in the different types of confidence that are part of finance. There is investor confidence, confidence in the banks, confidence in the state, and so on. Still, by introducing the concept of signs into the analysis, it is my belief that it can be substantially improved – and also that it can start moving in new and exciting directions.

References

Akerlof, George and Robert Shiller. (2009). *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*. Princeton: Princeton University Press.

Angier, Natalie. 2009. "The Biology Behind the Milk of Human Kindness", *New York Times* November 24, D2.

Arrow, Kenneth. 1974. *The Limits of Organization*. New York: W.W. Norton.

Arrow, Kenneth. 2009. "[Interview:] The Economy of Trust", Acton Institute. Downloaded on January 22, 2010 from http://www.acton.org/publications/randl/rl_interview_556.php

Bacharach, Michael and Diego Gambetta. 2001. "Trust in Signs". Pp. 148-84 in Karen Cook (ed.), *Trust in Society*. New York: Russell Sage Foundation.

Bagehot, Walter. [1873] 1922. *Lombard Street: A Description of the Money Market*. London: John Murray.

Barbalet, Jack. 1998. *Emotions, Social Theory and Social Structure*. Cambridge: Cambridge University Press.

Bernanke, Ben. 2008. "Liquidity Provision by the Federal Reserve". Downloaded on January 19, 2010 from http://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm

Bernanke, Ben. 2009. "Reflections on a Year in Crisis". Downloaded on January 19, 2010 from http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm

Dequech, David. 2001. "Confidence and Action: A Comment on Barbalet", *Journal of Socio-Economics* 29:503-15.

Fehr, Ernst. 2008. "On the Economics and Biology of Trust", Working paper IZA DP No. 3895, Bonn, Germany.

Fukuyama, Francis. 1995. *Trust: The Social Virtues and the Creation of Prosperity.* London: Penguin.

Griffin, Dale and Amos Tversky. 1992. "The Weighing of Evidence and the Determinants of Confidence", *Cognitive Psychology* 24:411-35.

Guiso, Luigi, Paola Sapienza and Luigi Zingales. 2008. "Trusting the Stock Market", *Journal of Finance* 63,6:2557-2600.

Hardin, Russell. 2001. “Conceptions and Explanations of Trust”. Pp. 3-39 in Karen Cook (ed.), *Trust in Society*. New York: Russell Sage Foundation.

Hart, Keith. 1988. “Kinship, Contract, and Trust: The Economic Organization of Migrants in an African Slum”. Pp. 176-83 in Diego Gambetta (ed.), *Trust*. Oxford: Blackwell.

Katona, George. 1975. *Psychological Economics*. New York: Elsevier.

Keynes, John Maynard. 1915. “The Works of Bagehot”, *Economic Journal* 25, 99:369-75.

Keynes, John Maynard. 1936. *The General Theory of Employment, Interest and Money*. London: Macmillan.

Keynes, John Maynard. 1937. “The General Theory of Employment”, *Quarterly Journal of Economics* 51, 2:209-23.

Kindleberger, Charles. 1978. *Manias, Panics and Crashes: A History of Financial Crises*. New York: Basic Books.

Knorr Cetina, Karin and Alex Preda (eds.). 2005. *The Sociology of Financial Markets*. New York: Oxford University Press.

La Porta, Rafael et al. 1997. “Trust in Large Organizations”, *American Economic Review* 87:333-38.

Luhman, Niklas. 1988. “Familiarity, Confidence, Trust: The Problems and Alternatives”. Pp. 94-108 in Diego Gambetta (ed.), *Trust*. Oxford: Blackwell.

Kanter, Rosabeth Moss. 2006. *Confidence; How Winning Streaks and Losing Streaks Begin and End.* New York: Three Rivers Press.

Merton, Robert K. [1948] 1968. “The Self-Fulfilling Prophecy”. Pp. 475-90 in *Social Theory and Social Structure*. New York: The Free Press.

Minsky, Hyman. 1982. *Can “It“ Happen Again? Essays on Instability and Finance.* Armonk, NY: M.E. Sharpe.

Pech, Wesley and Marcelo Milan. 2009. “Behavioral Economics and the Economics of Keynes”, *Journal of Socio-Economics* 38:891-902.

Peirce, Charles. 1991. *Peirce on Signs*. Ed. James Hoppes. Bloomington: Indiana University Press.

Pixley, Joycelyn. 2004. *Emotions in Finance: Distrust and Uncertainty in Global Markets.* Cambridge: Cambridge University Press.

Shiller, Robert. 1999. "Measuring Bubble Expectations and Investor Confidence". NBER Working paper Nr. 7008, Cambridge, Massachusetts.

Shiller, Robert. 2000. *Irrational Exuberance*. Princeton: Princeton University Press.

Sapienza, Paola. 2009. "Trusting and the Market", Talk at the Kellogg Graduate School of Management, October 24.

Schumpeter, Joseph A. 1954. *History of Economic Analysis*. London: Allen & Unwin.

Seligman, Adam. 1997. *The Problem of Trust*. Princeton: Princeton University Press.

Simmel, Georg. [1907] 1978. *The Philosophy of Money*. London: Routledge. The first German edition appeared in 1900.

Simmel, Georg. 1950. *The Sociology of Georg Simmel*. Ed. and trans. Kurt Wolff. New York: The Free Press.

Smith, Adam. [1766] 1997. "Lecture on the Influence of Commerce on Manners". Pp. 17-20 in *Reputation: Studies in the Voluntary Elicitation of Good Conduct*. Ann Arbor: University of Michigan Press.

Swedberg, Richard. Fortcoming a. "The Role of the Senses and Signs in the Economy: More on the Centrality of Materiality". Paper presented at the Conference of the International Sociological Association, Gothenburg.

Swedberg, Richard. Forthcoming b. "The Structure of Confidence and the Collapse of Lehman Brothers". In *Research in the Sociology of Organizations.*

Walters, Alan. 1992. "Confidence". Pp. 423-25 in Vol. 1 of *The New Palgrave Dictionary of Money and Finance*. London: Macmillan.

Weber, Max. [1920] 1946. "The Protestant Sects and the Spirit of Capitalism". Pp. 302-22 in *From Max Weber* (eds. Hans Gerth and C. Wright Mills). New York: Oxford University Press.

Williamson, Oliver. 1993. "Calculativeness, Trust, and Economic Organization", *Journal of Law and Economics* 36:453-86.