Crisis: classical and recent analysis. A text guide

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Analytical and empirical literature on crises is numerous. And the complexity of the present crisis, with global components and national specificities, financial causes amplified in their interaction with other variables and feedback between Wall Street and Main Street, makes Irving Fisher's saying from 1933 as true as ever: analysing «the» cycle and of course «the» crisis is a myth.

Here comes a summary of some classical (in the sense of being previous to the present situation) and recent views that may offer interpretative points and recommendations for policies with an interest from the current perspective. Some of the most interesting contributions are referred to and commented, sometimes with opposed points of view, but often with comments allowing to understand and tackle a delicate, complex situation as is the present one.

Readings of classics

John Maynard Keynes: Keynesian analysis and policies

Keynesian thought is fashionable again. The difficulties market mechanisms are having to quickly and automatically redress imbalance, especially in recession, are at the origin of the message that public authorities play an important role in such situations. But Keynes' original texts have many shadings.

Some writings («pamphlets», as he liked to say) included in his *Essays in Persuasion* were published in the early 1930s. One of them, titled «The Great Slump of 1930», starts in a way that is fully valid today: «The world took long to notice that we are living in the shadow of one of the biggest economic disasters of modern history this year. But now people on the street have noticed what is occurring [...], they feel overwhelmed by exaggerated fears; however, when the first signs of concern came up earlier, they did not experience what would have been reasonable unrest [...]. Are they now awakening from a sweet dream to face the darkness of reality? Or are they falling asleep with a nightmare that will pass?»

Keynes, J. M. (1930). «The great slump of 1930». In: *Essays in Persuasion*. New York: Harcourt Brace, 1932.
http://www.gutenberg.ca/ebooks/keynesslump/keynes-slump-00-h.html
Translation into Spanish: «La Gran Depresión de 1930». In: *Ensayos de persuasión*. Barcelona: Ed. Crítica, 1998, p. 134-142.

The articles included in the *Essays* refer to the role of insufficiency of private demand and how its effects are deepened by price fall, that is, fearful deflation. The dramatic increase of unemployment figures, the potential role of expansive policies – basically regarding anything related with public investment projects – estimates of the potential «multiplying» effect of such action on economic activity, etc. shares the same text with an interesting analysis of 1931 showing the effect of multiplying, now downward mechanisms of asset price reduction on the balance sheet of banks and their capacity to provide financing.

Keynes, J. M. (1931). «The Consequences to the Banks of the Collapse of Money Values». In: *Essays in Persuasion*. New York: Harcourt Brace, 1932.
Translation into Spanish: «Consecuencia del hundimiento de los valores monetarios en el sistemabancario». In: *Ensayos de persuasión*. Barcelona: Ed. Crítica, 1998, p. 157-165.

Another quotation might describe the fears in autumn 2008: «And now, in most of the world, the position of banks, though hidden from public view, may in fact be the weakest part in the whole situation [...]. If nothing is done, critical default will occur in banks all over the world.» This could be a warning having led Ben Bernanke, one of the best scholars of propagation mechanisms in the 1929 crisis before becoming president of the Federal Reserve, to clearly strive for rescuing the financial system at any price.

In *General Theory of Employment, Interest and Money* (1936), famous Chapter 12 is noteworthy, in which Keynes formulates the paramount role of expectations and variables like confidence, which are especially relevant in economies with sophisticated financial systems. Appendix A establishes a link between his theory and other explanations of economic cycles, providing an excellent summary. The role given to «delusion» of real return on investment compared with the expected one as one of the driving forces of cycles is also to be pointed out.

Keynes, J. M. (1936), *General Theory of Employment, Interest and Money.*
Translation into Catalan: Clàssics del Pensament Modern, no. 35. Barcelona: Eds. 62, 1987.
Translation into Spanish: Mexico City: Fondo de Cultura Económica, 1945.
Chap. 12: «The State of Long-term Expectation»

http://etext.library.adelaide.edu.au/k/keynes/john_maynard/k44g/chapter12.html
Chap. 22: «Notes on the Trade Cycle»
http://etext.library.adelaide.edu.au/k/keynes/john_maynard/k44g/chapter22.html

The Austrian school: monetary and financial factors

The Austrian school, led by Ludwig von Mises and Friedrich Hayek, is often presented as rivalling Keynes, especially due to its trust in automatic reaction without resorting to public intervention, generally held to be counterproductive. However, there are interesting sides to the Austrian explanation of cycles and crises from a current point of view, specifically the role given to monetary policies that support interest rates artificially under their natural or balanced level (a contrast also found in Scandinavian economist Knut Wicksell).

A consequence of this is induction to take excessive risk, looking for investment offering more profitability than that linked with current interest rates, originating what some (even the International Monetary Fund) have termed «appetite for risk». Objective risks are undervalued, with unpleasant results when true «risk-adjusted profitability» emerges from certain investments. Following criticism of the action of the Federal Reserve towards the end of the Greenspan era, accused of keeping interest rates artificially low for reasons explained later on, this Austrian mechanism seems to be valid again.

MISES, L. VON (1936): «La théorie dite autrichienne du cycle économique». *Bulletin de la Société Belge d'Études et d'Expansion*, 35:103, December, p. 459-464.
http://www.liberte-cherie.com/a2910-La_Theorie_dite_autrichienne_du_cycle_economique.html
Translation into Spanish: *Revista Libertas XII*, 43, October 2005. Barcelona: Instituto Universitario ESEADE.
http://www.eseade.edu.ar/servicios/Libertas/3_12_Mises_Teoria%20Austriaca.pdf

Irving Fisher: *debt deflation*

Another significant contribution is that of Irving Fisher. Although he incorrectly considered in early 1929 that the stock exchange could not collapse (he lost most of his personal wealth due to investment he made based on this conviction), in 1933 he published one of the most interesting pieces of analysis ever written about this subject (FISCHER, I., 1933). Fisher states the diversity of factors converging in the deepest crises such as the one that started in 1929, but he quickly states that the core aspect is fragility due to overborrowing induced by lax financial conditions. Such overborrowing interacts with an evolution of asset prices, first up and then down, leading to recession and deflation that makes it especially difficult to come out of overborrowing. When positions are to be undone through selling, the result is the loss in the value of assets to be sold, with a negative impact on the balance of involved organisations. It is a much more systematic and clearer text than other classical documents as well as worth reading from a present perspective. Much attention is to be paid to points 1-4, 15-24, 28-34 and 44-49 in the article.

FISHER, I. (1933): «Debt-deflation Theory of Great Depression», *Econometrica*, 1, p. 337-357.
http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf

Hyman Minsky: between classics and modern times. Intrinsic instability?

Between 1950 and 1980, economic development was much more placid, especially in advanced economies, which created the feeling that progress in stabilisation policies had managed to control cycles. However, some analysts insisted in the message of intrinsic instability of capitalist economies, especially regarding their financial systems. Among them is Hyman Minsky, who stands out thanks to his description of how «important cycles are due to financial attributes essential for capitalism». According to him, this leads to a transition between hype and depression called the «Minsky moment». Minsky studied how economic policies were able to stabilise an unstable economy using the title of one of his most relevant books (published in 1986 and symptomatically reedited in 2008). Among Minsky's contributions (MINSKY, H.P., 1992) his typology of economic units based on the relation between debt and income is noteworthy; being valid to a certain extent, it distinguishes between three categories. First, what he calls «hedge financing units» that fulfil their contractual duties with their cash flow. Then there is speculative finance relying on other sources such as asset appreciation. The third category are units with «Ponzi financing», relying on new stakeholders entering the debt pyramid. Do we need to give names of specific examples of today? The degree of financial stability is associated to the combination of these three types of positions.

MINSKY, H.P. (1992): «The Financial Instability Hypothesis». In: ARESTIS, Ph.; SAWYER, M. (eds.). *Handbook of Radical Political Economy. Working Paper*, 74. Edward Elgar. Aldershot, 1993.
http://www.levy.org/pubs/wp74.pdf

Contemporary readings

Contemporary analysis combines, with a different degree and emphasis, aspects related to the following concepts:

- **Own causes.** E.g. credit and debt increase, which led to relaxation or degradation of risk assessment that triggered housing financing even for debtors with a dubious record.

- **Causes of causes.** They include artificially low interest rates facilitated by the Federal Reserve. In other countries like Spain, this has occurred by means of lowering interest rates after entering the euro.

- **Causes with a global scope.** It is especially generation of savings surplus in emerging Asian economies (especially China) what has contributed to creating a «global savings glut» in Bernanke's words, basically channelled to the United States to look for top-quality financial assets in order to make up for low household savings.

- **Dissemination mechanisms.** They range from saving to leveraging segments in different capacities: competition in the finance sector, executive remuneration schemes, deregulation and relaxation of supervision, etc. It also includes risk distribution by means of innovative financial instruments between market segments, between institutions and at international level through elaborate, barely transparent tools and the role of rating agencies.

- **Transition from expansion to crisis.** Troubles in reactivation, asset value loss, deterioration of confidence, doubts on liquidity and solvency, stagnation in markets.

- **Response, rescue and emergencies in the finance sector.** Systemic risks, credit crunch, action on assets (toxic asset buying plans) and liabilities (recapitalisation, possible public participation in capital).

One view that could be considered as being representative of many such aspects is that of Raghuram Rajan in collaboration with Douglas Diamond. In 2005, being the head of research at the International Monetary Fund, Rajan explicitly warned by surprise of an increase in financial fragility, rejecting «irrational complacency» (an expression with which Krugman added to Greenspan's known term of «irrational exuberance»).

In «The Credit Crisis: Conjectures about Causes and Remedies», the authors explicitly refer to the role of the «climate» in business, which has turned it difficult to avoid gregarious behaviours, summarised in the famous saying of Chuck Prince, chairman of Citigroup, who in July 2007 declared: «When the music's over, things will become tough; but as long as the music is played, we'll have to keep dancing.

And we're still dancing.» Soon after, the music suddenly stopped.

DIAMOND, D. and RAJAN R. (2008): «The Credit Crisis: Conjectures about Causes and Remedies», written for the AEA Symposium, December 2008.
http://www.aeaweb.org/annual_mtg_papers/2009/retrieve.php?pdfid=401

Barry Eichengreen's text, much more selective, shorter and written in a plain language, points out two basic factors:

- **The role of deregulation,** from commissions to the derogation of restrictions imposed by the *Glass-Steagall Act*, which had been making a clear distinction between trade and investment banking in the US after the experience of the crisis in the 1930s. Instead of creating a banking model closer to the European one, it led to new formulas (including the one called «shadow financial system» by other sources) with a stronger trend towards leveraging to generate more income.

- **Excess savings** detected in China (with some savings rates indicators at 50% of GDP) and other economies. It is sought to place funds in public debt and assimilable assets (Fannie Mae and Freddy Mac bonds) in a safe way. This helped reduce the cost of leveraging in the United States despite its low household savings rate.

Eichengreen finishes with a message that intends to be optimistic: human nature cannot change, which includes greed, but if it has been decisions on economic policy what has magnified the crisis, there is room for correction for the future.

EICHENGREEN, B. (2008): «Anatomy of a Crisis».
http://www.voxeu.org/index.php?q=node/1684

In a much more critical tone, Joseph Stiglitz analyses the problems related with incentives and information as well as new instruments based on financial innovation and their perverse effects regarding microeconomic decisions and the macroeconomic impact as well as implications related with regulation and supervision requirements.

STIGLITZ, J. (2008). «The Financial Crisis of 2007/2008 and its Macroeconomic Consequences».
http://www2.gsb.columbia.edu/faculty/jstiglitz/download/papers/2008_Financial_Crisis.pdf

A quite more favourable position towards new developments (deregulation, innovation, etc.) comes from Charles Calomiris, who acknowledges some relevant «agency problems» as a novelty. This applies to conflicts of interest between decision-takers and those trusting them: from less sophisticated investors to shareholders, besides traditional asymmetric information regarding the different degree of risk knowledge between the parties to a transaction.

CALOMIRIS, C. (2008): «Banking Crisis». National Bureau of Economic Research, Research summary, 4.
http://www.nber.org/rporter/2008number4/calomiris.html

John B. Taylor, sub-secretary of the Department of the Treasury under George W. Bush, insists in irresponsibility of monetary policy, which was much more expansive than what could be inferred from the famous «Taylor rule». He also points out the convenience or need to go for global inflation goals.

TAYLOR, J. (2009), «The Financial Crisis and the Policy Responses: an Empirical Analysis of What Went Wrong». NBER, working paper 14631.
The version of the speech at the Bank of Canada can be found on:
http://www.stanford.edu/~johntayl/FCPR.pdf

Other contributions feature interesting opinions on the interaction between aspects to the crisis – causes, development and response – as well as between them and other economic ideas.

A short, relevant text by Daron Acemoglu introduces an original summary of what went wrong and what economists have learned with the crisis. Acemoglu points out three weaknesses:

- Believing that aggregate volatility was over, without noticing that more diversification could be juxtaposed with more interconnection.

- Ignoring the role of institutions, identifying free markets with markets free from regulation.

- Naïveness in believing that the reputation of historical organisations (such as some symbolic investment banks) were a permanent guarantee.

However, Acemoglu would not like the intellectual and sociopolitical climate to lead to an extreme that forgets the role of innovation and continuous Schumpeterian reallocation of resources vis-à-vis the most dynamic future developments as mechanisms of prosperity.

ACEMOGLU D. (2009). «The Crisis of 2008: Structural Lessons for and from Economics». Centre for Ecnomic Policy Research (CEPR), *Policy Insight*, 28 January. http://www.cepr.org/pubs/PolicyInsights/PolicyInsight28.pdf

Michael Bordo also points out the role of crises as a source of institutional reform, mentioning the risk of an interventionist and regulatory pendulum movement he calls a potential «government overkill».

BORDO, M. (2008). «An Historical Perspective of the Crisis of 2007-2008». National Bureau of Economic Research, working paper 14569. http://michael.bordo.googlepages.com/

Axel Leijonhufvud, the author of a 1968 reinterpretation of John M. Keynes, explains how theoretical mechanisms of return to balance by which the economy and markets work feature exceptions requiring intervention. This relates to the Keynesian argument that automatic market mechanisms are not effective in bringing about recovery out of recession. Leijonhufvud points out two factors:

- Abundant foreign savings numbed the signs sent out by the reduction in domestic savings (which would have led to higher interest rates). At the same time, the input of cheap import goods disguised inflationary pressure – inadequately measured by the consumer price index – also causing higher interest rates.

- Vulnerable leveraging in the light of herding, which requires regulation.

LEIJONHUFVUD, A. (2009). «Fixing the Crisis: Two Systemic Problems». voxeu.org, 12 January. http://www.voxeu.org/index.php?q=node/2784

Ricardo Caballero analyses the role of demand of top-quality assets for economies with a surplus but also for other more structural sources of demand like old-age benefit coverage, which will persist after the crisis. This demand led to lower interest rates but also to generate an offer of assets qualified as «synthetic AAA», with a rather more macroeconomic than individual degree of risk. The author also insists in the key role so-called «Knight's uncertainty» has played in the crisis, going far beyond statistically processable risk, as well as in the need of governments, especially the American, providing guarantees the private finance sector cannot in such uncertainty.

CABALLERO, R. (2009). «A Global Perspective on the Great Financial Insurance Run». voxeu.org, 23 January. http://www.voxeu.org/index.php?q=node/2827

What are the lessons experience from other crises teaches? What patterns are repeated and which are new? Among the numerous related studies stand out by Carmen Reinhart and Kenneth Rogoff, who in January 2008 made a first serious comparative analysis in which they showed the role of the lending boom compared to episodes of lending without guarantees. When the phenomenon occurred in developing economies, it led to harsh criticism of lacking institutional quality, but now they were occurring in the heart of the most developed financial systems. The subject is deepened in REINHART, C. and ROGOFF, K., 2009.

Acknowledging that the present crisis has a wider scope than the average of analysed crises – related to both its size and its international outreach, though with a potential role of adopted policies in smoothening the impact – the lessons history teaches talk of production decline at around 9% – with recession lasting roughly two years and, in the case of unemployment, four years – and a fall in housing prices at 35% (over 6 years) and stock markets at 55% (over more than three years). Another result is the increase of public debt (at around 86%), which adds to concerns about the cost all this will have for future generations and the increasing cost to be absorbed by financial markets.

REINHART, C. and ROGOFF, K (2009). «The Aftermath of Financial Crises». National Bureau of Economic Research, working paper 14656. Previous text:
http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf

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