“Our workers are no less productive than when this crisis began,” President Obama said in his inaugural speech. “Our minds are no less inventive, our goods and services no less needed than they were last week or last month or last year.” Why, then, did the country’s GDP drop by 6.2 percent in the fourth quarter of 2008? While it’s true, as the president says, that America’s stock of physical and human capital remains undiminished, something important was indeed destroyed last year: trust.

“Virtually every commercial transaction has within itself an element of trust,” writes economist Kenneth Arrow, a Nobel laureate. When we deposit money in a bank, we trust that it’s safe. When a company orders goods, it trusts its counterpart to deliver them in good faith. Trust facilitates transactions because it saves the costs of monitoring and screening; it is an essential lubricant that greases the wheels of the economic system.

The drop in trust, we believe, is a major factor behind the deteriorating economic conditions. To demonstrate its importance, we launched the Chicago Booth/Kellogg School Financial Trust Index. Our first set of data—based on interviews conducted at the end of December 2008—shows that between September and December, 52 percent of Americans lost trust in the banks. Similarly, 65 percent lost trust in the stock market. A BBB/Gallup poll that surveyed a similar sample of Americans last April confirms this dramatic drop. At that time, 42 percent of Americans trusted financial institutions, versus 34 percent in our survey today, while 53 percent said they trusted U.S. companies, versus just 12 percent today.

As trust declines, so does Americans’ willingness to invest their money in the financial system. Our data show that trust in the stock market affects people’s intention to buy stocks, even after accounting for expectations of future stock-market performance. Similarly, a person’s trust in banks predicts the likelihood that he will make a run on his bank in a moment of crisis: 25 percent of those who don’t trust banks withdrew their deposits and stored them as cash last fall, compared with only 3 percent of those who said they still trusted the banks. Thus, trust in financial institutions is a key factor for the smooth functioning of capital markets and, by extension, the economy. Changes in trust matter.

What causes the changes? Disappointment over short-term performance is only one way that a drop in the stock market becomes a trust crisis. Perceptions about the causes of a crisis seem to undermine trust even more: in the last quarter of 2008, 70 percent of those who believed that the crisis was due to poor corporate governance or lack of government regulation experienced a drop in trust, versus 54 percent of those who attributed the crisis to other causes, such as global imbalances.

But the main cause of the drop in trust is people’s beliefs about the type of government intervention
during the crisis. Around 80 percent of respondents felt less confident about investing in financial markets as a result of the type of government intervention in the last three months of 2008. This outcome was not the consequence of an ideological bias against government involvement; on the contrary, a majority of respondents believed that the government must regulate financial markets. They objected to the specifics of what was being done. Their trust was undermined, in part, by the perception that lobbying interests influenced the government intervention: 50 percent of respondents, for instance, thought that former treasury secretary Henry Paulson had acted in the interest of Goldman Sachs, not the United States.

For financial markets to play their vital role once again, we must restore people’s faith in them. The most effective way to do so is to eradicate the perception that the government is run in Wall Street’s interest. The ethics rules issued by President Obama are a good but insufficient first step. More important is to redesign the bank rescue plan so that it clearly acts in the interest of the country (having well-capitalized banks), not the interest of Wall Street (having taxpayers bail out current investors). Not only is this feasible, it is also fair. And fair rules of the game are what investors need to regain their trust.

*Paolo Sapienza is an associate professor of finance and the Zell Center Faculty Fellow at Northwestern University. Luigi Zingales is the Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business and the author of *Saving Capitalism from Capitalists.*