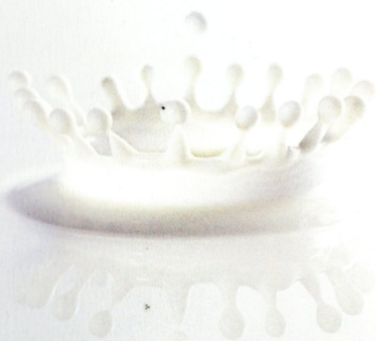




# THE ECONOMICS OF INTEGRITY



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FROM *Dairy Farmers to Toyota,*  
HOW *Wealth Is Built on Trust &*  
WHAT *That Means for Our Future*

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ANNA BERNASEK

- WHY DOES A SINGLE ATM WITHDRAWAL TAKE AN ENTIRE DAY TO PROCESS?
- WHAT MAKES TOYOTA THE MOST TRUSTED CAR COMPANY AMONG CONSUMERS?
- WHY IS ONE-QUARTER OF THE WORLD'S GOLD STORED IN THE FEDERAL RESERVE?

Acclaimed journalist Anna Bernasek answers these questions as she takes us on a colorful journey that reveals the deep layers of trust involved in even the simplest transactions. With examples that range from mill to mortgages, Bernasek shows how integrity in fact our greatest economic asset; it forms the invisible bedrock of our economy.

As the world emerges from the financial wreckage of 2008, the question facing nations, cities, and individuals is how to create a road to prosperity again. Understanding the role that trust and integrity play in our daily lives is the key. In the macroeconomy, it offers us the way we do business in this New Era of Responsibility. Bernasek's message is both timely and urgent. *The Economics of Integrity* is a must-read for our times.





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ECONOMICS OF  
INTEGRITY**

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PERDANA  
LEADERSHIP  
FOUNDATION  
YAYASAN  
KEPIMPINAN  
PERDANA



THE  
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How Wealth Is Built on Trust and  
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ANNA BERNASEK



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## INTRODUCTION

# Why Integrity?

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**A**t first, when I thought about the 2008 financial crisis, I was angry and pessimistic. It was by far the biggest economic disruption of my lifetime. As a nation, we've spent trillions of dollars to clean up the mess—a staggering amount of money. The effects will haunt us for decades. Beginning with those terrible concerns, I craved a way to go forward. This book is my own response to the question: What do we do now?

I have had the privilege of seeing the United States as an outsider. I was born in Boston but grew up in Australia. My father, a native of Czechoslovakia, risked his life to escape from communism in 1949 and gained political asylum in Australia. After marrying, he moved to the United States, where he earned a Ph.D. in economics and began his academic career. Like so many of his generation, my father admired the great qualities of the United States and he passed on that admiration to me.

This book pays tribute to the spirit of this nation: a spirit of optimism and idealism. America is a place where people can

dream and achieve. To be true to that spirit, my focus isn't on what went wrong. I am not primarily concerned with scandals, fraud, and cheating. Instead, I examine what makes this economy great and show how we can do more of those things.

For too long, the economics profession has minimized the critical role of cooperation in economic activity. Emphasis on the individual has risen above all else and overshadowed the profound ways we depend on each other. You may have heard a successful businessperson boast, "I did it all myself." I want to interrupt at that point. Every successful business requires the cooperative effort of many people—the banker who believes in the business plan, the customer who trusts the product, the employee who devotes precious time to the business and its owners.

If we ignore the important ways people cooperate to create wealth, we miss the most valuable source of wealth creation imaginable. Recognizing the true value of relationships, we can build stronger relationships and create and share greater wealth. It's a powerful way to reinvigorate the economy.

In this era, when so much seems to be going wrong, many have lost trust in their fellow citizens. But the path forward can't be to stop trusting. We need to build the trust that will power the economy for decades to come. The purpose of this book is to show how that can be done.

I wrote this book for everyone: individuals trying to make sense of the world, companies striving to grow and make a profit, and policy makers seeking ways to build a strong future. It's my sincerest hope to inspire everyone who reads this book to see the true miracle of integrity and trust in the economy.

The economy isn't some dirty game where all the players are only out for themselves, trying to make their names and their fortunes. It's a noble project. Each one of us has a meaningful role to play. In the end, what you do really does matter.

For companies slogging it out and for those starting new business projects, I wanted to provide a picture of what really drives business. By appreciating integrity as an asset that is valuable, companies can learn how to invest in it and create wealth. Knowing the techniques for investing in integrity, brands, feedback, and communications, among other things, we can build sustainable and valuable businesses.

All too frequently we are given the false choice between free markets or regulation. It's a pointless debate that has disturbed me for some time. This book bridges the gap between left and right and provides a fundamental approach. Understanding integrity will let us have an honest debate about how to make our system better.

This book provides a tool kit for creating more integrity anywhere in the economy. When policy makers are thinking about changing health care, reforming the tax system, or improving the financial system, they can use these tools to systematically build value. I encourage readers to see that integrity unlocks enormous opportunities for wealth creation that we may not yet imagine.



## CHAPTER ONE

# A New Way of Thinking

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**O**n a bitter cold Monday morning in winter, Ben Bernanke, chairman of the Federal Reserve, was in his office, glued to his computer screen. The bank was eerily quiet. Government offices were closed for a national holiday, and Bernanke had canceled travel plans to be at his desk. For months, financial markets around the world had been jittery about the unfolding subprime crisis, but in the early hours of January 21, 2008, nervousness turned to outright panic. Stock markets in Asia and Europe were in free fall. Suddenly global investors were questioning whether the U.S. financial system might be on the brink of collapse.

Investors could sense a meltdown, as one major financial player after another came forward to reveal enormous losses. And there seemed to be no end in sight. If a bank as big as Citibank might not be able to pay its bills, then could anyone? Might the whole grand system of money and markets around the world grind to a terrifying halt?

For some time, Bernanke and others inside the bank had

been seeing the cracks appear. It was becoming obvious that the financial system couldn't withstand a significant shock without help from the government. Trillions of dollars, a huge share of the entire economy, had been funneled into housing-related assets. And now those massive investments were becoming increasingly shaky as the housing market reversed course. It wouldn't take much—a shock from global stock markets, for instance—and everything could start to unravel.

With the U.S. stock market set to open the next day, Bernanke made up his mind to act. He knew the arguments of his detractors. The next Open Market Committee meeting was only eight days away. Couldn't a decision wait until then? Too hasty an action could cause a loss of confidence, or even panic. But in eight days' time, Bernanke feared it might be too late.

The next day, an hour before the opening bell, the Federal Reserve announced it was cutting interest rates by three-quarters of a percent—the largest emergency rate cut in decades. At the time, it was a dramatic policy change. As the year wore on, though, it turned out to be just a small drop in the vast bucket of money that would ultimately be needed to deal with the escalating financial crisis.

Little did Bernanke know that January morning that the thing he feared the most would soon come to pass. As trust unraveled, firms collapsed, markets broke down, and the entire world paid a heavy price with economic activity slowing at an alarming rate.

The financial crisis of 2008 was first and foremost a crisis of integrity. The seeds were sown as great numbers of people sought their own short-term advantage, knowing that they

were putting others at risk. In short, it happened like this: Homeowners took out mortgages that they knew were likely to prove unaffordable later on. Banks lent money knowing it was unlikely to be repaid. Wall Street operators bought the junk mortgages and resold them in the guise of sound investments. Accountants, lawyers, and ratings agencies collected hefty fees for misleading assurances. And investors giddily chased outlandish returns, unconcerned by the all too apparent risks. In the climate of greed, frauds great and small multiplied and spread like potent germs in a warm petri dish.

The whole vast and intricate financial universe, with all its sober rules and gray-haired regulators, had been diabolically converted by the nation's brightest minds into a casino where gamblers were risking mountainous piles of other people's money. Before the chips fell, those gamblers claimed a lion's share of false winnings and absconded with fortunes intact, leaving behind a generation's worth of toxic residue for the eventual contemplation of investing clients and the taxpaying public.

Formerly prudent and conservative financial institutions, mighty insurance companies and banks, used loopholes in rules to turn themselves into freewheeling risk takers and in the process ran their firms off the road. Bad strategy and risk taking at the top infected entire institutions and overwhelmed the hard work and diligence of thousands of individual employees. And all the while the true financial state of those institutions was obscured. Banks via reports and balance sheets said over and over that they were solvent, only to reveal later that they actually weren't.

In the end, those in charge compromised the integrity of their institutions and ultimately the integrity of the entire financial system. And they did it while those experts trusted to supervise the system looked the other way.

As soon as investors began questioning the integrity of individual institutions, the financial crisis erupted with a devastating fury. One major bank after another came forward to reveal breathtaking losses, and trust began to unravel. Players who had never questioned each other's integrity did so. Suddenly no one trusted anyone enough to do business with them, and credit markets stopped working. Policy makers and government institutions tried to call on the enormous credibility they had built in the past but instead looked panicked and uncertain. One government initiative after another failed to quell the fear, and investors lost confidence in the people charged with protecting the system itself.

The result of all that integrity and trust unraveling was an economic contraction so profound that it affected every American together with vast populations around the world.

It was a wake-up call. Ignoring or, worse, abusing integrity isn't just unpleasant for a few bad apples and their unlucky victims. It has profound economic consequences. At stake is the entire global economic system, the modern way of life.

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## The Cost of the Financial Crisis

### Government Spending in Billions of Dollars as of May 15, 2009

<b>Total</b>	<b>Promised 12,080</b>	<b>Provided 4,036</b>
<b>The Federal Reserve</b>		
Term Auction Credit	900	428
Other Loans:	Unlimited	132
Primary credit	Unlimited	42
Secondary credit	Unlimited	0
Seasonal credit	Unlimited	0
Primary dealer credit facility	Unlimited	0
Asset-Backed Commercial Paper		
Money Market Mutual Fund	Unlimited	29
AIG	46	46
AIG (for SPVs)	9	0
AIG (for ALICO, AIA)	26	0
Rescue of Bear Stearns*	27	26
AIG-RMBS Purchase Program*	23	16
AIG-CDO Purchase Program*	30	20
Term Securities Lending Facility	200	14
Commercial Paper Funding Facility*	1800	163
TALF	1000	16
Money Market Investor Funding Facility	540	0
Currency Swap Lines	Unlimited	247
Purchase of GSE Debt and MBS	1250	504
Guarantee of Citigroup Assets	286	0
Guarantee of Bank of America Assets	108	0
Purchase of Long-Term Treasuries	300	102
<b>Treasury</b>		
TARP	700	570
Fed Supplementary Financing Account	479	479
Backstop of Fannie Mae and Freddie Mac	400	0
<b>Federal Deposit Insurance Corporation</b>		
Guarantee of U.S. Banks' debt:*	1400	349
Guarantee of Citigroup Assets		10
Guarantee of Bank of America Assets		2.5

Transaction Deposit Accounts	500	0
Public-Private Investment Fund Guarantee	1000	0
<b>Federal Housing Administration</b>		
Refinancing of Mortgages	100	0
<b>Congress</b>		
Economic Stimulus Act of 2008	170	170
American Recovery and Reinvestment Act of 2009	787	787

\*Includes foreign-denominated debt.

Source: Moody's Economy.com

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## The Economic Value of Integrity

IF MISTAKES ARE learning experiences, the painful lesson from this financial crisis is that integrity really does matter. Not just to our moral well-being but to our economic well-being too.

Integrity is widely misunderstood. Conventionally, integrity is considered an “eat your spinach” topic: a personal issue, entirely up to individuals. If you are upright, good for you; if not, it’s no one else’s affair. While most people sense that doing the right thing is vaguely beneficial, it’s a safe bet they know from personal experience that bending the rules or exploiting loopholes can offer rewards. After all, who hasn’t jaywalked or run a red light?

It’s easy to point a finger at players in the subprime crisis—mortgage lenders making loans they knew couldn’t be paid back, investment bankers peddling junk as if it were prime

investments, and ratings agents who signed off on investment products they didn't, or didn't try to, understand—and criticize their lack of integrity. But that's where it usually ends. Little if any thought is given to understanding how integrity affects our economic interests.

This book turns conventional wisdom on its head. The real value of integrity is not personal; it's collective. It's the underpinning for all our commercial relationships. We are heirs to a huge stock of integrity, built up over centuries and visible in every aspect of our economy. It's a shared asset that makes us wealthy.

The dictionary defines *integrity* in terms of adherence to moral principles, rectitude, honor, and honesty. These are certainly admirable qualities. But we need to understand integrity as not simply a virtue but a shared asset that brings financial and economic rewards.

To actually practice integrity, to deal honestly, there has to be someone on the other side of the transaction. That means that to really understand integrity, we have to appreciate it as a relationship of trust.

Once a relationship of trust and integrity exists, remarkable efficiencies result. Partners in trust are spared a multitude of worries—whether they'll get paid, whether they'll get what they think they're paying for. They are freed to act quickly and with confidence, again and again. Pervasive integrity is fundamental to our enormous, fast-moving economy. Integrity isn't something that's nice to have. It's something we have to have.

For without integrity, the economy would not function.



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ADVANCE PRAISE FOR  
*The Economics of Integrity*

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“Bernasek delivers an engaging and enlightening journey into the roots of integrity, building a convincing case for why it is the bedrock of our economy. I learned a lot reading this book.”

—ROM BRAFMAN, author of *Sway*

“In an era of structured finance, nanotechnology, and complex business models, Anna Bernasek’s timely, valuable, and highly readable book reminds us that the economy runs on something much simpler: trust.”

—DAN GROSS, senior editor, *Newsweek*, and author of *Dumb Money*

“When our businesses and markets operate with integrity we are able to create enormous wealth. Anyone interested in understanding what makes our economy work must have this on their bookshelf.”

—MARK ZANDI, chief economist, Moody’s Economy.com

“In this fascinating little book, Anna Bernasek shows what delivering milk has in common with financial reform. The common thread?

Both need mechanisms to ensure integrity. Her insights will stick with you long after you put the book down.” —ALAN BLINDER, economist and co-director of Princeton’s Center for Economic Policy Studies

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