# REFLECTIONS ON RECENT FINANCIAL CRISIS AND THE PRE-CRISIS SITUATION

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***Keywords*:**

## 1 INTRODUCTION

In this short presentation I reflect on recent financial crisis and on some aspects of the pre-crisis situation.

The literature on financial and banking crisis is based mostly on contributions of Hyman Minsky, Charles Kindleberger, Michael Bordo and others. The stylized crisis can be described loosely in the following terms. Crisis to begin needs a boom in the real economy which is typically driven by an emergence of new profitable opportunities for investment. This boom is financed at times by new credit instruments. Innovation in credit instruments helps to create the atmosphere that this particular situation is different from what happened in previous times. Optimistic environment leads to euphoria in which it is difficult – for various reasons – to distinguish sound from unsound credit. This creates the background for an independent rise in asset prices. Bubble is born and creates additional investment opportunities which lead to high over-indebtedness of those who fuel the bubble. For an increasing number of agents an insufficient cash flow makes servicing liabilities more and more difficult. Then, an unexpected event happens which might lead to changes in economic policy. Ultimately, signs of panic appear, assets are being sold, bankruptcies occur, banks fail and overall recession steps in. It seems that one finds similarities of the recent crisis with this stylized picture.

## 2 BODY OF THE PAPER

However, even if we know this, crises always arrive as surprise, as ultimately they appear rarely. Especially rare are crises which seem to have potential to affect large part of the global economy. The recent crisis seemed, and to an extent was a crisis with this potential. Maybe that was the reason that various commentators and policy makers have compared the recent financial crisis to the crisis of 1929.[1] The

[1] See for example Almunia, Benetrix, Eichengreen, O'Rourke and Rua (2010) for the discussion of this issue. Also Bordo (2008) writes that the crisis 2007-2008 resembles some of the former international financial crises triggered by events in the U.S. financial system, among them includes also 1929-33 crisis. Reinhart and Rogoff (2009) write that the authorities today have

aggressive response of the authorities to early signs of the crisis was to prevent the effects of 1929.

The large number of experts in the economic and business community was not only surprised by the potential extent of the crisis, but also seemed not prepared how to react and handle it. It is true, we have observed serious crisis in different emerging markets in the 1990s and before. These crises were studied much in detail but the emphasis was typically on currency aspects of the crisis and less on the banking aspects. And above all, typically less studied was the impact on the real economy of the most developed parts of the world as it was implicitly assumed such crises avoid them.

It is natural – especially in the political realm – to try to identify those responsible for the crisis. This might be a prohibitively difficult problem if taken too seriously, but what we observe that in the 'blame game' different short-run considerations prevail. Generally, it seems that the general public would like to receive from the economic and finance theory if not the ability to predict the crisis, but at least some warning, especially before the crisis of such a magnitude. However, in social sciences the ability of prediction is very low. Economists, political scientists, anthropologists and sociologists together were not able to predict much large events as the current crisis, for example the beginnings of the World Wars or the fall of the Soviet Union. While it seems that maybe there should be more research on issues studying the boundaries between stable and un-stable situations in the economy; I also feel as if low ability to predict is an inherent characteristics of the social science disciplines in general.[2]

One can expect that the general public will not tolerate a repeated unsuccessful pattern of predictions of major negative events. This might be an impetus for new research agenda to be developed which will concentrate less on the normal states of the economy and more on conditions of crisis.

If we play the 'blame game' naturally we come to the point that one can blame the theory of finance and economics as those in the financial markets were trained mostly at these scientific disciplines. Especially, the high innovation dynamics in the financial sector reflects the high innovation dynamics of research at the leading departments across the world, and especially in the Anglo-Saxon countries. One can add, that a large number of modern contributions is typically created without considering institutional, psychological, moral, traditional and other factors.

It is also natural to blame the financial industry, the Wall Street and associates. It might seem unfair that representatives of the financial industry got rich when causing the chaos of the crisis, and when the bill was to be paid they asked the society and the

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more flexible monetary policy frameworks, thanks to a less rigid global exchange rate regime than it was in the gold standard period.

[2] The low ability to predict important events is especially worrisome as in methodological discourse the view of Friedman (1953) still prevails, i.e. that it is the ability of models to predict what is important as compared to the realism of their assumptions.

governments to fix the problem and pay for it.[3] This involves also lower moral standards in the pre-crisis behavior of the financial community in which one can see rent-seeking, plain cheating, and possibly asset-stripping.

The more complicated vision is of Eichengreen (2008) who sees the crisis – to an extent – as the result of unintended negative consequences of the right decisions made, especially in the American economic policy. Eichengreen (2008) mentions the deregulation of commissions paid to stockbrokers from the 1970s. Fixed commissions meant more comfortable life, deregulated commissions led to more intense competition, thinner margins and possible negative results. The second such step, Eichengreen (2008) mentions was the removal of the Glass-Steagall Act in the 1990s. This allowed commercial banks to enter into traditional investment bank' business, but also allowed investment banks to enter the businesses of originating and distributing derivative securities.

Naturally one can blame the regulators. Was it not a bad regulation to allow such high leverage ratios? Or to blame the credit rating agencies which provided so many excellent ratings to securities which were later in the heart of the crisis. In the spirit of Groucho Marx one can say that regulators and rating agencies do a really good job when nothing bad happens.

Reaction of policy makers to the recent crises was very activist. It showed the deep belief of economic policy but also business community in the ability of the American state to act. Despite typical anti-Washington rhetoric of the Wall Street, it was Washington were this community run. On the positive side of aggressive government intervention one should mention that it might have been this intervention which prevented panic to reach general population. On the negative side, it is difficult to see to what extent there were legitimate reasons for such large government intervention and to what extent it simply reflected the fact that large segments of the policy makers are in capture of banking and financial interests.

We note that at the beginning of the 1929-32 crisis the policy makers response was much more passive. This passivity is today seen as helping and aggravating the deepness of that crisis. For example the Secretary of Treasury, who was also at the Federal Reserve Board, Andrew William Mellon was a passionate advocate of inaction. But not only him, Heilbroner for example mentions the story of Joseph Schumpeter who when arrived at the Harvard University, came into the room announced in his Viennese accent, “Chentlemen, you are worried about the depression. You should not be. For capitalism, a depression is a good cold douche.”

We observe in the pre-crisis early years of this century a surge in stock, real estate, art, and commodities markets. In addition, emerging equity markets were also subjected to huge gains before the crisis. Risk began to be under-priced as for example the difference between different emerging market bond indexes and U.S. Treasury bonds decreased to historical minimum.

[3] This is for example opinion of Stiglitz (2007).

Different explanations are provided to understand the pre-crisis situation. There is an excess liquidity view which blames the Federal Reserve for flooding the world with cheap money with the intention to prevent the spread of some real shocks as was the dot.com collapse or the effects of terrorist attacks in 2001.[4] Another view speaks about global asset shortage. Caballero (2006) argues that this shortage reflects the limited ability of emerging markets to generate financial stores of value at the same speed as their economies are growing.[5] Another view is of Cooper (2007) who emphasizes that the desire of U.S. non-residents to invest in the U.S. economy results in the U.S. current account deficit. Ferguson and Schularick (2007) argue that the asset price hike was a natural reaction to an increase in the returns on capital as the East Asian workforce entered the global economy. They argue that as the cost of capital was depressed this led to huge increase in corporate profitability, and from this follows that it was wise to borrow money and buy earning streams.

Another explanation concentrates on the China – U.S. relationship. China today – as it was also during history - generates massive trade surpluses which they immediately lend back to the United States. This depresses the long-term interest rate in the U.S. as it creates large supply of loan-able funds. As these savings which are transferred to the U.S. cannot be savings of private individuals – as they are not allowed to invest abroad – it follows that most of these savings are channeled through state administration. These huge savings come mostly from Chinese corporate sector mostly because of the increase in profit and are from manufacturing and mining companies.[6]

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[4] However, this is not the opinion of the Fed governor. See for example Bernanke (2005) where he writes: „Although domestic developments have certainly played a role, I will argue that a satisfying explanation of the recent upward climb of the U.S. current account deficit requires a global perspective that more fully takes into account events outside the United States. To be more specific, I will argue that over the past decade a combination of diverse forces has created a significant increase in the global supply of saving--a global saving glut--which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today."

[5] Caballero (2006) writes: „The world has a shortage of financial assets. Asset supply is having a hard time keeping up with the global demand for store of value and collateral by households, corporations, governments, insurance companies, and financial intermediaries more broadly. ... The so-called "global imbalances," the recurrent emergence of speculative bubbles (which recently have transited from emerging markets, to the dot-coms, to real estate, to gold...), the historically low real interest rates and associated "interest-rate conundrum," and even the widespread low inflation environment and deflationary episodes in parts of the world, all fall into place once one adopts this asset shortage perspective."

[6] See Ferguson and Schularick (2007) for detailed analysis in this spirit.

## 3 CONCLUSION

We would expect that excess national savings should flow to regions of the world where return to capital is highest, and those are assumed to be low-income regions with a low ratio of capital to labor, and not the developed lands. However, because of the size and institutional arrangements the U.S. economy provides for international investors large number of securities which are more liquid than those in other countries. In addition the U.S. market offers a wider risk variety of financial assets. Not to speak about that property rights protection. Foreign investors know that in a number of countries effective confiscations happen(ed) which even more enhances the advantages of the U.S. market.

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