2 Origins of the ‘Great Recession’

2.1 Introduction

The purpose of this chapter is to discuss the origins of the crisis that emerged in August 2007, which we now know as the ‘great recession’. The focus is on the emphasis given to the Efficient Market Hypothesis (EMH), namely that all unfettered markets clear continuously, thereby making it highly unlikely that disequilibria, such as bubbles, will be the root of the crisis. Indeed, in terms of the EMH framework, economic policy designed to eliminate bubbles would lead to a situation of ‘financial repression’, which would be regarded as a very regrettable outcome. Ever since the early 1970s, when governments across the world succeeded in implementing financial liberalisation initiatives, in particular in the USA and the UK, the focus has been on creating financial markets that are free from any policy interference. This is based on the belief that liberalised financial markets are very innovative, and sure enough they are; indeed they were. Over the period prior to the ‘great recession’ and after the intense period of financial liberalisation especially in the USA, great strides were seen in the development and extension of new forms of securitisation and use of derivatives. This was a financial engineering practice, which led to the growth of collateralised debt instruments, especially so in the form of collateralised mortgages.

The experience with financial liberalisation is that it caused a number of deep financial crises and problems unparalleled in world financial history, in terms of both their depth and frequency. However, most significantly for the purposes of this contribution, it was the experience of the USA in relation to financial liberalisation that is most telling in relation to the cause of the current crisis. The crisis cannot be explained solely in terms of financial liberalisation. The size of the financial sector is also important. In this respect, it is important to note the enormous redistribution that had taken place in the countries at the centre of the crisis. In the 25 years to August 2007 there was significant redistribution from wage earners to the financial sector. That redistribution, along with the measures to introduce financial
liberalisation, produced the new financial engineering, rooted in the USA as mentioned above, which led to an extraordinary mispricing of risk, were the main causes of the crisis. But there were, we argue, other contributory factors. We isolate three of them: the international imbalances, mainly as a result of the growth of China, the monetary policy pursued by countries over the period leading to the crisis, and the role played by the credit rating agencies. The ‘great recession’, in our terminology, led to massive state support along with a subsequent deterioration of the public finances in most of the affected countries.

Significant income redistribution effects from wages to the profits of the financial sector and US financial liberalisation attempts, along with the financial innovations that followed them, have been causes of the ‘great recession’. In Arestis and Karakitsos (2011b) we deal extensively with these issues and show that all these factors were the main causes of the ‘great recession’. In section 2.2 we briefly summarise the main causes of the ‘great recession’. Furthermore, and as in Arestis and Karakitsos (op. cit.), we consider and discuss the contributory factors, namely international imbalances and monetary policy. We suggest, nonetheless, in the process that a third contributory feature is relevant; namely, the role played by the credit rating agencies. We discuss the contributory features in section 2.3 before we summarise and conclude in section 2.4.

2.2 The main features of the ‘great recession’

In discussing the origins of the current crisis we are very much aware of the limitations of current macroeconomics. Indeed, we agree with the conclusion of Minsky (1982), who argued more than three decades ago that ‘from the perspective of the standard economic theory of Keynes’s day and the presently dominant neoclassical theory, both financial crises and serious fluctuations of output and employment are anomalies: the theory offers no explanation of these phenomena’ (p. 60; see, also, Arestis, 2009).

The ‘great recession’ has been caused by US policies of financial liberalisation and the financial innovations that followed in their wake. That was greatly helped by significant income redistribution effects from wages to profits of the financial sector. An interesting statistic on this score is reported in Philippon and Reshef (2009) in the case of the USA. This is the pronounced above-average rise in the salaries of those employed in finance. Relative wages, the ratio of the wage bill in the financial sector to its full-time-equivalent employment share, enjoyed a steep increase in the period from the mid-1980s to 2006. What explains this development is deregulation in a causal way, followed by financial innovation. The impact of deregulation accounts for 83 per cent of the change in wages. Indeed, wages in the financial sector are higher than in other sectors, even after controlling for levels of education. Similar but less pronounced financial shares