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D3.12 – Synthesis: The characteristics of a more resilient financial and economic system

Inputs for the Discussion at the FESSUD workshop "Work Package 3: Causes and Consequences of the Finance Crisis"
8 May 2015,
Berlin School of Economics and Law, Berlin

IPE Berlin
Institute for International Political Economy Berlin

Hochschule für Wirtschaft und Recht Berlin
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A RECAP OF THE WORK IN WP3

A Recap of the Work in WP3

- 4 blocks of WP3
  - General views on financialisation and financial crises
    - D3.01 Theories of financial crises
    - D3.02 Previous financial crises leading to stagnation – selected case studies
    - D3.03 Financialisation, distribution, growth and crises – long-run tendencies
  - Exploration in the origins of the financial crisis
    - D3.04 8 papers exploring the factors generating and transmitting the financial crisis
    - D3.05 Synthesis paper on D3.04
  - Financialisation and the financial crisis – case studies: countries, sectors, markets
    - D3.06 Country studies
    - D3.07 Synthesis paper on D3.06
    - D3.08 Sector and market studies – Energy, Currency, Housing
    - D3.09 Synthesis paper on D3.08
  - Financialisation and the financial crisis – the EMU
    - D3.10 Financialisation and its effect on EMU and non-ÉMU countries / coherence of the EMU
    - D3.11 The financial crisis in the EMU

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THE TASK OF D3.12

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The task of D3.12: Synthesis report on the characteristics of more resilient financial and economic systems

- The DoW reads:

The final major task will involve integrating the understanding gained from the previous tasks and will have a **strong policy orientation**. In the light of an assessment of the different theoretical approaches to financial crisis and of the relation between the financial sector and other sectors of the economy, clear conclusions will be drawn about the **origin of the financial crisis**, the **specific nature of the vulnerabilities** of the different member states and the precise **channels** by which the crisis was **transmitted** to the different EU member states. In particular, the **effects of the crisis on the EMU** as a whole will be addressed. One major concern of this task will be to distinguish the ways in which **member states**, or groups of member states, were **affected in different ways as distinct from the way in which all the member states were affected**. It will be important to identify the factors which led to some countries being **especially badly affected by the crisis**, but also those factors which enabled other countries to establish a **degree of protection**. On the one hand, **the overriding concern is to identify the form of financial structure most favourable for engendering sustainable economic growth with high levels of employment and good work for the citizens of the Union. On the other hand, the aim is to establish the conditions under which the EMU as a whole will be less prone to financial and economic crisis in the future.**

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The task of D3.12: Synthesis report on the characteristics of more resilient financial and economic systems

The final major task will involve integrating the understanding gained from the previous tasks and will have a **strong policy orientation**.

1) Origin of the financial crisis (D3.01 – D3.05)
2) EU member states (D3.06 – D3.09)
   1) What was the specific nature of vulnerabilities and the precise channels of transmission to individual EU member states
   2) How did the crisis' affect all member states and what were effects only apparent for individual countries or groups of countries
   3) Identify factors why some countries were particularly badly affected and factors that gave a degree of protection
3) Effect of the crisis on the EMU as a whole (D3.10 – D3.11)

4) Identify financial structure ....

   \+ economic structure and policy regime...
   1) ...that is most favourable for engendering sustainable economic growth with high levels of employment and good work for the citizens
   2) ...and under which the EMU as a whole will be less prone to financial and economic crisis

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MAIN RESULTS OF EACH DELIVERABLE RELEVANT FOR D3.12

D3.01 Theories of Financial Crises

Paper compares how financial crises are explained by different schools of thought (Hayek, Schumpeter, Fisher, Keynes, Minsky, Behavioural Finance), develops own view on financial crises and draws some conclusions from this

- Financial markets
  - do not functions like assumed by the efficient financial market hypothesis and by rational expectations
  - lack an anchor in fundamentals
  - are driven by potentially quick and big changes of long-term expectations depending on historical developments including social and political factors
  - And by short-term speculation based on a short-term time horizon

- Herding and cumulative processes are endogenous to financial systems

- There are several feedback mechanisms which stimulate cumulative processes
  - Objective factors like the increase of asset prices during a boom
  - Subjective factors like information cascades and story telling

- The basis for asset prices bubbles is credit: during a boom phase the leverage increases, during a bust phase leverages decrease

- Bust phases can lead to long-term stagnation, they can get out of control when asset price deflation transforms in good market deflation

D3.02 Previous financial crises leading to stagnation – selected case studies

Three important historical financial crises which led to periods of long stagnation were analysed: the Great Depression, Latin American debt crisis of the 1980s, and the Japanese crisis of the 1990s. In identifying key problems related to each of these crises, four lessons for the present were drawn:

- **Clean-up of balance sheets** is extremely important as the perpetuation of bad loans hinders productive investment and a virtuous credit-investment-production-income cycle. As long as bad loans exist, firms and banks will opt to clean their balance sheets first, and this can take years.
- Governments should use the tool of setting a sufficient minimum wage, and **avoid at all costs the loss of the nominal wage anchor** which can trigger a wage-price downward spiral.
A danger of deflationary depression exists as long as stagnation is on-going (for ex. Japan), and it is directly related to the development of nominal wages.
- **Active government policies** are needed otherwise the economy can get stuck in a prolonged stagnation, and there are no self-adjusting mechanisms by which a recovery will initiate spontaneously.
- An international or supra-national mechanism should be established that will act as a stabiliser and the **lender of last resort** in crisis situations.

D3.03 Financialisation, distribution, growth and crises – long-run tendencies

Paper examines the empirical and theoretical literature on financialisation and shows in small models the macroeconomic effects

Channels of transmission of the dominance of finance on the macro economy

- **Distribution:** falling labour income shares, rising inequality
- **Investment:** dampening of investment in the capital stock through preference and internal means of finance channel ➔ 'profits without investment'
- **Consumption:** rising potential for wealth-based and debt-financed consumption
- **Current/capital account:** rising potential for persistent current account deficits, but also rising instabilities of international capital flows

Complementary macroeconomic regimes/types of development at the global scale

- **'debt-led consumption boom' regime**: rising debt-financed consumption (over) compensates lack of income-financed domestic demand + tendencies towards rising current account deficits ➔ problem: instability due to over-indebtedness of private households
- **'export-led mercantilist' regime**: rising net exports (partly) compensate for lack of income-financed domestic demand ➔ problem: global imbalances and instabilities due to over-indebtedness of counterpart current account deficit countries

D3.04/05 factors generating and transmitting the financial crisis

8 Papers comparing the different explanations brought forward to explain the financial crisis

- US interest rate policy
  - Interest rates held down too much for too long (Taylor)
  - Low interest rates 2002-04 prevented 2001 financial crash from developing into major crisis

- Global imbalances
  - Global savings glut (by Asian countries) led to large inflow of capital to US
  - Asian funds invested in (stable) US government bonds; inflow to (riskier) US banking from Europe, which allowed the crisis to transmit quickly to Europe…
  - But overall, the fragility of the US-financial system was due to the enormous growth of credit and the lack of regulation

- Perverse incentives
  - Such as bonuses from mortgage sales, profits from securitizing loans, fees from creating CDOs, income for rating agencies …
  - Greed not new; scale made possible by economic and regulatory context, approaches can help explaining propagation but not ultimate cause of the crisis

- Risk Management and its failure
  - Problems of risk management identified on many levels (technical, strategically, on the level of corporate governance, regulatory)…
  - … but lacks explanatory power for the crisis

D3.04/05 factors generating and transmitting the financial crisis

- **Excess capital**
  - Rising profit share and expansion of capital seeking ever higher returns in complex financial securities
  - Rise in borrowing to compensate for stagnant wages and growth of unsustainable financial bubbles

- **MBS and subprime lending**
  - Crisis in the subprime market as detonator of financial crisis, …
  - but more important role of more general expansion of credit

- **Deregulation of US financial system**
  - Began in 1970s, deepened under Reagan and Clinton governments: led to new, riskier instruments, enormous credit expansion and bubbles in stock market and house prices
  - Instigated by big financial institutions which initiated changes and promoted innovations which challenged legal limits

- **Worsening income and wealth distribution**
  - Depressed income based consumption
  - Rise in borrowing to compensate for stagnant wages and growth of unsustainable bubbles in some countries / or increasing exports

D3.04/05 factors generating and transmitting the financial crisis

Fundamental / Structural

→ Deregulation of finance and more generally

→ Worsening income and wealth distribution

→ Global imbalances

→ Excess capital

symptoms, transmitters, amplifiers

→ Perverse incentives

→ Risk Management and its failure

→ MBS and subprime lending

→ US interest rate policy

D3.06 / 07 Financialisation and the financial crisis – case studies: countries

- Debt-led consumption boom' and 'export-led mercantilist' type contains internal contradictions, with respect to household debt and with respect to foreign debt, which finally undermine the sustainability of these regimes.
  → Importance of tracking balance sheets as well as growth contributions of demand aggregates, for early identification of the sources of potential instability.

Type of development and the financial and economic crises:

- **Debt-led consumption boom economies (USA, UK, Spain, Estonia, Greece)** were most vulnerable to contagion effects from the financial crisis originated in the US, followed by prolonged deleveraging

→ Debt-led consumption economies with monetary autonomy were successful in stabilising the financial sector and the economy by government deficits, however, weaker growth

→ Debt-led consumption economies without monetary autonomy, stabilisation terminated by financial market pressure and then by fiscal austerity

- **Export-led mercantilist economies (Germany, Japan, Sweden)** were affected by the crisis primarily via trade channel,; however, fast recovery: domestic balance sheets were in order, financial crisis quickly contained, benefited from recovery of world economy + temporary active macroeconomic stabilisation, safe haven effect (Germany and Sweden)
  ➔ no role model for world econmy because of „beggar thy neighbour"

D3.06 / 07 Financialisation and the financial crisis – case studies: countries

- Transmission of the crisis in the case of **catching-up/dynamic domestic demand-led economie**s, with monetary policy autonomy (**Turkey, Poland, Hungary, South Africa**) played out mainly via financial flows – balance of payments channel ; however: relatively fast recovery, financial flows recovered rather quickly.

➔ Problem: accumulation of private and/or public debt in foreign currency during a boom and stabilisation of exchange rate constrain room of manoeuvre

- **Mature domestic demand-led economies**, without monetary policy autonomy (**France, Italy, Portugal**) were affected by global financial crisis via rising borrowing costs and rising uncertainty, but no major or prolonged problems in the banking sector given the low exposure of domestic banks to sub-prime financial products from the US. Recovery in 2009-2010 but with the euro crisis came a slowdown in private consumption and investment → result primarily of 'soft' (France and Italy) or severe (Portugal) austerity policies; weak growth since.

D3.08 / 09 Financialisation and the financial crisis – case studies: sectors and markets

3 Papers examine the effect of financialisation in different important markets

- With the fundamental changes of the type of capitalism in the 1970s/1980s financialisation processes are triggered in all markets

- Currency / Capital Flows
  - Deregulation of international capital flows triggered huge volumes of capital flows,...
  - ...created exchange rate instability,
  - made the foreign exchange markets between the leading currencies to a casino,
  - increasing current account imbalances in developed and developing countries,
  - led to boom-and bust cycles especially in developing countries,
  - led to a high level of uncertainty and increased to power of finance over governments

- Energy markets
  - Future markets for oil and other commodities became a new investment area in the early 2000s....
  - ...with a destabilisation of spot markets via developments on future markets for commodities;
  - financialisation has increased the volatility of commodity markets and the likelihood of bubbles in oil and similar markets;
  - index trading led to similar price movements of commodities which prices were not correlated before

D3.08 / 09 Financialisation and the financial crisis – case studies: sectors and markets

- Residential property markets
  - Widespread deregulation of mortgage finance in 1980s and early 1990s
  - Shift from highly-regulated specialized mortgage lenders to lending by commercial banks
  - Major growth of mortgage lending
  - Rapid rise in house prices from mid-1990s
  - Housing 'bubble' burst 2006 – 2008, steep price declines
  - Prices remain at historically high level in many countries

- Overall conclusions
  - Currencies, natural resources and real estate markets are asset markets. As soon as they are deregulated the logic of asset markets starts to dominate these markets
  - New profit seeking and speculative oriented investors enter the market
  - Prices in all three markets are driven by
    - Long-term expectations without anchor (what are the fundamentals?)
    - Short-term speculation
    - Medium-term volatility of price movements increases. As all asset markets the markets are driven by boom-bust cycles
  - Instabilities of all three markets add to the instability of the whole economy via
    - Increasing the level of uncertainty
    - Add to financial crisis and over-indebtedness
    - Lead to spill-over effects to the rest of the economy
  - All three markets need to be strictly regulated to control their instability potential

D3.10 / 11 Financialisation and the financial crisis – the EMU

- UPV

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DISCUSSION

Some preliminary hypothesis

- The assumption that the growth of finance is uniformly positive is clearly wrong and it needs to be differentiated which kind of finance is created (speculation vs. real investment) (for example local banks may be more prone to give productive credit)
- Triggers and turning points in boom bust cycles seem to be historically unique
- Debt is a driver of unsustainable growth processes
  - Institutions and instruments for supervision and control of debt levels should be established
- Feedback mechanisms for unsustainable growth processes should be examined closely and potentially be undermined (e.g. professional investment fund management, short term performance related pay)

- Financialisation contributed to depress sustainable economic growth since the 1980s through different channels
- But through national and international financial liberalization allowed for the establishment of alternative sources of growth regimes
  - Debt led consumption booms / asset price bubbles sustained growth for a while, but countries did build up vulnerability due to over-accumulation of debt
  - Open capital accounts allowed export-led mercantilist countries to free-ride on demand generated by these countries

Some preliminary hypothesis

- Two different policy questions:
  - How to prevent unsustainable developments?
  - How to generate sustainable growth?
    - Financial regulation / Macroprudential supervision and intervention / Financial structure
    - General Re-regulation
    - Stabilising Macro-policy (Demand management, use of fiscal policy, supporting monetary policy / role of the CB, income policies)
    - Distribution
    - International coordination (e.g. external balances)