On the Origins (and Causes) of the Financial Crisis

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1. Introduction

This paper aims to discuss the origins of the financial crisis by reference to the existing literature and to some influential post-Keynesian scholars whose contributions shed light on the crisis. **The aim of the paper is to evaluate whether a range of heterogeneous viewpoints could have been successfully translated into 'better' economic policies during the period in which the causes of the crisis developed**. This is done by relating and comparing a strictly financial perspective on the crisis with other perspectives: for instance, I provide a discussion on the 'economic culture' and argue that the current crisis can be usefully assessed from a cultural as much as a financial point of view.

In the current debate on the economic crisis, it is important to make a clear distinction between the concepts of cause and origin; an *origin* refers to a source, and denotes the point at which something (a process, a growth, a development, or a *crisis*) starts from. The origins of the 2007-2008 financial crisis are to be found in the unintended consequences of liberal financial policies, and in the increasing globalisation and connectedness of financial markets. Conversely, a *cause* refers to what – in part or in whole – produces an effect or a substantial result. The main causes of the crisis are to be found in the policies pursued by some investment banks that directly and indirectly increased leverage, the rapid development of new, risky financial products and their poor regulation; and the subsequent failure of the US subprime mortgage market with dramatic effects on the banking and financial system as well as on the real economy.

Key questions regarding origins include:

1. How can one account for the expansion and the subsequent failure of the US subprime mortgage markets?
2. Why has the development of financial markets and the expansion of financial products in the last decades not been matched by a proper regulation so to prevent or at least limit their risks?
3. What enabled investment banks to pursue strong profit-maximising policies and what stopped them from timely recognising the risks that they were undertaking with their strategies?

There are also other questions that focus on economics as a science and on the role of the economists. For example:

4. Have economists and policy-makers an adequate understanding on financial crises and their origins?

I would also contend that a full account on the origins of the crisis and its implications for how financial systems are regulated, requires that other, non-financial aspects be taken into account. Indeed, it is sensible to argue that there is a list of diverse yet related origins that help one to analyse the crisis. In this regard, I refer to culture with the aim of exploring the non-financial sides of the crisis. This task is particularly demanding since there is no straightforward definition of culture.

Moreover, there are different views on how culture influences the economy (Ray and Sayer, 1999). This paper centres on how culture can be interpreted with respect to finance and business, and aims at casting light on how it shapes entrepreneurial goals and the idea of trust (Fukuyama, 1996).

2. In what ways are post-Keynesian theories relevant for an assessment of the crisis?

First of all, it is urgent to pose some basic questions: **Why have economists underestimated the possibilities of the occurrence of a crisis?** Why has the economic theory on financial crises been ignored? In fact, there exists a vast literature on financial crises in both developed and emerging markets! It appears as if a whole generation of economists that centred their scholarly research on financial crises has been largely neglected, and therefore one may at least partially question the validity of contemporary academic economics.

As Colander et al. (2009) suggest, 'the confinement of macroeconomic models of stable states that are perturbed by limited external shocks and that neglect the intrinsic recurrent boom-and-bust dynamics of our economic system is remarkable. After all, worldwide financial and economic crises are hardly new and they have had a tremendous impact beyond the immediate economic consequences of mass unemployment and hyperinflation. This is even more surprising given the long academic legacy of earlier economists' study of crisis phenomena, which can be found in the work of Walter Bagehot (1873), Axel Leijonhvud (2000), Charles Kindleberger (1989), and Hyman Minsky (1986), to name a few prominent examples. This tradition, however, has been neglected and even suppressed' (p. 2-3).

One of the lessons from post-Keynesian scholars such as Sylos Labini (2006) is that high levels of debt can be viewed as a principal cause of instability. One can separate between household debt and firms' debt. The need for private enterprises to renew existing loans may be at the base of a financial crisis. On the other hand, as observed by D'Ippoliti (2009), some economists tend to view the excessive debt of the US households as a speculative financial behaviour, quite similar to that of private firms. Such an analogy neglects an important distinction: namely, that existing between *endogenous* and *exogenous* dynamics in contemporary capitalist systems. Economists and policy-makers should be aware of such a distinction.

The neoclassical synthesis suggests that, unless disturbed by exogenous factors, markets adopt a policy of self-regulation and therefore show a tendency towards a self-sustaining and full-employment equilibrium. Such an argument assumes rationality in expectations as well as in all other aspects of entrepreneurial behaviour. It also stresses the efficiency in market equilibrium where prices 'fully reflect' available information (Muth, 1961; Fama, 1970). Within an evaluation of the actual crisis, this perspective suggests looking for its causes elsewhere, outside the market, and potentially neglects that it can generate from within the market (which seems to be currently the case).

By contrast, scholars such as Minsky argue that contemporary capitalist economies simply cannot lead to sustained and full-employment equilibrium; instead, business cycles are distinctive to such economies. Minsky's analysis is particularly useful in the analysis of the US subprime mortgage markets: following his observations, one may argue that enterprises and other economic operators tend to incur in financial risks to make profits. Therefore, they can result in instability in the financial system. This view stresses the need for an adequate basis for the supervision of economic agents and their behaviour.

3. A financial view

The 2007-2008 financial crisis is global and the most severe of a number of crises that followed in the last decades. There is no developed or advanced economy that in the last decades stayed immune from financial break-ups, speculation and financial debacles. As noted by the post-Keynesian scholars such as Hyman Minsky (2008), this suggests that **financial instability is somewhat inherent to both contemporary economies and advanced financial systems**,. It is helpful to provide a brief account of some of the most significant banking crises from the last three or four decades. Evidence suggests that an increasing instability in the macroeconomic framework and in the financial system since the 1970s has been matched by inflation and a rise in unemployment.

i) Macroeconomic perspective

Mishkin (2002) and De Bonis (2008) provide outlines on the numerous financial and banking crises in the US, Europe and across the world. The US witnessed the saving and loans crisis in the 1980s, with losses of almost $200 billion and the default of roughly 3,000 intermediaries due to both competition from monetary funds and inflation. At the beginning of the 1990s, some major financial institutions in Sweden, Norway and Finland faced severe problems with negative repercussions on the Scandinavian economy.

Virtually no macroeconomic area stayed immune from financial and banking crises. In the 1990s, several Japanese banks faced a number of problems and subsequent losses with an economic stagnation that lasted for at least a decade. In the years 1997-1998, emerging Asian economies such as Thailand, Malaysia, Singapore, Indonesia and South Korea all experienced severe financial and banking crises.

ii) Specific examples from banking

In 1991, the Bank of Credit and Commerce International (BCCI), founded in 1972 and registered in Luxemburg, was declared insolvent and liquidated on the ground that it had lost its entire capital and reserves from the year before. Despite the improvements in the regulation of international banks after this case, fears remained that another BCCI-like scandal could happen again (Mishkin, 2002, 292). In 1994, the UK-based Barings bank (founded in the Eighteenth century), was brought down in 1995 due to unauthorised trading in derivatives.

There are several examples of banking failures in Italy from the last decades (De Bonis, 2008, 76-78), some of which are well-known (for instance, Banco Ambrosiano), but others are not accounted for accurately: for instance, two banks from the Slovene community in Italy, namely the Tržaška Kreditna Banka originally based in Trieste, and the Kmečka Banka originally Gorizia have been merged with other banks after large losses and consequent failures, on which no definitive report exists. Note that, whatever the example, the implications of the failure are economic and social at the same time.

To design the best policies to limit the outcomes of the current crisis on the real economy and prevent their repetition in the future, it is important to start a discussion from the financial aspects of the crisis. In the following paragraphs, I will attempt to provide an outline of **the main causes of the crisis from a financial perspective, namely**: *(a)* the profit-maximising policies common to many financial intermediaries (particularly investment and commercial banks); *(b)* the increasing segmentation of the financial market and fragmentation of market strategies; *(c)* the lack of transparency in some segments of the financial markets, particularly in innovative financial instruments; *(d)* market complacency after some years of positive returns; *(e)* finally, a regulation of financial markets and the banking sector that proved inadequate and particularly poor in some circumstances.

First, the crisis is in part the result of the profit-maximising policies pursued by a number of important financial intermediaries. Data on the US subprime mortgages (namely, the riskiest category of consumer loans) show that in the years preceding the actual manifestation of the crisis, many financial intermediaries – particularly investment banks such as Lehman Brothers– increased the level of risk related to their policies. Extant research reveals a gradual shift in the number of mortgage approvals: especially in regions with the highest degree of mortgage refusals in 1996, the number of refusals decreased significantly (Mian, A.R. and Sufi, A. 2008). The same conclusion is provided by Dell'Ariccia et al. (2008), whose paper stresses the decline in lending standards in some US areas of high income price appreciation.

Second, the crisis is the result of an unprecedented segmentation and fragmentation of the credit market with a very limited social contribution (such as a decrease in fees). The subprime mortgage market can be thought of as a market niche, which developed because other segments of the financial market resulted in increasing saturation. Such development was paralleled by a rapid development of innovative financial products, which were largely the outcome of the so-called 'creative financing' (i.e. non-traditional means of real-estate financing) but without a proper social contribution. According to Stiglitz, 'many new financial products were sold as lowering transactions costs and providing new risk arbitrage opportunities, but pricing was based on information provided by existing assets, and they succeeded in generating huge fees' (Stiglitz, 2008, 6).

Third, as observed by Zingales (2008), there seems to be a relatedness between the lack of transparency in several financial products and market complacency brought about by several years of positive returns. Regulators were not fully capable of recognising potential threats from financial innovation and, consequently, markets grew increasingly opaque and risky. No adequate account of their risks was provided: for instance, in ten years the market for credit default swaps (CDS) grew from almost zero to more than $44 trillion (that is, more than twice the size of the US stock market). Stated otherwise, since CDS are forms of insurance that are prone to being used as forms of speculation and have been sold as a solution to risk. Their implications are yet to be fully understood.

Unfortunately, potential threats translated into real problems and the collapse of the US mortgage market, several banking institutions, and with negative repercussions on the real economy and a decrease in market trust. Similar opaqueness was present in the mortgage-backed security market. Indeed, most securities have been issued only with limited disclosure. As a result it became more and more difficult to account for ownership and clearly distinguish "who exactly owned what".

Finally, liberal policies, deregulation, and a consequent decrease in regulatory standards are ultimately among the main sources from which the crisis originated. As Crotty puts it, 'several decades of deregulation and globalisation of financial markets, combined with the rapid pace of financial innovation and the moral hazard caused by frequent government bailouts helped create conditions that led to this devastating financial crisis. The severity of the global financial crisis and the global economic recession that accompanied it demonstrate the utter bankruptcy of the deregulated global neoliberal financial system' (Crotty, 2009, 575).

4. A cultural view

<u>i) Culture and the economic analysis</u>

To fully understand the origins of the crisis, it is essential to address the problem from a cultural perspective since the latter offers some valuable insights on the origins of the crisis. This is a challenging task for a number of reasons: it is hard to clearly define the relatedness between the financial sphere and the cultural sphere. The concept of 'culture' is sometimes vague and often blurred, particularly within a financial or business debate. Indeed, some scholars may prefer the concept of ‘corporate philosophy’ or ‘entrepreneurial culture’ to stress the commonalities between culture, corporate governance and the financial system. However, it has to be recognised that they do not refer to the same thing. Culture involves customs, values, communication. Therefore, financial problems are not easy to explain in terms of communication.

Communication is central to what I refer to as ‘economic culture’. **When economists provide analyses on the economy, their results need to be properly communicated.** Such communication appears to be smooth when positive sides of the market – say, market success – are stressed, but things become much more complicated when economists point to the market inefficiencies and fallacies. Also, communication needs to be mutual. The market’s inability to make a proper use of the scholarly research and analysis can be listed among the major reasons for its inability to recognise the occurrence of the crisis and prevent its negative outcomes. It is perhaps surprising that only a few economists refer to a cultural analysis to support their economic conclusions.

In 2004, the late Italian economist Sylos Labini (2006) detected the widespread speculative trends in some sectors of the US economy, which produced a speculative bubble. As he argues, there was a Wall Street bubble burst at the end of 2000 with a negative impact on the bargaining power of households. After its burst, it survived and moved forward another time. This is not surprising: indeed, according to Sylos Labini, one of the distinguishing traits of a global economy is the fact that speculative trends tend to spread to the developed economies although at different times. (Sylos Labini, 2006, 121).

ii) Speculation

At this point, it is important to centre on speculation as well as provide a definition of the term ‘speculation’ by reference to real examples. There have been a number of large US companies that at the turn of the century went bankrupt as a consequence of their speculative attitude and fraudulent corporate governance. Perhaps one of the worst examples of fraudulent corporate governance is constituted by WorldCom, a communication group which in the 1990s grew to become the 25th largest company in the US and one of the largest providers and carriers of international voice traffic in the world, and one of the major communication services provider to the US corporations and the market. Its growth was supported by the developments of the Internet and information technology.

The unfortunate example of the WorldCom failure can be better understood by reference to the deregulation of the US telecommunications policy of the 1990s which was aimed at increasing competition and competitiveness. Unfortunately, not only the opposite occurred, but such policies provided the basis for speculation in that industry. As Clarke observes, ‘deregulation in telecommunications also saw deregulation in the accounting, banking and the financial sector … It became a form of regulation on behalf of powerful interests with no one representing the public. WorldCom became one of the principal actors to take advantage of this regulatory-friendly environment’ (Clarke, 2007, 332).

Speculation contrasts reliable and trustful behaviour. A sound economic system should recognise and prevent speculative attitudes ahead of time. Instead, not only the ‘rules of the game’ – particularly those of a ‘fair game’ (Fama, 1970) – have been circumvented and the crisis prevention mechanisms showed unable to fully recognise the growth of a bubble; they were not even able to clearly recognise the growth of a second bubble and its negative implications. It is not surprising then, that there is still some confusion in defining bubbles and in distinguishing ‘rational’ from ‘irrational’ bubbles. Cotemporary economics attempts to develop sophisticate statistical models to detect bubbles. It may be argued that, if such statistical models are not accompanied by a cultural and sociological perspective, they are likely to be flawed and may not be as accurate as they pretend.

There are other reasons to support the argument that a cultural perspective is relevant to an economic and business analysis. Scholars such as Fukuyama (1996) argue that business and economic organisations are a product of trust. Such a point of view is particularly useful to understand the origins of the 2007-2008 crisis: if different forms of governance systems are conceived around different forms of trust relations and, consequently, the economy can be viewed as a complex network built around trust, the crisis can be viewed as the result from a misuse and the subsequent loss of trust. If this argument proved correct, one could conclude that contemporary capitalism failed exactly where it claimed to be strongest, namely in securing and promoting trust among a variety of economic actors.

5. Criticisms directed to policies adopted by central banks

Crotty (2009) provides an outline on the structural causes of the global financial crisis: the main argument of his paper is that the deep cause of the financial crisis is to be found in the flawed institutions and practices of the current financial regime referred to as the New Financial Architecture, based on light regulation of commercial and investment banks. Such an argument suggests that an institutional perspective is very relevant to our discussion. An institutional point of view can complement other perspectives – say, a post-Keynesian view – and provide important theoretical insights.

A focus on the role of central banks is essential for a discussion on the origins of the 2007-2008 crisis. Central banks provide financial and banking services for the government of a country and are in charge of implementing the government's monetary policy. Their goals include – among other things – the management of government's accounts; the acceptance of deposits and the grant of loans to commercial banks; the management of public debt; acting as a lender of last resort to the banking system. Their decisions influence both the financial system and the economy. Their policy, organisation, and goals are at the centre of many debates.

Critical realism in economics asserts that mainstream economics embraces an exaggerated enthusiasm for formalism; and believes in strong conditional predictions in economics despite repeated failures. There is one paper written from a perspective resembling critical realist that is particularly valuable in the debate on the origins of the financial crisis, namely Morgan's 'The Limits of Central Bank Policy' (2009) which examines the development of central bank policy during and after the crisis, and the failure of applied monetarism in accordance to the Taylor rule policy. The latter identifies short-term interest rates as a means to create low and stable inflation.

This, however poses a number of methodological concerns due to the fact that the approach is rooted in modified rational expectations: 'the equilibriums constructed from trend rates ultimately assume normal distributions that underpin the notion of statistical convergence around measures of GDP and inflation. Put another way, reality has a series of fundamentals that provide an enduring rational calculative basis for actors within the system allowing it to return to equilibrium. When this is conjoined with forecasting based on collected data this shifting idealised point becomes not just the goal but also the real point of the system at any one time' (Morgan, 2009, 587).

Central banks are often criticised with respect to their functions and policies. The financial crisis provides an unprecedented possibility to discuss the role of central banks and suggest some directions for an improvement of their policies. I am not arguing that the policies by central banks such as the FED or the Bank of England helped to generate the crisis. Nonetheless, as some scholars suggest, the crisis forces a reappraisal of the role of central banks and their duties as the regulators of the financial and banking system.

The above-issues have important implications on our understanding on the functioning of the economy and the banking system. What if new crises occurred in the coming future? If one attempts to put together the different points of view, namely:

- the idea that central banks are unable to forecast crises
- the idea that crises are recurrent and unavoidable
- the idea that contemporary financial systems are inherently unstable as suggested by Minsky

then one may conclude that crises are inevitable.

6. Conclusion and policy-implications

This paper suggested new ways of looking at the financial crisis by clearly separating between its origins and causes. The 2007-2008 financial crisis suggests that a new regulation is urgent in financial markets and banking. In this respect, much can be learnt from an analysis of the origins and causes of the crisis. As suggested by extant literature (Dell'Ariccia, 2008; Mian and Sufi, 2008; Stiglitz, 2008; Zingales, 2008), the crisis is the result of profit-maximising policies pursued by several financial intermediaries which increased leverage, the segmentation of financial markets, and lack of transparency in innovative financial products. Some areas are yet to be analysed further, for instance: intra-financial multiplication, the role of prime brokers and hedge funds as well as the relation betweeb financial organisations and regulatory institutional effects such as the Basel I and II accords.

Ultimately, one may suggest that the origins of the financial crisis may be traced back to the unintended consequences of liberal financial policies. It is therefore worth reviewing the models on rational expectations and efficient market hypothesis since they help in explaining the roots of the neo-classical inspired limited regulation approach to markets. A cultural view on the economy and finance can complement such a view and reveal its potential shortcomings. Unfortunately, only few scholars refer to culture in order to obtain new insights or support their findings. Furthermore, economists and policy-makers could benefit from a better understanding of post-Keynesian theories and from the valuable insights on the structural instability of contemporary financial systems offered by scholars such as Minsky and Sylos Labini. Stated otherwise, a range of heterogeneous viewpoints can be translated into better economic policies with both positive economic and social returns.

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