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How Reality Ate Itself: Orthodoxy, Economy & Trust

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Quis custodiet ipsos custodies?
Who guards the guards?

An economic theory that cannot sustain its own possibility is a poor one but can also be a powerful one. A market economy may valorise the symbolism of the invisible hand but it is as equally beholden to the symbolism of the tacit handshake. The handshake is a metonym for a relation and a market economy is a set of relations inscribed in rules, tacit or otherwise. First amongst equals are trust and the means by which trust is enacted and maintained. Without trust nothing else functions and social reality would be impossible. The philosopher J. L. Austin was one of the first to recognise the importance of this.[1] There are at least two dynamics to talking about social reality. First, description where we designate things true or false by reference to them as objects or past events - the hat is black, yesterday was Wednesday and we had lunch. Second, performance, where current conduct and dialogue constitute a new conceptual element to social reality with material repercussions for future relations – the meeting of hands and *it's a deal*, or the negotiation and witnessed signing of a contract. In the immediate sense, performance is neither strictly true nor false since it is not initially a description, but a doing or making. The doing is in this first instance appropriate or inappropriate, sincere or insincere, successful or a failure. That it is done is in the second instance true or false – the contract as negotiated by two parties with the legal authority to engage in those negotiations was signed by each and entered into in good faith. The glue in this transition is the trust that binds the particular rules of appropriate interaction. The interaction may fail for a variety of reasons that cause immediate problems – an earthquake may prevent the delivery of a consignment required for a just in time production process. But these reasons are not devastating to the social institution in which they occur – the sustainability of business agreements perpetuating economic activity. However, when practices are designed to confound basic principles of transparent dealing, when rules are insincerely held, when a promise ceases to be something you intend to keep, trust dissolves and markets cease to look quite so 'spontaneously' vibrant.

[1] pp. 45-52, J. L. Austin, *How To Do Things With Words* (Oxford: Oxford University Press, 1962)

The orthodox Cheshire cat

As has often been argued, the timeless, ahistorical, institution-free fundamentals of orthodox method cannot be easily reconciled to problems of markets as rule systems. But what does it mean that trust and the rules that constitute market systems are not a central problem for orthodox economics? Orthodoxy is about the spontaneous optimality that emerges from the removal of impediments. Since the very idea of rules tends to be conflated with regulation there's nowhere left to hang the structuring of markets. This of course forgets that deregulation is itself a (demonstrably inefficient) form of regulating rule. Its inefficiency and its contradiction is that this form of regulation tends to create the conditions for abuse that undermine the trust on which the free economic activity of markets is based. The radical individualism inscribed in it provides for the belief that *freedom to* massively predominates over *freedom from*. *Freedom from*, our collective protection from the abuses that undermine the very possibility of individual action, is pushed aside. This deep ideological commitment can be heard in the words of Milton Friedman:

> What's interfering with the recovery is all this fuss about corporate governance, which, in my opinion, is being carried too far. In all these cases – Enron. Global Crossing, WorldCom – it was the collapse in the market that brought attention to them. What's happening now is that the hullabaloo, which in effect is saying that to be a CEO is to be a member of a criminal class, is very adverse for enterprise and risk.[2]

But the collapse of the market is not some natural event, it is the dynamic consequence of complex interactions, many of them unanticipated or unintended. One aspect of that is how the practices that constitute markets can undermine the trust that markets require to function. Criminalising CEOs *is* adverse for enterprise and risk but would not be occurring if their practices did not contribute to crises where they can no longer be disguised or ignored. Economists tend to forget about power, but all human systems have power asymmetries. For the powerful to be held to account indicates deep concerns. That orthodoxy cannot recognise this, still less contribute to its analysis in terms of its own theoretical tenets, indicates that it has little that is constructive to say concerning the analysis of an important cause of economic crisis.

In any case, one rarely sees far when the view is from the top, however clear the view may potentially be. In a recent speech Federal Reserve Chairman Alan Greenspan argued that both the $8 trillion dollar loss of share vale on the DOW at the start of the new century and the problems incurred as a result of Enron etc. indicated the general *health* of the financial system.[3] The basis of his argument was that technology had produced new opportunities for financial 'risk dispersion' and that 'a more flexible world economy' was spreading costs and absorbing shocks more readily. The proof? 'No major US financial institution was driven to default.' In adopting this position, Greenspan reveals himself as something of a stoic - w*hatever doesn't kill us makes us stronger*. Still, the US financial institutions are scarcely the whole body of economy. Default has quite a different meaning for those impoverished by collapsing share values and 'financial irregularities'. Risk dispersion is a rather hollow term for those unable to pay their mortgages or with no jobs to go to (US unemployment is 6% and rising). If we call the financial head healthy we must still ask ourselves how it is treating its economic body – as a temple or a trashcan? And need we call it healthy? 2001 was a record breaking year for fraud class actions (488)

[2] D. Smith, 'Feisty at 90 – Friedman Speaks Out,' *The Times Business* September 8th 2002.

[3] Text reproduced in full *The Times Business*, September 27th 2002.

in the US against firms.[4] The majority by state pension funds and union pension schemes. Around 8 to 10,000 individual cases are being filed a year at the National Association of Securities Dealers (NASD). And all of this despite a change in the law to make it *more* difficult to sue firms for compensation for irregularity - the 1995 Private Securities Litigation Act means that 'aiders and abetters' of wrongdoing in a fraud case cannot be held liable.

Practices that undermine trust

The context of the problem of trust is a finance system keyed to the unrelenting pursuit of the next profitable firm and the next growth sector. Consistent growth provides the basis of a profitable firm and a profitable bull market for the financial industry. When a firm meets its revenue forecasts it can mean a large increase in its share valuation. Analysts categorise firms as 'Market Out-performers' (MOs), 'Market Performers' (MPs) and 'Market Under-performers' (MUs). Whether a stock is rated as a 'buy' a 'neutral' or a 'sell' is, in principle, related to which direction it is tending to in terms of these categories. Conventionally, our perception of shares is based on their price-earnings ratio or P/E.[5] The lower the ratio the greater the earnings of the stock as a proportion of its price and thus the faster one recoups the initial investment. P/E therefore provides a measure of the attractiveness of stock as equity. But how reliable are the price of the share and the earnings of the firms as indicators of the decision to invest? What lurks beneath the numbers? Here, knowledge is power:

- The power to construct the firm's reported revenue stream occurs within strong pressures to place it in its best possible light. In terms of trust, one confronts the question of how far the relationship between the accountants and the firm can stretch. When does creative accounting become aggressive accounting that in turn becomes collusion in fraud?

- The power to manipulate stock prices through complex financial arrangements on the basis of information that others do not have. Here, the problem of trust comes up against the question of at what point expertise becomes self-interest to the detriment of the system from which it feeds?

This is not just an issue of legality since trust is more than a question of 'were any laws broken?' Part of the constitution of trust are the ethics that inform how law is made and how it is adhered to – in its spirit or in its letter? The grounds of trust are extremely difficult to define, but easily lost. Losing sight of the importance of trust is the downfall of the system. Its dysfunction becomes ravenous and reality begins to eats itself. Its clearest expression is a debilitating scepticism. Its immediate, though by no means final, consequence is a downward spiral of corporate valuation.

Cannibalising reality?

The past five or six years have seen numerous financial scandals. Since economy is an open system one tends to find a complex interaction of some or all of the above practices within those scandals. The dot.com bubble provided a great deal of scope for spinning (the preferential allocation of stock to favoured clients) and laddering (having investors promise to buy more stock at progressively higher

[4] J. Doran, 'After the bust, a boom in fraud suits for Wall Street's lawyers,' *The Times Business,* November 30th 2002.

[5] R. Marris, 'Have the markets reached bottom?' *The Times Business* November 7th 2002. R. Cole, 'P/e ratios indicate good value,' *The Times Business* July 20th 2002.

prices once trading begins). Though cases of spinning are alleged on the London markets, New York has been the focus of investigation.[6] New York Attorney-general Eliot Spitzer has been engaged in protracted investigation of 12 of the major financial institutions for forms of spinning. Most of the evidence is based on private e-mails and documents that contradict the public statements of investment analysts. Henry Blodget, a Merrill Lynch analyst, for example, publicly rated Infospace stock as a buy whilst privately noting, 'This stock is a powder keg… given the bad smell comments that so many institutions are bringing up.'[7] Breach of Chinese walls is also alleged against Citigroup's investment banking arm Salomon Smith Barney, which consistently rated Qwest Communications as a 'buy' up to the point of its price collapse. At the same time, Philip Anschutz, Qwest's founder, was selling Qwest shares amassing a $1.45 billion profit. Anschutz also received 57 allocations for various share issues at a personal profit of around $5 million from Salomon whilst Qwest had generated $37 million in revenue for Salomon from its transactions.[8] Fines imposed by the Securities and Exchange Commission (SEC) on the banks currently stand at $1.4 billion. $900 million of which constitutes compensation for investors, $450 million to fund independent research (to maintain Chinese walls) and $85 million for 'investor education'.[9] $400 million of the total will come from Citigroup (who have also set aside $1.5 billion to meet the costs of compensation for further investor litigation).[10]

The dot.com firms themselves and also the new telecoms were highly prone to creative accounting based on capacity swaps and barter in order to massage their revenue figures during the early phase of set-up. This and talk of new business models making money in completely new ways with extremely low long-run fixed costs sucked in masses of venture capital (over $40 billion of which is now lost).[11] At the same time, as a high growth sector, dot.coms provided (along with various high growth sectors of overseas markets) one of the initial areas of high-risk that proved extremely attractive to split capital trust (SCT) managers. The fact that some of these issues were spun, of course, meant that the estimation of risk by those managers was baseless and their vulnerability far greater than even they could imagine. Any other shock to the system, such as 9/11, could only exacerbate their vulnerability. The collapse of Aberdeen Asset Management's SCTs, contributed to the £10 billion lost by more than 50,000 private investors in this sector.[12]

The possibility that even apparently low risk investments are not what they seem also emerged. The misuse of "special purpose vehicles" and "off-balance sheet obligations" (OSOs) prevents investors relying on firm's accounts with any degree of confidence. WorldCom used OSO's to keep $4 billion off balance. In 2000 Enron was 7th in the *Fortune* top 500 with reported revenue in excess of $100 billion (a 150% increase on the previous year).[13] Its shares traded at over $60. Its chief financial officer, Andrew Fastow orchestrated several SPVs set up in the name of his children and his wife, from which he allegedly earned $30 million in fees and siphoned assets. The decline of the DOW over the turn of the millennium made the use of Enron stock to finance continued debt restructuring more difficult and on October 16th 2001 Enron posted a bombshell $1.01 billion loss. The vulnerability inherent in its revenue enhancements then kicked in in earnest. On the 17th the *Wall Street Journal* publicised

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[6] In the UK see, Insight team, 'Revealed: the cosy deals that taint Goldman Sachs,' *The Sunday Times Business* November 24th 2002.
[7] See A. Rayner, 'Spitzer poised to reveal fresh evidence against 12 banks,' *The Times Business* November 22nd 2002.
[8] R. Lambert, 'Are Wall Street's Ethics Dead?' *The Times* October 8th 2002.
[9] D. Rushe, 'War is over (on Wall Street at least),' *The Sunday Times Business* December 22nd 2002.
[10] J. Doran, 'Citigroup plans $1.5bn fund for compensation,' *The Times Business* December 24th 2002. A. Rayner, 'US banks to settle with regulators,' *The Times* December 9th 2002.
[11] N. Hopkins & T. Bawden, 'Spectre of high-tech bubblelingers on,' *The Times Business* November 8th 2002.
[12] P. Durman & L. Armistead, 'Dotty, the champion of split caps,' *The Sunday Times Business* October 27th 2002.
[13] See B. Cruver, *Anatomy of Greed* (London: Hutchinson, 2002).

Fastow's SPV connections. On the 29th Moody's Investor Service, down-rated Enron's credit rating increasing the servicing costs of its newly revealed debt. By December 2001 the firm had filed for bankruptcy and it was all over. Its share price had collapsed to less than a cent. Numerous small investors who had relied on its stock for their pensions and large pension funds themselves were hit hard. State pension funds in New York, Georgia and Ohio lost over $350 million. By February 2002 the Bank of America had $231m in Enron related losses. One hundred Merrill Lynch executives lost $16 million of their own money invested in an Enron partnership.[14] Ordinary Enron employees received no severance pay. In November, however, senior staff had awarded themselves $55 million in 'retention bonuses' from the dregs of its coffers. Just prior to the October 16th loss statement 29 senior executives sold stock, over a dozen reaping in excess of $10 million. A class action suit has now been brought against them for insider trading whilst Fastow, and a number of collaborating London bankers, have been indicted for fraud.[15] Meanwhile, Enron's accountant, Arthur Andersen was indicted for obstruction of justice. Its other clients bailed out to the remaining Big Four accountancy firms and Arthur Andersen, previously the fifth largest professional services firm in the world was liquidated. The nature of Andersen's relation to Enron is suggested by the following statement from an anonymous former executive of the firm:

> Everyone makes the mistake of thinking Andersen and Enron are separate companies. There are hundreds of ex-Andersen people inside Enron, a bunch of young kids just out of college. Give those new Andersen kids a downtown loft, a new Lexus and show each one the golden path to becoming a partner. Hey learn to do things the Enron way.[16]

The initial fallout from Enron was the re-auditing of accounts previously held by Andersen. Deloitte & Touche, for example, took over the audit of MyTravel from Arthur Andersen, its re-audit took £15m off the profitability of the firm. Share prices subsequently fell by 36%.[17] With revelations concerning SPVs major news, corporations moved quickly to distance themselves from any hint of scandal. Blue-chip firms, such as Xerox, have been publicly realigning their former accounts and future forecasts. But according to the IMF, 'questions regarding the quality of reported corporate profits in the aftermath of Enron's failure continue to have an adverse impact on international and corporate bond markets.' As Mathew Wickens of ABN Amro says, part of the problem are the figures firms are posting because 'we don't really know what they mean.'[18] Presswatch ranks accountancy as the top service sector for column inches of negative publicity. People are sceptical about stock markets. In a survey by the investor group Pro-Share more than half the 450 investors questioned felt less confident in the accuracy of company accounts. 'One in three believes auditors are not independent of the companies they audit.'[19] The collapse of trust, therefore, places Friedman and Greenspan's rather blithe accounts of the $8 trillion fall in the DOW in a rather different light.

The effects of the collapse have been widespread. California, the richest state in the union with an economy of $1.3 trillion faces a $21 billion budget shortfall in 2002.[20] Some of this is due to general recession to which the collapse of the stock market has contributed. Some if it is directly attributable to that collapse. In 2000, California received $17 billion in taxes on stock market profits, mainly from

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[14] D. Rushe, 'Enron Watch,' *The Sunday Times* February 3rd 2002.

[15] 78 charges have been filed so far. 'Former Enron chief to face more charges,' *The Times Business* December 27th 2002.

[16] B. Cruver, 'I had a lucrative career… but it cost me my soul,' *The Times Business* October 2nd 2002.

[17] J. Ashworth, 'Unearthing the Arthur Andersen time bombs,' *The Times Business* Thursday October 10th 2002.

[18] L. Paterson & G Duncan, 'IMF fears more shares misery,' *The Times Business* June 13th 2002.

[19] D. Wild, 'A horrible year, but at least now accountancy is sexy,' *The Times Business* December 19th 2002.

[20] C. Ayres, 'Economic woes take lustre off Golden State,' *The Times* December 11th 2002.

dot.coms, in 2002 that fell to $5 billion. Cuts in state spending of $10 billion have subsequently been announced including state worker redundancies, pay freezes and also reduced healthcare expenditure for the poorest in society. Californians were also direct victims of Enron. It has been alleged that Enron traders triggered widespread blackouts by buying huge blocks of power capacity in the state's electricity market to artificially increase the price of their own supply.[21]

What secrecy reveals

Sophisticated capitalism allows for a variety of primitive abuses. This is not simply an issue of lies and deceit. To argue this way is to reduce the problem to the agent, to the bad apple, rather than the conditions of enablement within the orchard. Analytically, this does not move one far enough away from orthodoxy and radical individualism. Deceit is the tip of the structural iceberg. The full nature of the rules of the structure and the way in which they are held needs to be considered. The US Sarbanes-Oxley Act, which now requires finance directors and CEOs of listed companies to attest to the accuracy of their accounts or risk jail, is a step forward in giving teeth to corporate governance, but it is not in itself corporate governance. Nor does it restore trust, since once rules are codified firms will seek to exploit them. What is also needed are ethics of appropriate action that mitigate the desire for such exploitation. How one might maintain them under the pressures of competitive capitalism is an open question, but it is not one that should be conflated with lying *per se*. There can be an ethical good in being economical with the truth. In macro policy it makes no sense to confirm a run on a currency or confirm some policy that relies on surprise for its effectiveness but has been leaked (such as currency devaluation). Equally, rules cannot be overly general across economy – there are good reasons why the police don't work on commission. What is certain is that orthodoxy adds nothing constructive to the debate on markets as rule systems. It does not lie, but it is false. A lie in social science, like honesty in politics, is usually found out and punished. But false knowledge has a life of its own. Ironically, one wonders, therefore, if Keynes is entirely correct in his sentiment when he argues, 'you can't convict your opponent, you can only convince him.'[22]

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[21] J. O'Donnell, 'Enron's 'tricks plunged California into darkness'', *The Sunday Times Business* October 6th 2002.

[22] Thanks to Vicky Chick for reminding me of the quote from Keynes used in the conclusion.