Introduction

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The recession of 2008 (the First Great Recession of the 21st century) puzzled everybody. Economists were aware of the international trade imbalances and of the speculative bubbles in the real estate and stock exchange markets. However, few of them dared think that the recession was so close and that it was going to be so deep. Its severity is only comparable with the Great Depression of 1929.

The recession offers an opportunity to revise economic theories in order to identify their flaws. And also to compare different economic paradigms to find the one that provides a more plausible explanation and a more credible cure.

With this purpose, the University of Castilla-La Mancha (UCLM) and the European Society for the History of Economic Thought (ESHET) jointly organized an international symposium in January 2010 in Albacete, Spain, with the title ‘The Recession of 2008. Do Economists Ever Agree on Analysis and Prescriptions?’1 This book gathers together some of the papers presented, to which we have added a couple more in order to give a proper account of the broad array of the streams of thought in modern economics.

The book has been organized in three parts, following a train of thought that we hope will be made clear in this Introduction.

Part I – Economists on Trial – gathers together five papers that discuss which economists are to be praised and which are to be blamed in connection with the present crisis, and to which theories – Post-Keynesian or Neo-Austrian – we should turn to salvage this situation. What is wrong and what has been misinterpreted in economics is assessed from different theoretical perspectives, a task those authors undertake with equal concern for the present economic situation.

The first contribution, by Dirk J. Bezemer, scrutinizes the work of 12 economists who predicted the crisis. In seeking for some common features the author argues that in their analysis, unlike the forecasting models used by central banks (such as Dynamic Stochastic General Equilibrium
models) these economists share the view that financial assets are prone to bubbles and that credit feeds the stock of debt. Most of these authors are Post-Keynesians or Institutionalists who have in common an approach that stresses uncertainty and non-optimizing behaviour; who favour empirical work rather than theoretical formalism and object to methodological individualism; and who recommend integrating flow-stock accounts from the financial and the real sides of the economy.

In the second contribution Jesús Huerta de Soto claims that the approach of the Austrian Business Cycle Theory of Ludwig von Mises and Friedrich Hayek is well equipped to explain recent events. According to the Austrian view there is no way in which the economy can escape the sacrifice of present consumption and bypass the discipline of accumulated saving: credit expansion and (fiduciary) inflation of the media of exchange offer no short cut to stable and sustained economic development. Money that does not originate from saving, but is generated only by credit expansion is bound to be channelled into ‘bad’ investments, which eventually result in a reduction of capacity and employment, produce inflation in good and asset markets, and give rise to speculative bubbles that are certain to burst sooner or later. Following the ‘free market’ prescriptions of the Austrian School, Huerta de Soto proposes privatizing and liberalizing financial markets, whose institutions are said to be unable to rule the business cycle, and are responsible for fostering rather than preventing disturbances in the markets.

In the third contribution, by Ekaterina Svetlova and Matthias Fiedler, the blame is laid on standard economic theory for failing to distinguish between uncertainty and risk, the former being identified with the latter by assigning probability values to all possible events. The current crisis has shown how models based on these assumptions have mispriced subprime mortgages, have facilitated unjustifiable risk-taking by lay and professional investors and have shut their eyes to the brewing crisis. Economists have to learn to cope with imperfect knowledge (not just ‘imperfect information’) and genuine uncertainty (not just ‘risk’), taking inspiration from the work of Knight, Keynes and Shackle. Despite their theoretical differences, these three authors share a belief that the economy is pervaded by insufficient knowledge, true uncertainty, uniqueness of events and exposure to surprise, and that institutions are needed to monitor market confidence and stabilize markets.

Also, Gumersindo Ruiz and Ramón Trías – in the fourth contribution to this section – focus on the central role of risk management, as the ‘raison d’être’ of finance. Their account of the different methods of risk valuation introduced in the last quarter of the 20th century, is given as a historical background to current events. Risk theory was backward
Introduction

looking and statistically driven; it undervalued the dynamic characteristics of markets, boosted diversification and misused volatility as a proxy variable for risk measurement; it was clearly procyclical. What is required is a new approach to macroeconomics, which is forward looking. We need to devise measurement tools that can stabilize the valuation of assets all along the economic cycle, to have a better understanding of the relationship between risk and diversification and to provide new instruments to hedge those rare events known as fat-tail risk.

In the final contribution in this section, Julio Segura asks whether the ‘efficient market hypothesis’ (EMH) – on which modern finance relies – is at the root of the financial crash of 2007–08. The author believes the blame should be laid on the practitioners who use the models based on EMH, without being aware of the strict conditions to which they should be applied and academics who do not make these assumptions sufficiently explicit. Segura’s point is that modern economics has recognized that financial markets suffer from insufficient transparency and asymmetric information; that agency problems and conflicts of interests in rating agencies are a source of market failures; that financial regulation becomes flawed when economic agents are able to ‘capture’ the regulator. It would therefore be equally wrong to invoke EMH to avoid any type of regulation or to accept as good whatever financial innovations markets may produce.

The economists on trial in this section are those, mainly heterodox, who are looked upon as sources of inspiration for the understanding of the crisis and those, mainly mainstream, who are seen as having inspired a type of behaviour that has fuelled the crisis. The well-known paragraph in the closing pages of The General Theory – ‘Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist’ (Keynes, 1936, p. 383) – comes to mind, but adapted to the present circumstances: it is in ‘some living economists’ that practitioners in financial markets have put too much faith. Perhaps it is now time to recognize that the road to travel is back to history.

The papers in Part II – What Does History Tell Us? – provide a historical background to the crisis, from the double perspective of economic history and history of economic thought. For more than a century some streams of thought have warned that capitalist market economies are crisis-prone, and those who continue in that tradition refer to the recession of 2008 as the key proof of the inherent instability of capitalism.

In the first contribution to the second section, Sunanda Sen compares the Great Depression of 1929 and the 1930s with the recession of 2008 from a Keynesian perspective. Similarities and parallels can be traced in the current account imbalances (although the main players have changed
The first great recession of the 21st century

their roles; the USA used to be the biggest lender, now it is the biggest borrower); the increasing weight of international capital flows, more concerned with speculative gains than with production; exchange rate mismatches; deflationary policies in an attempt to gain international competitiveness (the control of inflation becomes the way); speculative bubbles in the stock exchange that compromise the solvency of the bank system in case of a sudden burst. Sen argues that to learn the lesson that history teaches us and to avoid the policy errors of the 1930s, we must follow Keynes's guidance, which points not only to fiscal expansion but also to financial regulation and international cooperation.

In the second contribution Catherine and Adrian Winnett draw attention to the rise in the 1930s of approaches that – unlike Keynes’s exclusive concern with persistent unemployment – focused on cycles and dynamic disequilibrium. The Stockholm School (Lundberg, Ohlin and Myrdal), the Austrian School (Hayek) and a thread in the Cambridge tradition (Roberston) all have in common explanations of the business cycle, which ultimately rested on the non-neutrality of money and the importance of real phenomena. In the same years, Schumpeter and Kalecki insisted on the key role of technical change, distribution and other determinants of growth and cycles. The lesson to be drawn from the 1930s’ theories is that they are highly relevant to explain the recession of 2008, as triggered by financial problems, but reflecting weaknesses in the real side of the economy.

In the third contribution, Jack Rasmus coins the term ‘Epic Recession’ to denote major breakdowns in the economy. Outstanding examples are the US crisis of 1907–14, the international Great Depression of the 1930s and the current worldwide recession. The impact of an Epic Recession is broader and deeper than ordinary downturns and, as a consequence, the recovery will require more time (between seven and ten years). The common feature is that, unlike goods and wages, the supply of assets does not adjust, so that the price of assets will grow pari passu with speculative demand. The speculative bubble initially crowds out productive investment and later, when it bursts, as the most indebted firms and households default, it disrupts capacity and employment.

The next chapter in this part, by Edith Skriner, provides empirical support to the Austrian hypothesis that credit expansions (generally due to artificially low interest rates) cause assets bubbles and recessions. After scrutinizing an impressive amount of international economic data from 1974 to 2009 and building a broad array of economic variables, Skriner concludes that the current crisis responds to this pattern. Surprisingly enough, causality also operates the other way round, and with higher intensity. After a 1 per cent increase in asset prices, interest rates used to
rise six basis points. In her opinion, central banks should include stock market prices in their monetary policy rules.

Finally, Steven Kates takes issue with the argument – used by governments worldwide fighting the current recession with Keynesian expansionary fiscal policies – that the Great Depression was defeated by Keynesian analysis and prescriptions. His view is that in the mid-1930s the only country in recession was the USA, despite the expansionary policies of the New Deal; the remaining economies had recovered applying classical remedies based on Say’s Law. This brings into focus the role of the history of economic thought in understanding what Say and Keynes really meant and which conditions are required for a successful implementation of their prescriptions.

The records of facts and ideas from the past allow us to put current events in perspective, to find similarities and differences without which the analysis would be myopic. Knowledge of the history of discipline, makes room for the acceptance that there is more than one way to interpret phenomena in the real world, enriching the ability to understand and to prevent crisis. The stress on modelling and econometric exercises has misled economists into thinking that economics is closer to the physical world and the methods to employ are those of the natural sciences. It is interesting to be reminded of what a very successful market player, George Soros, has recently remarked:

Financial markets should not be treated as a physics laboratory but as a form of history. The course of events is time-bound and one-directional. Predictions and explanations are not reversible. Some timelessly valid generalizations can serve to explain events but not to predict them. (Soros, 2010, p. 3)

Chapters in Part III – Country Cases in a Global Crisis – analyse the crisis from the angle of a specific country. By looking at the recession through the magnifying glass, small corners of the world come into focus as case studies. The knowledge that is gained by looking closer at individual countries allows us to get deeper into the consequences and who will bear the brunt of the costs of the crisis.

There is a common agreement that the origin of the current crisis is related to the expansion of subprime mortgages in the USA after 2002 and the diffusion of financial derivatives related to these mortgages all over the world. The ‘Testimony’ of Alan Greenspan before the Financial Crisis Inquiry Commission of the US Congress, on 7 April 2010, is probably the best way to approach it. At the beginning of this section we reproduce a part of his speech. The Chairman of the Federal Reserve from 1987 till 2006 admits that low interest rates played a role in the residential
investment boom and subsequent bust. He considers, however, that what matters for residential investment is the long-term mortgage rate, not the overnight interest rate fixed by the Fed. According to him, mortgage rates were abnormally low because of the saving glut occasioned by the increasing trade surplus of China, India and other developing countries. Greenspan admits, however, that international imbalances should not conceal the responsibility of financial institutions in generating and spreading risks. A more demanding capitalization of financial institutions is required.

The core country is indeed the USA, from which many of the financial innovations and troubles originated. In the second chapter of this section Davide Gualerzi looks at the US economy from a long-term perspective that focuses on the real side, and at its structural low level of effective demand. In the golden age of capitalism (1950–70) the new markets for automobiles, industrial appliances and the like, justified a continuous flow of investment and were strong enough to overcome the ordinary fluctuations of demand. In the 1990s the new technologies of information took the relay as the new locomotive of the economy. So far, however, its creative impact on employment has been lower than the destructive one. The US economy recovered easily from the first stock market crash (the ‘dot-com’ bubble of 2001) because the housing market seemed promising. The recovery from the burst of the real estate bubble in 2007 and 2008, is taking longer than expected because US entrepreneurs do not see new markets that justify massive investments.

The next chapter examines the impact of the crisis on small, developing economies. Ivars Brīvers shows how at the turn of the century, when transition to a capitalist system was almost completed, Latvia experienced the highest rates of growth in its recorded history (around 10 per cent). However, the economic rally was more the mirage of speculative activities in the financial markets than the fruit of productive investment creating wealth and employment. As a matter of fact, at that time one-tenth of the Latvian population was forced to emigrate in search for a job. The locomotive of the economy was always outside the country and evolved in a three-step process: first came direct foreign investment to buy all the valuable assets stemming from the privatization of the former public enterprises. Later, foreign banks lent all the money necessary to allow Latvians to keep their standard of living in times of high inflation. The shrinking of liquidity that followed the international crisis put the entire economy on the verge of collapse.

The final chapter analyses a country, Spain, which at the time of writing (June 2010) is under the spotlight as one of the most fragile links in the eurozone. Óscar Dejuán and Eladio Febrero show that after joining the
Introduction

European Monetary Union, Spain enjoyed the same nominal interest rates as Germany, but since inflation was one or two points above, long-term real interest rates became almost nil. In order to keep profitability up in an epoch of minimal interest rates, banks multiplied mortgage credits and lengthened monthly instalments. The result was the strongest expansion in output and employment among developed countries, but also the generation of three major disequilibria: (1) a current account deficit amounting to 10 per cent of GDP; (2) speculative bubbles in the real estate and the stock exchange; (3) an unbearable burden of debt whose deflationary effects will be felt for a long time. The Spanish crisis can be seen as the terminal station of an unsustainable pattern of growth propelled by a single sector (construction) and fed by cheap credit to households whose nominal wages grew at 3 per cent in a decade where house prices trebled.

The three countries under investigation have been severely hit by the crisis and in all the three cases we find a consistent pattern in which low interest rates, aggressive bank lending, inflated real estate prices set in motion a train of events that ultimately ended in high unemployment, repayment defaults and recession. The responsibility of financial institutions in generating and spreading the speculative bubble implies that a coordinated set of tighter regulations and binding capital requirements in all these countries might have prevented the disaster from occurring.

To the question posed to the participants of the Albacete Workshop: ‘Do economists ever agree on analysis?’, we feel that as far as the contributors to this volume are concerned, the answer is in the main affirmative. Here is a sample of the ideas that are recurrent in the chapters of the book:

- The roots of the recession of 2008 lie in the financial sector, which, in the last decades, has been growing in size and complexity. Financial innovation has decoupled the real and financial sectors, not always to the benefit of economic stability. Economists should give proper weight to financial variables and integrate them into their models.
- Genuine uncertainty (as opposed to statistical risk) is a key element in the generation of booms and busts. Economists have to integrate uncertainty into economic analysis. At the same time, financial economists should figure out how to make risks more transparent, how to price them and how to account for them.
- The integration of finance in economic variables starts by the recognition that rising flows of credit result in piling up stocks of debt. The repayment of this debt reduces disposable income and has a deflationary impact on aggregate demand. Over-indebtedness makes recessions deeper and longer, most of all, when the leverage ratio is above the normal levels.
Speculative bubbles in the stock exchange markets and in real estate seem unavoidable and may have an impact on productive investment. Monetary policy should take asset inflation into consideration.

Medium-term cycles are usually embedded in a long-term path of growth. The recovery will not be fully warranted unless there is a leading sector with an important potential market and with strong drawing effects on the rest of the economy.

A ‘proper’ distribution of income is another condition to ensure a sustainable pattern of growth. The recession of 2008 evidences the unsustainability of a pattern of growth based on construction when the price of houses rose systematically above wages.

Growth is not possible without savings. In a prodigal community that consumes the whole output, banks may grant increasing amounts of credit that will generate speculative bubbles in the asset markets, productive investment by no means leading to economic growth.

The balance of payments constraint will continue to be operative even in a fully globalized economy with a common currency. A worldwide pattern of growth where some countries stand systematically as net borrowers, while others stand as net lenders, is unsustainable. The increasing pile of foreign debt will eventually result in prohibitive interest rates.

Are we also going to answer in the affirmative as far as the second question is concerned, that is, ‘Do economists agree on prescriptions?’ Which are the economic policies that need to be implemented and which are the institutional reforms to bring about so as to overcome the recession and to avoid it in the future? All the contributors to this volume strongly believe that the financial sector cannot be left unregulated as in the past, although this is more a question of quality than of quantity. We should figure out the right type of regulatory measures. Economic agents should enjoy the benefits of their successful decisions and suffer the losses of their wrong ones. The lack of accountability leads to agency problems, moral hazard situations, casino scenarios and the like. The key move advocated by most is to improve the transparency of financial products and to raise the capital requirements of agents engaged in risky operations.

Bearing in mind the errors of the Great Depression of 1929, governments, all over the world, hurried up to grant banks all the money necessary to prevent a financial collapse; central banks lowered the official rate of interest to historical minima in order to stimulate private investment; and fiscal authorities multiplied public expenditure to match the fall
Introduction

in private demand. Explicitly or implicitly, most of the authors in this volume admit the necessity of these Keynesian macroeconomic policies. But what should governments do if two years after the ‘Great Recession’ of 2008 the economy has not recovered as expected? And how can we interpret this policy failure?

Some authors in this volume point to the inefficiency of expansionary monetary and fiscal policies in over-indebted economies, most of all when the state of confidence of economic agents is at rock bottom. Others warn about the long-term undesirable consequences of ‘permanent’ expansionary policies. If banks know they will be rescued with public money in case of a failure, they won’t pay enough attention to risk. If the interest rate falls in order to encourage private investment, we may soon reproduce another artificial boom, leading to an even worse recession. For sure, if public expenditure is unable to propel the private economy in a year or so, the pile of public debt will be added to the already existing private debt, making things worse for everybody. As a matter of fact, financial markets (which are a thermometer of the general estate of confidence) continue to be ‘nervous’.

Will economics learn something from the ‘Great Recession’ of 2008 as usually happens after a major crisis? Certainly textbook economics, which has dominated the Washington Consensus and the curricula of prestigious universities, are unlikely to remain unscathed by the current crisis and the debates that have ensued. An interesting counterfactual exercise is to speculate that had Minsky and Keynes rather than Lucas or Fama been on the reading list of PhD courses in the 1980s, would we have had a generation of economists better equipped to foresee and even to prevent the 2008 meltdown? However, while there are signs that the profession is becoming more aware of the dangers of unregulated markets, we still have to see those radical changes that many of the contributors to this volume believe are necessary. We hope that the readers of this book, having scrutinized the logical coherence and explanatory power of the different approaches to the Great Recession of 2008 presented in this volume, will agree with our conclusion that diversity and pluralism of approaches in economics is the recipe for making economics a better and more useful science.

NOTE

1. The scientific committee was constituted by Óscar Dejuán, Eladio Febrero, Harald Hagemann, Maria Cristina Marcuzzo and Pedro Teixeira; and the local committee by Fabio Monsalve and María Ángeles Tobarra. We are grateful to all the participants for stimulating discussions and to ESHET and UCLM for their support.
REFERENCES
