

IS THIS “IT”? ARE WE WITNESSING THE GREAT DEPRESSION OF THE 2010s?

(Draft for discussion, not to be quoted)

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1. Introduction: What is “It”?

The financial crisis that began in 2007, and later transformed itself into a full-fledged economic crisis, has led not only the press but also the overwhelming majority of the economics academic community to become familiar with the name of Hyman Minsky. Up until then, Minsky was at most a secondary reference to the citation of Kindleberger’s *Manias and Panics* book, made by authors who evidently didn’t see the need to actually read him. In fact, Kindleberger himself was usually mentioned for the exotic value of the stories he told, a little like than a more respectable version of Mackay’s *Extraordinary Popular Delusions*. Both Minsky and Kindleberger were quoted as authors who presented the view that financial markets could be less than efficient, in the Eugene Fama’s sense, because financial agents were less rational than assumed by the efficient market hypothesis. Nowadays, most books on the crisis make at least a ritual reference to Minsky, sometimes recommending one of his books or articles, as an author who broke with the lazy complacency of the efficient market hypothesis, although it rarely comes to the point of actually explaining his approach.

In the post Keynesian literature, in contrast, there has been certainly a plethora of texts introducing Minsky’s ideas, with particular emphasis on the three-fold classification of portfolio strategies he created, hedge, speculative and Ponzi. But Minsky’s legacy includes a lot else, of course, including some aphorisms, such as “stability is destabilizing”, expressions, such as “sell position to make position”, and shorthands like “it”.

“It” was a mention to the unmentionable, a reference to the great dislocations of the 1930s, particularly in the United States, Minsky’s favored frame of analysis, naturally. Again, in the post Keynesian literature and debates, “it” became a familiar, if a little vague, reference to how things can go disastrously wrong in capitalist economies (as conceived in the Wall Street Paradigm, another of Minsky’s inspired phrases) and how could these catastrophes be avoided.

The meaning of “it” could be left vague for a long time, since no one believed it could actually happen again, as Minsky rhetorically asked in one of his papers, which gave the name to his 1982 collection of essays. In fact, establishing that “it” was theoretically possible mostly served to introduce and examine the policy instruments that could be mobilized to fight it and prevent it. Big government and active central banks (plus some efficient financial regulation) should be enough to keep “it” just a theoretical possibility, even though at many points Minsky seemed to fear that these instruments could not be used with efficacy.

Now, it seems that “it” *has* happened again. The deepest crisis since the 1930s is unfolding, and there is no sure sign that it is really over, notwithstanding the revival of financial markets and some rebound in economic growth that has taken place in the last months. Whether the economy is really out of the woods or not is surrounded by thick uncertainties, and so are the perspectives for the immediate and mediate future. In order to reduce these uncertainties, it is necessary to proceed from a powerful image, “it”, to a definite concept appropriate to characterize the current crisis and its main characteristics.

In this paper, we want to characterize the phenomenon referred to as “it”. In fact, to most readers, “it” is a very direct reference to the Great Depression. In many cases, however, Minsky used the pronoun in reference to a more specific event, an important aspect of the depression, but not necessarily the whole of it. So we begin, in section 2, by trying to locate the precise meaning of “it”. Even finding out that it may not be a reference to the depression as a whole, Minsky’s “it” takes its importance from being a central element in the mechanism generating depressions. But why is a depression so scary? In other words, what happens in a depression that may characterize it as a particularly serious malfunctioning of a modern market economy? Section 3 tries to examine some of the answers to this question. In section 4, we use these notions to make a preliminary discussion of whether we can say that the present crisis fits the characterization of a depression. Section 5 concludes the paper with some speculation about the perspectives for the resolution of the current crisis, oriented by the discussion that preceded it.

2. What is “It”?

As we will discuss later, there are generally two different approaches to what constituted the Great Depression of the 1930s. Each of these approaches entails significantly different policy implications. On the one hand, there are those who understand the great depression as the steep fall in production and employment, besides other macroeconomic variables, in the early years of the decade, as well as the virtual collapse of the financial system, most particularly the banking system, that preceded it and accompanied it. The second group calls a depression not only the collapse itself, but also the protracted period of difficulties that followed it, in which recovery was slow and uncertain, and unemployment remained very high. In this second approach, the depression was actually ended by the outbreak of World War II and the great revival of aggregate demand that resulted from it.

Minsky’s “it” seems to fit the first approach. In fact, it has a more restricted meaning than the one advanced by that approach. Minsky’s “it” refers to the financial crisis itself, not necessarily to the “real” crisis that followed or the difficulty to reach a sustainable recovery in the rest of the decade. In the very first lines of his 1982 book, Minsky explained:

“Fifty years ago, in the winter of 1932-33, the American financial and economic system came to a halt: the collapse was well nigh complete. Two generations of the public (and the politicians they elect) have been haunted by the specter of “It” (such a great collapse) happening again.” (Minsky, 1982: vii)

A few pages later, Minsky clarified his concept: “Can ‘It’ – a Great Depression – happen again?” (Minsky, 1982: xi).

In these two quotations, Minsky not only defined “it” as a depression, but he also included the problems of the “financial and economic system”. Subsequent argument, however, makes it clear that *economic* problems *follow* the financial collapse.¹ The

¹ One should not exaggerate the importance of this distinction though. As it is well-known, a central feature of the Post Keynesian branch of theory more directly influenced by Keynes’s own ideas is that there is no distinction between “real” and “monetary” phenomena, or that money is a ‘real’ variable in

contraction of the *real* economy, the fall in output prices that bankrupted many firms, rising unemployment, and so on, *resulted* from the financial collapse. Minsky's dating is very precise: the winter of 1932/33 is when "it" finally happened, crowning a process initiated with the 1929 stock market crash.² Even if the language is still rather vague, in a comparison between the problems of 1962 and the 1933 collapse, Minsky again clarified what "it" means, by referring to the overall conditions that may prevent it:

"The 1962 event did not trigger a deflationary process like that set off in 1929. It is meaningful to inquire whether this difference is the result of essential changes in the institutional or behavioral characteristics of the economy, *so that a debt-deflation process leading to a financial collapse cannot now occur*, or merely of differences in magnitudes within a financial and economic structure that in its essential attributes has not changed." (1982: 3, emphasis added)

It is clear from the statement above, that the decisive feature of the 1930s crisis was the "debt-deflation process". Without "it", the destructive consequences of the "events" could be contained allowing the economy to survive the shock.

The full Minskyian concept of a financial crisis is well-known: an increasingly important group of agents with overleveraged and maturity-mismatched balance sheets suffer a shock that they cannot absorb. The nature of the shock is irrelevant, and if leverage and maturity mismatch has gone far enough, even its intensity may be unimportant.³ Any shock may be lethal if the economy is operating in an *instability zone* defined, in the 1982 paper, by household and business leverage ratios (measured by the debt to income ratio).⁴ The inability to honor one's liabilities forces a debt

any relevant meaning. The distinction is being made here only in the sense of where this class of problems may originate. In Minsky's view, they clearly originate in financial imbalances *strictu sensu*, rather than in markets for goods and non-financial services.

² Again, "In the winter of 1933 the financial system of the United States collapsed. This implosion was an end result of a cumulative deflationary process whose beginning can be conveniently identified as the stock-market crash of late 1929." (1982: 3).

³ Cardim de Carvalho (2009) for a discussion of systemic crisis within a Minskyian framework.

⁴ "A rise in an income-producing unit's debt-income ratio decreases the percentage decline in income which will make it difficult, if not impossible, for the unit to meet the payment commitments stated on its debt from its normal sources, which depend upon the unit's income. If payment commitments cannot be met from the normal sources, then a unit is forced either to borrow or to sell assets. Both borrowing on unfavorable terms and the forced sale of assets usually result in a capital loss for the affected unit. However, for any unit, capital losses and gains are not symmetrical: there is a ceiling to the capital losses a unit can take and still fulfill its commitments. Any loss beyond this limit is passed on to its creditors by

deflation process, which is to sell assets to in order to pay debts. Selling assets depresses asset markets, making it necessary to increase sales to pay debts and so on until there is a complete asset price collapse.⁵

Policy implications from this discussion are reasonably clear. “It” can be avoided mostly if excess leveraging and maturity mismatching can be prevented. In addition, fiscal and monetary policies can be geared towards maintaining income levels high enough to allow liabilities to be honored and asset prices to remain stable. However, if these dykes are breached, it is not entirely clear what should ensue. A financial collapse would obviously threaten production and employment, probably durably. Could it be compensated by appropriate macroeconomic policy? How long would these difficulties last? There are many questions left unsolved once “it” has happened, instead of being prevented.

3. Is There a Theory of Depressions?

References to depressions are legion both in the literature on macroeconomic problems and in historical analysis. It is not always obvious, however, whether the term depression is meant to refer to a specific kind of phenomenon, obeying specific laws and following a specific dynamic, or it is just a synonym to “serious recession” or a particularly deep recession, or even a normal recession, nothing more than a word one appeals to avoid repeating the same word too many times.

A recession is not a self-contained event. For most economists, it is a stage of *cyclical* processes, which confers to it a fundamental property: it is supposed to dissipate by itself, in time, giving way to recovery. In this view, implementing counter-cyclical policies may be justified if one wishes to avoid the waste of resources caused by a recession, but they are not really necessary to promote recovery, which would happen anyway. They may be even dangerous when it is believed that those policies may prevent the operation of some cleansing mechanism, such as getting rid of unproductive

way of default or refinancing of the contracts. Such induced capital losses result in a further contraction of consumption and investment beyond that due to the initiating decline in income. This can result in a recursive debt-deflation process.” (1982: 6/7)

⁵ Minsky was inspired by Fisher’s conception of a debt deflation process, but, as will be seen in section 3, below, Fisher considers a goods price deflation as a trigger of debt deflation. But after the fire selling of assets begins, Minsky and Fisher share a similar view of how the process unfolds.

firms, restoring workers' discipline, etc. Many authors actually use the term "depression" in this sense, which obviates the need to develop a specific theory of depressions.

In the opposite camp, we find authors who apply the term "depression" to specific classes of phenomena, even though different, sometimes contrasting, views may be offered as to what those phenomena may be. Generally, we may identify two groups of theories in this category: for some, as in the case of Minsky, just presented, a depression is a violent form of economic contraction, usually induced by, or simultaneous with, a financial collapse; for others, the most distinguishing feature of a depression is the short-circuit in the mechanisms that could guarantee a spontaneous recovery, causing the contraction to last more or less indefinitely. More or less complex mechanisms are postulated by this second group to explain the failure of economies afflicted by a depression to recover. In fact, economies are not supposed to keep contracting or even to stagnate at pit-bottom. Weak and fragile recoveries may happen or some structural change reducing the growth potential of the economy may set in, or others factors may be at work, but the result would be the inability of the economy to resume anything like a "satisfactory" level of activity, as vague as this statement may sound.

We may find very important economic thinkers in all these groups. One word of caution, however: many of these thinkers wrote about the depression of the 1930s while actually living it. Without the benefit of hindsight, some of them may have minimized the peculiarities of that event because of the novelty of the experience and because it could be impossible to foresee its developments. Accordingly, most authors writing in the early 1930s would not characterize the crisis as a depression, no matter how deep the contraction seemed to be (which in itself was not entirely obvious in the absence of the necessary macroeconomic information which began to be generated only later). But it is also important to recognize that some would already use the word depression to mean just a tough recession, along lines referred to above. Independently of the ability to recognize the 1930s as a special time, the term depression was used more or less freely by some influential economists.

Let us begin with Keynes. The 1930s mark, of course, his transition from more conventional modes of thinking to the General Theory-frame of mind. Nevertheless, there is some continuity in his approach to the problems of the decade.

Perhaps the most important change in Keynes's approach to the issues under discussion was the abandonment of the cyclical view characteristic of the *Treatise on Money* and the works that surround it, in favor of the unemployment equilibrium model proposed in the *General Theory*. Already in 1931 Keynes was discussing the crisis, advancing the idea that it was a cyclical recession, albeit a particularly tough one. Applying the scheme he had detailed in *Treatise*, he argued that the natural rate of interest, a measure of the profitability of investments, was reduced after World War I, but market rates of interest remained high for various reasons. Excess savings (over desired investment) would then cause the value of aggregate demand to fall below supply resulting in the recession. In the case of Great Britain the situation was worse because of the ill-considered return to the gold standard, in the mid-1920s, at overvalued exchange rates. The inability of the British economy to adjust itself to the excess value of the pound created high unemployment and a stagnant economy even before the 1931 crisis hit the economy again.

In that time, Keynes was rather pessimistic about the immediate future. In fact, as months went by, the only reason he could point to that could sustain some optimism was that the crisis had forced the abandonment of the gold standard. Now, a policy of expanding public investments could be supplemented not only by lower policy interest rates but also by higher exports induced by the devaluation of the pound. Keynes's pessimism, however, seemed to have more to do with inadequacies of policy-making, particularly with respect to fiscal policy than with the idea that the economic contraction exhibited some special characteristic. In fact, Keynes did use a few times the word *depression*, but he gave no indication that it should be understood as anything different from a recession. He pointed out the exceptional depth and duration of the recession, but this was not enough to define the events by appealing to any special conceptual structure. Keynes insisted that the main policy instrument to fight the recession in the long term was to keep interest rates low.

There were a few glimpses, though, that perhaps Keynes was acknowledging some peculiarities in the situation. He did refer, for instance, to a change in behavior (he referred to it as “abnormal psychology”) witnessed in 1931 whereby risk aversion and liquidity preference had increased dramatically (e.g., CWJMK XX: 536/7). Earlier in the same year, Keynes still proposed that businessmen’s expectations were down because demand was down, but that they would improve as soon as an increase in expenditures could be induced. Even more interesting was the perception, a little later, that the economy was operating then under different “rules of the game”. He observed that the crisis had perhaps gone too far: “by now they have allowed the collapse to reach a point where the whole system may have lost its resiliency and its capacity for a rebound.” (CWJMK XXI: 41). As it will be argued below, for some economists the loss of the capacity to rebound spontaneously can be seen as the main feature of a depression, as opposed to a recession, no matter how hard the latter may be. Despite these glimpses, Keynes basically stuck, in the period, to his main explanatory model, based on the notion that it was a recession after all, and that it would eventually give way to a recovery, although the latter could be accelerated if the right policies were implemented.

A possibly important feature of Keynes’s reflections was the relatively limited concern with financial conditions. He observed that the crisis in America was initiated by a financial collapse, but in Great Britain the problem had begun with balance of payments problems. What was more important, in both cases it was the inability of the affected economies to lower their market interest rates to the new level of natural interest rates that was the root cause of the recession.

Keynes’s arguments suffered a radical transformation around 1932/3, when the concepts and the model to be proposed in *The General Theory* consolidated in his mind. The cyclical perspective was abandoned. In *The General Theory*, the chapter dedicated to cycles does not rely on any notion of deterministic, periodical movement. Cycles are now attributed to changes in the marginal efficiency of capital, which is determined by a non-mechanistic factor, the state of long term expectations. The new framework presented in *The General Theory* is the unemployment equilibrium approach, according to which entrepreneurial economies can settle in anyone of multiple equilibrium positions, most of which are characterized by the presence of involuntary equilibrium. It

would seem, at first sight, that Keynes had accepted the idea a depression, as a situation where the “capacity to rebound” is lost. However, the change is somewhat paradoxical, since the stability of unemployment equilibrium would not only characterize special circumstances, as it is the core of the concept of depression, but would in fact be present all the time in all situations. Given the context when the book was published, many interpreters, beginning with John Hicks (Hicks, 1967) stated that the General Theory was the *economics of depression*, because of the concern with the possibility of stable equilibria with deficient effective demand. But Keynes argued this possibility for any level of output and of employment, not only the ones that would be characteristic of a depression and result from a special configuration of economic variables. In any case, in The General Theory, even more than before, financial elements are downplayed, since there are no banks or financial institutions in the book, other than the central bank, and no reference to balance sheets of any kind.

Schumpeter was also concerned with cyclical processes. It was the 1930s experience that led him to identify in the depressions a separate class of events distinct from recession, a term Schumpeter reserved for cyclical downturns. The distinguishing feature of a depression was its duration. Schumpeter pointed out that there was no *natural* (which means cyclical) recovery in the case of a depression, although he was uncertain whether this meant that it could last indefinitely or that it took such a long time to dissipate that, in practice, no country could afford to wait for a spontaneous recovery. Whatever the case, in a depression the normal mechanisms regulating the activity of capitalist economies would break down. He advanced two possible explanations for the break down: 1. *abnormal liquidations*, induced by adding to the normal process of creative destruction (whereby non-innovating and non-imitating firms would be eliminated by competition) a *secondary wave*, caused by non-essential phenomena such as debt deflation and other financial disturbances, could take the economy beyond the point where automatic adjustment mechanisms would work; a coincidence of the downturn in the three classes of business cycles (*Kitchin*, the short-term inventory cycle; *Juglar*, the ten-year investment cycle; and *Kondratieff*, the long-term technological cycle based on major innovations), putting an exceptionally strong pressure on firms.

In both cases, Schumpeter was arguing that a depression would result from extraordinary pressures being put on the economy that would jam its adjustment mechanisms, causing it to get stuck in a low level of activity. In the historical part of his major work, *Business Cycle*, first published in 1939, Schumpeter tried to illustrate his thesis with the events of the 1930s.

Although Schumpeter's explanation of the Great Depression in terms of the coincidence between the three cycles sounds awkward, the first hypothesis, that the depression resulted from adding exceptional financial pressures to a "normal" cyclical downturn seems to be more promising. In fact, a few of the most influential theses about the depression can be seen as variants of the same idea. Fisher (1933)'s debt deflation approach, for instance, also follows the same mold. Fisher also posed the question of when an adverse shock can end up being so destructive that the natural recovery mechanisms of the economy break down. In his words:

"There may be equilibrium which, though stable, is so delicately poised that, after departure from it beyond certain limits, instability ensues, just as, at first, a stick may bend under strain, ready all the time to bend back, until a certain point is reached, when it breaks. This simile probably applies when a debtor gets 'broke', or when the breaking of many debtors constitutes a 'crash', after which there is no coming back to the original equilibrium." (1933: 339)

What causes "the stick to break"? Fisher's hypothesis is that when over-indebtedness meets a deflation, a snowfall-like process of contraction ensues. This combination creates a cumulative disequilibria process that will only stop when bankruptcies are widespread:

"... deflation caused by the debts reacts on the debt. Each dollar of debt still unpaid becomes a bigger dollar, and if the over-indebtedness with which we started was great enough, the liquidation of debts cannot keep up with the fall of prices which it causes. In that case, the liquidation defeats itself. While it diminishes the number of dollars owed, it may not do so as fast as it increases the value of each dollar owed. Then, *the very effort of individuals to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate in swelling each dollar owed.* Then we have the

great paradox which, I submit, is the chief secret of most, if not all, great depressions: *The more the debtors pay, the more they owe.* The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but it is capsizing.” (1933: 344, emphases in the original)

Again, the main point is that a depression is an *exceptional situation*, generated by *exceptional pressures*. The result of these pressures is to strain the operation of the normal adjustment mechanisms of the economy, causing to crawl or limp away for prolonged periods of time.

More traditional debates about the Great Depression seem to focus mainly on the contraction itself, not on the stagnation that followed it. Thus, the classical reference, Friedman and Schwartz (1963) as it is widely known, blame the Fed’s inability to sustain the stock of money in the aftermath of the banking crises taking place between 1929 and 1933 (1963: 300). The stock of money fell because the public, distrusting the health of the banking system, tried to cash their deposits and because banks, facing the run, tried to hoard reserves (1963: 352). Friedman and Schwartz acknowledge that “is by no means clear” (1963: 330) why banking panic was renewed at least twice in that time but stress the view that the central bank could have avoided it and the contraction that followed.

The Keynesian counter-argument was presented mostly by Temin (1976, 1991). Temin argued that the banking crisis was a consequence, not a cause, of the depression, which is not conceived as anything more than a serious recession. He argued that there is always some deviation from the norm, and the 1930s are noteworthy because the deviation was larger than what usually happens. But being larger does not mean having a different nature. According to Temin, aggregate demand was falling even before 1929, mostly in consumption and exports (1976: 65). In his later work, Temin also added to the argument the adverse influence of the gold standard in the face of World War I:

“The postwar gold standard spread the shock of the war in two ways, by imparting a deflationary bias to national economic policies of gold-standard countries in the late 1920s and by indicating that deflation was the appropriate remedy for the ills of the early 1930s.” (1991: 42)

More recently, Bernanke (2000) restored the focus on the depression as the decade-long process of contraction-plus-difficult-recovery. In fact, he seems more concerned with explaining the failure of the United States economy to recover vigorously than with the contraction itself. He pays homage to Friedman and Schwartz, as it became almost a ritual in the conventional literature, but distances himself from the core analysis of their book. He acknowledges from the start an obvious shortcoming of the neoclassical analysis in the eyes of post Keynesians:

“ ... the effects of monetary contraction on real economic variables appeared to be persistent as well as large. Explaining this persistent non-neutrality is particularly challenging to contemporary macroeconomists, since current theories of non-neutrality (such as those based on menu costs or the confusion of relative and absolute price levels) typically predict that the real effects of monetary shocks will be transitory.” (2000: 24)⁶

He finds persistency factors mostly in the destruction of informational capital of banks, after widespread bank failures, which raised the cost of financial intermediation and rationed credit to firms. The root of the depression, therefore, should be found at the debt deflation process that destroyed the financial system beyond the damage created by banking runs and other highly visible phenomena (Bernanke, 2000: 44). Once a hostile environment was created to enterprise by bank failures and other forms of panic, a somber mood would could expectations, making recoveries more difficult and tentative.⁷ As noted by Bernanke:

“The reluctance of even cash-rich corporations to expand production during the depression suggests that consideration of the aggregate demand channel for credit market effects on output may be more fruitful.” (2000: 56) “Most important, however, was a noticeable change in attitude among lenders; they emerged from the 1930-33 episode chastened and conservative.” (2000: 63)

⁶ Bernanke reaffirmed the point later: “One problem is that there is no theory of monetary effects on the real economy that can explain protracted nonneutrality.” (2000: 42) Of course, Bernanke’s point is an indictment of neoclassical theory, not of economic theory as such.

⁷ As Galbraith (1997: 169) remarked: “Far more important than the rate of interest and the supply of credit is the mood.”

In sum, we would like to stress a few points from this quick examination of approaches to the Great Depression. First, the most promising concept of depression seems to be the one that emphasizes the interaction between intense shocks and protracted stagnation (or slow recovery). What makes the depression an interesting phenomenon for most researchers is not only how deep it went but also how difficult was to overcome it, from the New Deal policies to the push to aggregate demand represented by World War II.⁸ Secondly, it is very difficult to paint a stylized picture of a depression, since there are only a few cases of depression that could be used as templates to describe a “model” of a depression. Arguably, of a “great” depression, there is only one example, the 1930s, or, if we use more flexible criteria, perhaps two or three more. In addition, the 1930s depression is complex enough to make the task of isolating its essential elements very hard.⁹ Third, and possibly the most important preliminary conclusion so far, the common thread between most of the approaches presented in this section seems to be the notion that there may occur, under special circumstances, a shock that is so intense as to disarm the self-equilibrating mechanisms of the system, causing it to break down and work defectively for possibly indefinitely long periods of time. A theory of depressions, therefore, would emphasize the non-linear nature of the dynamics of entrepreneurial economies.¹⁰

Finally, a Post Keynesian theory of a depression should specialize the arguments both as to what type of shock may cause such a deep impact on the operation of the economy, enough to take it off its normal path, and to what keeps the economy down

⁸ Again, it may be impossibility to improve on the way Galbraith put it: What, then, are the plausible causes of the depression? The task of answering can be simplified somewhat by dividing the problem into two parts. First there is the question of why economic activity turned down in 1929. Second there is the vastly more important question of why, having started down, on this unhappy occasion it went down and down and down and remained low for a full decade.” (1997: 174)

⁹ The complexity of factors contributing in some way to the generation of the crisis can be assessed by checking any of the innumerable works reporting on the 1929 crash, its antecedents and its aftermath, until the end of 1930s. Kindleberger (1975) is a classic reference to the historical presentation of the 1930s crisis, beginning with events from the mid-1920s and advancing into the New Deal. Kennedy (1999) gives a more political emphasis in his report of the period.

¹⁰ A promising concept in this particular is Clower’s and Leijonhufvud’s notion of *corridor*. The corridor would demarcate a zone of stability, where homeostatic mechanisms prevail. When a shock to a economy is so intense that it may take it out of its stability corridor, effects become disproportional to causes, and unstable behavior prevails. Cf., e.g., Leijonhufvud (1981, chapter 6). Corridor effects can result, in Post Keynesian models, from changes in expectations or in the state of confidence. Another factor that creates non-linearities is leverage, as noted by Minsky, Galbraith and others. Non-linearities, of course, are also important to some more conventional works, such as Cecchetti, Kohler and Upper (2009). See also Solow (2009).

for so long. The answer to the first query seems to reside in Minsky's financial fragility theory, which explains not only how dangerous sources of vulnerability are systematically generated in capitalist economies, but how, once out in open, they transform into a major shock, through the debt-deflation process. Once a financial collapse takes place, its impact on factors like the state of confidence, liquidity preference, profit expectations, wealth and income effects, etc, would depress aggregate demand and cause the economy "to remain low", as described by Galbraith.

A potentially important argument to be explored in the Post Keynesian tradition is the behavioral impact of a sharp increase in uncertainty, as one would expect to result from this kind of process. Minsky had already called attention to the fact that confidence may be considered at least partly endogenous. Bad experiences tend to shape behavior while it they are strong in memory, in the same way good times lead people to underestimate risks.¹¹ Shouldn't we expect that all economic agents acted in more careful and defensive ways in the aftermath of a financial collapse? Shouldn't we expect increasing liquidity preferences by firms, consumers and banks, lower consumption multipliers, dampened accelerators and the like? Post Keynesian theory would predict such changes in the dynamic parameters of the economy, which would go a long way to explain why financial collapse should be followed by protracted stagnation or low growth.

4. Is The Current Crisis a Depression?

It is, of course, still early to offer any definite characterization of the current crisis. Nevertheless, it already seems to exhibit many of the distinguishing signs discussed above. Firstly, "it" did happen again. A full-fledged financial crisis, including a debt deflation process, took place from 2007 to late 2008. It was stopped by strong and coordinated action by practically every important central bank. Bank failures either occurred or were prevented by having other banks taking the problem banks over, sometimes, it seems, at gun-point. The financial crisis did hit the "real" economy, through the collapse of the supply of credit, be it bank credit or securitized loans. The recovery we are witnessing during these latter months of 2009 is, so far, fragile, weak and possibly short-lived. Most importantly, it is not fed by a return of consumers and

¹¹ In this particular aspect, Minsky's aphorism "stability is destabilizing" could well be a conclusion of *behavioral finance* followers.

firms to spending, but by expansive fiscal policies and topic policies like the “cash for clunkers” in the United States and the incentives to car purchases in Germany. Every indication and growth projection, although they have been inflated lately by more optimistic expectations, still point to protracted slow growth. Consumers, firms and financial institutions are *de-leveraging*. While they do it, aggregate demand will be subdued, domestically and worldwide (with the usual exceptions, such as China).

If we accept the hypothesis that this is a depression, and take the stylized sequence financial collapse – protracted fall of aggregate demand as descriptive of the fundamental dynamics of a depression, it would seem likely that the first stage is largely over.¹² To say it is over does not mean that new serious financial problems cannot emerge, but the *collapse* is over, that is, the phase of panic, serial bankruptcies, runs, etc, has ended. If this is true, we should expect future financial difficulties to emerge as a result of fragilities in non-financial markets, through, for instance, rising credit risks in loans to consumers and firms. Large scale financial problems created by large scale financial failures, however, do not seem likely in the near future.

The financial collapse initiated with the turmoil in the subprime mortgage sector in early 2007 which later spread to the whole financial system, is, by now, known in detail.¹³ The pattern followed in this episode fits very well the debt-deflation model.¹⁴ Perceived increasing credit risk by the late 2006 and early 2007 led to a downgrade of some issues of mortgage-backed securities. Some holders of these securities were forced to sell them or to cover higher margins, pushing their prices down. The realization that these securities were not as safe as initially believed allied to the strengthening of bearish sentiment about them led to additional selling rounds, increasing the capital losses not only of those holder that tried to sell but, in fact, to every other holder as well, as a result of the adoption of mark-to-market portfolio evaluation methods. Pressures spilled over to other securities, either because of attempts to sell them to cover losses

¹² Not everybody agrees. See, for instance, J. Weil, “Next bubble to burst is banks’ big loan values”, August 13, 2009, Bloomberg.com.

¹³ The interested reader can consult an enormous literature about the financial crisis that is currently available. The IMF’s half-annual report Global Financial Stability Report, covering in detail the evolution of the crisis can be consulted at www.imf.org. More compact reports can be found in Acharya et alli (2009) and de Portu (2009), available at <http://prismcapadv.net/home>.

¹⁴ See Kregel (2008) for a description of the collapse using Minsky’s categories and adapted to the new environment dominated by securitization methods e derivatives markets.

with mortgage-based securities or because of the deterioration of market expectations in general.

Clearly, from 2007 to early 2008, a debt deflation process occurred while financial institutions tried to de-leverage, leading to the collapse of securities markets. As these markets have constituted an increasing source of bank funding, either directly through issuance of bank securities, or indirectly, through issuance of debt securities by special-purpose vehicles created by banks, the debt deflation process constituted a direct threat to the banking system and to any other financial institutions that financed its assets in similar ways. Again, the failure of Lehman Brothers, later in 2008, in a deeply nervous environment marked by the daily accumulation of bad news, worked as napalm, setting the whole system on fire. An intense search for liquidity set in, strengthening the crisis momentum. As the BIS noted in its last annual report:

“Evidence of serious trouble emerged when banks became less willing to lend to each, because they were no longer sure how to value the assets held and the promises made – both their own and those of potential borrowers.” (BIS, 2009a:3/4)

As already noted, this process is very well-documented in various sources. What is important for the present discussion is to note that “it” has finally happened again: a wide and deep debt deflation process, which could not be detained even by a wide and coordinated initiative of many central banks, implementing all kinds of policy instruments, some for the first time ever. Supplying reserves to banks, however, avoided their failure, but could not restore financing to the rest of the economy. As it happened in similar circumstances in the past, banks would put their hands on whatever liquidity they could find and sit on it:

“With banks hoarding liquidity, US dollar Libor/OIS spread surged from already elevated levels of around 80 basis points in early September [2008] to near 250 points at the end of the month.” (BIS, 2009a: 27)

Debt deflation, in an environment dominated by financial conglomerates, had to threaten the banking system, which it did in a dramatic way by late 2008. Again, only the forceful intervention of central banks and Treasuries in the advanced economies

could contain the banking crises, at the cost of passing rescue programs involving so far unimaginable amount of money.¹⁵

Government intervention in the advanced countries seems to have been very effective, in the end, to contain the collapse of the banking system. By late 2009, there is already some talk about the revival of financial markets and the attempt by banks to repay the debt they accumulated with government support initiatives. However, the essential channels linking the financial collapse to negative effects on the “real” economy are still very much active. Banks’ recovering health has not been translated in an expanding supply to firms and consumers in any advanced economy so far, quite the opposite. Again, and in contrast with the 1930s experience, the appeal to more active fiscal policies, especially in the United States, may have attenuated the effects of the financial crisis, but it is still far from clear if they were sufficient to actually put a floor under the falling economy.

Thus, although it is always exceedingly risky to try to diagnose a situation while it is still unfolding, it seems that the essential elements a Post Keynesian theory would propose to identify a depression are present in the current crisis. The amplification mechanisms, represented mainly, but not only, by the debt deflation process, did take place, with their consequences attenuated by a strong anti-crisis rhetoric, sometimes accompanied by also strong policy measures. Eichengreen and O’Rourke (2009) have been presenting frequently updated analyses of the similarities between the events of 2008/9 and the 1930s.¹⁶ Their data shows that developments have been so far closely alike in the two experiences, even though manufacturing production seems to have reached a floor, probably due to expansive fiscal policies adopted in the last two years, before the situation could be as bad as it was in the 1930s.

¹⁵ Cf. BIS (2009b) for a list of the monetary measures adopted by advanced countries, the values involved and what has been effectively spent with these programs. Fiscal policies adopted by G 20 countries are listed in Horton, Kumar and Mauro (2009).

¹⁶ The latest version of the study in progress, dated 1 September 2009, is available at <http://www.voxeu.org/index.php?q=node/3421>.

6. Conclusion: What to expect in the near future?

The appropriate characterization of a depression is not a semantic issue. If depressions are in fact a specific kind of phenomenon, being able to identify its occurrence allows analysts and policy-makers to understand its mechanisms and predict its evolution. If depressions are the combination of financial collapse and protracted slow growth¹⁷, we should not be surprised with the signs of recovery that have become frequent lately nor should we assume that this means that the affected economies are out of the woods.

On the other hand, consumers', firms' and banks' liquidity preferences (for precautionary reasons) are likely to have increased, raising the cost of finance and contributing to keep aggregate demand subdued, except for government spending. It is also possible that consumption multipliers have been reduced, particularly in the United States, because of an increase in precautionary savings.¹⁸

Evidences of recovery rely presently mostly in an upward stage in the inventory cycle in the United States and some export expansion in Germany, besides some improvement in expectations, which, however, tend to oscillate wildly. Not only these are movements that may not last, but they are also the result, at least in part, of the large number of expansive policy measures that have been adopted since 2008. If the current situation is in fact a stage in a depression, we should be prepared not only for a relatively long period of slow growth, and high unemployment, but also for new episodes of contraction, if not necessarily of panic. It is to be expected that consumers and firms will remain cautious for quite some time with their expenditure plans, that banks will try to remain liquid, to reduce their exposure to credit risks and to deleverage to a larger extent than they have done so far. A tough recession may have ended, but if we are

¹⁷ There is some empirical evidence that serious financial crisis may impact negatively the economy in the long term, in the sense that even when recovery eventually takes place, the level of income lost in the crisis may be never recuperated. See, for instance, Furceri and Mourogagne (2009); Haugh, Ollivaud and Turner (2009), and Cerra and Saxena (2007).

¹⁸ The possibility that consumption multipliers may have been reduced is raised, among others, by Spilimbergo, Symansky and Schindler (2009), although there would be reasons also for the opposite. As they argued: "The impact of the crisis on the size of multipliers is uncertain because: (i) the uncertainty has probably induced consumers to increase precautionary saving (e.g. based on aggregate data, the 2008 US tax rebate appears to have been largely saved), reducing the marginal propensity to consume and the size of the multipliers; (ii) the ongoing deleveraging has likely increased the proportion of credit constrained consumers and firms, raising the size of multipliers; (iii) monetary policy is extremely accommodative, with the short rate close to zero, and a commitment to keep it there for as long as needed, increasing considerably the size of multipliers." (p. 4).

living through a depression, even if its worst possibilities were aborted by policy intervention, we should still be preparing for prolonged tough times.

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