

## ADAM SMITH: THE INVISIBLE HAND OR CONFIDENCE

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### SUMMARY

In 1776 Adam Smith raised the matter that an invisible hand was the one which moved the markets to obtain its efficiency. Despite in the present paper we are going to raise the hypothesis, that this invisible hand is in fact the confidence that each person feels when he is going to do business. That in addition it is unique, because it is different from the confidence of the others and that is a variable nonlinear that essentially is ligatured to respective personal histories. For that we are going to take as its bases the paper by Leopoldo Abadía (2009), with respect to the financial economy crisis that happened in 2007-2008, to evidence the form in which confidence operates. Therefore the contribution that we hope to do with this paper is to emphasize that, the level of confidence of the different actors, is the one which really moves the markets, (therefore the economy) and that the crisis of the subprime mortgages is a confidence crisis at world-wide level.

**KEY WORDS:** Confidence; Crisis; Adam Smith; Invisible hand.

### INTRODUCTION

The financial economy crisis that began to be felt at the beginning of 2008 in the United

States of North America (USA), and that ended up affecting, in one way or another, the world-wide economy, put in evidence the importance of the relationships in which to establish a confidence bond which is the form to do business, which was demonstrated by Adam Smith himself when he expressed that

Business and the manufactures seldom can bloom a long time in any state that does not enjoy a regular administration of justice, in which the people do not feel safe in the possession of their goods, in which the faith of contracts is not compatible with the law. [Smith, 1776a, P. 1227] <sup>(1)</sup>

Or Pedro Kropotkin in 1900, when he said,

Speak to a man who knows the business, and he will tell you that the changes operated every day between businessmen would be of absolute impossibility if they did not have as a base the mutual confidence. The custom to fulfill his word, the desire of not losing credit, is wide enough to maintain that business honesty. [Kropotkin, P., 1995a, p 38.] <sup>(2)</sup>

In these commentaries we find the key, which for not being respected, took to the world-wide economy to the crisis situation that determined the bankruptcy of very prestigious institutions in the financial world. It is important to emphasize that the cultural and ethical values presented at the time of establishing a business like “the custom of fulfilling the promised word, the desire of not losing the credit” [Kropotkin, P., 1995b, 38 P.] <sup>(3)</sup> are of extreme importance in our analysis, thus, we are going to consider that all of them, really constitute, the attitude of the actors that allows to maintain that commercial honesty and that in the present paper we will denominate as the mutual confidence.

It is important to emphasize that in Adam Smith’s paper, the existing relation between the social dimensions and the economy of the human being is put in evidence. In his Theory of the Moral Feelings, it takes as it bases the affection and the social responsibility uses and them to put in evidence the moral feelings among which are justice, virtue, resentment, revenge, admiration and corruption. Which puts into evidence among other things, Smith’s belief insofar as man can as much be it good as bad. That is, the people present an individual moral dimension and another social one, which manifest themselves in their interaction with the media. Therefore when making the question with respect to “Which is the reward more adapted to foment the industry, prudence and circumspection”? He responds “to the success in every kind of businesses”. [Smith, A., 1984a, p167] <sup>(4)</sup>

According to Adam Smith (1984) morality has its origin as long as the fact that the

surroundings approve or disapprove, the different actions therefore “the practice of truth, justice and humanity is a certain method and almost infallible to acquire virtues mainly of those that they have as objective, confidence and love of those who surround us” [Smith, A., 1984b, p167.] <sup>(5)</sup>.

It is there where they place the bases of the economy dimension that is manifest in later papers like *An Inquiry into the Nature and Causes of The Wealth of Nations* (1776) and in *Lectures on Jurisprudence* (1782). Adam Smith also emphasizes the personal values that influence in the businesses when he comments on the *Theory of the Moral Feelings* with respect to the different professions which,

The success of these people, almost always depends on the favor and good opinion of their neighbors and peers, and without a sufficiently common behavior these very rarely can obtain it. The old and good proverb, therefore, that honesty is the best policy, is in this kind of situations, almost always perfectly certain. In such situations generally, a high degree of virtue can be expected and luckily for the moral of society, these are the situations that prevail in the immense majority of humanity. [Smith, 1984c, p 63] <sup>(6)</sup>

After two centuries from his death Adam Smith is still valid, when showing that his warnings in which excesses can be committed, still conserve the strength of when they were raised and therefore one requires a control that prevents that a few benefit at the expense of the rest.

The most interesting matter of the crisis lived was that Hyman Minsky an economist not very well known in his time had anticipated it. Even more when between 1946 and 1966 everyone was enjoying an apparent calm and attributing the small differences

to the adjustment errors by which those which maintained that the fiscal intervention was necessary (Keynesian conventional) or to errors of control of supplying money on the part of those who maintained that the fiscal intervention was not necessary (the emergency monetarists). None of these two rival schools of analysis and advising on policies, accepted that there are economy processes within the capitalist economy, with a sophisticated financial system, that tend to generate at first inflationary expansion and then the propitious conditions to the financial instability. [Minsky, 1986, p 45] <sup>(7)</sup>

I. e., that the combination of a relative calm and a bad interpretation of the effective economy reality, made the economists not to consider the surging of a possible financial instability and therefore, neither organizing the Federal Reserve as moneylender of last resource. Therefore, the relax produced by the apparent calm prevented to see that a financial instability era and so, neither did they prepare themselves to face it should it occur. As a result of his research Hyman Mynski raised two theorems with respect to the financial instability,

The first theorem of the hypothesis of financial instability is that the economy has financing regimes by virtue of which it is stable and financing regimes in which it is unstable. The

second theorem of the hypothesis of the financial instability says that during prolonged periods of prosperity, the economy goes through financial relations that take it from being a stable system to financial relations that make it an unstable system. [Minsky, 1992 P. 7-8]<sup>(8)</sup>

Therefore the hypothesis of the financial instability (that is applied to the capitalist economy), has a cycle that begins in some change or disturbance, as the time that it appeared in the case of dot com or the case that interests us in the present paper, the increase of the value of properties. Which generated an improvement in the economy, that brought about the entrance of speculation, the one that persecuting and encouraging the growth of real estate value and the confidence of the investors, facilitated the soft credits and the financial instruments not controlled correctly, until the bubble exploded and the loss of confidence took place that resulted in the confidence crisis that moved to the globalized world. (Minsky1992).

An example of institutions of world-wide prestige, that fell into problems for not considering, among others things, Adam Smith and essentially to Hyman Minsky, one finds the Merrill Lynch Bank, one of the major financial institutions of the world that provides banking services of investment and management of assets, to all kind of clients (people, enterprises and institutions). Its portfolio of medium and small clients ascended to more than 59 million consumers with more than 6,100 offices of retail banks, near 18,000 automatic tellers, it is present in 150 countries, or the Bank Lehman Brothers, that was founded in 1850 and established itself as one of the four more important banks of the USA.

In agreement with what presented by Kropotkin (1995), Minsky (1992) and Smith (1984) everything begins with a crisis of ethical values on behalf of the actors, those that are pronounced in attitudes as for example, the non-fulfillment of the promised word and that concludes in the financial crisis, that is not another thing than the result of having violated the confidence of the investors. This crisis was provoked when the investors realized that the word in which they had been trusting for years no longer had value, and therefore that bond of trust was broken that had maintained them together, such as the investors with the financial institutions. It is possible to emphasize that this confidence is not a linear variable, I. e., that, according to Gache and Otero (2010) whenever the level of permeability changes to the risk, to a person, institution, etc., it is not going to respond in the same way, nor is it possible either to expect two people (although they be twin brothers), to react in the same way facing the same stimulus. Therefore, if the behavior of a

single person or institution cannot be predicted, with what criterion can the behavior of a market be determined? Facing this limitation, it is important to put in evidence the fundamental roll that a present State must fulfill, in the control of the regulation organisms, as a way to guarantee its financial economy security.

But this is not new. Confidence is and has been the element that is been present whenever the people met to satisfy their needs interchanging products and services.

Then who proposes to another a treaty, is doing one of these proposals. Give me what I need and you will have what you wish, is the sense of any class of offer, and thus we obtain from the others most of the services that we need. It is not the benevolence of the butcher, the brewer or the baker the one which gives us our food, but the consideration of their own interests. We do not invoke their humanitarian feelings but their egoism; nor do not speak to them of our needs, but of their advantages [Smith A., 1776b, p.31] <sup>(9)</sup>.

I. e., That the actors of the interchange, must have a level of acceptable confidence with respect to each other, insofar as they are going to receive the satisfaction factor which they are looking for at the time of the transaction. In case some of the parts do not consider the counterpart reliable or that the product or service to be received does not satisfy the minimum requirements took that it took to negotiate, in conditions of freedom, the business relationship is broken. When we say conditions of freedom, we make reference to what was exposed by the 1998 Nobel economy prize Amartya Sen when talking about to the perspective of freedom, express that,

Development demands the elimination of the main sources of freedom deprivation: poverty and tyranny, the systematic shortage of economy opportunities and social deprivations, the abandonment in which the public services and the intolerance or the excess of intervention of the repressive States [Sen A., 2000, p 19] <sup>(10)</sup>.

### **Confidence as a nonlinear variable**

Of our studies of basic physics we know that in a linear relation each given cause responds with a single effect, I. e., when talking about a linear effect we are referring about a system that obeys the property of Superposition: If an entrance V produces an exit W, and an entrance Y produces an exit Z, then an entrance V+Y will produce W+Z.

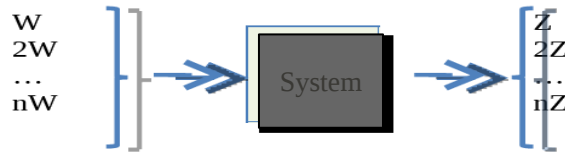
Which means that for example, if we took the case of a pendulum at rest, to which we apply a force W to it, we will obtain an oscillation Z<sup>1</sup>. If then, to the same device, once at rest, we applied a force 2W to it, the exit answer is going to be an oscillation 2Z, I.e. proportional to the magnitude of

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1 We are referring to a pendulum with small oscillations, I. e. a pendulum which can be described with a dynamic equation that can be made lineal

its entrance. Those criteria imply that a linear system will not produce exits which have not been generated proportionally with an entrance.

Figure 1: Linear System



Source: own elaboration

On the contrary, reality locates us

in circular surroundings in movement. Each action is based on present conditions and the actions affect future conditions, so that the modified conditions become the foundation of later actions. There is neither beginning nor completion of the process. The refeeding curls interconnect to the people between they themselves. Each person reacts before the echo of his passed actions, and also before the actions passed of the others [Forrester, J., 1998a, 2 P.] <sup>(11)</sup>.

From 1920, year in which the General Theory of the Systems settles down as a discipline, and to the death of Ludwig von Bertalanffy in 1972, this author studied and raised the bases that given sustenance to the systems in general form, since it is possible to be applied to any set of elements that present/display an interaction among them. (Bertalanffy, 1962; Rappoport, 1985).

He is interested at this moment to put in evidence that within the systems studied by the General Systems theory there can be made one first social classification in physical systems and systems, and that

People are obstinate to think that the physical systems and the humans have the same nature. Although the social systems are more complex than the physical, they belong to the same class of systems highly organized, fed-back and nonlinear than the physical systems [Forrester, J., 1998b, P. 1] <sup>(12)</sup>

On the other hand, the relations that settle down within the social systems are determinants of the behavior of the people that form that it, so

The concept of systems contradicts the belief that the people act in a totally free way. In fact, the individuals are deeply sensible to the changes in their circumstances [Forrester, J., 1998c, P. 1] <sup>(13)</sup>.

This commentary of Jay W. Forester, makes us to think that the social systems are complex systems, because the actions that arise as a result of the degrees of freedom of some affect those of the others and vice versa and. Therefore

A system is a perceived totality whose elements 'agglomerate' because they are affected reciprocally throughout time and they operate with a common intention. The word derives from the Greek verb *sunislánai* that originally meant to 'cause a union'. As this origin suggests, the structure of a system includes the unifying perception of the observer. [Senge, et al, 1995a, p 94.] <sup>(14)</sup>.

In this way we can take as complex systems

the living organisms (including the human beings), the atmosphere, diseases, ecological niches, the factories, the chemical reactions, the political organizations, the communities, the industries, the families, the equipment and all the organizations [Senge, et al, 1995b, p94 ] <sup>(15)</sup>.

In the complexity of the treatment between the human beings the construction of confidence is obtained by means of the sum of messages that a person sends to another one in reiterated form, without putting a limit. But this message is interrupted or it changes, so that the receiver perceives a negative connotation, automatically it destroys the enchantment, since the confidence is very ligatured to believe in the other part, assuming that it will fulfill the promised word, it will act honesty, etc., responding to the counterpart with actions similar to the received ones (Jackson, 1980).

According to Stephen Covey and Rebeca Merrill, (2006) when there is confidence the businesses acquire speed, are more transparent and costs are reduced. This statement expresses the linear mathematical one, by means of the basic principle of businesses, where it considers that to be able to obtain good results it must count on two fundamental elements such as their Strategy and Execution. Which allows us to infer that if we have a good strategy and this strategy is implemented by means of a brilliant execution there exists a great possibility of obtaining excellent Results. This is expressed in fig 2

Figure 2 Relation Strategies, Execution, Results

**(↑) Strategy x (↑) Execution → (↑)Results**

Source: Own elaboration as from Stephen Covey's The Speed of Trust

But is it applicable to all the cases? Does it always fulfill that to equal strategy and execution the same results are obtained? We all know by our own experience that in spite of reproducing exactly the same strategies and executing them similarly, the results are hardly equal. This is due that according with what mentioned beforehand, the enterprises behave like complex systems that

adapt to the environment, in which there are variables nonlinear like Confidence, which put in evidence out of proportion effects when there are almost imperceptible stimuli fig 3.

Figure 3 Relation Strategy, Execution, Results more Confidence

**(↑) Strategy x (↑) Execution x (↓) Confidence → (↓↓↓) Results**

**(↓) Strategy x (↓) Execution x (↑) Confidence → (↑↑↑) Results**

Source: Own elaboration from Stephen Covey's The Speed of Trust

Briefly, confidence means security. The opposite of confidence is distrust (l. e. suspicion), which is put into evidence for example when the recent person in charge of an area, must choose the people are going to be under him.

But why we so emphatically affirm the non-linear of the confidence factor. Society and in particular the world of economy moves like an intricate network of basic elements that interact one with another. It is that aspect of intercommunicated network that gives the economy a strong similarity with the behavior of other complex systems, as for example the social insects: ants, termites, bees, etc. Nevertheless the interconnection that in those insects generates a spectacular order, in structure as in functioning is not indeed the case of the world of economy. The difference resides exactly on the subject of confidence. The behavior almost mechanic of each member of a swarm, ensures the generating cooperation the venture. The quota of free will in bees or ants is nonexistent and the confidence concept is genetically implicit. Obviously the same does not happen to the intervening parts in the economy processes. The last subject is the individual that characterizes himself exactly by his free will. On the base of that free determination the subject can (or not) maintain the confidence of his cooperation in the system. If he maintains the confidence, the behavior of the complex system will be ordered like a honeycomb or an anthill. If the lack of confidence extends the complex system it can end up in a chaotic behavior. Both limits are within the expectations for a nonlinear system.

### **The confidence crisis**

The nonlinear condition of confidence, usually causes that everyday facts can derive in chaotic situations with terrible consequences, as is the rumor of a possible new "corralito"(a



financial corral) in Argentina, can generate a bank run that can bankrupt banks or very solid financial institutions. In the case of Argentina, the condition of instability is reinforced by the turbulence of the markets and the lack of legal security.

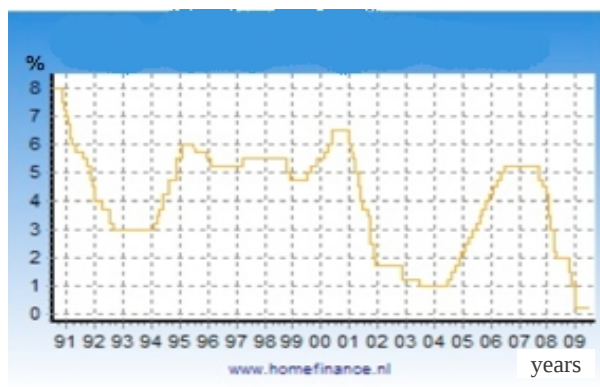
Therefore that is why it is interesting to use concepts related to the chaos theory and by virtue it is useful, already the famous phrase that the meteorologist Eduard N. Lorenz, raised as a title for the conference that he gave in Washington in 1972, "Does the flap of to butterfly's wings in Brazil set off to tornado in Texas" [Lorenz, 1995, 14 P.] <sup>(16)</sup>. We are going to show how, in the case of the crisis of 2008 that also a small cause, as a variation similar to the one already done on other occasions by the Federal Reserves System (well-known also as the FED), in the interbank interest rate in the United States of North America, was fulfilled that (USA.), unleashed a series of events that for not respecting the values that give strength to confidence, as much as internal as external level of the institutions, produced a terrible effect, and which was a consequence of the nonlinear character of confidence.

It is possible to emphasize that by the clarity of concepts shown with respect to the crisis, we are going to take as its bases of the analysis of the crisis, Leopoldo Abadía's book (2009).

The fluttering of the butterfly (beginning of 2008 crisis) took place because the USA banks saw their gains diminish as a result of a loss of the price of money on the part of the Federal Reserve.

Although the Federal Reserve of the USA, already had experience in overcoming crisis, since in the last decades it had faced two recessions, the one of 1990 that it solved as shown fig 4, taking to the short term interest rates from 9% to 3% and the one of 2001 in which applying the same strategy it took the interest rates from 6,5% to 1%, managing to stabilize the situation again.

Figure 4 EDF - Rate of Federal funds from 13/07/1990 to the 26/06/2009



Source: <http://www.homefinance.nl/algemeen/informatie/amerikaanse-rente-fed.asp>

When in mid 2007 once again there was a recession situation, the Federal Reserve, trusting that it knew how to solve it, wanted to use the same successful strategy in the previous occasions, by means of the reduction of them short term interest rate from 5.25% to almost 0%.

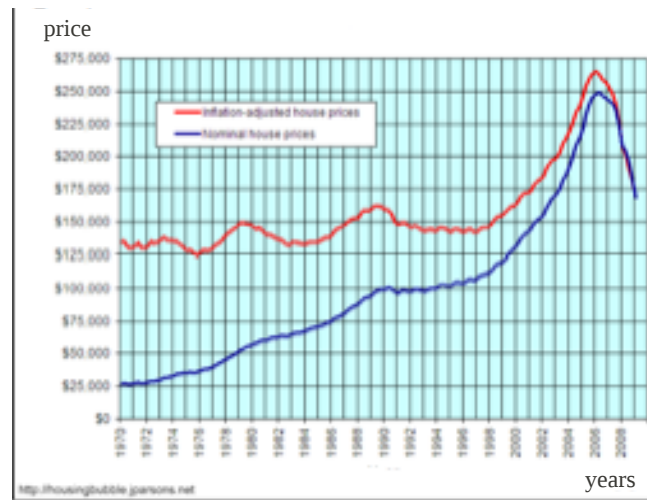
But this lowering did not give the awaited result. Since this would cause that the investing banks would accumulate cash, instead of generating real loans.

So at the end of 2008, with interest rates, basically to the value that Macroeconomists calls limit inferior to zero, as the recession continued deepening itself, conventional monetary policy had lost all possibility of action". [Krugman P., 06/09/2009] <sup>(17)</sup>.

But the financial market is extremely dynamic to the point of not being able to lose a moment, because time is gold and every minute that is lost can represent a loss for the shareholders or investors. Therefore, the bankers to compensate this loss of gain looked for in the market what papers that were registering raises and detected that from 1991 the value of the properties was in increase and especially in 2007, in agreement to fig 5 the growth slope was important.

From the point of view of confidence, the business seemed solid and it would allow them to avoid losses. Thus, they trusted that if offered a great amount of loans for mortgages that would facilitated the purchase of new houses, they could do good business. But ambition was even much more, if they used the risk as a lever, then generating mortgages with a greater risk level to the habitual one, this would allow them to acquire a higher interest, consequently the business would be more interesting

Figure 5 Price of the houses in the United States of North America 1970-2009



Source: <http://mysite.verizon.net/vzeqrguz/housingbubble/>

This was the moment in which they began to move away of the confidence scheme in which they had been operating and therefore they began to be more permeable to risk, since the organizations of regulation of the investment market failed, those that they were created to guarantee the security of the investments and therefore to maintain the confidence in the system.

With a view to diminish this permeability, one would be due to have consulted to the investors before assuming it, so that each had the possibility of accepting it or of rejecting it.

With the aim of not losing the opportunity to increase the dividends, the strategy was put into practice to offer a great amount of loans for mortgages, which facilitated the purchase of new houses, with a greater risk level than the habitual one. It was interesting to know that by virtue of the determined objectives, the strategy chosen qualified them to acquire greater interest; consequently they could recover the gains non-obtained by the loss of the interest rates.

The problem of how to obtain it? was in which the gains would take advantage of the increase in the values of the properties, so as to put in the market mortgages that would be destined to the ninja (no income, no job, no assets) (Abadía, L. 2009), i. e., it would be offered to people who did not have an income, nor fixed jobs and did not have properties either.

For the banking institutions, although they were more permeable to the risk, serious problems were not seen in the short term. I. e., the idea functioned very well, then, in addition it was allowing the weakest people (economically speaking), to accede to solidify their position in society and market.

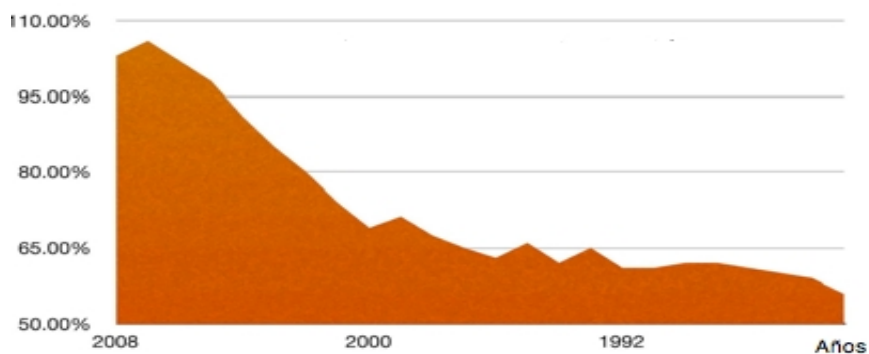
But, supported by the confidence granted by the investors, (who did not know the reality of the facts), they returned once again took a step towards the abyss, tempted to get greater gain in the business. Based on the increases that the real estate market presented, they decided to offer to the real estate market subprime mortgages<sup>2</sup>, which granted values superiors to those of the goods to be acquired. The reason of this strategy, was based on considering that as the real estate market was in ascent (before 2007), the value of the properties were going to increase, within the term of the credit, in an amount higher to the loan amount. Therefore, besides the house, (and very possibly also in terms), some bought a car, adapted the house to their needs, went off on vacations, etc.

From the optics of the confidence of the people who acquired the long term mortgages, they were betting very strongly, which generated in ninjas a confidence sensation went on increasing, because every time they were in better situation, in agreement with what shown in fig 6.

It is important to highlight that the strength of this strategy was in that the takers of mortgages (risk investors), were temporary workers who had the possibility of taking jobs (opportunities) in the labor market, which determined a very interesting competitive advantage because temporary jobs were obtained and of that form the quotas of their mortgages could be paid.

It is possible to remember that the true strength of the strategy was based on the capacity of the risk investors of being able to pay the quotas of their mortgages and since there was work and confidence reigned, the future was promissory.

Figure 6 % of Mortgages in USA versus the GDP between 1985 and 2008



Source: <http://brucekrasting.blogspot.com/2009/04/us-mortgage-market-20002008-follow.html>

2 The subprime mortgages, are those mortgages which have a certain non payment risk and receive on an evaluation of 850 points, a value which oscillates between 620 (the not so good) and is very low. Its value in the same scale oscillates between 850 points for the better ones and 620 for those which are not so good.

## **The tornado begins to be generated**

At first everything functioned correctly, because the risk investors, making use of their strengths, put in evidence opportunities (Otero and Gache, 2006) in the labor market and in that way they managed to pay the quotas of their mortgages. But the situation of apparent calm and favorable winds like on the high seas can change at any time. And in this case, said stability was very precarious because it depended on the non modification of the conditions of the environment (real estate market in ascent). In other words, the confidence put on the mortgage system was taken to the limit of confidence placed on the subprime mortgages and therefore every time the permeability level rose, towards the risk.

But, the good acceptance that the mortgages put in the market had, evidenced a weakness of the banks that quickly were transformed into threats. Since the money that the banking institutions gave the ninja, diminished their reserves and therefore increased the risk level of not observing the banking safety rules fixed in Basel by the Basel Committee on Banking Supervision (BCBS) (BCBS, 2004).

Following what presented by Avila (2009), the situation began to worsen because these mortgages were accepted by a great majority of ninja, because in this way, for being people with limited resources, they saw their social economy situation improve. Which, on the other hand, allowed them to improve their self confidence.

Up till there went well, but the amount of money that had to be distributed by the banking institutions, did that these, saw diminish alarmingly their reserves losing the security determined by the agreement of Basel and it therefore forced them to resort to other banking institutions that allowed them to recover their stability (some from other countries), and so in fact the situation was being tightened up, because every time there was a greater number involved.

What in fact was really happening was that although, in agreement with the Norms of Basel the financial organizations that operate with deposits on sight had to conserve a minimum reserve of capital, that had to be in relation to its assets, the Investment banks<sup>3</sup> were not reached by these.

But as the generating banks of the subprime mortgages carried away by the avalanche of orders of

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<sup>3</sup> Investment Bank: is the one which designs and executes the Acquisition Public Offer (OFAS), issuing bonds, large financial transactions between enterprises, etc., they must not be confounded with Commercial Banks.

mortgages, had given away more money than what allowed, were exposed to being sanctioned for violating these norms of security and confidence. Therefore they had to request money to be able to compensate for that which had been given to the risk investors. Therefore these banks, with the object of covering this flank, that began to leak, generate a Securitization, that consists of packing the mortgages making a mix between the primes and sub primes and they call them Mortgage Backed Securities, (MBS) that is, Obligations Guaranteed by Mortgages. In other words, what they have done is what is usually done in businesses in which one needs to remove merchandize that does not have exit, joining them with those that have exit, making special offers.

But the true problem was that it was playing with the confidence of those institutions, when not informing them the true bases by which they had to go out to request loans that endorse their operations, and therefore making them share in an unknown risk.

All this made that the level of permeability to the risk was increasing (the tornado continued being stronger). Now the interesting thing was to determine who would buy such an offer? In order to ensure their sale, the banks generated conduits, which are not more than special branches of the same banks, that as they do not have to fulfill the regulations to consolidate their balance with Central Offices, they were freed of being controlled and therefore free of confrontation. Said conduits, bought the MBS asking credit from other banks or selling them by means of investment funds, financiers, etc., every time involving more people who did not have any idea of the problem in which they were entering, because they trusted the organization that offered them the opportunity to invest, which was as well the institution with which they were doing their investments for some time. Again the level of permeability to the risk takes place, another turn of the tornado always increasing, with the aggravation that the investors did not know the reality of the risk run.

But it is possible that there does not exist a way to avoid this type of maneuvers, an institution that verifies the trustworthiness and helps the investors to diminish the permeability to the risk? Well, yes, they exist and are known as rating agencies<sup>4</sup> that are the ones in charge to qualify the conduits, the MBS and other papers and institutions, giving to the investors a measurement of the trustworthiness.

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4 RATING. Credit qualification of an Enterprise or Institution, made by a specialized agency. In Spain the leading agency on this matter is Fitch Ratings.

However, some banks, by means of the financial magicians could wash their face of the MBS generating groups or sections of MBS to which they gave the name of tranches<sup>5</sup>, in which they gather or group the MBS with relatively good qualification, those that they are more or less and those which are very risky or bad. I. e., they played with their confidence (they camouflaged), so that the ratings agencies had a good image and emitted their qualification by virtue of that. However, as if this were little, the financial magicians continued generating other financial products, to which they put names like Collateralized Debt Obligations, (CDO), or Credit Default Swaps, (CDS) or Financial Exchanges for Unpaid Credits, etc.

In this way the rating agencies qualified as reliable to products that in fact were not, causing that more and more trusting investors put their savings in the institutions that had gained their confidence by virtue of years of operations with low permeability levels of risk and that these, by trusting the rating agencies gave very cheap banking credits to be able to buy them.

It is possible to emphasize that at this point, the bubble was already very big and the only thing that was maintaining it, was the ninja capacity of payment.

Summing up, as a result of a loss of interest rate in USA at the beginning of the new millennium, the financial market, looking for an alternative way trusted the real estate market, which by the law of supply and demand made the value of the properties increase, therefore the banks stimulated by the possibility of obtaining benefit from this increase, generated a line of hypothecating credits of subprime risks, that granted a greater amount of money than required to buy the house, considering that the raise in prices of the properties that served to them as guarantee, would compensate said extra. As a form to present an image of security to the subprime mortgages, the banks, by means of financial magic emitted great amounts of MBS that are not another thing than negotiable titles whose endorsement was the same subprime mortgages. It is possible to emphasize that they had a great acceptance in the USA, Japanese and European markets.

It is very simple to see the effect that the fluttering of a butterfly in the USA, produced in Europe, especially in Spain, Germany and in Greece. In fact what has happened is that the

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<sup>5</sup> One of the several parts or sections in which connected values are offered at the same time and that generally has different risks, reward, and/or characteristics of the maturity.

financial system has generated the infectious virus of distrust and a world-wide pandemic has broken out.

### **The tornado begins to devastate**

When in the USA as from the end of 2006 and beginning of 2007 interest rates, began to recover (fluttering of a butterfly) the demand of houses fell, their prices lowered and a great amount of ninja took became conscious, that the real value of property, now cost less than what they were paying. Therefore the subprime mortgages now no longer were endorsement for the emitted titles and most serious still, it is that with them the financial markets of Japan and Europe had been saturated.

This reality, caused that ninja could not (or did not want) to continue paying their quotas. Which made it evident that possible investors, for want of endorsement and credibility (confidence) did not ask for them, they would they accept nor them from their investments advisors and the possessors of the different titles emitted, could not get rid of them.

This it was the moment when distrust began to expand and the people who up till now accepted the advice suggested by their investment agents, no longer would let themselves be taken so easily and the same happened between the banks, since this deceit took them by surprise in their good faith, since it has attacked and violated the credibility of the bankers and the investors, forcing all to fall back and to begin to watch several times an offer before making a decision, since as the popular Spanish saying says, one burnt with milk, when he sees a cow he cries.

In other words a crisis of confidence broke out, forcing the investors to take refuge in the places of maximum safety or confidence.

Following with the analysis presented by Abadía (2009), one had reached at a real crisis of confidence as, the banks began to doubt all the operations that they had done, to the point of not being able to guarantee the minimum level of confidence of the packages of mortgages that they themselves had acquired. Even more serious of all is that in fact, neither private nor public investors could know true state of risk in which they were, because it was like a virus that had gone into all corners, even the deepest.

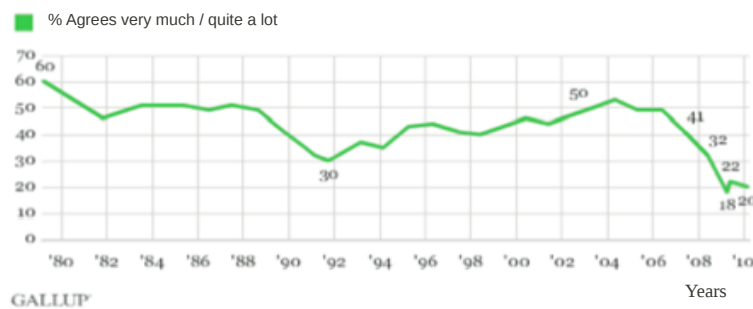
We can see that in that situation of total chaos, nobody really knew where they were standing



and what happened was that facing the total lack of confidence the different investing types, banks, financiers, people (physical and legal), acted in response to a stimulus that, in this case was a serious risk, that generated all the time greater distrust.

It is interesting to see the result of the survey that the Gallup consultant carried out from 1979 to 2010, with respect to the confidence that the North Americans have in their banking institutions and how this confidence was weakened at the moments of crisis. In fig 7 it is observed that the clients' vision with respect to the trustworthiness of the banks is very ligatured to the crises that continued developing during those years, putting in evidence the close relation that exists between confidence and businesses.

**Figure 7 Tendency of Confidence in Banks between 1979 and 2010**



**Source:** Americans' Confidence in Banks Remains at Historical Low Gallup

<http://www.gallup.com/poll/127226/Americans-Confidence-Banks-Remains-Historic-Low.aspx?version=print>

In this case we are using the perception that the clients of the USA banks have respect to the banking institutions with which they operate. It is interesting to emphasize that one can detect at first sight the different crises that have marked the users of the banking services from 1979 to the present.

In fig 7, the results obtained by the Gallup consultant have been registered respect the confidence that the public of the USA, has in the banks. In the same it is possible to see that the confidence drops from 60% to 47% due to the recession that had its beginning in July 1981 and lasted almost a year and a half ending in the month of November 1982.

The other great drop of confidence took place in the 90-91 crisis in which it reached a minimum of 30%. It is important to emphasize the value of 18% to which the Americans mortgages crisis reached the level of confidence of in the subprime crisis. This survey of the Gallup consultant really evidences that the economy crises are in fact, as we have been saying in this paper, true

confidence crises.

Similarly the different people, enterprises or institutions, grouped in the classic Supply and Demand, studied in the economy courses, at the moment in which they are in the market, operate in agreement with the level of confidence inspired by their business counterparts, the surroundings, the history of previous transactions, the requirements that each one has taken to the market, etc. I. e., in fact each one of the different actors which take part in the business, is going to present a unique level of confidence.

Therefore independent of the level of supply and demand, who fixes the concretion or not of the business, is the level of confidence that each one of the actors experiments at that moment. It is possible to emphasize that when we say confidence level we are involving in said concept the sum of principles that belong to each person and therefore they become evident whenever they decide or they take action from their respective job posts. Then although the parties (supply and demand), arrived at the market with a determined expectation, the concretion of the business will be possible if and only if, the confidence level manages to be greater than the level of involved risk.

In fact the different actors from a business are moved by their personal good and therefore they are neither rational, nor the market is so perfect. Adam Smith in 1776 said with respect to the person who operates in the local market, that in fact he is looking for his personal interest and that, the fact to be choosing to do business within his country, is not another thing than to satisfy the necessity to obtain a better situation, for him as for his surroundings,

and it is in this case, like in many other cases, lead by an invisible hand to promote an end that did not comprise part of his intention. .... When persecuting his own interest, he frequently promotes the society one, more effectively than if he really had the intention to promote it [Smith A., 1776c p234.]<sup>(18)</sup>.

Talking on the subject with Professor Mg Juan Carlos Viegas, he referred us to a very interesting analogy with respect to the invisible hand, hat we would like to present, due to its clarity and proximity to the central subject of the paper. He says that, the hand has five fingers and that in this case those fingers are ethics, word, honesty, regulations and confidence.

Despite this and by virtue of the presented matter, it is our opinion and the hypothesis that we are presenting, that the invisible hand is in fact the confidence, which really, constitutes in the representation or sum of all these values, thus we will reframe the fingers so that these are, ethics,

word, honesty, integrity and results. Which that are in agreement with the expressed moral dimension in Smith's papers.

Following with the metaphor, there remains an element that must regulate that hand and the brain, which in the majority of the cases, determines that the actions carried out are within the margins of the promotion of the interest of the society, function that the State must regulate through the competent Organisms and that under no situation can be abandoned.

It is possible to emphasize that the expression the invisible hand is used by Adam Smith on other two occasions besides the mentioned one, in the Theory of the Moral Feelings (1759) and in the History of Astronomy (1795), although in each of these publications in different form. According to Mark Thornton (2006) and as a form to look for the possible influences that made Adam Smith to raise his already famous metaphor, exposes that Richard Cantillon's 1755), paper *Essai sur la Nature du Commerce en Général* was the inspiring source and guarantees it referring that Smith himself in repeated opportunities names it in his paper of 1776.

The fame of the invisible hand has provoked that a great amount of authors overturn their interest in the interpretation that Smith has given to the invisible hand. According to Mark Thornton (2006), the subject has presented sufficient interest so that the publications *American Economy Review* (AER), *Journal of Economic Perspectives* (JEP), and *Journal of Political Economy* (JPE), give place to different authors to publish their papers in which the metaphor of the invisible hand was put in evidence. Only to the effect to put them in evidence, since their more complete analysis is part of a paper in research stage, the papers of GRAMPP, William D (2000). can be mentioned as an example. What Did Smith mean by the Invisible Hand?, AHMAD, Syed (1990). Adam Smith's Four Invisible Hands, CROPSEY, Joseph. (1980). The Invisible Hand: Moral and Political Considerations, MACFIE, A.L. (1959). Adam Smith's Moral Sentiments as Foundation for His Wealth of Nations, MINOWITZ Peter (2004), Adam Smith's Invisible Hands, among others.

William Grampp (2000) raises ten different meaning for the metaphor that occupies us, the first nine have been recompiled and the tenth is his proposal. The idea is simply to enumerate them, for greater information we recommended to see his paper, What Did Smith Mean by the Invisible Hand? (Grampp, 2000), since, as we already said, the development of each one of the

interpretations with respect to our proposal comprises of a next paper. The deferential interpretations are:

- The own interest promotes the general interest: of all the possible interpretations it is the one that has more followers, and would imply that the people must have their own interest as guide.
- The commentary of Grampp on the matter is that it is not always and he backs it with examples.
- Almost at the same level as the previous one, would be the mechanism of prices: in this case he argues that it is not valid, due to the fact that as much the buyer as the salesman can decide a price, does not imply that this is going to maximize the public well-being
- The neo-Austrian vision propose by Ludmig von Mises and Friederich von Hayek is based on a system of natural freedom not shared by Smith.
- That the invisible hand is the competition, express that Smith does not say that the competition is related to it.
- Insofar as the invisible hand is the mutual benefit that arises from the interchange. Smith does not consider in his paper that this benefit is invisible
- That the metaphor does not have a real application and could be a joke is a new proposal although it does not agree with Smith's paper.
- That reference to acquisition, knowledge, habits and abilities that allow to improve the wealth level. Again, although its statement is certain, it does not bear relation to Smith's paper.
- With respect to which the invisible hand is Providence, Smith on the matter, did not make an explicit reference in the *Wealth of the Nations* (1776),
- That the interpretation in which the invisible hand, behaves like a force that serves to avoid the exit of the capital from the country, is the one that most approaches William Grampp's position, although he considers that it is not complete.
- Finally that the "invisible hand turns out to be the egoistic interest that allows to generate positive externalities tending to improve the public good" [Grampp, 2000, p451 ]<sup>(19)</sup>.

We now add our proposal by means of which one interprets the invisible hand as the confidence, because we consider that it is one of the pillars on which the interchange activity is

sustained to satisfy needs. Adam Smith himself says that this interchange begins in the egoism of each person, the one that moves on the basis of his convenience, which really has as a decision maker element the level of confidence awakened by his counterpart and the surroundings in which he has been called on operate. That is, confidence is one of the first echelon of the commercial treatment, which implies that often a very good treatment from which one can obtain an interesting gain, like a bad one in which one loses or can lose, is going to have as a filter - it passes or does not pass – the confidence generated in the parts. It is an example of the first case, somebody who wants to give a stranger a great amount of money or for the second case a son who asks his father for a certain object or amount of money.

From there it arises, that like sum of individual transactions and for the purposes of being lasting, one requires the propose moral dimension in his Theory of Moral Feelings (1984) as are ethics, the word, honesty, integrity and the results. As well as the justice, without which it is not possible to incubate confidence.

As has been shown in the in the analysis of the crisis of the mortgages, the basis of all the operations, was and will be the confidence and what is resulting difficult to recover is the moral dimension proposed by Adam Smith.

It is interesting at this moment to analyze briefly what is raised by the Nobel prize in Economy<sup>6</sup>, Hebert Simon, Amartya Sen and Joseph Stiglitz, with respect to the form in which the different actors of the market make their decisions.

Herbert Simon (1977) on the other hand, raises that the people when they make decisions they do it from an optics of limited rationality and bases it on the fact that perfect rationality by the orthodox economy does not exist, since some times the people do not have all the elements necessary to make the correct decision. On the other hand neither the system can provide all the required information. In addition he raises, that the size of the organization is an element that can make difficult the decision making, since, the greater it is, there will be a greater amount of dimensions that will make difficult the decision making, (Simon, H. 1977).

As far as Amartya Sen's (2007), opinion it is possible to concentrate that from her point of view, the attitudes of the people cannot be described using the criterion of the maximization of the 6 Nobel prize in Economy: Hebert Simon (1978), Amartya Sen (1998) and Joseph Stiglitz (2001).

utility, because if we obeyed the its guidelines, we would not be contemplating the situation of other people, nor the different capacities of those which take part. This is presented in her question,

Why must it be solely rational to follow the own interest excluding all the others? Naturally, it could be totally absurd to affirm that the maximization of the one's own interest is not rational, at least necessarily, but to maintain that in any other thing except the maximization of one's own interest it must be rational seems to be absolutely extraordinary... the universal egoism as a reality could be false, but the universal egoism as a requisite as of the rationality is evidently absurd [Sen A., 2007 p.35-36] <sup>(20)</sup>.

An interesting case as evidence is the one that arises in a great amount of cases in which the family takes part, where the level of resignation to personal benefits to the benefit of the intimate circle is put in evidence. On the base of being or not being egoistic, is that a person or group is constructed in values like loyalty to a peron, association, communities, unions, etc.

In the same way, that the economists already mentioned Joseph Stiglitz (2002), raise the matter that the person in his decision is influenced by other elements, besides the rational form defended by the classic economists, like personal elements, or referred to the enterprises with which they share certain surroundings. It then that, in the search for an answer to the questioning, with respect as to why the classic economists continue defending the total rationality, he expresses that,

Kahneman, psychologist, demonstrated that the individuals behave systematically in a less rational way than those in which the orthodox economists create. His research not only demonstrates that the individuals act sometimes in a different way from which the standard economy theory predicts, they do it, regularly and systematically, in ways that can be understood and be interpreted by means of alternative hypotheses that compete with that the orthodox economists use [Stiglitz, J., 20/12/2002] <sup>(21)</sup>.

In the same article the Nobel prize put in evidence that John Maynard Keyneses talking about "to the stock market like something based not on rational people who fight to reveal the fundamental rules of the market, but like a contest of beauty in which he wins is the one who guesses the verdict of the judges". [Stiglitz, J., 20/12/2002] <sup>(22)</sup>.

That is, the people in their activity every day in the market, do not handle this in a completely rational form, because what is moving them to decide is the reasoning, to which are added a series of elements that are going to depend on the person, their history and the surroundings.

But there are more elements than allow us to maintain the actors who move within the different markets interacting moved by forces that are far away from the proposed matter by the

defenders of the orthodox theory. Since besides being guided by the confidence level that the business generates to them under analysis then, the information at the disposal of one of the actors has a decisive influence, since all of them are different, with different histories, with perceptions that depend on their socio-economic characteristics, really in the different judgment elements that each owns then. Elements that under no circumstance are complete or consider all the possible alternatives. In addition they facilitate the people who are working, in a certain economy surroundings or for being a friend of the indicated person or by simply having been in the indicated place at the indicated moment, accede to a preferential information that allows them to obtain a particular gain, where others have not managed to make a difference or simply have lost the investment made. It serves as an example the case as the people who knew, in 2001, the imminent matter of the “corralito” (pen) and that taking advantage of this information put their money in a safe place placet. But also there were those that, in spite of being informed, trusted more their perception of the reality and they did not do anything, until when seeing the facts of public knowledge, ran desperately to try to save something. Obvious, neither the people, nor the enterprises or institutions that removed their money in time, nor those that did not do it, acted following the rules given by the reason, because the first generated an evacuation and the second, must have acted with calm and avoided salary the bank stampede, both actions that aggravated the situation.

It is therefore that there should be an superior institution that can control these differences, avoiding the pronounced un-even nesses that are generated when in a market compete actors in frank inequality of conditions. That is why:

the government played an important role. Adam Smith's invisible hand – he idea that the free markets take the efficiency as if they were guided by unobserved forces - invisible, at least partly, because it is not there.

This is not the news for those who either work day after day in the market and amass their fortune taking advantage from the information asymmetries and surpassing them [Stiglitz, J., 20/12/2002] <sup>(23)</sup>.

Returning to the analysis of the confidence crisis that was unleashed by the subprime mortgages, it is important to recognize that, although these mortgages have implicit in themselves a risk, the same could have been controlled by means of the risks qualification agencies, in which

the investors had deposited their confidence, investing or no, in agreement with the granted qualification.

Therefore we see that once the maneuver realized by the generating banks came to be known these mortgages, that were also being covered by the excellent qualifications of the Risk Examining Agencies, the different actors reacted by virtue of the distrust level produced in them, knowledge that their investments no longer had the endorsement of the organizations which they trusted and therefore, each tried to save himself the best way possible, producing the fall of institutions that until that moment were as solid as a rock.

I. e., when in 2007 the crystal broke, distrust propagated itself round the world, there was a very violent retraction that restrained investments, loans, constructions. The factories dismissed workers, the people who were paying their mortgage lost what they had put and others were in marginal situations, etc. People felt their credibility violated, because they did not expect that the institutions in which they trusted would do them such a dirty trick.

It is interesting, finally, to put in evidence that of the different economy theories, one rescues the importance of considering the economy as a social science, and that therefore its center is the human being. What we have analyzed in the present paper evidences that one of the most important parameters in the development of an economy is based on the construction of confidence and that this is essentially a nonlinear and complex variable. Seeing the importance of the economy from this new perspective we will be continued this line of research, analyzing the different economy theories, putting in evidence the incidence level that each of them assigns to confidence and therefore the level of prevention of future financial crises.

## **CONCLUSIONS**

In agreement with this matter, we began analyzing the importance of confidence in the process of the hypothecating crisis, concluding that it was really a confidence crisis that took place because the banks, did not make their investors participate of the risk level which they were running and therefore when reality exploded, the investors felt defrauded by those institutions in



which they had deposited their confidence.

Also it was evidenced that as much the risk as the confidence are unique for each person, enterprise or institution and that each of them is going to respond before a stimulus of the market in a way totally different from another one. Therefore, the invisible hand proposed by Adam Smith in fact is not another thing than the sum of answers of each one of those that comprise the market, and that individually they look for buying or selling, that the balance between the risk level and the level of confidence favors this last one, otherwise there is no sense in doing business.

Which evidences that there does not exist the total rationality between those who operate in the different markets, because each one tries to defend his personal position, the one which includes his very close circle, at the expense of what rationality considers for each case. Very especially when possessing preferential information by being a friend, known person or relative who must take a action or apply a certain tax or simply is in the indicated place at the precise moment.

Despite this it is important to emphasize, that although this one is the majority of the cases, there exist situations in which other characteristics of the human beings take part, which can prioritize other values at the time of making the decision. But even so the obtained results are not totally rational or at least rationally limited, because as he is going to develop following this line of research, the human beings, like the economy, are unique adaptive open complex systems. That continuously are adapting themselves to the environment in which they operate, as a way to be able to subsist.

## **BIBLIOGRAPHICAL APPOINTMENTS**

Please refer to articles Spanish bibliography.