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Anatomy of a Typical Crisis

History vs economics

For historians each event is unique. In contrast economists maintain that there are patterns in the data and particular events are likely to induce similar responses. History is particular; economics is general. The business cycle is a standard feature of market economies; increases in investment in plant and equipment lead to increases in household income and the rate of growth of national income. Macroeconomics focuses on the explanations for the cyclical variations in the rate of growth of national income relative to its long-run trend rate of growth.

An economic model of a general financial crisis is presented in this chapter, while the various phases of the speculative manias that lead to crises are illustrated in the following chapters. This model of general financial crises covers the boom and the subsequent bust and centers on the episodic nature of the manias and the subsequent crises. This model differs from those that focus on the variations and the periodicity of economic expansions and contractions, including the Kitchin inventory cycle of thirty-nine months, the Juglar cycle of investment in plant and equipment that has a periodicity of seven or eight years and the Kuznets cycle of twenty years that highlights the rise and fall in housing construction. In the first two-thirds of the nineteenth century, crises occurred regularly at ten-year intervals (1816, 1826, 1837, 1847, 1857, 1866), thereafter crises occurred less regularly (1873, 1907, 1921, 1929).

The model

A model developed by Hyman Minsky is used to interpret the financial crises in the United States, Great Britain and other market economies. Minsky highlighted the pro-cyclical changes in the supply of credit, which increased when the economy was booming and decreased during economic slowdowns. During the expansion phase investors became more optimistic about the future and
they revised upward their estimates of the profitability of a wide range of investments and so they became more eager to borrow. At the same time, both the lenders’ assessments of the risk of individual investments and their risk averseness declined and so they became more willing to make loans, including some for investments that previously had seemed too risky.

When the economic conditions slowed, the investors became less optimistic and more cautious. At the same time, the loan losses of the lenders increased and they became much more cautious.

Minsky believed that the pro-cyclical increases in the supply of credit in good times and the decline in the supply of credit in less buoyant economic times led to fragility in financial arrangements and increased the likelihood of financial crisis.

This model is in the tradition of the classical economists, including John Stuart Mill, Alfred Marshall, Knut Wicksell and Irving Fisher, who also focused on the instability in the supply of credit. Minsky followed Fisher and attached great importance to the behavior of heavily indebted borrowers, particularly those that increased their indebtedness in the expansion to finance the purchase of real estate or stocks or commodities for short-term capital gains. The motive for these transactions was that the anticipated rates of increase in the prices of these assets would exceed the interest rates on the funds borrowed to finance their purchases. When the economy slowed some of these borrowers might be disappointed because the rates of increase in the prices of the assets proved smaller than the interest rates on the borrowed money and so many would become distress sellers.

Minsky argued that the events that lead to a crisis start with a ‘displacement’, some exogenous, outside shock to the macroeconomic system. If the shock was sufficiently large and pervasive, the economic outlook and the anticipated profit opportunities would improve in at least one important sector of the economy. Business firms and individuals would borrow to take advantage of the increase in the anticipated profits associated with a wide range of investments. The rate of economic growth would accelerate and in turn there might be a feedback to even greater optimism. It’s ‘Japan as Number One’ or the ‘East Asian Miracle’ or ‘The New American Economy’ – a new sense of more profound optimism about the economic environment. The words differ across the countries but the tune is the same.

The nature of the shock varies from one speculative boom to another. The shock in the United States in the 1920s was the rapid expansion of automobile production and associated development of highways together with the electrification of much of the country and the rapid expansion of the number of households with telephones. The shocks in Japan in the 1980s were financial liberalization and the surge in the foreign exchange value of the yen. The shock in the Nordic countries in the 1980s was financial liberalization.