The White Swan

Source: Crisis Economics Roubini and Mihn, cap. 1.

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A.A. 2021-2022

The White Swan

Crisis as a black **swan**? Improbable, unpredictable so a comforting event.

The 2008 crisis, the **Great Recession**, has many similarities with the **Great Depression**, but also with the see bubble of 1720, the global financial crisis of 1825, the American saving and loan crisis and many other crisis during the ‘80s and ‘90s around the world.

In the history of modern capitalism crises are the **norm**. **Causes** may be different: house bubble, stock exchange bubble, currency crisis etc..

Crisis Habit

Also the **effects** may be different: much depends on government intervention and international coordination.

Crises have a **pattern**:

- Bubble of some asset.
- Bubble are associated to some innovation (real or financial).
- Increasing debt of agents.
- Increasing credit supply due to lax regulation.
- This time is different assumption.

The white swan: the bubble

- Large credit supply makes **credit cheap** this, in turns, makes easy to buy the desired asset (Low wages and expansionary policy in US).
- The asset can be used as a collateral to borrow more (houses as cash machines).
- At some point the supply exceeds the demand or credit becomes more expensive, thus the bubble explodes.

The white swan: the burst

- The **value start to declines**, so banks ask for more collateral and creditor sells more units of the assets and price goes down further.
- Banks try to sell the asset and price decline far below the fundamental value of the asset.
- Moreover banks start to reduce the overall amount of credit to reduce their exposure, thus the whole economy contracts.

Dark ages

- At the beginning government default: Edward III in the mid fourteen century defaulted, after French, Spain, Austria,Prussia and Portugal.
- In the 1630, ‘Tulip mania’ in Holland.
- John’s Law Mississipi Company (1719), in Britain 1825 (Republic of Poyais), global meltdown 1873. (Crises in 1819,1837,1866,1893).
- 1907 crises, speculative booms on real estates and stocks, that triggered a bank run. Six years later the FED was born as lender of last resort.
- 1929 the worst crisis, unemployment rose from 3.2 to 24.9 the US. Opened the way to Nazism. In US the New Deal.

Great Moderation

- After the second world war the Bretton Wood agreement (GATT, IMF, WB) with the dollar exchange standard.
- In the 1971 the Bretton Wood system falls down, oil crises in 1973 and 1979.
- In the early ‘80s, Paul Volker (Fed) increased the interest rate, the economy collapsed but inflation get under control.
- The **great moderation** in US: low inflation, high growth and mild recessions (1987 crash do not lead to a recession, in 1990 short recession).
- While in Latin America huge debt crises because of the growth the interest rate on foreign credit.

Not So Great Moderation

- Great moderation some reason: business and fiscal deregulation augments flexibility, China produces cheap goods that reduce inflation, reduced labor strength.
- But in the nineteen **Japan Crisis** on real estate sustained by low credit (the value of land near the Imperial palace is the same as California). When the cost of credit increased the bubble burst. The Japanese economic growth stopped.
- **Capital account crises** in emerging countries (Mexico in 1994, Argentina, Russia, Asian Tigers). This country borrowed in foreign currency and suffer for sudden stops of credit.

Not So Great Moderation

- The tech bubble in the late ’90s, with several dot com failures, but scarce effects on the real economy. But obliged the FED to an expansionary policy.

Crisis Redux

- Market fundamentalism in the US: **deregulation**.
- Innovation in the financial sector: **securization**.
- **Fed** to respond to the tech crisis in 2001 reduced the cost of credit.
- **Asian countries** brought dollars and assets in dollars to avoid exchange rate crisis and to undervaluate their currency.
- Cheap credit sustained the **housing bubble**, that collapsed only in 2006-2007.

Crisis Redux

- Failure of credit institute as **Lehman brothers** lead the crisis out of control.
- The crisis **spreads** all over the world, many country had bubble and excess of indebtedness.
- Moreover, the crisis diffused through the international **trade network**.