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The financial sector and the future of capitalism

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ABSTRACT

Financial sector innovation and development since the 1970s contributed to global prosperity, but increased the probability of bank failures. The post-2007 financial crisis was one of many crises with idiosyncratic catalysts but common underlying causes. Public policies, such as deposit insurance, with moral hazard implications increased the likelihood of crises, and cheap money exacerbated the situation by encouraging highly leveraged investments. The policy challenge is to address moral hazard without repressing the financial sector. This is not the end of capitalism, but a reminder of the difficulty in policing the financial sector which is at the heart of capitalist economies.

1. Introduction

The 2007–2008 financial crisis evinced a chorus of lessons from history, mostly drawn from 1929 and with advice that governments needed to act decisively. The depression of the 1930s is a poor source because almost any lessons can be drawn and because the economy of eighty years ago was vastly different from today's economy. So many mistakes were made after 1929 in the USA and Europe in monetary policy, fiscal policy, banking policy, trade policy. The list seems endless, and with so many policy errors it is difficult to know which were critical and what policy changes would have been sufficient to reduce the severity of the depression. Moreover, today's economy is both more complex, in large part because of financial innovations, and has more institutional diversity than that of 1929, when central banks were instinctively opposed to interventionist measures and international institutions such as the International Monetary Fund did not yet exist.[1]

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[1] Ahamed (2009) provides an entertaining account of the role of central bankers in the 1920s and 1930s.

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More relevant lessons from history can be taken from the three decades before 2007–2008 when financial market liberalization was accompanied by economic prosperity punctuated by frequent crises.[2] Financial liberalization was part of the reform package that underlay the 1986–1993 prosperity of Mexico and the 1982–1996 boom in Thailand (during this period the fastest growing economy in the world). Despite signs that capital inflows were decelerating, neither government was willing to take action before their economies suffered a hard landing in the 1994 Tequila Crisis and the 1997 Asian Crisis. These, as well as the many other crises of the 1990s, were considered country-specific (e.g. due to the dollar-indexed nature of Mexican debt, unregulated financial institutions in Thailand or the special form of Russian government liabilities in 1998) rather than a concomitant of liberalization. In the high-income countries, the Japanese experience and Scandinavian banking crises were dismissed as special cases, perhaps exacerbated by macroeconomic mismanagement,[3] while in the USA the S&L Crisis was dismissed as a special case of poor management and greed and neither the 1987 stock market crash nor the dot-com bubble bursting in 2000 caused sufficient concern to worry about systemic instability.

In this paper I argue that increased vulnerability to financial crises is a consequence of financial development that has been exacerbated by easy monetary policy. Although nobody welcomes crises, it is important to place them in a longer term context of financial reform generally delivering greater prosperity.[4] Financial innovation has accentuated these benefits, whether in Renaissance Florence, eighteenth century England or in many countries in the last quarter of the twentieth century. Today's short-attention-span media coverage focuses on dramatic events (the crises) and not on the longer term context, such as Mexico's economic development over the two decades after 1986.[5] Japan has not lost the fruits of its post-1945 rapid economic growth; despite the magnitude of the asset bubble that burst in the late 1980s and the 'lost decade' of the 1990s, Japan remains the world's second-largest economy.

Financially more developed economies grow faster, but are exposed to sources of instability unknown in less developed economies. The policy dilemma—how to balance the demands of long-term growth and short-term stability—is a typical financial trade-off between return and risk. The business cycles of the last two centuries and Keynesian macroeconomics are consequences of financial intermediation that opens up the possibility of a mismatch between desired saving and desired investment.[6] Governments since 1945 have responded to the challenge with discretionary macroeconomic policy and by financial regulation. As macropolicy has succeeded in dampening business cycles and fears of unemployment approaching 1930s levels had receded, governments

[2] Eichengreen and Bordo (2002) identify 38 financial crises between 1945 and 1973 and 139 between 1973 and 1997. Caprio and Klingebiel (1997) identified 112 banking crises in 93 countries (and 51 borderline crises in 46 countries) between the late 1970s and 1997, with an average fiscal cost of about 12% of GDP. Laeven and Valencia (2008), excluding 'crises' affecting isolated banks, identify 124 systemic banking crises from 1970 to 2007 and examine 42 of these in detail.

[3] Following financial market deregulation, Finland, Norway and Sweden all experienced equity market and housing bubbles in the 1980s, which were accompanied by procyclical macro policies (Jonung, 2008). Norway's 1988 crisis followed the decline of energy prices and depressions in Finland in 1990 and Sweden in 1991 were associated with the economic collapse in Eastern Europe.

[4] I ignore egregious exceptions like Albania in 1996–1997 where gullible depositors were taken in by pyramid schemes whose deposits, held by two-thirds of the population, reached almost half of GDP before the institutions collapsed, and the huge loss of people's savings contributed to civil disorder in which several thousand people were killed. An economically literate population is a prerequisite for an efficient financial sector. The formerly centrally planned economies were an exceptional case of countries with good education levels but a low degree of understanding of market economies.

[5] The real effects of the Tequila Crisis lasted no more than a couple of years, as economic growth resumed in 1996 and had reached 7% per annum in 1999. Economic growth also resumed in Brazil, the main sufferer from contagion from the Tequila Crisis, and was sufficiently firmly based that Brazil would be viewed as one of the leading emerging economies in the 2000s. Ranciere et al. (2008) provide more systematic evidence of a positive relationship between crisis-prone economies and growth, although their time series does not include the post-2007 data points.

[6] The nineteenth century French economist, Clément Juglar, whose best-known aphorism is "The only cause of depression is prosperity", expounded a similar view. For Juglar, depressions were only truly possible in a system with credit creation (and hence were a nineteenth century novelty), and it was the abuse of credit rather than the issue of money that led to crises; credit encourages speculation, and overoptimism and herding lead to this getting out of hand. In his emphasis on "animal spirits", Juglar predates Keynes, but whereas Keynes focussed on the depression, Juglar focused on prosperity with depression as an unavoidable concomitant. Schumpeter championed this view, where the depression contributes to creative destruction by weeding out inefficient firms, in his *History of Economic Analysis*. See Dal-Pont Legrand and Hagemann (2005).