Financial Deepening and Social Capital

by

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Abstract

This paper provides an alternative interpretation to the financial crisis of 2007-2009 that relies upon "toxic" financial deepening defined as proliferation of financial derivatives. This reduces social capital and trust. The final outcome is that distrust makes financial markets fragile before (and not after) a crisis unveils. Using microeconomic data from Eurobarometer and financial data from the Bank of International Settlements, we test the hypothesis that trust in institutions, our measure of social capital, is negatively affected by the level of global foreign exchange derivatives, our measure of financial deepening. Results are robust for alternative measures of social capital, different sub-periods and country subsamples, and the inclusion of additional financial deepening aspects. The impact has economic relevance, particularly in countries with large financial markets: at current growth rates, financial deepening destroys social capital up to 0.5 percent annually. Financial deepening may lead into the "trap of social capital" with potential negative effects for all economic transactions.

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