

# MANAGING CRISES, CAUSING BUBBLES?

D'Maris Coffman, 27 September 2013

# BRIEF OVERVIEW



- Structural Analyses of Crises
- Behavioral Models of Bubbles
- The Retreat of the State and the Rise of 'Privatized Keynesianism'
- What responses are possible?

# STRUCTURAL BUSINESS CYCLES: MACRO

- Cycles (booms and busts) are not unique to capitalism; essential feature of economic life (Kindleberger, 2000); but industrial capitalism gives them certain inflections.
- From late 19<sup>th</sup> century, we can identify:
  - ▣ Juglar cycles: 8-10 years
  - ▣ Kitchin cycles: 36-40 months
  - ▣ Kuznet cycles: 16-20 years\*\*
  - ▣ Kondratieff waves? 50-60 years
- Today 'real business cycle' theory is more complex; but 'crises' are still just a phase in these cycles.
- Policy: how far can (and should) monetary policy mitigate (or even 'eliminate') business cycles? Link to bubbles?

# MANAGING BUSINESS CYCLES

- Freshwater versus saltwater economists
- Under Alan Greenspan, central bankers believed in the 1990s that they had eliminated business cycles.
- This was known as ‘The Greenspan Put’
- Well-intentioned and perhaps necessary, but it comes at a very great price:
  - ▣ Fuels short-term asset price bubbles
  - ▣ Has produced creeping private sector indebtedness
  - ▣ Even as the state has neglected both physical and social infrastructure in the last 30 years

# COST OF DOING NOTHING

Table 23. Comparison of Impact on Output (Depression)

(Source: G.H. Eley, The German Navy League in German Politics, 1914, unpubl. dissertation, 1952, p. 357)

*Effects of the Great Depression: Movement of Industrial Output in the 1930s (in percentages)*

	1932, as against 1929	1937, as against 1932	1937, as against 1929
<b>Group I</b>			
Japan	- 2	74.4	71
Greece	1	49.5	51
Finland	-17	79.5	49
Sweden	-11	67.4	49
Hungary	-23	77.9	37
Denmark	- 9	47.2	34
Rumania	-11	48.3	32
Norway	- 7	37.6	28
United Kingdom	-17	49.3	24
<b>Group II</b>			
Germany	-42	100.0	16
Austria	-39	73.7	6
<b>Group III</b>			
Canada*	-42	72.4	00
Italy	-33	49.2	—
Czechoslovakia	-36	50.0	-4
Belgium	-31	36.2	-6
United States	-46	70.3	-8
Netherlands	-38	46.7	-9
<b>Group IV</b>			
Poland	-46	57.4	-15
France	-31	4.3	-28

(Source: D. Landes, p. 391)

# WE NO LONGER 'DO NOTHING'

## Riding to the Rescue

How the Fed has responded to financial crises

Year	Crisis	Fed Chairman	What the Fed Did
<b>1970</b>	Penn Central Railroad default causes commercial-paper market to dry up	Arthur Burns	Made discount window loans to banks that lent to CP issuers, offered to help firms unable to issue CP
<b>1982</b>	Latin American default crisis	Paul Volcker	Lent money to Mexico, arranged moratorium on repayment of bank loans
<b>1984</b>	Continental Illinois bank collapse		Lent \$8 billion through discount window, endorsed bailout of uninsured depositors
<b>1987</b>	Stock-market crash	Alan Greenspan	Cut interest rates, pushed banks to keep lending to Wall Street
<b>1994</b>	Mexican peso devaluation		Cooperated in loan to Mexico
<b>1998</b>	Long-Term Capital Management meltdown		Cut interest rates, brokered private bailout of LTCM
<b>2007</b>	Subprime-mortgage mess	Ben Bernanke	Lowered discount rate, eased related lending terms

<http://online.wsj.com/article/SB118841384006012433.html>

# MICRO FOUNDATIONS OF BUBBLES

- Essentially a behavioral model that explains why people engage in debt-leveraged acquisition of assets
- The Minsky-Kindelberger Model
  - ▣ Steady-state of relatively low returns (such as those produced by the Greenspan put)
  - ▣ Displacement -> new opportunities
  - ▣ Expansion of Bank Credit (also encouraged by Greenspan)
  - ▣ Euphoria -> Overtrading
  - ▣ Torschlusspanik, or 'The Devil Takes the Hindmost'
  - ▣ Revulsion and Regret (Anger, Shame, Guilt)
- Are bubbles always bad?

# OBJECT OF SPECULATION DOES MATTER!

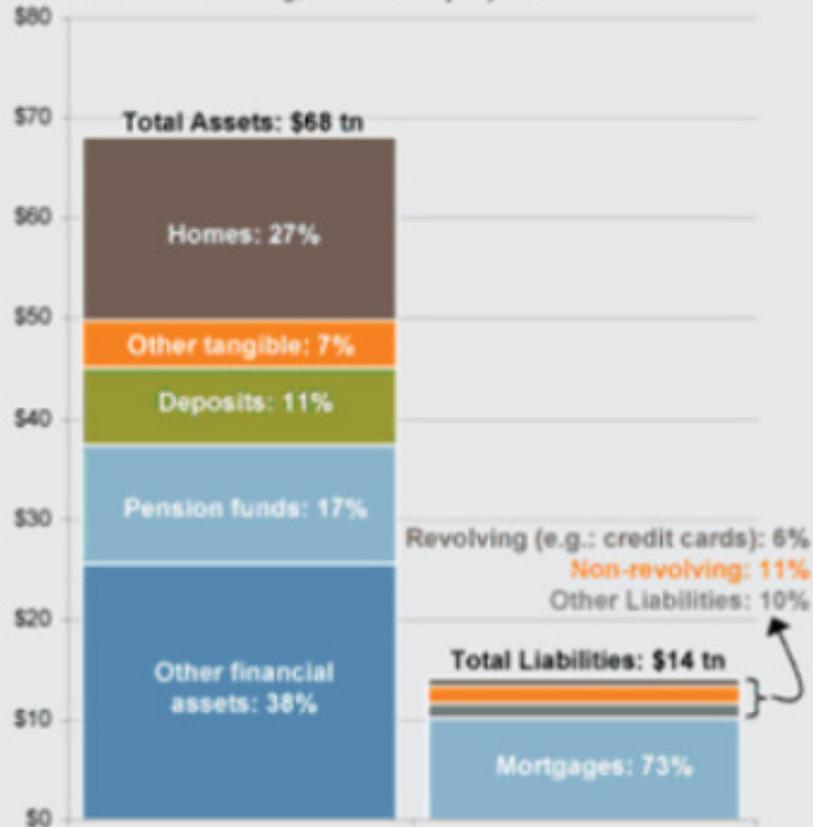
- Some bubbles are worse than others
- Asset-price bubbles around technological innovation
  - ▣ Canals, railroads, DotCom stocks, etc.
  - ▣ Ultimately resolve a ‘Lemons’ Problem (Akerloff, 1970)
  - ▣ Basically a zero-sum game for participants and probably a net gain for society (Janeway, 2012)
  - ▣ Leads to Schumpeterian waste
- Policy Issue: Main challenge is to protect retail investors from abusive market practices and from themselves

# WHEN ARE BUBBLES HARMFUL?

- Asset-price bubbles around non-productive assets that are also perceived as stores of value
  - ▣ Frequently debt-financed as people see ‘opportunities’ and borrow to join the game (e.g. the housing ladder)
  - ▣ Essentially an exercise in Ponzi Finance, though demographics do matter
  - ▣ Risk disguising ‘consumption’ as ‘investment’
  - ▣ These are terribly destructive, i.e. result in Keynesian waste.
- Policy Issues: Why have many industrial nations been positively encouraging these sorts of bubbles? One answer is that they are built into how we manage business cycles.
- At the Centre for Financial History, we have a research programme on ‘Privatised Keynesianism’.

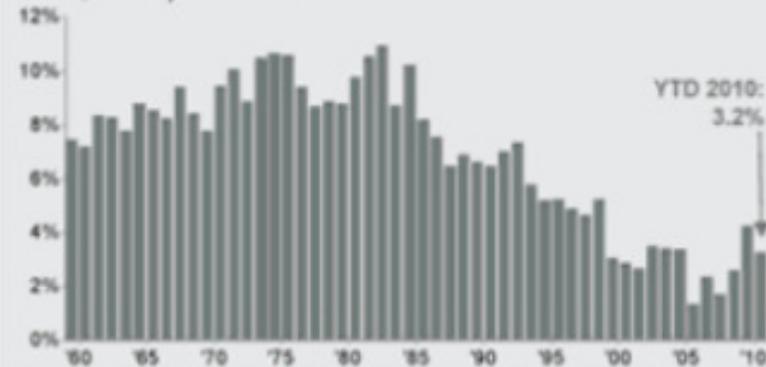
## Consumer Balance Sheet

Trillions of dollars outstanding, not seasonally adjusted



## Personal Savings Rate

Annual, % of disposable income



## Household Debt Service Ratio

Debt payments as % of disposable personal income, seasonally adjusted

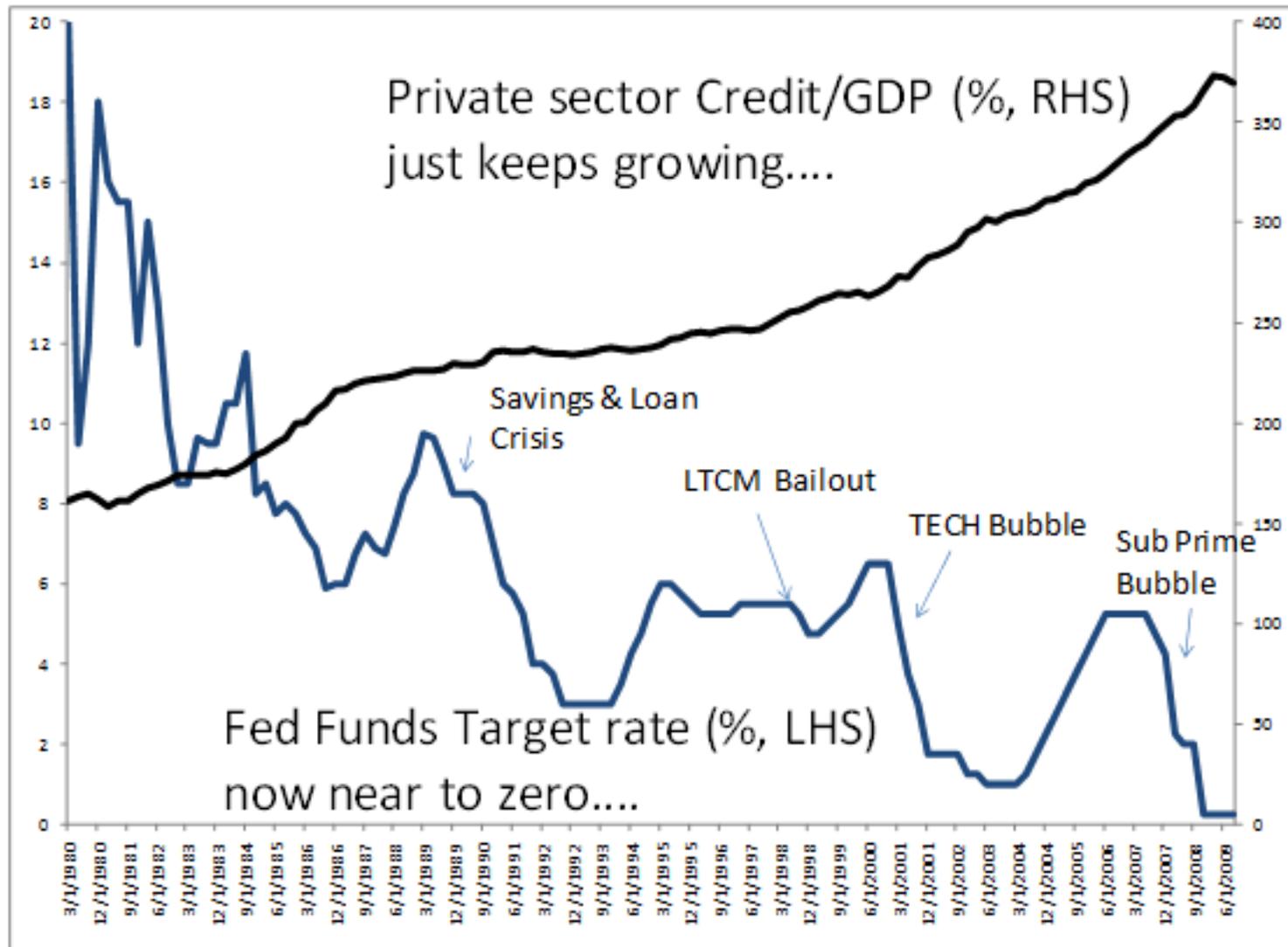


Source: (Left chart) FRB, J.P. Morgan Asset Management. Data includes households and nonprofit organizations. (Right charts) BEA, FRB, J.P. Morgan Asset Management.

Personal savings rate is calculated as personal savings (after-tax income – personal outlays) divided by after-tax income and reflects data through February. Employer and employee contributions to retirement funds are included in after-tax income but not in personal outlays, and thus are implicitly included in personal savings.

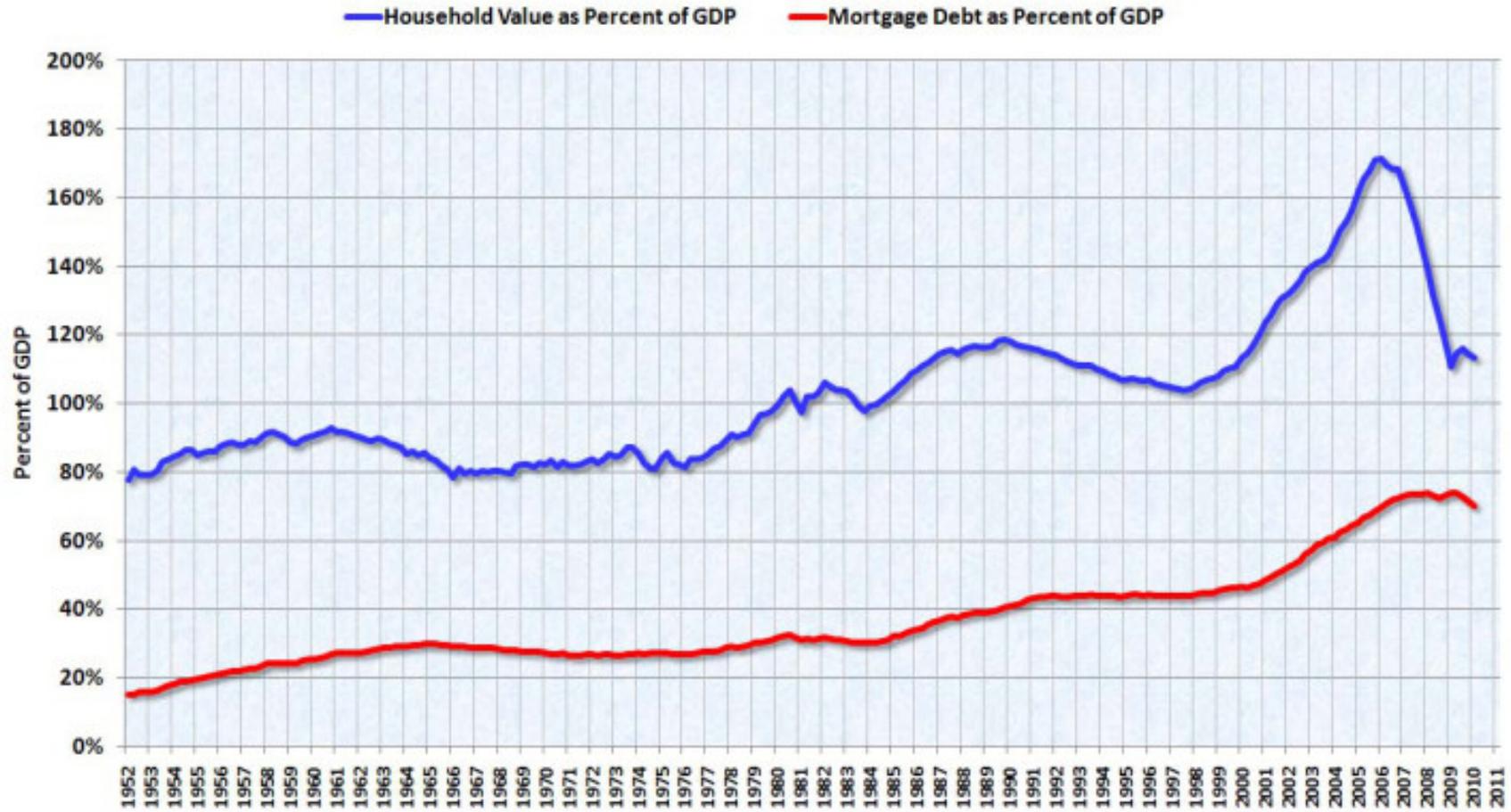
Savings rate data are as of Feb. 2010. All other data are as of 4Q09.

**J.P.Morgan**  
Asset Management



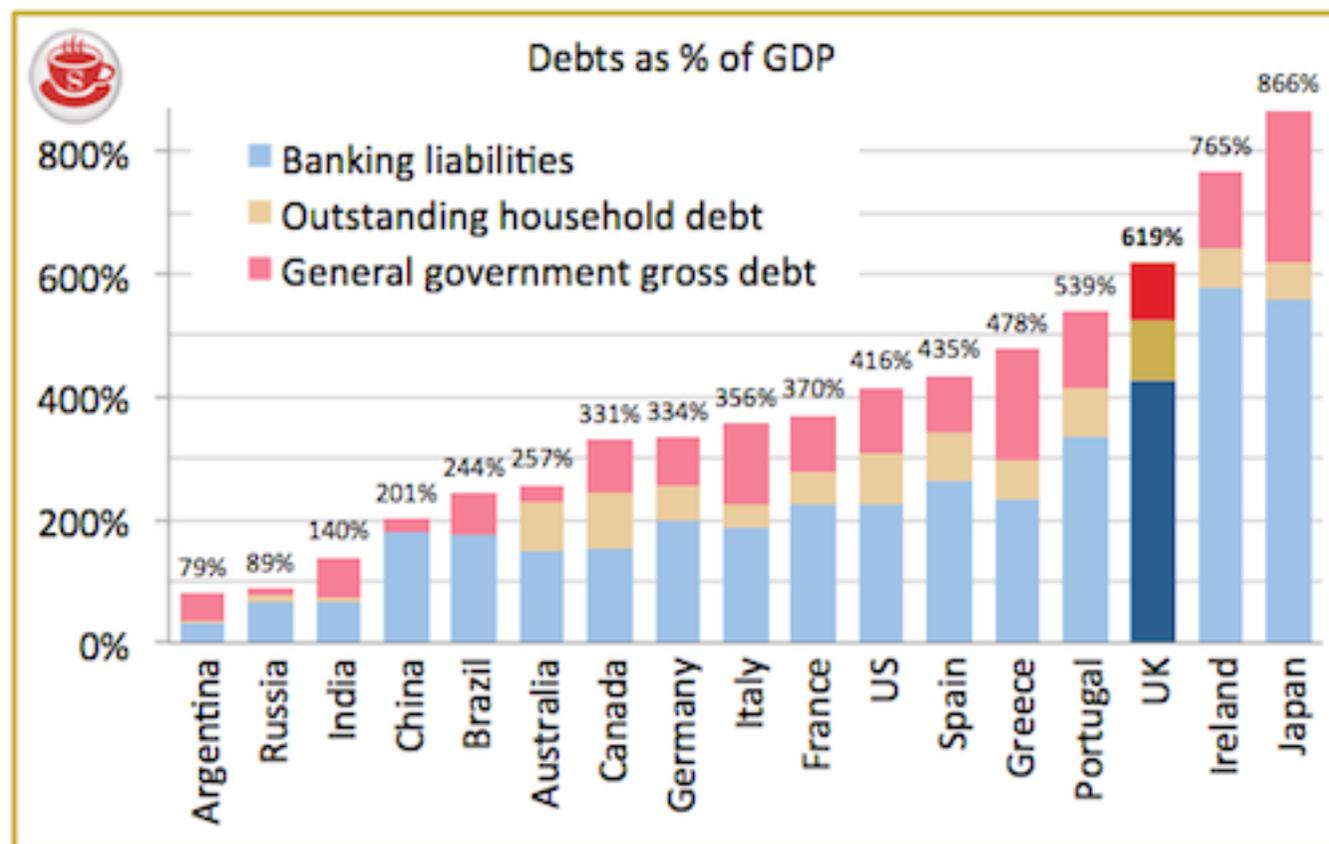
<http://www.voxeu.org/article/risk-taking-regulatory-capture-and-bailouts-doomsday-cycle>

### Household Real Estate Value and Household Mortgage Debt as Percent of GDP



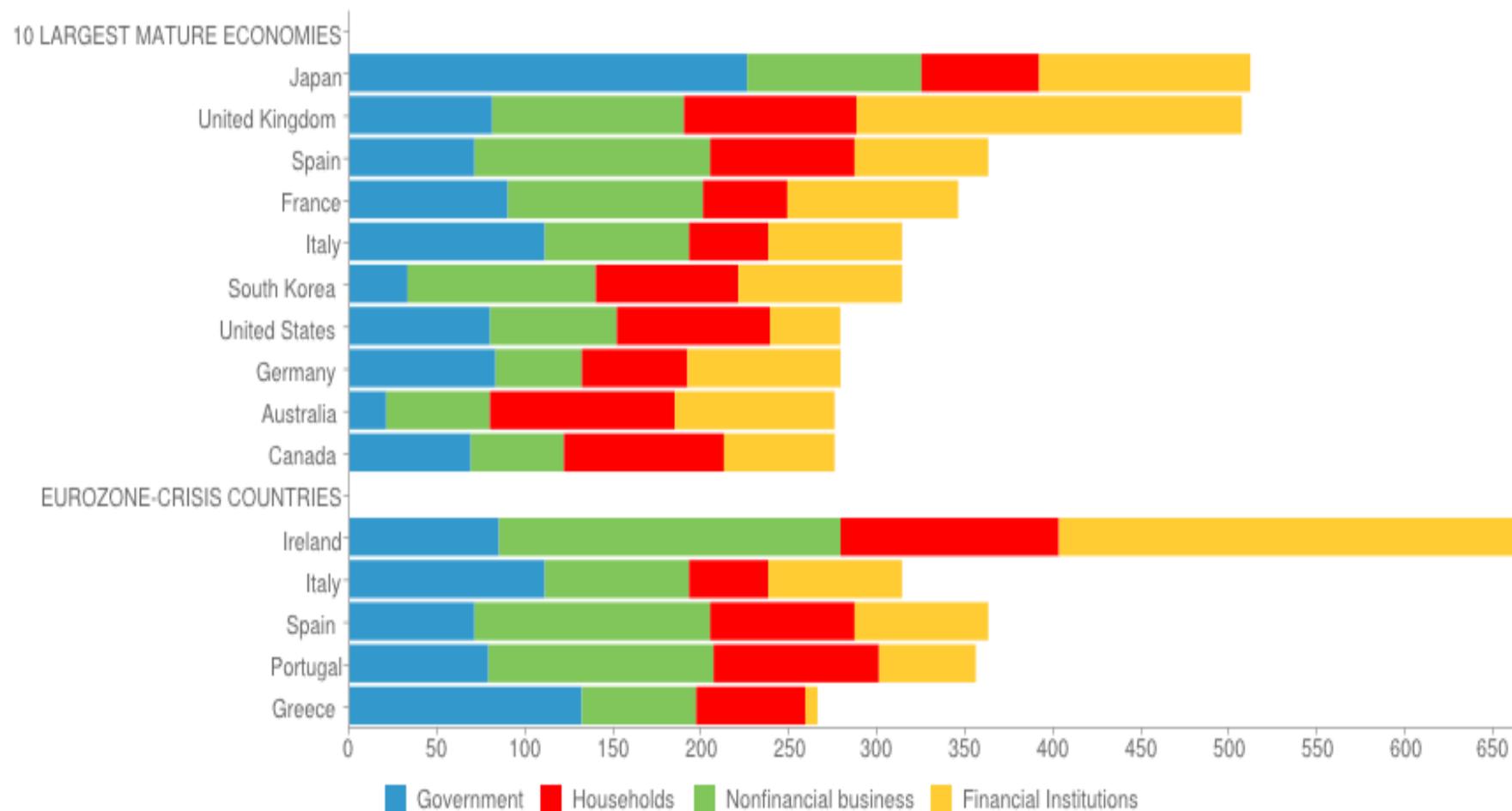
<http://www.calculatedriskblog.com/> Source: Federal Reserve Flow of Funds

# DEBTS TO GDP IN DEVELOPED ECONOMIES



Data from Dominc Raab MP, kindly provided to Coffee House on request.

# DEBT-TO-GDP: SOME COMPARISONS



<http://www.gfmag.com/tools/global-database/economic-data/11855-total-debt-to-gdp.html>

# HOUSEHOLD RESPONSES TO THE CRISIS



The Economist, 1 June 2013: <http://www.economist.com/news/economic-and-financial-indicators/21578669-household-debt>

# SOME CONCLUSIONS

- Cycles and fluctuations are a part of economic life; industrial capitalism gives them certain contours.
- Not all financial bubbles are bad
- Many western economies have been managing business cycles in a way that encourages unproductive and harmful financial crises
- Last 30 years have not been a rejection of Keynes, but Keynes would nevertheless have abhorred the solution of 'privatised Keynesianism'
- We need to find a better way of managing business cycles than using interest rates to re-inflate bubbles in financial markets!

# FURTHER READING

- Akerloff, George A. (1970) 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism,' in *The Quarterly Journal of Economics*. 84:3, pp. 388-500.
- Chancellor, Edward. *Devil Take the Hindmost: A History of Financial Speculation*. (Plume Books, 2000).
- Crouch, Colin. 'Privatised Keynesianism: An Unacknowledged Policy Regime,' in *The British Journal of Politics and International Relations*. 11: 382-399 (2009).
- Janeway, William H. *Doing Capitalism in the Innovation Economy: Markets, Speculation and the State*. (Cambridge University Press, 2012).
- Kindleberger, Charles. *Manias, Panics and Crashes: A History of Financial Crisis*. (John Wiley & Sons, 2000).
- Vogel, Harold. *Financial Market Bubbles and Crashes* (Cambridge University Press, 2009).