Analysis of Causes of Economic Crisis

Michal Růžička 1), Monika Hromasová 2)
1) University of Glasgow
Business School
Glasgow, G12 8QQ
Scotland, United Kingdom
2) Czech University of Life Sciences Prague
Technical faculty, Department of Electrical Engineering and Automation
Kamycka 129
Prague 6 – Suchdol, 165 21
Czech Republic
email: hromasova@tf.czu.cz

Abstract
This article deals with some of the issues concerning the economic downturn, looks for its causes and attempts to analyse them, such as the bank ratings, the role of the trade regulators, the managers' responsibilities, evaluation system and level of education, and the violation of the financial system. This article also brings hindsight to capitalist history and describes the current stage of the neoliberal capitalism. Further the authors critically evaluate the letter which was written by some eminent economists to the UK's Monarch in 2009 stating that the financial crisis was mainly due to: "a failure of the collective imagination of many bright people … to understand the risks to the system as a whole".

Keywords: history of capitalism, economic downturn, economic crisis
JEL codes: N00, G01,

1. Introduction

The economic downturn came as predicted by many experts, e.g. Minsky (1980) and also the Bank of England (Besley, 2009). This affected mainly countries with large financial sector such as the US. Hodgson (2009, p.1) states that leading economists (Coase, Friedman, Leontief) pointed out that *"in recent years economics has turned virtually into a branch of applied mathematics, and has been become detached from real-world institutions and events".* Unfortunately these views were not heeded. *"There were many warnings in the financial markets and the global economy*" and also *"imbalance in the economy"* (Besley, 2009, p.1). Nobody took these warnings to heart. Besley describes the atmosphere in society where politicians were fascinated by economic boom, talented professionals and top managers were in leading positions and the wider public believed in their ability to foresee risk. In reality, the leaders consciously or unconsciously deceived themselves and others, the wider public gained from cheap goods and low unemployment, businessmen from cheap borrowings, bankers from worldwide business expansion and their benefits, and government from high tax revenues. These supported prevalent opinion and nobody who profited wanted to break this (Besley, 2009), *"no one wanted to kill the goose that was laying golden eggs" (Crotty, 2009, p.572).*

Experience from previous crises (e.g. from 2001 in the US when bailouts were used to sort the "dot.com" bubble out) supported the idea that potential crises can be solved the instant they appear. Inflation, the basic indicator of economic overheating, had consistently held at low levels (Besley, 2009) and gave no indication of potential issues. Such factors stifled the policy critic's opinions. Societal attitudes and failures led to an economic downturn (apparently the most serious since the Second World War and by impact the biggest since 1930) possessing according Wray (2009) the characteristics of a systemic crisis.

2. Criticism of Besley's Letter

Hodgson (2009) in his letter to the queen of the UK agrees with some of Besley's arguments about what caused the downturn, though he emphasises the responsibility of some leading and influential economists. Nevertheless generally he sees Besley's analysis as inadequate as it misses the issue of "*the training or culture of economists*". Firstly he emphasises the importance of maths, mathematical models and simulation models, but simultaneously he accentuates the importance of seeing economics as a whole from the functional point of view, as maths and models cannot cover all aspects and areas. Secondly he sees that there were important fields such as psychology, philosophy and economic history which Besley omitted. Thirdly he criticises the fact that managers' decisions were not made on the basis of a *"belief in universal rationality or the efficient markets hypothesis"* (both broadly accepted by mainstream economists) and finally he lambastes the naivety, lack of wisdom and irresponsibility of key managers. All these supported unrealistic assumptions and superseded critical perspectives and consequently the system lost its necessary feedback. These factors and a general satisfaction, which could also be termed blindness, lack of responsibility and selfishness, were probably the main reasons for the economic downturn.

3. Capitalist History - Hindsight

The stabilised system of capitalism after the 1930s crisis brought *"a bigger role of the government in regulating and supervising business behaviour and provided numerous safety nets and guarantees"* and *"had also promoted greater equality and growing incomes"* (Wray, 2009, p.809). After the Second World War this system encouraged high levels of consumption and employment, greater equality and financial stability (Wray, 2009), and worked effectively until the 1960s (Crotty, 2009).

Over time and under lobbying from interest groups, the stabilisation of the 1930s gradually disappeared and the system became more fragile, generating increasingly frequent and severe financial crises. Despite all this, *"previous crises were resolved quickly"* (Wray, 2009, p.807), but the current one appears significantly worse and leads him to doubt the sustainability of neoliberal capitalism.

The system was, outside of a few wobbles, stable until crisis hit in the 1970s (according to Minsky this era was the paternalistic capitalism). The characteristic feature of this stage of capitalism was that the manager's decisions were consistent with the public interest. This quiescence was *"interpreted to validate the orthodox belief that market processes are naturally stable"* Wray (2009, p.812) and the existing system was destroyed by *"deregulation pushed by financial institutions and justified by efficient financial market theory"* (Crotty, 2009, p.564). Paternalistic capitalism was replaced by a new form of finance capitalism - neoliberal capitalism (called by Minsky money manager capitalism) - a system with *"relatively small government, usage of external finance for investment, and growing concentration of economic power in the hands of trusts - or what can be today called megacorporations with... varied interests and diverse affiliations across industry, finance and insurance" (Wray, 2009, p.807).*

4. Current Stage of Neoliberal Capitalism

Wray (2009) and Minsky (1980) see the problem of system instability in neoliberal capitalism to be that it continuously under-evaluates risk which may impact on profit. The current system is built *"on patently unrealistic assumptions and has no convincing empirical support"* (Crotty, 2009, p.564), brings weak regulation of the commercial and investment banks and supports lax regulation (Wray, 2009). These all bring to the system the lack of clarity, non-transparency and excessive risk which manifest themselves in stimulation of overheated growth followed by downturns.

The latest economic downturn was triggered by a US housing bubble and indebtedness of the US householders (Baker, 2008) due to unsecured mortgages (with the mortgage vendors' irresponsible behaviour significantly contributing to it) but in reality this problem was just the tip of the iceberg. The cause of the failure, at least in part, lies in the economic system and its practises (Crotty, 2009). He points out that since deregulation in 1980s, growth has been repeatedly followed by a crisis and then by government bailouts which caused further expansion. The financial market *"grew ever larger relative to the non-financial economy, important financial products became more complex, opaque and illiquid, and system-wide leverage exploded"* (Crotty, 2009, p.564).

Currently it seems that system has become insensitive to all government rescue efforts and attempts at intervention.

5. The significant issues of neoliberal capitalism which caused the economic downturn

Whalen (2007) and Crotty (2008) describe how unregulated mortgage brokers were motivated by numbers of loan sales. They were required to maximise the flows through the system without looking at quality and security. Simultaneously home-buyers were willing to borrow money, as they were encouraged by the amount of savings that they had, the low level of inflation, US government policy (social policy which supported the increase of ownership) and all-round positive social mood (Baker, 2008; Robinson, 2008).

Baker (2008) and Crotty (2009) criticise the high bonuses paid by banks to the top traders and executives *"whose risk-taking generates high revenue and profits"* (Crotty, 2009) but ultimately losses which bring an element of destabilisation to the system. Under these conditions, it is obvious that managers have excessively risky attitudes. Nevertheless they must have known that their decisions would lead to a crash. All this is emphasised by cases when managers got their bonuses in spite of the fact that the companies did not perform well e.g. the case of AIG (Pleven, 2009). These confirm the manager's behaviour which is often not in phase with the shareholders' interests and this is described by agency theory (Kulik, 2005; Williamson, 1985).

The rating agencies were the next element which weakened the system. The rating agencies make ratings for the banks and are simultaneously paid by these same banks. Logically these agencies want to satisfy their customer's needs. The banks look for the best rates (which give them the opportunity to sell their "well rated" financial products e.g. CDOs (Collateralised Debt Obligations) to others at a best price; this also distributed risk and provided further financial resources to provide new loans) and consequently for agencies which are willing to give them the best rates (Baker, 2008). This meant that there were banks on the market that had *"absurdly high ratings"* but possessed *"illiquid, non-transparent, structured financial products and collateralised loan obligations"* (Crotty, 2009, p.566). Lewis (2009) emphasises that the rating organisation instead of exposing risk did the opposite – covered risk in order to maximise their income.

Next, complex, opaque and risky financial products such as CDOs were held by the banks. Being difficult to price, their liquidity dropped quickly during the downturn. As these products are complex, it is difficult to calculate their values, predict their value movements and their simulation models are thus unreliable. This presents opportunities for manipulation (Crotty, 2009). The CDOs that brought long term high profits to the banks resulted in huge loses during the downturn (Crotty, 2008) e.g. *"Citigroup lost more money than it made from the financial instruments based on the U.S. subprime mortgages"* (Vina, 2007). Meanwhile, subprime mortgages (subprime mortgages were typically given to people with low credit history; often to casual workers) doubled between 2002-2004, while wages lagged inflation. This was a clear signal of the potential problem on the house market (Baker, 2008).

Furthermore, the regulators allowed banks to keep their often risky securities off balance sheet (involving CDOs) without having capital to cover them (Weissman, 2009; Brunnermeier, 2009). This was despite the fact the regulators in power e.g. American FED (Federal Reserve System) had the necessary tools to stop at least the worst cases (Baker, 2008). As the banks were later forced to return their devalued and damaged securities back to their balance sheets, it badly affected their capital. In their attempts to repair their positions, the banks raised their interest rates. It is surprising to hear the statements of key managers such as Anthony Bolton (president of investments at Fidelity International): *''In spite of more than 30 years in the business, I was unaware of the extent of banks' off-balance-sheet assets such as securities''* (Tett, 2009) or Peter Kurer, UBS chairman statement: *"We never paid much attention ... because our risk managers said those instruments were triple-A"* (Tett, 2009). Both of these sound like excuses, and indicate a damning inconsistency, naivety or even possibly criminal negligence.

The next fault, again the regulators', was allowing banks to evaluate both their risk and their capital requirements on their own. A method call VAR (Value at Risk) was used for risk evaluation purposes. This widespread method has its limitations and should be used together with other evaluation methods. It ignores certain risks and it uses data from previous periods (Partnoy, 2003); the length of the period is eligible and in times of economical volatility assumes that security prices follow normal distributions (which usually does not correspond to reality) and that asset price correlations from the past will be similar in the future (Crotty, 2007).

Furthermore a dangerous level of leverage was accepted, which allowed a doubling in the borrowings of the US financial institutions as a percentage of GDP (Gross Domestic Product). The SEC (US Securities and Exchange Commission) established a voluntary regulation regime for investment banks which limited debt-to-net capital ratio to 12 times (1975-2003); in 2004 it raised to 40 times. This increased bank vulnerability and brought about the mess of derivative investments (Weissman, 2009; Crotty, 2009).

Next the American Economic Association through its Commission on the state of graduate education in economics in the US has expressed fears about the quality of graduate programs and doubts about the academically educated graduate's usefulness in real economics (Krueger, 1991; Hodgson, 2009). Hodgson (2009) emphasis that managers should be trained in and able to use non-quantified warnings which can show potential economic instability. This group of leaders should obtain complex economic training based not just on the maths and models but also the influence of "*historical, institutional, psychological and other highly relevant factors*" Hodgson (2009). These should put economists back in touch with real world of economics.

6. System Stability

Minsky (1980) emphasises that the control of system stability is as important from the policy and growth points of view as it was in the 1930s. Inspired by Keynes' work, Minsky developed the financial instability hypothesis, in which he maintains that during the economic growth periods the system becomes fragile; "*endogenous processes breed financial and economic instability, and cyclical downturns are associated with involuntary unemployment*" (Whalen, 2007). This puts Smith's work in contrast, which is a second view of how the economy works, "*where endogenous processes generate an economic equilibrium and business cycles are the product of exogenous shocks*" (Whalen, 2007). According to Minsky capitalism has the potential to survive as it has shown that it is vital and adaptable over time, compared to socialism in its Soviet version which was conserved and collapsed (Minsky, 1993). Wray

(2009) recommends that the latest economic downturn could lead to systemic transformation and bring a more robust capitalism with a higher level of stability.

7. Conclusion

Besley (2009) states that *"the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in the UK and internationally, to understand the risks to the system as a whole"*. This kind of simple excuse cannot be accepted, simply undertaking a failure analysis and waiting for next crisis. Under the circumstances which have happened and under which the system failed, stabilisation elements have to be brought to the system to secure it against next crisis as much as possible.

Capitalism cannot be stable under conditions which support high risk and high leverage strategies. Under these conditions the system must regularly end up in crisis. The system will not be stable if there are rating agencies directly dependent on the banks. Independent regulatory, rating and financial institutions would ensure clear and reasonable regulations and real evaluation of financial institutions and consequently the minimisation of fake ratings. Further it would minimise attempts to screw the system and generally it would increase systemic clarity and robustness by protecting it from unexpected surprises.

Particular attention should be given to managers' education and training to provide them with understanding of complex systems and the consequences of their decisions. All these would prevent managers from taking narrow and simplistic views of issues.

The manager's responsibility is the next point which has to be enhanced. They have to be directly responsible for their decisions and their business units' performance. Both have to have a direct connection with their bonuses. There have to be ways to claim back previously paid bonuses in cases where failure appears later. Also logically there should be no bonuses paid in cases where company performance is bad. The negative impact of managerial bonuses should be considered. All these points would help to stabilise capitalism.

Also the importance of economic system stability and sustainability should be evaluated, and the level of risk which is acceptable with regards to levels of acceptable regulation. The long term question which remains is whether the next downturn or crisis is evitable (or better said whether the economic downturn impacts can be minimised), whether we are able to learn from our previous mistakes, whether we are able to keep them in mind, or whether the screwing of the system will in some form be repeated.

References

Baker, D. 2008. The Housing Bubble and the Financial Crisis. *Real-World Economics Review*, vol.33, issue 46, pp.73-81, available from: <http://www.paecon.net/PAEReview/issue46/Baker46.pdf> [Accessed 16 February 2011]. ISSN: 1755-9472.

Besley, T., Hennessy, P. 2009. *The Global Financial Crisis – Why Didn't Anybody Notice?* Open Letter to the Queen, British Academy, 26th July, available from: <http://docs.google.com/viewer?a=v&q=cache:hPV6WsjNVu8J:media.ft.com/cms/3e3b6ca8-7a08-11de-b86f-00144feabdc0.pdf+letter+to+the+queen+re:+financial+crisis&hl=en&gl=uk&pid=bl&srcid=ADGEESimi0EMUzjrjiMU1gZSs4JDzm-ktXFC5Wk56G9mAzWLqJUNAQuiZbL8j9c5addNkmh4z-M5mV4679EwwIKmv1UWK0n6dy2NqJuhlM2v_XBjEY9as1W3w26FzyR7Rrv8lQ6xJqnM&sig=AHIEtbR301hobpqS0mrrB723G1HGmM_wPQ> [Accessed 12 February 2011].

Brunnermeier, M. 2008. *Deciphering the Liquidity and Credit Crunch 2007–2008.* Working Paper 14612, National Bureau of Economic Research, MA, USA, available from: <http://www.nber.org/papers/w14612> [Accessed 17 February 2011].

Crotty, J. 2007. *If Financial Market Competition Is so Intense, Why Are Financial Firm Profits so High? Reflections on the Current 'Golden Age' of Finance.* Political Economy Research Institute (PERI), University of Massachusetts Amherst, MA, USA, Working Paper no.134, available from: <www.peri.umass.edu> [Accessed 10 February 2011].

Crotty, J. 2008. *Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'.* Political Economy Research Institute (PERI), University of Massachusetts Amherst, MA, USA, Working Paper no.180, available from: <www.peri.umass.edu> [Accessed 9 February 2011].

Crotty, J. 2009. Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'. *Cambridge Journal of Economics*, Oxford Journals, Oxford University Press, vol.33, issue 4, pp.563-580, ISSN: 1464-3545.

Hodgson, G. et al. 2009. *Open Letter to the Queen*, 15th August, available from: <http://docs.google.com/viewer?a=v&q=cache:4KK-KgHQuDEJ:www.feed-charity.org/user/image/queen2009b.pdf+hodgson+letter+to+the+queen&hl=en&gl=uk&pid=bl&srcid=ADGEESgSmGtUU33UR2IanTZnufg47sqb8rtOD6B31wY_g4-TJbK4lDWeeliGVevH8clwnoqCLXLAg6W7Wjuu8PM34IHh9bq-dg4lsgQwl4VRot7U9SdBAvSDpbX8etrJXXvuiaSBQWmq&sig=AHIEtbRxTK4sG5TPEab55zcwLRKEKg_4lA> [Accessed 12 February 2011].

Krueger, O. et al. 1991. Report of the Commission on Graduate Education in Economics. *Journal of Economic Literature*, vol.29, issue 3, pp.1035-1053, available through database: Business Source Premier, [Accessed 13 February 2011]. ISSN: 0022-0515

Kulik, B. 2005. Agency Theory, Reasoning and Culture at Enron: In Search of a Solution. *Journal of Business Ethics*, vol.59, no.4, pp.347–360, available from: <http://www.springerlink.com/content/nr40x067450hr684/> [Accessed 17 February 2011]. ISSN: 1573-0697.

Lewis, M., Einhorn, D. 2009. *The End of the Financial World as We Know It*. New York Times, 3 January 2009, The New York Times Company, available from: <http://www.nytimes.com/2009/01/04/opinion/04lewiseinhorn.html?_r=1&pagewanted=2> [Accessed 10 February 2011].

Minsky, H. 1980. Capitalist Financial Processes and the Instability of Capitalism. *Journal of Economic Issues*, vol.14, issue 2, pp.505-523, available through database: Business Source Premier, [Accessed 8 February 2011]. ISSN: 0021-3624.

Minsky, H. 1993. *Finance and Stability: The Limits of Capitalism.* Working Paper No.93, Levy Economics Institute, available from: <http://www.levy.org/pubs/wp93.pdf> [Accessed 9 February 2011].

Partnoy, F. 2003. *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets.* Henry Holt and Company, New York, ISBN: 0-8050-7267-5.

Pleven, L., Ng, S., Reddy, S. 2009. *AIG Faces Growing Wrath over Payments.* Wall Street Journal, vol. 253, issue 61, p.A1-A16, available through database: Business Source Premier, [Accessed 9 February 2011]. ISSN: 0099-9660.

Robinson, T. 2008. *The Credit Crunch: How Did We Get Here?* AllenbridgeEpic Investment Advisers Limited, UK, available from: <http://www.allenbridgeepic.com/pdf/credit-crunch/CCEssay1.pdf> [Accessed 17 February 2011].

Ruzicka, M. 2011. *The Analysis of Causes of Economic Crisis*. Business School. University of Glasgow.

Tett, G. 2009. *Lost Through Destructive Creation*. Financial Times ltd., 10 March, available through database: News Bank Newspapers-UK & International, [Accessed 10 February 2011]. ISSN: 0307-1766

Vina, G., Boyd. S: 2007. *Citi's Losses 'Greatly Exceeded' Profits for Subprime*. Bloomberg, available from: <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azVaP3hBOkQ4> [Accessed 10 February 2011].

Weissman, R., Donahue, J. 2009. *Sold out. How Wall Street and Washington Betrayed America.* Wall Street Watch. Consumer Education Foundation, March, available from: <http://www.wallstreetwatch.org/reports/sold_out.pdf> [Accessed 14 February 2011].

Whalen, C. 2007. The US Credit Crunch: A Minsky Moment. *The Public Brief Policy*, The Levy Economics Institute of Bard College, no.92, available from: <http://www.levyinstitute.org/pubs/ppb_92.pdf> [Accessed 16 February 2011]. ISSN 1063-5297.

Williamson, O. 1985. *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting.* Collier Macmillan Publishers, London. ISBN: 0-68-486374-X

Wray, L. 2009. The Rise and Fall of Money Manager Capitalism: A Minskian Approach. *Cambridge Journal of Economics*, Oxford Journals, Oxford University Press, vol.33, issue 4, pp.807-828, ISSN: 1464-3545.