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?
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 19th 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)**


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

<table>
<thead>
<tr>
<th>Group</th>
<th>Country</th>
<th>1913, as against 1929</th>
<th>1917, as against 1932</th>
<th>1917, as against 1929</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group I</td>
<td>Japan</td>
<td>- 2</td>
<td>79.4</td>
<td>71.4</td>
</tr>
<tr>
<td></td>
<td>Greece</td>
<td>1</td>
<td>49.3</td>
<td>51.4</td>
</tr>
<tr>
<td></td>
<td>Finland</td>
<td>-17</td>
<td>79.3</td>
<td>49</td>
</tr>
<tr>
<td></td>
<td>Sweden</td>
<td>-11</td>
<td>67.4</td>
<td>49</td>
</tr>
<tr>
<td></td>
<td>Hungary</td>
<td>-23</td>
<td>77.9</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>Denmark</td>
<td>-9</td>
<td>47.3</td>
<td>34</td>
</tr>
<tr>
<td></td>
<td>Rumania</td>
<td>-11</td>
<td>49.3</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>Norway</td>
<td>-7</td>
<td>37.6</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>United Kingdom</td>
<td>-17</td>
<td>49.3</td>
<td>24</td>
</tr>
<tr>
<td>Group II</td>
<td>Germany</td>
<td>-42</td>
<td>100.0</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>Austria</td>
<td>-19</td>
<td>73.7</td>
<td>6</td>
</tr>
<tr>
<td>Group III</td>
<td>Canada</td>
<td>-42</td>
<td>79.4</td>
<td>00</td>
</tr>
<tr>
<td></td>
<td>Italy</td>
<td>-33</td>
<td>49.2</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Czechoslovakia</td>
<td>-36</td>
<td>50.0</td>
<td>-4</td>
</tr>
<tr>
<td></td>
<td>Belgium</td>
<td>-31</td>
<td>36.2</td>
<td>-6</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td>-46</td>
<td>70.3</td>
<td>-8</td>
</tr>
<tr>
<td></td>
<td>Netherlands</td>
<td>-38</td>
<td>46.7</td>
<td>-9</td>
</tr>
<tr>
<td>Group IV</td>
<td>Poland</td>
<td>-46</td>
<td>57.4</td>
<td>-15</td>
</tr>
<tr>
<td></td>
<td>France</td>
<td>-31</td>
<td>41.3</td>
<td>-28</td>
</tr>
</tbody>
</table>

(Source: D. Landes, p. 391)
**Riding to the Rescue**

How the Fed has responded to financial crises

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

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 (Akerlof, 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

Total Assets: $68 tn
- Homes: 27%
- Other tangible: 7%
- Deposits: 11%
- Pension funds: 17%
- Other financial assets: 38%

Total Liabilities: $14 tn
- Revolving (e.g., credit cards): 6%
- Non-revolving: 11%
- Other Liabilities: 10%
- Mortgages: 73%

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.
Debts to GDP in Developed Economies

Data from Dominic Raab MP, kindly provided to Coffee House on request.
Debt-to-GDP: Some Comparisons

HOUSCHELD RESPONSES TO THE CRISIS

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!


