

Closed networks and the economics of trust

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The kinship network of the *Daig* raises a question that economists and sociologists have studied in many contexts: the role of closed networks in the organisation of trade and finance. In a world in which contracts are difficult to enforce and information is scarce, networks based on kinship, religion or ethnicity allow their members to trade and lend to each other with confidence, because members who cheat can be excluded and their reputation destroyed within the network. Economic historians have described such networks among the Jewish Maghribi traders of the medieval Mediterranean, the Armenian merchants of the early modern period, the Huguenot bankers of the eighteenth century and the Chinese merchant networks of Southeast Asia.¹

The *Daig* functioned in a similar way. Its members knew each other, were related to each other and depended on each other's goodwill. A member who defaulted on a debt, betrayed a partner or disgraced his family would lose his standing in the network, with severe consequences for his business and his social life. The network thus enforced honesty and reliability through social sanctions, which were often more effective than the courts.

Closed networks have limits. They exclude outsiders, who may have valuable capital, skills or ideas. They can become complacent and resistant to change. They can protect members who deserve sanction, when loyalty to the family outweighs honesty towards outsiders. And they can be too small to finance large projects that require capital beyond the resources of the network. The history of banking in the nineteenth century is in part the history of the transition from networks based on kinship and personal trust to institutions based on legal rules, public accounts and impersonal capital markets. The joint-stock banks, the stock exchanges and the regulatory authorities of the modern financial system replaced the networks of trust of the merchant elites, although they never entirely eliminated them.

In private banking, personal trust has remained essential. The relationship between a private banker and his client is still based on personal knowledge, discretion and long-term loyalty. Many clients choose their bank on the recommendation of family members, friends or advisers. The modern rules on the identification of clients and the prevention of money laundering have added a layer of formal verification to this personal trust, but they have not replaced it. The private banks of Basel, several of which are still owned and managed by members of the old families, continue to combine the personal trust of the network with the formal requirements of the law.

1 Notes

1. On the economics of trust in closed merchant networks, see e.g. Avner Greif, *Institutions and the Path to the Modern Economy*, Cambridge 2006 (Maghribi traders); the literature on diaspora trading networks. To be verified. ↩

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