Crisis Economists

Source: Crisis Economics Roubini and Mihn, cap. 2.

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Introduction

- Crisis are caused by government intervention or lacking government intervention causes them?
- Do bubbles exist or they are just the reaction of markets to new information?
- After a crisis government must act as lender of last resort and with expansionary market or expansionary policies are dangerous?

Economics is not an hard science, several opposing opinions that impact on policy making.

When markets behave badly

- Adam Smith with ‘The invisible hand’ metaphor represent market as self-regulating.
- The corollary is that prices are correct, they depend on information. Indeed you cannot beat the market.
- Behavioral economics shows that positive feed back mechanisms tend to create bubble ‘irrational exuberance’ (biased self-attibution), at the same time they can create negative bubbles.

The cradle of Crisis Economics

- John Stuart Mill (1848) describes a model of boom and bust cycle:
  - an external shock or catalyst for boom.
  - speculative mania driven by psychology.
  - a feedback mechanism that increases enormously prices.
  - credit easily available.
  - inevitable crash of the financial system.
  - negative consequences on the real economy.
- Jevons fluctuations are associated to external phenomenons (as sunspots).

The cradle of Crisis Economics

Marx crises:

- Capitalist tries to increase profit introducing **innovations** but this determines instability.
- Crisis are not generated by exogenous forces but they are inherent to capitalistic development.

The Long Shadow of Keynes

The Great Depression determines how we think about crisis.

Keynes crisis are associated to lack of demand:

- If there is low demand firms will produce and creating unemployment. Moreover, low demand can worst expectation so reducing investments.
- Higher unemployment reduces consumer demand. Moreover can create negative expectations and reduce further the demand

The Long Shadow of Keynes

So **self-reinforcing** circles may be created, low demand can create negative expectations and further reduce demand of both firms and consumers, this may lead to an unemployment equilibrium. Animal spirits of capitalism vanish.

The solution is that the government must **create demand** reversing the downward spiral.

The monetarist view

- The Great Depression was not due to a collapse of the demand but by a contraction of banks deposit and reserves: the **Great contraction**.
- Because people **withdraw** their money from the bank that risked to collapse, so a small crisis become an economic collapse.
- The Great depression could be avoided if the federal reserve acted as a **lender of last resort** and if the fed decreased the interest rate.

Minsky Financial Instability Hypothesis

According to Minsky:

- Instability is inherent and inescapable flaw of capitalism.
- The role of financial intermediaries (banks, investment funds) is fundamental in understanding crisis.

Minsky Financial Instability Hypothesis

In the Minsky Financial Instability Hypothesis debtors are categorized in three ways:

- Hedge borrowers: can repay interest and the principal through their cash flow.
- Speculative borrowers: car repay only interest, they have to roll over their debt.
- Ponzi borrowers: cannot coever neither interest neither principal.

Minsky Financial Instability Hypothesis

During a crisis Speculative and Ponzi borrowers increase and just a small trigger may let fall all the debit pyramids.

Moreover when the financial system has a crisis, banks and firms may have problem to have liquidity so they have to sell their assets. Thus asset prices goes down.

More in general even prices of goods start to decline because people buy less.

Deflation makes the real value of debt increase, this lead to a collapse of the economy.

Crisis Policies

- Expansionary fiscal policy are used to sustain the economy during a crisis (’keynesian’)
- Expansionary monetary policy to reinflate the economy and lending of last resort (’monetarist’)
- But these policies may have negative long run consequences ...

Austrian and crisis

According to the Austrian:

- Capitalism is characterized by crisis that are moment of creative destruction.
- Saving failing bank and firm creates zombie company that are not able to survive by themselves.
- Moreover lending of last resort leads to moral hazard behaviours.
- Public expenditure produce bridge to nowhere, so let the market work

Short and long run

- However in the short run even sound firm may fail.
- While in the long run saving all may be counterproductive.
- Saving may leads to moral hazard behaviours.

A controlled creative destruction may be a good compromise. It is important to sustain the economy in the short run without creating moral hazard. Is it possible?