Introduction

Joëlle J. Leclaire, Tae-Hee Jo and Jane E. Knodell

In 2008, the American financial structure was put to the test. A financial crisis, the magnitude of which we had not seen since the Great Depression, shook the foundations of stability both financial and economic of the US and world economy. Granted, many underlying issues began to surface in 2006 and 2008, but it was in the fall of 2008 that we saw the most radical declines in financial asset values and the emergence of new tools used by the Federal Reserve to stop losses. This book combines a variety of chapters written to bring forward one fundamental and yet still for the most part, fleeting, truth: that is, that the financial system is inherently unstable. Hyman Minsky, the economist responsible for the financial instability hypothesis, emphasized the importance of basing any analysis of the financial system on the idea of inherent instability. Here we are, now facing overall levels of unemployment of 10 percent, which means they are much higher for certain demographic groups and certain regions, and the relationship between the instability of the financial market and the welfare of the economy has never been more clear. In the fall of 2009, we worked with a team of colleagues at Buffalo State College, to bring together a distinguished group of scholars who were studying the causes, consequences and solutions to the current financial and economic crisis. We took the lead in organizing and hosting the 4th bi-annual Cross-Border Post Keynesian Conference at Buffalo State College, NY. The theme was Financial Crisis and Reform and the response was excellent. We had over 50 scholars presenting their work. Of these presentations, this book contains only 12 chapters, which we feel do a good job of representing the key ideas that were presented at the conference. The book is divided into three parts: Financial Crisis and Reform, History and Political Economy of Financial Crisis, and Theoretical Analyses of Financial Crisis. Our hope is that the book will help contribute something to our knowledge of financial crises, their impact on the economy and society, and through this reading, bring to light policies that can and should be changed to better deal with what is sure to be a recurrent phenomenon.

Part I, Financial Crisis and Reform, regroups articles written by the
keynote speakers from the conference. The first chapter by Jan Kregel asks the question of whether financial system regulations can indeed be reformed. Here, Kregel shows that the financial crisis cannot be alleviated by suddenly enforcing existing regulations, or by providing more short-term liquidity to markets for assets whose values have declined. He indicates that in this case, the assets themselves and the institutions that hold the latter are insolvent. An insolvency issue cannot be handled by legislation and tools meant to solve a liquidity shortfall. If Kregel is right, then recovery and effective financial reform will be a long time coming.

In the second chapter, Yeva Nersisyan and L. Randall Wray explain that sound retirement income cannot be guaranteed by the market and therefore retirement savings should be invested in treasuries directly. What’s interesting is that pensions and retirement plans are historically under-funded and actually need a speculative bubble to be fully funded. The idea that money managers can beat the market leads us to think that Wall Street is capable of generating greater returns for our retirement savings than simple investment in US Treasuries. Nersisyan and Wray show us that on average we would be better served by investing in US government Treasuries directly. Social Security could provide a decent standard of living through retirement for most people.

Part II, History and Political Economy of Financial Crisis, brings together four chapters that deal with the history and underpinnings of financial crises. This part reminds us that financial crises are recurrent, expected phenomena, within the framework of a capitalist market economy. In Chapter 3, Robert W. Dimand and Robert H. Koehn argue that central bankers and financial policy makers of the 1990s and 2000s ignored the lessons that were learned by eminent economists of the early twentieth century. In their chapter, they use a history of economic thought approach to show that any student of economics in the second half of the twentieth century had access to Thorstein Veblen’s idea of speculation promotion of the business enterprise, John M. Keynes’s insights into the dangers of price deflation for the solvency of the banking system, Irving Fisher’s theory of debt deflation, and Graham and Dodd’s ideas about value-based investing. Yet none of these lessons were incorporated into either the design of financial regulation or the practice of central banking.

The main reason that these important lessons were not learned is that they were taught by heterodox economists whose writings were largely ignored by the profession at large. Ironically, Ben Bernanke and Mervyn King, head of the US and British central banks at the time of the financial crisis of 2008–09, probably did read some of this literature, because they contributed to it earlier in their careers as economists. Even so, neither of
them, in the judgment of the authors, learned their lessons well enough when it came time to apply what they had learned.

In Chapter 4, William T. Ganley compares three major economic crashes in the history of US capitalism. In his story, seemingly unrelated and distant historical incidents become connected to each other and, thereby, instructive to current readers. Traveling from the past (circa 1890s) to the present, Ganley makes his point very clear: ‘The illusion that additional liquidity would stop a crisis proved as futile as it had in earlier panics. . . . Financial panics and depressions are a natural part of the capitalist system.’ The historical account of crashes thus breaks up orthodox economics that is founded on the illusion of self-adjusting efficient markets.

Ganley’s journey begins with the Panic of 1907. He argues that it was the consequence of the era of the speculation economy nourished by the merger movement between 1897 and 1903. As a result, there emerged not only big industrial corporations, but also powerful Wall Street players like J.P. Morgan who organized the Money Trust and in fact kept the US economy from falling into a severe crisis in the absence of the Federal Reserve System. Similarly, Ganley finds that there were three key causes of the 1929 Crash and 2008 Panic that led to the Great Depression and the Great Recession respectively: (1) increasing speculation on securities (in many ‘new’ forms), (2) deregulation (in favor of Wall Street players) and (3) policy makers’ false belief in efficient markets. Due to these systematic factors, Ganley concludes that ‘governmental responses to economic crises seldom are effective, or at least, tend to be insufficient,’ and ipso facto we may add to this that at least a new mode of organizing the capitalist system is needed for the survival of the system. Or, should heterodox economists envision a different system?

As many heterodox thinkers have already noticed, making a better system hardly ever takes place in a human society. It becomes even harder if the established system is founded upon ‘artificial stupidity’ (Briffault, 1936, p. 50). This is precisely the case for the nearly religious belief in efficient and self-adjusting markets. In Chapter 5, Robert E. Prasch dethrones the efficient markets hypothesis by paying special attention to the assumption of smart money as well as the biased role of credit ratings agencies. Let us go directly into two salient arguments made by Prasch.

First, the efficient markets theory requires imaginary smart money traders (like the Walrasian auctioneer) whose rational behavior brings back spontaneous market equilibrium. Stable markets along with economic growth become the norm and crisis is caused by an unexplained shock in neoclassical economics. The evidence provided by business cycles and repeated crises demonstrate that such an assumption is simply flawed.
Even smart money traders, if they exist, destabilize markets due to their propensity to be contrarian investors. Second, the efficient markets theory was institutionally supported by establishing credit ratings agencies in the USA. It was assumed that by providing neutral and objective valuations of assets, investors would maximize their returns and efficient asset trades would be facilitated. However, Prasch argues, since credit ratings agencies are publicly traded profit-oriented corporations, they have every reason to serve their banker-customers’ interests. The outcome is chronic market instability, leading to severe recession.

In Chapter 6, John F. Henry asks heterodox economists an important question: where is the outrage at the ‘normal, anti-social operation of capitalism’ that used to be a major concern of heterodox economists? That is to say, as Henry worries, many heterodox economists of our time are missing something important in their accounts of capitalism and its crisis. Contemporary heterodox economists of all colors are in one way or another progeny of Keynes’s ideas. Keynes, however, was on the side of saving capitalism from its structural malfunctions, whereas his precursors – Sismondi, Marx and Veblen, in Henry’s view – were concerned about challenging the status quo for the same reason. Marx’s and Veblen’s ideas are relatively well known, but Sismondi’s are not. Henry thus brings up Sismondi vis-à-vis Keynes. Sismondi and Keynes would agree with each other on particular theoretical points – especially the rejection of Say’s law and the adoption of dynamic analysis. But the fundamental difference is that while Sismondi, like Marx and Veblen, called for a new social order because ‘capitalism exercises a corrupting, corrosive force on the population as a whole,’ Keynes offered a way out of inherent problems of capitalism by means of providing jobs and income for the general population. The reason why Keynes stopped at the existing capitalist order is open to question. Henry’s historical account, however, makes one thing clear. The precursors’ anger at the predatory nature of capitalism was legitimate and germane. So is Henry’s conclusion: ‘One should also ask to what extent the influence of Keynes has assisted in the quelling of that outrage.’

Part III, Theoretical Analyses of Financial Crisis, provides the reader with macro, micro and international perspectives on the nature of financial crises and their possible solutions. Chapter 7, by Yan Liang, shows the development of money manager capitalism, which is characterized by the majority of corporate liabilities being held by financial institutions, and a new layer of intermediation being added to the financial structure. Liang shows that the rise of pension funds and mutual funds has created incentives for financial innovation which increases the degree of financialization in the economy. The degree of financialization has now become so great that it threatens the wellbeing of the real economy. She considers...
that finance should be made to work in support of industrial capital and the social good. Chapter 8, by Eric Tymoigne, argues that creating regulations to stabilize the financial system depends on a strong understanding of Ponzi finance. He looks at the evolution of finance over the past 40 years, brings us to the current time, where Ponzi finance often dominates, and makes practical suggestions for new regulations that are designed to promote economic growth. He finds that Ponzi finance is difficult if not impossible to regulate and for this reason should probably be prohibited. What is most insightful here is the perspective that financial activities should support economic growth; when financial activities threaten economic growth, they should not be allowed. How ingenious to think that the financial system should be made to support the real economy! This idea comes directly from Keynes. In The General Theory, Keynes made this often quoted statement:

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. (Keynes, 1973, 159)

Tae-Hee Jo and Tuna Baskoy, in Chapters 9 and 10, explore business cycles and financial crisis from a heterodox microeconomic perspective. Such an approach is distinctive from heterodox macroeconomic analyses. Competition between business enterprises is considered to be the main cause of capitalist instability. Moreover, looking at business cycles through microscopic lenses renders what is often untold and unnoticed by heterodox economists visible and explicable.

According to Jo, the instability of capitalism is not only the outcome of economic activities under fundamental uncertainty, but also closely associated with the capitalist social order that is to be protected for the sake of the vested interests of the ruling class. In this regard, ‘what is really meant by instability in the heterodox perspective is not the irregularity in quantitative variables (or empirical reality), but the uncertainty/instability of the life and the unreliability of capitalist market principles.’ The account of instability thus requires both micro and macro analysis as well as both economic and social inquiry. To expand the horizon of the heterodox theory of business cycles, Jo argues, the frictionless notion of a capitalist society and the class-neutral notion of the capitalist state received by many heterodox economists (for example, Schumpeter and Minsky) are to be questioned and reconsidered.

The micro-instability qua the vulnerability of the life of agents as well as the macro-instability qua cycles and crises along with the deregulated
financial system are not the result of unexpected shocks or market failures, but the outcome of deliberate (often short-sighted) actions made by private business enterprises and the state. Such an argument is detailed and strengthened by the analysis of the monetary production economy with an emphasis on the business decision-making process.

Baskoy’s chapter explores a blind spot in the Post Keynesian analysis of business cycles. He brings up evolving business competition as a crucial factor that contributed to the 2007–08 financial crisis in the USA and argues that business enterprises take different actions with regard to the intensity of competition and to the stages in the business cycle. Those strategic business actions become self-ruinous in the face of a business downturn in which profit opportunities are exhausted. To support his argument, Baskoy looks into the actual behavior of the ‘captains of finance’ in the USA, especially between 1997 and 2007. He finds that financial business enterprises were forced to move from the prime market to the sub-prime market mainly due to the depletion of profit opportunities in the former. As a further result, those financial business enterprises were in cut-throat competition before the onset of the financial crisis.

The last two chapters give us some insight into how financial crises are linked to the international system and to the welfare of developing nations. Jörg Bibow’s chapter provides a macroeconomic analysis of the global financial crisis, centering on the role of the US dollar as the reserve currency and the US consumer as the borrower and spender of last resort. In Bibow’s analysis, the current ‘Bretton Woods 2’ system committed the USA to countering deflationary tendencies in the rest of the global economy, rendering it impossible for the Federal Reserve to lean against the speculative buildup in asset markets. Although the USA performed the role it needed to play as issuer of the reserve currency leading up to the crisis, Bibow does not believe that ‘Bretton Woods 2’ provides a sustainable way forward for the global monetary system. There is a big problem, for Bibow, in the nature of the liabilities which the USA issued as the global borrower of last resort. This critique provides the basis for Bibow to identify alternative, more sustainable, global monetary orders. One could still be centered around the US dollar and economy, or the other, a de-centered, multi-lateral system as originally conceived (but never realized) by Keynes.

Like Bibow, Alfredo Castillo Polanco and Ted P. Schmidt, in Chapter 12, are interested in optimal monetary arrangements (in this case exchange rate regimes), but from the perspective of developing and emerging economies within the world system. During deep recessions in the center, developing economies have to deal with large reductions in export demand. Why do we see larger contractions in some developing economies than in
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others? To answer this question, the authors develop a Post Keynesian, short-period model of small open economies, based on institutionally realistic assumptions such as a class structure, lack of substitutability between export production and production for the home market, and accounting balances defined in nominal terms. They show that a flexible exchange rate regime allows the owners of productive capacity to protect their nominal incomes, but is sub-optimal from the point of view of society as a whole. The job of the central banks in these developing economies is to intervene ‘optimally’ in exchange rate setting (if possible) to produce the smallest reduction in real income necessary to sustain the confidence of external creditors and investors.

Perhaps the most important idea presented in this book is that financial crises are recurrent phenomena. The solutions currently provided by the administration are incapable of solving the insolvency that plagues many of our largest financial enterprises. The need to save for retirement has created a huge mass of wealth that generates the need for a complex financial infrastructure that pushes the financial system away from a support for industrial production. As the financial system moves further from its supportive role, it begins to act as a parasite on real production and incomes. As this becomes more obvious, the role of Wall Street in generating greater than average returns for our retirement savings comes into question. The existing financial structure persists despite recurrent crises because we ignore important lessons from our past, and, we continually try to rework the current system to meet our short-term needs. Our ignorance of the past stems from not learning those lessons well enough, such that speculation, deregulation and the belief in the efficient markets hypothesis seem like a reasonable way to deal with the financial market. Moreover, for a certain number of us, Keynes provided a justification for patching the current system, making it work, rather than overhauling it entirely, like some of his predecessors have suggested. The rise of money manager capitalism has put us in a position where greater levels of financialization put the real economy at risk. Banning Ponzi finance, because it doesn’t support general wellbeing, should be a priority. Financial crises and business cycles make it plain to see that deliberate actions of business enterprises within a monetary production economy result in the insecurity of life within the capitalist system. The nature of competition between business enterprises becomes more intense as profit opportunities change, and this relationship between competition and profitability is linked to the business cycle. The international financial system, based on the US dollar as reserve currency, can and should be questioned. Would the alternative de-centered financial structure work for the present time? For developing economies, the role of the central bank in a flexible exchange rate regime
Heterodox analysis of financial crisis and reform

is to protect national incomes while quelling foreign creditors. Balancing those interests is certainly a significant challenge. The current financial crisis has brought forward a great number of issues that need our attention. Are we now up to the task of rebuilding the financial system such that it supports incomes and the real economy, or will these lessons need to be learned again in the future?

REFERENCES