

How to create a crisis

The roots of financial collapse

- Economic crises are caused by an imbalance between the financial sector and the real economy.
- Modern neoclassical economic theory lacks a comprehensive understanding of the roots of crisis, and this blind spot is shared by politicians.
- Professor Erik S Reinert at the UCL Institute for Innovation and Public Purpose in the UK delves into historical examples and traditional economic theory to elucidate the misunderstood mechanisms behind collapses.
- Reinert's book 'How rich countries got rich... and why poor countries stay poor' has been translated into about 25 languages.

Since ancient times – as far back as the Bronze Age – a distinction has been drawn between the financial sector and the real economy: the latter being 'real' or non-financial goods and services. When the real economy requires funding for investments, such as building a new factory, the financial sector can provide the necessary capital. In return, factories can produce wealth that flows back into finance, forming a productive cycle of synergies between the two sectors. However, the financial sector can become detached from the real economy and begin earning money from itself in projects that resemble pyramid schemes. This imbalance creates a parasitical relationship that gives rise to financial crises. After all, sole profiteering in the financial sector does not create real economic value, and it is only through actual value that the system can sustain itself.

In 1783, Welsh economist Richard Price calculated the enormous power of compound interest: 'One penny put out at our Saviour's birth to five per cent compound interest would have increased to a greater sum than would be contained in two hundred million of earths, all in solid gold'.

Erik S Reinert, Professor at the UCL Institute for Innovation and Public Purpose in the UK, explores the history and theory of crisis. His primary observation concerns the signs of collapse. Unlike inflation or deflation, financial crises are not immediately visible in changes to average consumer prices. Instead, they manifest as *asset inflation* and *debt deflation*. More specifically, a massive accumulation of wealth in the financial sector is invested in assets, which undergo inflation. The resulting crisis will cause a drop in both wages and prices, increasing the real value of outstanding debt. A generalised risk of businesses and consumers defaulting on their loans then becomes the catalyst for financial collapse.

The blind spots

Financial crises were once a well-understood phenomenon across the political spectrum, with economists like Karl Marx on the left, social democrat Rudolf Hilferding, and political conservative Joseph Schumpeter all theorising about the roots of economic collapse. However, modern theorists lack a comprehensive understanding of the role of the financial sector, and this blind spot has also affected politicians. With 'equilibrium' being the basic metaphor for economic theory, this virtually excludes the kind of phenomena that create financial crises. While some economists, particularly in the United States, have rediscovered useful theories like Irving Fisher's 'debt deflation', there are many more insights to be revived before the field of economics regains a firm grasp on the causes of crisis.

Since the late 1700s, the mainstream economic tradition has ignored the monetary or financial sector in its theorising. Theories put forth by

British economists – like David Ricardo's trade theory – tended to be based on the barter of labour hours. Consequently, any conflict between production and finance would not exist. This tradition thus failed to address the core imbalance behind crises, that is, between finance and the real economy. Alternative schools of thought have always distinguished between these sectors, but their theories lost significance after the Second World War. In their place, sprung neoclassical economics, which suffers from the same blind spot as the mainstream British approaches that precede it. Neoclassicism sees the market economy as a frictionless machine that operates harmoniously, thereby rejecting the idea of a systemic conflict buried deep within capitalism.

Crisis at its core

The origins of the imbalance between the real and financial economy can be traced back to ancient Mesopotamia under King Hammurabi (around 1,500 BC). It was seen that compound interest would expand the financial economy much faster than the real economy, building up debt in the latter. To prevent the collapse of the real economy, Hammurabi and his followers would periodically cancel all debt (except short-term commercial debt) in what were known as 'Jubilee Years'. The biblical word for unproductive capital was 'mammon'. Many religious and philosophical traditions follow this same principle, including the Muslim prohibition against charging interest.

Later, in the 5th century AD, King Theodoric of Italy recognised that the pagan custom of depositing gold and silver in tombs was contributing to an economic imbalance and ordered for such metals to be removed and used in coining for the public profit. Philosopher

Nicolas Oresme (1325–1382) noted that in Theodoric's Italy, 'it was a crime to leave hidden among the dead and useless, what would keep the living alive'. This history reflects a broad understanding that the financial sector should be restrained and made to benefit the real economy. However, in contemporary times, neoclassical economics and neoliberalism have replaced the voices speaking out against the excesses of the financial sector.

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US Economist Hyman Minsky (1919–1996) was for a long time a lone voice arguing that financial crises, like the one in 1929, could happen again. Minsky argued that these crises are caused by financial innovation. These include speculative projects, such as mortgage-based securities and credit default swaps. In extreme cases – what Minsky calls Ponzi schemes – the income flows from operations are not enough even to cover the interest costs of their loans. Such activity expands the level of debt beyond what the real economy can repay. Meanwhile, this imbalance brings about further mechanisms of failure. For example, substantial wealth is channelled into the rentier economy, where 'rental' income is earned from the mere ownership or control of scarce assets. This can price consumers out of things like home ownership and generally reduces their disposable income. Together with a dearth of investment into wealth-making enterprises, the rentier economy brings a dangerous drop in demand. For Minsky, these roots

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of financial crisis emerge from the capitalist system itself and the relationship between innovation cycles in the real economy and the financial sector. Indeed, Gabriel Palma quantified this imbalance, showing an increase in financial assets compared to GDP in the run up to previous collapses.

Carlota Perez concludes that the roots of crisis lie in technological innovation. Bubbles of rapid economic expansion, such as the Dot-com boom, become a source of stock market speculation that overshadows the real economy, until the bubble bursts and buries them both. As Perez explains, increases in stock prices for companies with revolutionary technologies can spur hopeless projects

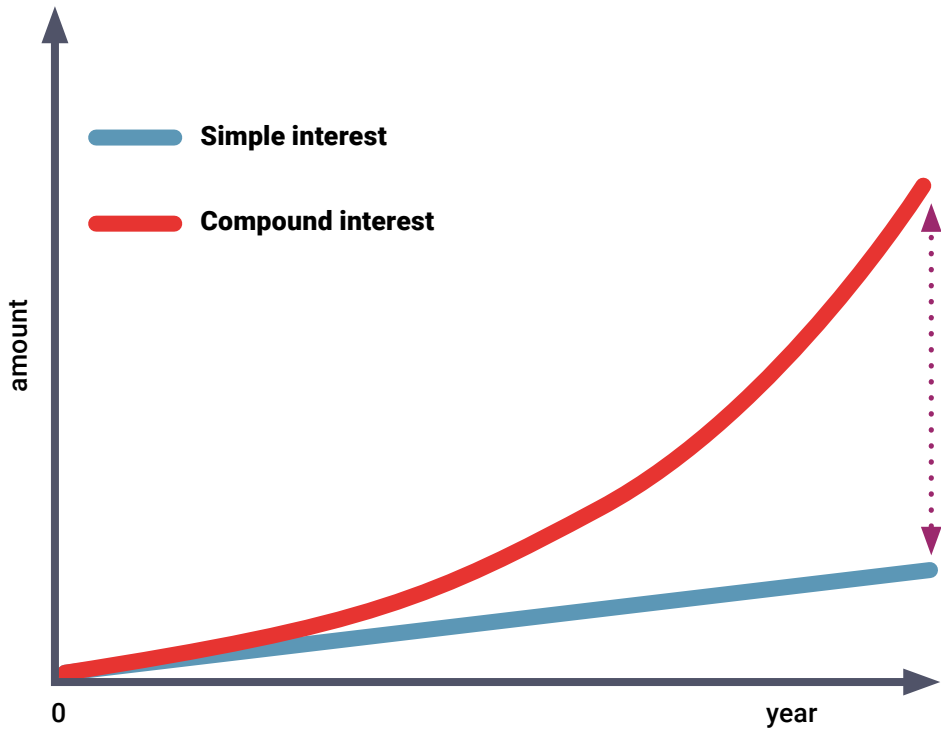
and pyramid schemes in the financial sector. For Erik Reinert, it is clear that government regulation is necessary to limit and prohibit financial excess, and yet successive administrations across the Western world have adopted a programme of low taxes and deregulation.

Breaking the cycle

Even in their responses to crisis, governments too often misunderstand the mechanisms behind collapse. In many countries, massive financial packages designed to save the banks and the real economy have failed to reach the latter. As a result, banks and large corporations are accumulating significant amounts of wealth, reducing overall demand and preventing a healthy recovery. This very tendency is what brought the economist Joseph Schumpeter to claim that governments should not intervene in crises, as it only strengthens the forces behind the original downfall. But perhaps the real question is ‘how’ rather than ‘whether’ to intervene. John Maynard Keynes proposed a ‘tax on imbalances’ to address the creation and consequences of financial crises. While this proposal was blocked by the US and other powerful actors, it may be in such thinking that nations can effectively counteract the true causes of crisis.

The power of compounding

Compound interest vs simple interest



Details



w: www.ucl.ac.uk/bartlett/public-purpose/people/erik-reinert
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Bio

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the History of Economic Policy as an under-researched area.

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Personal response

What inspired you to conduct this research?

I had a long-term interest in the history of economic thought from before ‘equilibrium’ became the ruling metaphor in the late 19th century. In 2010, I was elected member of the Norwegian Government’s Committee to study the Financial Crisis. An early version of my paper ‘Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez, and Minsky’ was published by the Norwegian Ministry of Finance in 2010. In 2012 and 2013, I held the Tun Ismail Ali Distinguished Chair in Investment and Finance at the National University of Malaysia (UKM), Kuala Lumpur. This made it possible to finish the article in an environment where the Muslim view of finance dominated. At the same time, I was working to publish Martin Luther’s ‘Von Kauffshandlung und Wucher’ / ‘On Commerce and Usury’ (1524) in English, edited by Philipp Robinson Rössner, London, Anthem, 2015. I found that the fear of the creation of ‘mammon’ (unproductive capital) was profound not only with the Muslims, but also in Martin Luther’s writings. He wanted a maximum interest rate of 4%.

When I started my economic studies at the University of St Gallen in Switzerland, several of my professors had studied economics before WW II and did not agree with neoclassical economics as it developed during the Cold War (when Paul Samuelson’s textbook slowly took over in the field for decades to come). During the first semester, I was presented with the graph based on the teachings of Joseph Schumpeter (Figure 1).

During ideal conditions, the financial sector creates funds to finance the growth of the real economy. A production company, for example, needs to build a new factory, which will last for at least 50 years. The

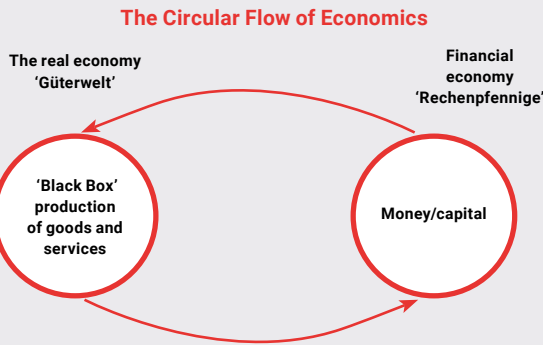


Figure 1. Separating the Real Economy from the Financial Economy in a Schumpeterian fashion. Güterwelt = the world of goods (and services), Rechenpfennige = accounting units. The ‘modern’ solution to the financial crisis has been to create more ‘accounting units’, inflating the size of the financial sector, but – through austerity – preventing these newly created accounting units to reach the real economy in the form of increased demand for goods and services.

funds for this are supplied by the financial sector. In this situation, the financial sector and the real economy work in symbiosis, supporting each other. During a build-up to a financial crisis, the financial sector starts to make money by itself, money that does not touch on the real economy. This creates Ponzi schemes and bubbles that sooner or later are bound to collapse in a crisis. The point when everyone sees that the bubble will collapse is called a ‘Minsky moment’. The collapse not only takes place in the financially core countries, but the panic also rapidly leads to collapses in markets very far away.

How do you think governments should act to prevent financial crises? And how should they respond to them?

By keeping track of the main sources: the mismatch between the

amount of money in circulation and the growth of the real economy. There are three fundamentally different mechanisms behind financial crises, and I have decided to name them after the three pioneers who first identified each mechanism:

Hammurabi = the long-term effects of compound interest. Hammurabi was the ruler of Babylonia from 1792 BC to 1750 BC. His mathematicians discovered the power of compound interest and understood that debt (excluding short-term debt) needed to be cancelled to prevent the real economy from collapsing under a burden of debt. The years when debt was cancelled came to be called ‘Jubilee years’.

Hyman Minsky (1919–1996) = ‘destabilising stability’. For Minsky, the nature of instability is linked to the relation between finance and investment in capital assets during the business cycle. The movement to more units engaged in Ponzi finance happens as a natural consequence of periods of stability and prosperity. During economic expansions, borrowers and lenders become confident in the ability of the former to meet cash commitments, which is a rational response based on recent past experiences and on the higher probabilities of success associated with the expansionary environment. Thus, economic units are not likely to have difficulties to meet their payment commitments as they come due during economic expansions. However, such optimistic expectations lead to relaxing lending standards and reducing margins of safety. They also validate riskier projects, the use of more debt relative to assets, and lower liquidity; all of which increase the fragility of the economic system.

Carlota Perez (born 1939) = important breakthrough technologies,

new techno-economic paradigms which create bubbles. In the paradigm-carrying activities, the bubbles are based on events in the real economy, but artificial bubbles develop in many activities where this optimism is not warranted. Example: ‘US Steel’ created a sensible bubble, ‘US Leather’ did not.

Why do governments allow the excessive growth of the financial sector which leads to crisis?

At the most abstract level, modern economics fails to differentiate between the financial sector and the real economy. During times when the financial and real estate sectors have much political power – as it will have if Trump wins the US elections – there will be few restraints. In a situation when labour unions have political power, the opposite will happen.

What would your promoted methodologies say about the current situation and how close we are to another financial crisis?

The policies of the European Central Bank under Mario Draghi (2011–2019) created an ‘asset inflation’ (raising the price of real estate, housing, while keeping wages down for those who need housing). The lowering of marginal tax rates clearly increases the risk of creating unproductive capital (mammon). In 1960, the highest rates for individual income tax in the United States was 91%. By 2021, the latest year I have found, the marginal income tax rate is 37%. For a single filer, the highest rate, 91%, was reached at an income of 200,000USD. In 2021, the highest rate, also for a single filer, is reached at 523,000USD.

The percentage of GDP that goes to the financial and real-estate sector increases, while the share going to wages falls relatively. Again, it is difficult to predict when a crisis will follow.