Chapter 2

Theories of Financial Crises

This book surveys four contemporary theories of financial crises. These four were chosen from a larger collection of work because they maintain prominence in current discussions. In other words, the first financial crisis of the twenty-first century has garnered significant interest in rethinking many aspects of macroeconomic and financial economics. Some of the focus is on the effectiveness of theory, including theories of financial crises. It is clear from these discussions that the theories presented in this book hold a central place in the re-evaluation. Consequently, these four theories are the focus of both this chapter and several of the later chapters.

I Four theories

Two of the theories take place within the context of the business cycle. The first is the Financial Instability Hypothesis of Hyman P. Minsky. Minsky developed this perspective of financial crises after witnessing increasing financial instability in the post-war period in the United States. His primary influence was the work of Keynes.1 The second is the Austrian Business Cycle Theory of Roger Garrison, which is a major refinement of earlier Austrian scholarship on financial crises. Earlier work from the Austrian perspective includes scholarship from Friedrich A. Hayek and Ludwig von Mises, among others.2 Garrison adds coherence to this existing work and, in the process, generates a unified theory of financial crises from the Austrian perspective. Both Minsky and Garrison offer theories of financial crisis that take place within the context of the business cycle, but do so from different underlying perspectives.
The other two theories surveyed here are considered noncyclical theories because they do not require the crisis to take place within the context of a business cycle. Certainly, while the crisis may take place, and often does take place, within a larger business cycle, it is not a precondition to the theory. The first of these is the Speculative Investment perspective of Charles Kindleberger. This theory, in which speculative behavior plays a central role, was inspired by the earlier theoretical work of Adam Smith, John Stuart Mill, Knut Wicksell, and Irving Fisher as well as Minsky. The fourth and final theory considered here is the Asymmetric Information Theory of Frederic Mishkin. In the 1970s and 1980s, Mishkin took a new and burgeoning literature on asymmetric information and applied it to the understanding of financial disturbances. In the process, he constructed a theory of financial crisis in which parties with unequal information inject inefficiencies into the financial sector that may lead to crisis.

In this chapter, the cyclical theories are surveyed first, followed by the noncyclical theories. The objective is to expose the reader to the most important points and concepts in each theory. These theories are analyzed relative to one another in Chapter 3, and later, in Chapter 6, the theories are used to try and understand the first financial crisis of the twenty-first century.

II The Financial Instability Hypothesis

The Financial Instability Hypothesis was developed by Hyman P. Minsky in the 1970s. Born in 1919, Minsky witnessed the incredible stability of the financial sector and the macroeconomy during the 20 or so years following the Second World War. At the same time, he also witnessed the growing instability that began with a credit crunch in 1966. This was followed by growing instability during several episodes in the 1970s. Minsky wanted to try and understand the Keynesian framework in light of these increasingly severe financial disturbances. The result of his efforts was his Financial Instability Hypothesis. While it is rooted in the Keynesian tradition, it was important to Minsky that his work, first and foremost, offered a meaningful explanation of real economic events. Figure 2.1 is this author’s attempt to capture this theory visually and is meant to help the reader understand the verbal description which follows.