The Continuous Crisis Chain in the USA

Akos Keri-Nagy[1]

Abstract:

The publication examines the United States' speculative bubbles in the past three decades. The author follows the concepts of the Austrian School by trying to find a link between them and exposing how the prevention and treatment of financial crises led to the inflation of another immense bubble and thereby to a more deeper slump. These events that defined the economic history for the past thirty years turn out to have many resemblance and connection to each other and their sequence doesn't seem to end due to constant failure in monetary and fiscal policy. The goal of the next years will be defined by fundamentally reforming the financial system and finding a way out of this continuous crisis chain.

Key words: crisis, economy, financial system

Absztrakt:

A tanulmány az Egyesült Államok utóbbi három évtizedének spekulációs buborékait vizsgálja az Austrian School szemszögéből, és annak elvei mentén von le következtetéseket. Kapcsolatot keres az egyes buborékok között, bemutatva azt, hogy a válságok megelőzése és kezelése miként indította el újabb hiperbuborékok kifejlődését, előidézve a korábbiaknál még nagyobb gazdasági hanyatlást. Ezek az események USA elmúlt harmincévnyi gazdaságtörténelmét pregnánsan meghatározták, és mint kiderül, többféle módon függenek össze és egyben következnek is egymásból. Az állandó téves monetáris és fiskális politikának köszönhetően egyelőre nem látszik a rendszerszintű kiút ebből a folyamatból. Vagy talán a pénzügyi rendszer fundamentális reformja lesz a kiút ebből a folyamatos válságláncból?

Kulcsszavak: krízis, gazdaság, pénzügyi rendszer

[1] *BSc degree in economics and business (Vienna University of Economics and Business)*
Field of research: speculative bublbes

With the rise of modern capitalism, mankind has been facing economic crises over and over again. Although there are always approximate explanations *ex post facto* for each calamity, economists and sociologists still can't figure out why the markets always slide in the wrong direction. Many of them search for the answers in the system itself, blaming free competition for the root of bubbles. They think that the framework is not properly shaped and that the amount of government regulation is insufficient. Most of these analysts predict the complete downfall of the current system every time there is turmoil in the economy, all of them ready to bury capitalism. This has been going on for many decades and yet the status quo has been almost unchanged and seems indestructible. On the other hand there are economists who approach this issue differently.

According to their conception, the market will always correct itself but its proper workings get distorted by the intervention of the policymakers, and by trying to solve crises for the short term they create another one instead. This article tries to examine this theory and adapt it to find the links between the continuous bubbles that have been haunting the economy for the past three decades.

The three factors that characterized the last three decades of the 20th century were globalization, innovation and deregulation.[2] With the cold war coming to an end, borders were opened, thus letting more capital flow into post-socialist countries. The developed communication technologies and newly established international treaties were inducing cooperation and more productivity. Moreover, financial engineers managed to invent instruments such as derivatives to shift and manage risk more effectively. These tools were working flawlessly in theory and the "new world" was just the right place to try them out in practice. In the United States the future looked bright as well with an economy that seemed to have stabilized after the mild recessionary phase of the 70s. The memory of the 1930s had started to fade and this had an effect on both a social and political level. The former can be noticed by observing the increasing debt of households.[3] People were feeling confident and started to spend more. This spending was mainly financed by borrowing. This led to the vulnerability of the households; however the age of prosperity had only just started and so they disregarded this fact.

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[2] *Cassis Y. (2011): Capitals of Capital, p.242*

[3] *United States Consumer Credit Change 1950-2015, available at http://www.tradingeconomics.com/united-states/consumer-credit*

On the political level the new era brought a wave of deregulation. The protective mechanisms which had been established after the Great Depression were slowly eliminated. It all started with the trend of deregulating different industries such as oil, air transport and freight transport in order to stimulate competition. The next question was whether the finance industry was eligible for such deregulations as well. The Glass Steagall Act of 1932 had been created to prevent bank panics such as the ones during the dawn of the Great Depression. First it established the FDIC (Federal Deposit Insurance Company) to protect the deposits in case of an insolvency of the bank. This would have led to reckless bankers gambling with the customers' money. Therefore the act also separated investment and commercial banking. The latter could only take deposits and lend them to trusted borrowers, just as conventional banks used to do back when these institutions were only about deposits. They were prohibited from investing this money in the stock market or any unorthodox instruments.

The Glass Steagall Act was working as planned for decades, ensuring a stable banking sector without any huge calamities or bank runs. The Reagan administration, however, wanted to loosen these rules and create competition among banks. As a first step it allowed them to offer different interest rates on different deposits. In the next years the Glass Steagall Act was weakened over and over again until President Clinton abolished the barriers between commercial and investment banks.

The overconfidence of the era reflected on the financial sector as well and it had its effect. It inflated a bubble which burst on Black Monday in 1987.

The Dow Jones declined 27%, causing investors to lose almost a trillion dollars that day.[4] The reaction from this event was fear and uncertainty. The New York Times published an article titled "Does 1987 equal 1929?", and the doom of the 30s was expected.[5] But it did not happen. Alan Greenspan, the newly assigned chairman of the Federal Reserve, did not fail to intervene. He aggressively started to buy government bonds, thus ensuring liquidity for the market and providing the much needed money for the banks, so that they didn't stop lending. Furthermore Greenspan stated that the Federal Reserve would bail out any bank in trouble to guarantee credit flow on the market. The Fed managed to prevent a recession in 1987 and it only took one year for the stock market to recover. A depression in the 90s was avoided. But was this all a success? These measures demonstrated for the market that the government was more than ready to clean up its mess. The liquidity provided by the Fed was already being

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[4] *Fergusson N. (2008): The Ascent of Money, p.165*

[5] *New York Times Article, available at http://www.nytimes.com/1987/10/20/business/stocks-plunge-508-points-drop-22.6-604-million-volume-nearly-doubles-record-does.html*

used by investment banks to fuel another bubble. The positive economic environment and therefore confidence continued throughout the 90s, with GDP growing steadily.

The US encountered only a mild recession in 1991 lasting but eight months.[6] Since interest rates were relatively low and commercial banks no longer had to treat deposits conventionally, investors were looking at other opportunities to achieve higher returns. The booming IT sector was a suitable place for that. Although computers had been present everywhere since the 70s, companies started to discover their true potential only in the 90s, and they started to take advantage of them. Many businesses were fully computerized, thus allowing them to operate more efficiently. Consequently the growth rate of US productivity experienced a sharp acceleration.[7] The so-called dotcoms, companies offering different IT services, became the trend of the decade and of course investors saw the opportunity in them.

The trend quickly turned euphoric and everyone started to found such companies, with investors recklessly financing them. Consequently a bubble started to inflate. It is clear that this event was the second part in the bubble chain, and that it was not a standalone "black swan" event, but rather a consequence of the treatment of the 80s bubble. Greenspan even recognized the growing bubble and called the decade the era of "irrational exuberance".[8]

Nevertheless the Fed did not do anything to calm the markets, and it even lowered interest rates from 6% in 1995 to 4,75% in 1998. The effect was not surprising; it fueled the bubble even further. Investors negligently financed every IT firm, even though most of these companies had never earned a single dollar. Stock prices soared, the price earning ratios were higher than ever. It did not take long for the Dow Jones to pass the 10,000 mark. By then it had become clear that there was a huge bubble in the sector, but no one knew when it would pop and which companies would survive. Around the summer of 2000 the inevitable happened and the bubble burst. There was no single one-day crash like before; instead stock prices plunged over a two-year period. The NASDAQ Composite index lost around 80% of its value from its all-time high. The declining stock markets and the 9/11 attacks aroused fear that the country could not avoid a harsh recession this time.

Meanwhile the Fed remained very passive until the blow up of the markets; it only tried to clean up the mess afterwards. Greenspan finally stepped in and slowly decreased interest rates to an all-time low of 1% in June 2003. This helped investors who had lost most of their assets recover. It also halted the count-

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[6] United States GDP Growth Rate 1947-2015, available at http://www.tradingeconomics.com/united-states/gdp-growth

[7] Krugman P. (2008): The Return of Depression Economics, p. 141

[8] Remarks by Chairman Alan Greenspan, December 5, 1996

ry from sliding into a long recession. This induced an idea in people that the old rules no longer applied and that the experienced Fed could solve every issue. This was only true in the short term because while the aftermath of the bursting dotcom bubble had been evaded, the seeds of next bubble were already rooted. Again the Fed did not deal with the issue as a whole but covered it up by aggressively intervening in the market. As a result of low interest rates, banks and investors had to look at alternative investment opportunities.

This time they were much more willing to take risk because there was a clear signal from the Fed and the government that it would protect them no matter what they did. Moreover they could borrow cheaply, and there was also an ongoing innovation in the housing industry. By securitizing mortgages, investment banks could create mortgage backed securities (MBS), and to make these instruments more attractive, they repackaged them into collateralized debt obligations (CDO). These had different tranches with different risk classes, so that even funds that could only hold safe assets in their portfolio (e.g. pension funds) could buy them. These securities offered a much higher return than AAA government bonds so it did not take long until they became prominent.

Considering how profitable trading these assets was, banks went into a frenzy again. They repackaged and restructured securities regularly and sold them aggressively. They did not fear the consequences because they calculated and rated them with the expectation of continuously increasing housing prices, and secondly, because they purchased insurance on them, and lastly, because they were counting on the government to intervene in cases something went wrong. At the same time a housing bubble was inflating as well, fueled by the innovations in the finance market.

Thanks to low interest rates, homebuyers could acquire credit cheaply and real estate had always been considered a safe investment. Huge demand pushed real estate prices higher. Although most of this credit were worthless - because of the poor creditworthiness of the borrowers - rising housing prices kept them prosperous since a borrower could always sell his house and pay back the loan. As a result real estate prices almost doubled between 2002 and 2006.[9] The Fed saw the bust coming again and slowly started to increase interest rates, but it was too late. Instead of keeping the bubble from inflating further, the continuous increasing triggered its slow burst. In particular it caused the banks to raise interest rates on loans and that led to many borrowers defaulting on their credit.

The banks had to sell those houses and that started a decline in housing prices. Therefore the many "innovative" instruments lost their value as well. These securities were long-term illiquid assets and were financed by short-term borro-

[9] *As a measure I decided use the Case-Shiller Home Price Index, reported by S&P*

wing, so the banks were left without any liquidity and stopped lending to each other. Although many banks and agencies were saved with capital injections and nationalizations, Lehman Brothers was not rescued by the government, which enhanced fear in the market even further. The Fed had to step in again and assure liquidity for the market. The newly appointed leader, Ben Bernanke, cut the interest rate to 0.25% so the banks could borrow and lend again. This and various governmental measures helped the economy recover within two years after contracting in 2008. It has been growing ever since; however, the chain of economic catastrophes is not over yet.

On one hand the long-term structural problems were not solved and the intensive government intervening clearly stated again that no matter how many more times banks get greedy, they will always be rescued. On the other hand this continuous growth could only be achieved by keeping interest rates low and endlessly injecting money into the economy, so the monetary policy instruments are exhausted and in case of another threat the Fed's tools will be limited. Even the IMF has suggested that monetary policies become less effective at times of calamities.[10] That is due to the fact that the Fed has been using all its powers to keep the country from facing its real problems, and instead it is focusing on countering short-term threats. Meanwhile there are clear signs of bubbles in the oil industry, in the biotech sector and even in alternative energy source production. In order to intervene effectively the Fed has to recognize when to start increasing the interest rates and put an end to the over financing of the mentioned sectors.

Looking at the past three decades it will not happen in time and who knows how painful the unraveling of the next bubble will be. What is certain is that this progress cannot be maintained any longer. The outcome of its next parts will be even more catastrophic if the government doesn't get out of the chain it has created. The country has not fully experienced the outcome of a bubble in the past thirty years and could not press the reset button on its business cycle like after the Great Depression. Schumpeter suggested that bubbles and crises appear for a reason. They are part of the "creative destruction" process, which means that after a financial meltdown the economy can start over again. Artificial interference only delays this reboot but can't hold it off forever. The exaggerated intervention of the government in the market might have solved the particular issues for the short term, but one day the US and the world will have to face the outbreaks of the past three decades which were contained artificially. And the longer it postpones dealing with the large-scale crisis, the harder it will be to solve it and the more resources it will take.

[10] *IMF (2009): World Economic Outlook, p. 104*

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