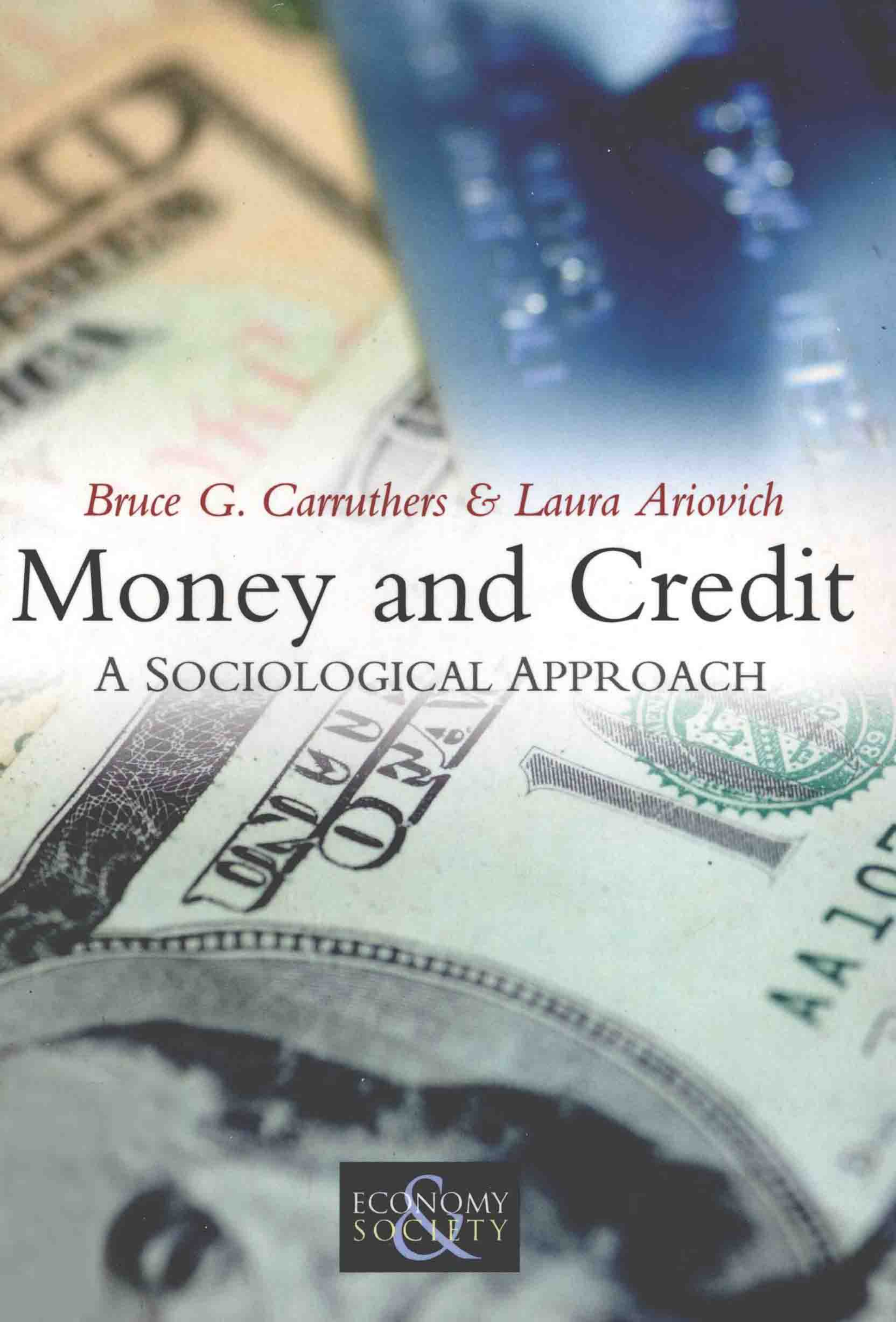
Bruce G. Carruthers & Laura Ariovich

Money and Credit

A Sociological Approach



ECONOMY & SOCIETY

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Introduction

The events of 2007 and 2008 demonstrated that modern financial systems, built on solid foundations of credit and supported by massive amounts of capital, can nevertheless be surprisingly fragile. A number of the biggest financial institutions in leading international centers like London and New York City came perilously close to complete collapse. Some institutions simply failed (Lehman Brothers), some had to be rescued through acquisition by another institution (viz., JPMorgan Chase's purchase of Bear Stearns, or Bank of America's purchase of Merrill Lynch), some were simply nationalized (Northern Rock in Britain), and others survived because the British or U.S. governments directly injected huge sums of money (e.g., Britain's bailout of the Royal Bank of Scotland, or the case of AIG in the U.S.). Assets on balance sheets which in 2006 had been highly rated by the credit rating agencies (Moody's, and Standard & Poor's) and which seemed so solid suddenly became suspect, and even "toxic." Banks, which are in the lending business, stopped lending, even to each other. As reported in the *Wall Street Journal* (January 26, 2009, p. A1), big U.S. banks were doing *less* lending, even after they had received billions in government funding intended to encourage *more* lending. Liquidity had disappeared.

In retrospect, some of the practices that led up to today's crisis seem obviously unsound. So-called "subprime mortgages" were intended for riskier borrowers whose financial status and credit history did not qualify them for regular home mortgages. Helping people to buy their own homes is a commendable goal, but given the greater risks involved with subprime lending, a couple of adjustments might have seemed prudent: determining with certainty the borrower's income and ability to service the loan; insisting on a larger down-payment, and so on. In fact, the U.S. subprime mortgage market grew dramatically between 2000 and 2007 but was filled with strange practices like NINA loans (short for "no income, no assets") and "liar's loans" (also known as "no doc" or "low doc" loans because there was little or no documentation), where the lender simply took at face value the borrower's claims about their income. If someone said they earned $100,000 annually, then that was good enough for the lender. Subprime loans were then "securitized," that is, bundled together into large pools and then sold off to investors. Increasingly, mortgage loan originators no longer "held" the loans they originated, and with securitization, the originator would suffer little if the loans went sour. A strange variety of exotic financial instruments were then built out of these securitized mortgage loans: CDOs, CMOs, MBSs, SIVs, and so on. The classic movie *It's a Wonderful Life* (directed by Frank Capra and starring Jimmy Stewart) presented a memorable picture of mortgage lending that is largely irrelevant today: financial institutions no longer just take deposits from local customers and then lend the money locally, holding thirty-year mortgages in their portfolios until the loan is fully repaid. But if "liar's loans" are bad ideas in retrospect, at the time they were made they seemed attractive to many borrowers and lenders. How could appearances have been so deceiving? How could things have deteriorated so quickly?

People have been stunned by the severity of the crisis and the speed with which it hit the economy, but many find it hard to reconcile the fact that even as banks, investment banks, and other financial institutions were performing poorly, their top managers were being enriched personally. The discrepancy between organizational performance and CEO compensation has produced outrage among ordinary citizens whose tax dollars have been used to bail out many financial institutions. Among scholars, it has raised again the issue of corporate governance and how to ensure that management serves shareholder interests (Bebchuk and Fried 2004). During the 1990s, many economists and management consultants argued that the solution to the problem of corporate governance lay in the compensation system for CEOs: stock options and performance-based bonuses would supposedly ensure that the interests of top management were aligned with those of shareholders. Sadly, we have learned that it isn't that simple.

Today's crisis is among the worst in a recent series of impressive American financial debacles. Within recent memory, the savings-and-loan crisis of the 1980s, the collapse of Long Term Capital Management (a hedge fund whose partners included two Nobel Prize-winning financial economists), and the Enron bankruptcy would surely be among the best known. Although each episode had its own unique features, they were all very costly to taxpayers, shareholders, investors, and employees, and demonstrated that creditworthiness, the appearance of unimpeachable economic solidity, is ephemeral. Credit is a fickle thing, and economic value can seemingly turn into worthless vapor overnight.

If economic value is trickier than we thought (or at least much less stable), it does seem pretty obvious how to go about measuring it. As with other measurement problems, one begins with a unit of measure. To measure length, people use a ruler to indicate feet, inches, or meters. In this instance, we use some monetary unit to measure value: dollars and cents, pounds, euros, yen, pesos, shekels, dinars, won, francs, baht, and so on. Then, once the appropriate metric is selected (dollars in the U.S., euros in Germany, etc.), the value of something is indicated by its market price. An object is worth what it costs to purchase it, measured in money.

This simple recipe for measuring value seems straightforward, but it conceals a lot of complications. To begin, some extremely valuable things don't have a price because they are not bought or sold. Sacred objects, heirlooms, and other "priceless" objects have meaning and value that cannot be calculated in monetary terms. And if you attempt to attach such a value, someone is bound to become very, very upset (try getting a parent to say how much a child is worth, in dollars and cents).

Sometimes the monetary sum that is attached to an object or relationship is essentially made up, negotiated, or stipulated. Although it looks like a price, it doesn't reflect an actual arm's-length market transaction. Examples of this would include the "transfer prices" that large corporations use to account for their own internal transactions, or the sum that a court of law sets as compensation in a wrongful death lawsuit, or the monetary gift that parents make to their married children to help them purchase their first home, or the *wergeld* ("blood money") paid to avoid a feud or vendetta. In today's financial crisis, it also seems that some of the monetary values attached to bank assets were "made up" in the sense that their true value is quite mysterious and that giving them a specific dollar value creates a misleading appearance of accuracy. It is these assets of indeterminate value that are now deemed so "toxic" and which weigh down bank balance sheets.

Monetary prices are sometimes seen from the perspective of "fairness": it isn't just that prices are low or high depending on "natural" market forces, for in addition they are sometimes perceived as fair or unfair. For example, employees compare themselves to their peers to see if their compensation seems fair; they also compare their raises with those of their superiors (so if a corporate CEO gets a 100% increase while employees get only 5% raises, the employees may feel that they have been treated unfairly). Certainly many taxpayers have been outraged by the large bonuses paid to American investment bankers whose firms have lost billions of dollars (and required massive public bailouts). The enrichment of incompetence seems just wrong. A retailer who takes advantage of a temporary shortage by jacking up his prices will be accused of "price gouging" and suffer from ill-will and bad publicity. Similarly, buyers who take advantage of desperate sellers by offering very low prices (so-called "fire sale prices") may also be accused of unfairness.

Finally, people put money into different categories and then treat it differently (even though it is "just money"). Behavioral economists call this process "mental accounting" (Thaler 1999). Even though $10,000 of earned income is indistinguishable from $10,000 won through a lottery, people perceive the winnings as special money and use it very differently than their ordinary earnings. Or suppose that someone's monetary compensation for work comes in two parts: salary and bonus. The bonus portion is "extra" and deemed "special," even though strictly speaking the money is indistinguishable. Money generated from an illicit activity is considered "dirty money," and people treat it in a distinctive manner. Within traditional families, money earned by wives was regarded as somehow "less valuable" than the money earned by the husband. Such differences remind us that money has symbolic as well as material value (Mickel and Barron 2008).

The uneven availability of credit and the unequal distribution of money (as income or wealth) are important political issues in the contemporary U.S. Why do some workers earn less than others? Has economic inequality increased? And so on. But money *per se* is not particularly controversial. Ordinary people treat money like a fact of nature: it just is. However, this taken-for-granted status wasn't always the case. In fact, the value of money was a very salient issue in American politics after the Civil War and before World War I. William Jennings Bryan's famous "Cross of Gold" speech, decrying the gold standard, resonated with many American voters even though he lost to William McKinley in the presidential election of 1896. For several decades after the Civil War, Americans argued over the gold standard, and whether the U.S. money supply should be based on gold, or on silver and gold, or on fiat money. Greenbackers argued with bullionists, "soft money" advocates took issue with their "hard money" opponents, and "free silver" supporters weighed in as well. The debate raged until the U.S. came down firmly on the side of the gold standard in 1900.

Money is no longer a "hot button" political issue, but credit and finance have returned to the U.S. political agenda because of the current financial crisis. And finance has remained a religious issue for some, particularly the devout adherents of the world religions that came out of the Middle East. Christianity, Judaism, and Islam all prohibited usury, or the payment of interest for a loan. Over the centuries, that prohibition has been relaxed or circumvented in Western countries, but it remains active in the Arab Middle East.

Given how much money has flowed into Islamic countries over the last several decades (because of oil exports), Islamic banking has become quite an active financial arena.

Even though ordinary people mostly take money for granted, their latent feelings can surface when money is threatened. One appreciates just how deeply people care about their own currency by recalling the controversies in Europe over the replacement of various national currencies (the beloved franc, guilder, pound, and lira) by the euro. It may have made perfect economic sense to create a single currency for Europe, but a national currency remains a powerful political symbol that some Europeans were reluctant to relinquish. It is also clear, from the historical record, that periods of hyperinflation (when the value of currency declines precipitously) can devastate a market economy and lead to political turmoil (e.g., Zimbabwe in 2008, Yugoslavia in the early 1990s, Hungary right after World War II, Germany in the early 1920s). Money isn't an apolitical matter, even though monetary politics come visibly to the surface only once in a while.

What is Money?

Money is a generalized, legitimate claim on value (Carruthers 2005: 355). This means that: (1) money *grants access* to valuable things – people can use it to acquire goods and services – money is a form of power; (2) the access that money makes possible is *legitimate* (i.e., it seems proper to acquire things by purchasing them, unlike the illegitimate ways in which people sometimes acquire things, such as theft or plunder); and (3) money is a *generalized* claim (it can be used generally to obtain all kinds of goods and services). Geoffrey Ingham, a sociologist who has studied money a good deal, simply states that money is "a social relation" (Ingham 2004: 12). In particular, money is constituted through the social relations between creditors and debtors (Ingham 2004: 72; 2008: 69, 74). Economists prefer to give a more functional definition in which money is what money does: it functions as a store of value, medium of exchange, and unit of account. Money is used to store value over time (perhaps in a vault or a mattress), it can be used in market exchange, and it is applied in various settings as a unit of measurement.

Under any of these definitions, it is clear that many things can serve as money. And indeed, across different eras and societies, many things have served as money, including pieces of paper, precious metals like gold and silver, not-so-precious metals like copper and brass, vodka, stringed beads, cigarettes, private debts, accounting entries, and so on. This is one reason why money is such an interesting topic: mostly we take it for granted as a self-evident feature of everyday life, and yet because it can vary in such weird ways, it warrants closer scrutiny. How is it possible that all these things can serve as money?

The substance of money has certainly changed over time. Early forms of money consisted of tangible objects of value: gold and silver in Western Europe, cowry shells in sub-Saharan Africa. Later on, representational forms began to function as money. Paper notes were invented first in China and later used in Western Europe (Goody 2004: 107). As fully developed by banks issuing convertible notes in a fractional reserve system, paper money represented tangible objects of value because the note holder could, in principle, go to the issuing bank and redeem the note for its equivalent in gold bullion. The paper note represented the gold in the bank vault, even if the note holder never actually took the gold out of the vault. Today, most people's money is in the form of a checking or savings account, and if they need cash, they simply visit an ATM (or if they are feeling old-fashioned, go to a bank teller). This means that rather than having any kind of physical object, whether representational or not, the money people possess mostly consists of electronic accounting entries maintained in their bank's computer system. Money has been physically reduced. Payment of \$1 billion is a mighty chore if it means hauling sacks of gold, and it is still a physical challenge when moving stacks of \$100 bills (over ten tons of currency), but it is trivial if all that needs to be done is to enter some key strokes on a computer. Money has become disembodied and virtual, and can now move around the globe in large amounts and at the speed of light.

Introduction

Money and Credit

Ordinarily, money is used to buy things, and so money and market exchange are closely connected. But money and credit are equally close. For example, even when people don't have cash, they can still proceed with a purchase on credit. Either the seller extends credit directly to the buyer, or some third party lends money to the buyer so that they can buy the goods (as we will see in chapter 4, credit is an important marketing tool for sellers). In the first case, the seller lets the buyer take possession of the good, but the buyer promises to pay the money owed within a certain time period (perhaps thirty days, or ninety days, or a year). Deferred payment is a very common form of credit. In the second case, a lender gives a sum of money to a borrower (who promises to repay within a certain time, depending on the terms of the loan) and the borrower then uses that money to make a purchase (e.g., a bank lends money to an individual so they can buy a home). In either case, credit involves a promise. And the willingness of lenders to extend credit depends on the credibility of the borrower's promise. Does the lender trust the borrower?

One of the most interesting economic changes over the last two centuries concerns this simple question: when do lenders trust borrowers? The vitality of the economy rests on the answer because so many transactions now depend on credit. In fact, we live in a "credit economy." If lenders do not trust borrowers, then lending ceases and the wheels of commerce grind to a halt. But trust is a tricky matter because lenders who trust no-one never lend, and lenders who trust everyone lose their money. So the goal for lenders is to trust the trustworthy, and distrust the untrustworthy. And it can be very difficult to tell the difference between these two groups, especially when borrowers, whether they are trustworthy or not, try to appear trustworthy to lenders.

Lenders have evaluated the trustworthiness of borrowers in different ways. For most of history, this evaluation fundamentally depended upon networks of social relationships. People who were part of the same social circle, or who were members of the same community or kinship group, knew a lot about each other and so were better able to trust one another. They could also more easily sanction someone who betrayed that trust. Seldom did people lend to strangers. So, as we will see in later chapters, U.S. banks in the early nineteenth century often loaned money to people who were "connected" to the bank in one way or another: borrowers were friends of someone on the board of directors, or related to someone on the board, or had a similar connection. Direct knowledge of a person, or knowledge of their reputation within a community, allowed lenders to assess the personal character of the borrower and decide if that person were trustworthy enough. Historians have acknowledged the importance of social ties for access to credit in the past (Earle 1989; Hancock 1995; Lamoreaux 1994; Muldrew 1998), but today social connections still make a difference for business lending (Uzzi 1999). On the personal side, if someone today needs serious help, they are most likely to get a loan from a family member (Furnham and Argyle 1998: 190).

Starting in the middle of the nineteenth century, however, evaluations of trustworthiness began to change. The shift started in the wholesale sector and concerned trade credit. As the U.S. economy became a truly national economy, dry-goods suppliers based in New York City were increasingly shipping their wares to other parts of the country, without having much, or even any, personal knowledge of their customers. Suppliers typically shipped goods to their customers and received payment in one or two months' time, and so in effect they extended credit over that period. So suppliers had to figure out who was trustworthy. If they extended credit to everyone who wanted it, they would lose money, but if they gave credit to no-one, they wouldn't have any customers. And as trade expanded out of the immediate geographical region (in part thanks to an improving transportation system), suppliers couldn't rely on their social networks to help them. But help was on the way in the form of credit rating agencies, which gathered information about businesses all over the country, kept detailed files, constructed credit assessments, and then sold their assessments to customers who wanted to know whom they could trust.

Credit rating agencies, the precursors of today's Dun &

Bradstreet, grew rapidly and by the end of the nineteenth century were rating over a million firms nationwide. They even expanded overseas. The information they developed for assessing creditworthiness was impressive enough to be used at the end of the nineteenth century by commercial banks, as they established their own credit departments, and insurance companies, as they estimated the risks associated with credit insurance. When the bond rating agencies (the predecessors of today's Moody's and Standard & Poor's) began to rate railway bonds, and later corporate bonds, in the early twentieth century, they adopted the same basic idea. And later in the twentieth century, firms began to issue credit scores for individual consumers (consider the now ubiquitous FICO score[1]). As anyone who has applied for credit knows, these scores are highly consequential. In fact, they are so important that some firms will help consumers "repair" their damaged credit scores (for a fee, of course). Without a high FICO score, it is more difficult and expensive for an individual to borrow. Insurance companies have even started to use FICO scores to price the products they sell to consumers (a low FICO score can mean higher automobile insurance premiums). In many different ways, creditors at all levels have shifted away from using social networks and personal connections when they assess the creditworthiness of debtors, and increasingly rely on impersonal, quantitative evaluations generated on the basis of large-scale data sets.

The methods and institutions developed in the Anglo-American world to allocate credit faced new challenges when other parts of the world adopted market economies. Guseva (2008) shows how the credit card industry has grown in post-communist Russia. A number of the techniques successfully used to encourage the widespread adoption of credit cards in the U.S. during the 1960s simply do not work, and so card companies have had to figure out other ways to determine who in the new Russia is creditworthy. Transplanting financial institutions from one country to another is not a trivial task, even when the basic problem (whom can you trust?) is essentially the same.

Another very important historical change concerns financial and monetary regulation. Governments have always played a central role in the creation of money, from issuance of gold coins at the royal mint to printing Federal Reserve bank notes. Governments often helped to establish financial markets, like stock exchanges, when they had to borrow on a large scale (Carruthers 1996; Ferguson 2001). Government has also played a changing role in the regulation of commercial banks, investment banks, credit unions, savings-and-loans, and other financial institutions, and in oversight of financial contracts (to protect borrowers from usurious or predatory lenders, to ensure that pension funds and insurance companies invest prudently, etc.). The level of public scrutiny over the financial system has waxed and waned, and hasn't gone in any one simple direction. Even when the financial sector goes through a period of sustained deregulation (such as happened in the U.S. during the 1980s and 1990s), the state still plays a role. And since economic crisis often motivates further change in regulation, it seems likely that before the U.S. has fully recovered from the current recession, there will be some federal re-regulation of the financial sector. After all, the Great Depression of the 1930s resulted in a lot of new public regulation and oversight in the form of the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the Federal Housing Administration (FHA). Many of these institutional innovations were the centerpieces of public policy intended to support particular kinds of credit. Indeed, it is important to remember that the aim of many regulatory interventions was not to extinguish or curtail market activity – quite the contrary – the aim was to encourage it. For instance, the goal of "Fannie Mae" (the Federal National Mortgage Association, founded in 1938) was to increase mortgage lending so people could purchase homes – a process that was encouraged by regulation.

Ideas about Money

One of the interesting things about money as a social institution is that because it is so old (if one starts from its original form as