Who is responsible for the financial crisis?

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Most economists and policy makers agree that the collapse of the American housing market has caused the financial crisis of 2008. But who is responsible for the crisis? A great number of explanations have been proposed on that subject in the past few months, none of which, in my opinion, explain the crisis sufficiently. Hereafter I will first present the most often cited causes of the financial crisis, and subsequently discuss the role of the economists and the prevailing economic theory. They are co-responsible for the privatization of the financial markets and for the fact that another important explanation for the crisis, namely the unequal distribution of income, has received little attention in the Netherlands until now. This also implies that reorganization measures that do not visibly improve the income distribution will have no result in the long run.

The most often cited causes of the financial crisis

The failing monetary policy of the United States is most often said to have caused the crisis. Alan Greenspan, Chairman of the United States Federal Reserve Board, would have been responsible for a tragedy of mistakes (Buiter, 2008). For instance, he reduced the American discount rate, a measure that did not lead to more investments but to the excessive liquidity of banks, which were then forced to grant riskier loans. In addition, he interpreted the American inflation figures incorrectly. With his policy of low interest and stimulation of investment, Greenspan wanted to curb a decreasing price level that did not exist due to raw material speculation and increased raw material costs. According to Willem Buiter, he used an incorrect inflation percentage, namely the core inflation percentage, which does not include the raw material prices. Also, he supposedly underestimated the influx of liquid assets into the American economy through Asian investments in the dollar. Buiter lists a total of eight such errors by Greenspan that led to the financial crisis.
George Soros, amongst others, thinks that it wasn't Greenspan, but the pursuit of profit on the part of the banks that caused the crisis: "The salient feature of the current financial crisis is that it was not caused by some external shock like OPEC raising the price of oil (. . .) . The crisis was generated by the financial system itself." (Soros quoted in Skidelsky, 2008). Banks have been nonchalant about granting mortgages, knowing that unemployed debtors will never be able to pay back mortgages such as these, which are frequently interest and repayment free for two to three years. However, because banks speculated on continuously rising house prices, they thought they could make a profit in case of non-payment of the mortgage by the debtor by means of a forced sale of the house for a price higher than the granted mortgage. Banks have willingly and knowingly granted loans to debtors who were not able to repay them.
Still others suggest that the credit rating agencies are responsible for the crisis. They are said to have given products a triple A score, whereas they were extremely risky. As early as 2004, the FBI supposedly pointed out cases of fraud within the American mortgage market to the then government, without this leading to further investigations. Against their better judgment, credit rating agencies would have given a high rating to the complex products that were often

developed in collaboration with banks, without ever checking the creditworthiness of the borrowers. We know what happened: complex products, better known as toxic securities, were purchased worldwide, especially by European banks and special purpose vehicles (I. Mozart, 2009).
Along with Greenspan, the banks' pursuit of profit and criminal or incompetent credit rating agencies, risky borrowers and incompetent or overburdened supervisors are mentioned as well. Also cited are wrong incentives (Theewes, 2009), especially wrong reward incentives for bank managers, or too large banks (Van Witteloostuijn, 2009).
The question of guilt is relevant for two reasons: on the one hand to be able to designate a clear cause and make the culprits take responsibility, and on the other hand to be able to take adequate political-economic measures and tackle the problem of the crisis at the roots. Although all of the aforementioned people and groups are jointly responsible for the creation of the financial crisis, each one forms only a small part of the big picture. Each of them has, in fact, only tried to survive as best they can in a system that required ever-riskier actions. Greenspan wanted to stimulate the economy with a low interest rate, because he wanted to prevent an imminent deflation and crisis. Banks wanted to continue their profits; likewise credit rating agencies and bank managers wanted to maximize their income. In fact, everyone acted very rationally within the existing system. Exactly the way the economic theory tells them to.
The crisis therefore did not originate from a sudden hysteria of the markets, but from the fact that the sum of individual (rational) decisions can have macroeconomic consequences that eventually also affected the financial market itself (and unfortunately a lot of others as well).

The contribution of economists to an explanation of the crisis

How is it possible that, although economic subjects behave rationally and in accordance with economic theory, a crisis arises, whereas the economic theory proves mathematically that no crisis can arise? Are the economists also responsible for the crisis then? After all, they have wrongly advised the economic policy makers, partly due to the fact that they are lobbyists for the financial market and are paid by the same market, partly because they have based their recommendations on entirely incorrect models for the past 30 years (Buiter 2009). Professorships in finance at universities are frequently sponsored by the financial sector. And it is there that the models were designed that have blurred reality, which is the reason to point the accusatory finger.

> "Knowledge of financial markets has been partially lost within the government bureaucracy, because supervision has been delegated to the financial industry and to partially independent supervisory institutions. It is there that the prevailing economy has an influence unlike anywhere else in the economic field. These institutions have been infected with the liberal and radical market thinking. Regulation of the financial market and economy have struck an unhealthy alliance. The mainstream economy has played a substantial part in causing the crisis." (Mozart, 2009)

The money and macroeconomics of the last 30 years in particular are suggested to have been a disastrous dead-end street. Economists advise politicians, who do not understand the complicated models and their underlying terrifying assumptions. Buiter (2009) criticizes that neither the new classical macroeconomic theories (Lucas, 1975; Barro, 1977, 1989) with their "efficient market hypothesis", nor the New Keynesian Economics (Gregory Mankiw, 1985; Gregory Mankiw & Romer, 1991; Michael Woodford 2003) with their dynamic general

equilibrium models are able to analyze crises or liquidity problems. Both theories work on the basis of rational expectations, i.e. that economic subjects generally are not mistaken in the long run, the first with regard to flexible prices, the other with regard to fixed prices. The assumption of complete markets, which means that at any time and in every given situation anywhere in the world a market exists (and that therefore there is always a possibility to exchange one asset with another, and thus there is never a lack of liquidity) is illogical, according to Buiter (2009). It would be more useful to develop a theory that takes autarky (economic self-sufficiency) as a point of departure and that would explain why a market exists in the first place, instead of assuming that there is an endless number of complete markets. In a world in which more than 50% of the global trade does not take place via the market (for example trade within companies) and that clearly has liquidity problems, Buiter's goal to strive towards a more realistic economy is very sensible.

Economists on the fringe

The mainstream macroeconomics and monetary theory have reached a dead end in the past 30 years, whereas the heterodox economists have been pushed to the fringe. We're paying the price for the fact that heterodox economists such as Hyman Minsky, who developed a trade cycle and crisis theory in which the banks are the guiding factor, or John M. Keynes (1936), who held the stock market and financial speculation responsible for crises, have been marginalized. One hears this argument in German-speaking areas in particular (Kregel, 2009, Unger, 2009), but hardly ever in the Netherlands.

According to Minsky (1982) it is a fundamental characteristic of our economy that the financial system goes back and forth between robustness and fragility. He sees this as the cause of the business cycle. In times of an economic boom, when income and cash flow increase, investors experience a sense of euphoria, debts exceed what borrowers can pay with their income, bubbles are created. The uncertainty concerning what debtors can pay off increases more and more, which causes banks to become more cautious about granting credit. They make higher demands on collateral and credit worthiness. This credit rationing is a preface to the recession. Many businesses that apply for credit for further investments no longer receive it. The demand for investment goods drops as a result of lack of credit. Employees in the investment goods industry are dismissed. Due to rising unemployment the demand for consumer goods decreases as well. Many private borrowers can no longer pay their debts as a result of the changed economic circumstances. Bankruptcies are the result. Minsky interprets this as an endogenous process, in which the successful completion of financial transactions leads to rising uncertainty concerning the success of further financial transactions, which has real consequences. Economic stability creates its own collapse through increased financial fragility.

Jan Kregel shows that the current crisis has many similarities to the crisis of the 1930s. Banks that had invested in Florida's real estate boom in 1927 crashed, the result being the stock market crash. Eventually this led to the bank holidays of 1933, which were followed by a depression. This crisis also started in the United States and originated within the housing market.

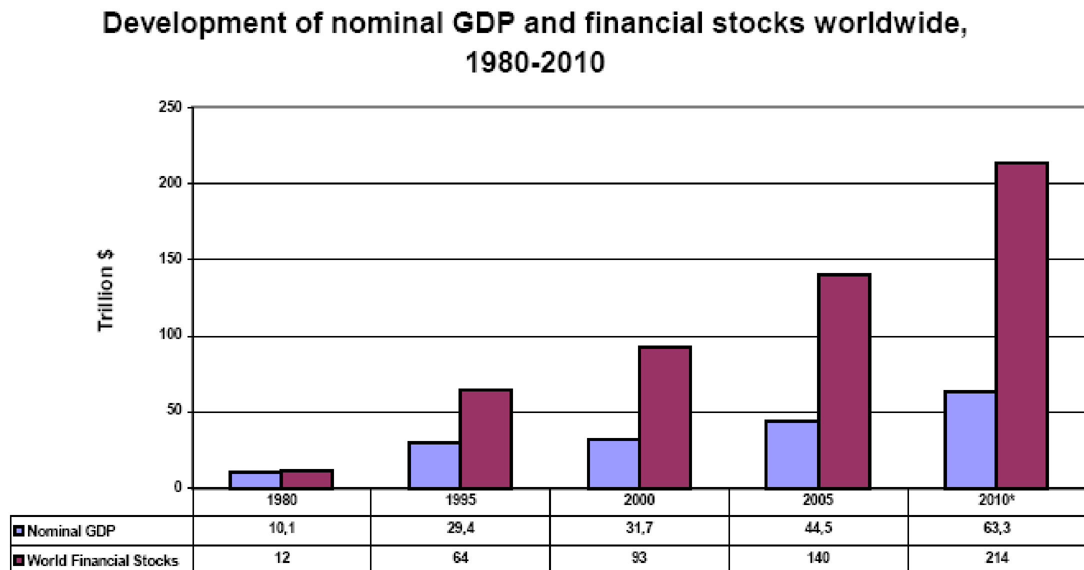
Minsky makes the distinction between three different kinds of debtors. In normal times the 'hedge borrower' predominates. He can finance both the interest and the borrowed capital from the cash flow of his investment. In times of economic prosperity banks try to prevent decreases in their profits by means of risky financial transactions and investments. An increasing number of 'speculative borrowers' are amongst their debtors. These are debtors who can pay the interest on their debt from their cash flow, but not the borrowed capital. During the continuing boom the 'Ponzi borrowers' will start to dominate. They just speculate

on the value increase of their assets, and can neither pay the interest nor the borrowed capital from the cash flow of their investment. At some point the uncertainty becomes too great for the banks and they place the loans that are too risky and bad elsewhere and tighten up their credit terms, which leads to an economic decline.
Minsky has primarily developed a trade cycle theory, not a crisis theory. In his 1980 essay collection *Can it happen again?*, but also in his most recent large work, *Stabilizing an unstable economy*, Minsky addresses the question of whether the depression of the 1930s could repeat itself. He does not think that a depression of which the scope was increased as a result of disastrous economic-political errors - from restrictive monetary and tax policies up to a “beggar-thy-neighbor” policy in the form of a protectionist trade policy and a devaluation race will repeat. The economic politics has learned from these mistakes, according to Minsky.

Privatized Keynesianism

In the meantime, in England Colin Crouch (2008; 2009) is less optimistic about the crisis. He speaks of the death of “privatized Keynesianism” as a consequence of the financial crisis. “Under original Keynesianism it was governments that took on debt to stimulate the economy. Under the privatized form individuals, particularly poor ones, took on that role by incurring debt on the market” (Crouch 2008). According to him, under privatized Keynesianism the demand was maintained artificially by means of credit. Keeping the consumption at a steady level through the creation of debt was achieved by granting all sorts of mortgages, loans and credit cards to poorer people. Instead of debts covered by the state (*government debts*), like under original Keynesianism, uncovered debts (*unsecured debts*) piled up. Individuals are considerably less well equipped to pay off their debts and the risk for the credit provider is considerably higher than under traditional Keynesianism. For this reason, markets for risks and risk sharing arose. A lively trade in debts developed, because everyone believed that he could rebundle the debt package (*securitization* became the buzz word) and resell it at a profit in an ever-expanding pyramid game. The problem was that the link with the actual debt, with the real sector, got lost somewhere in the process. The financial markets lost touch with reality. The secondary market was no longer linked with developments in the primary market, until everything collapsed like a house of cards.
When you look at the development of the real economy and that of the financial market, you notice that they have never been further apart. Huffschmid (2008) demonstrates that the financial sector in the past few years was four times as large as the real sector. To buy goods for a price of 100 euros, you need financial resources equaling 100 euros. Thus a ratio of (around) 1:1 between the real and financial sector is necessary, something that was true up to the 1980s. Since the liberalization of the financial markets this ratio has become increasingly more unbalanced. Kregel (2009) blames the banks for paying less and less attention to fulfilling their actual tasks, namely converting short-term savings into long-term loans, risk transformation and ensuring liquidity. They deal increasingly less directly with businesses and households, and have changed more and more into organizers, into arrangers. They create new financial products, which they then sell to another company that is usually also managed by themselves, which in turn sells them again. Out of the line of vision of the real sector “hot air” is sold more and more often. The danger that the bubble bursts and the demand for hot air quickly drops, that at a given moment there’s no confidence left in a “financial” economy that is disconnected from the real sector, an economy of which the innovations and products aren’t tangible, can’t be eaten and can’t be used, increased continuously from the mid-1990s onwards.

Figure 1: The development of the nominal Gross Domestic Product and financial stocks worldwide.

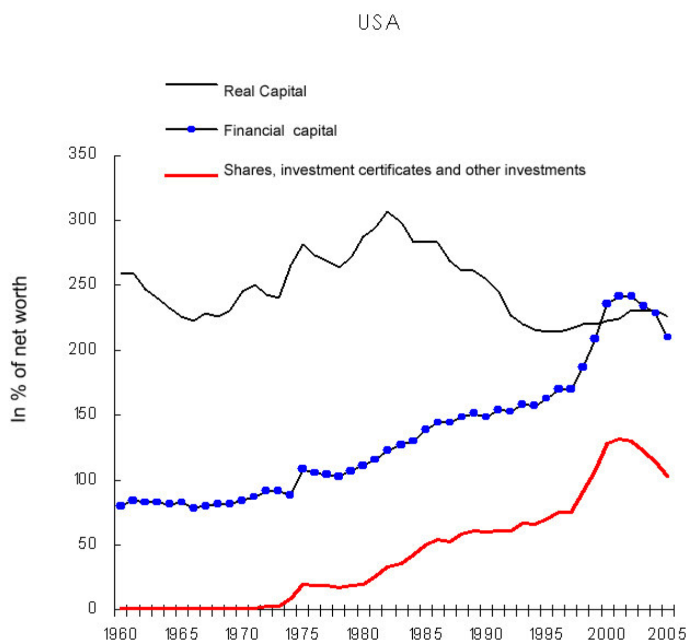


	1980	1995	2000	2005	2010*
Nominal GDP	10,1	29,4	31,7	44,5	63,3
World Financial Stocks	12	64	93	140	214

Source: Huffschmid (2007) and http://www.mckinsey.com/mgi/publications/Mapping_Global/index.asp

Schulmeister (2009) speaks of financial capitalism ("Finanzkapitalismus"), which has taken over from industrial capitalism. When we look at the development of financial capital and investment in real capital within companies with share capital, it is notable that businesses also hold increasingly more financial capital instead of real capital. The graph shows this development for the United States, but this trend is also visible in European countries.

Figure 2: The unequal development of real and financial capital in companies with share capital.



Source: Stephan Schulmeister (2008)

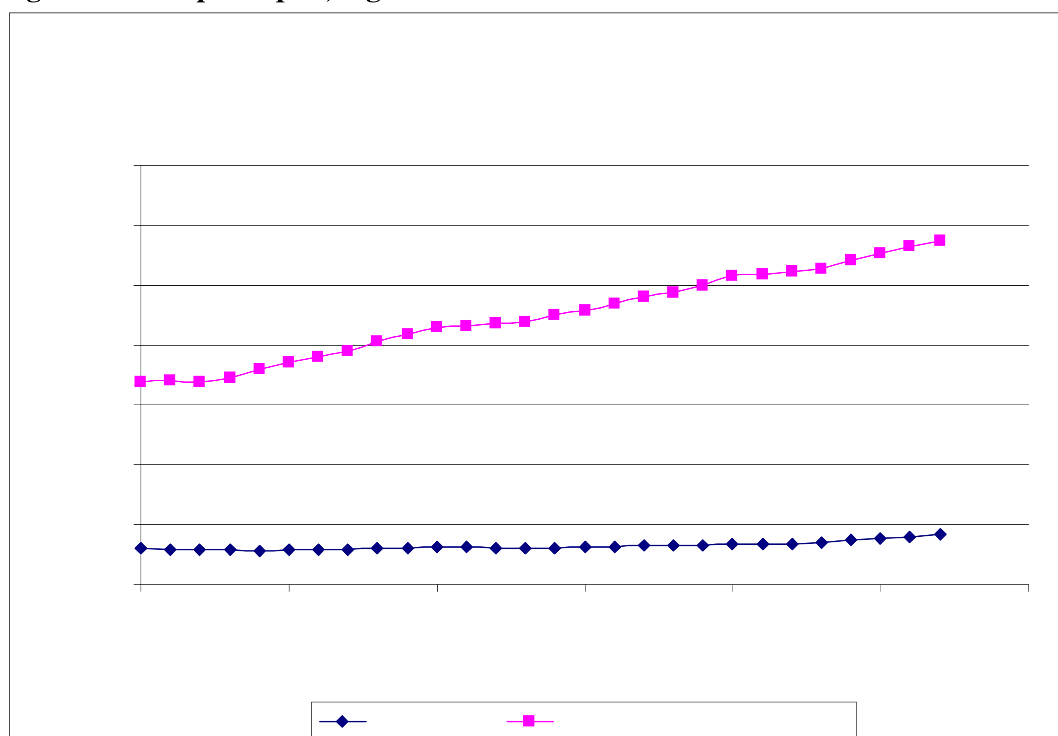
Apparently it no longer pays for businesses to invest in the real sector. Instead they have invested more and more in financial products, a trend that Keynes (1936, chapter 12) already warned about. In the last few years, the financial sector was increasingly considered a real sector, which is partly true of course - people work there, ones with a higher education even, the sector is very innovative, thanks to the "financial innovations". Although the financial sector makes it possible to postpone decisions, and to perform risk and period transformations, it doesn't produce something that people need to live. When investors invest in financial products rather than in real ones, and at the same time the consumption is only maintained artificially by granting loans to poor debtors who are not able to pay them back, then there is a danger that a shortage in demand will arise within both the investment market and the consumer goods market.

The unequal distribution of income and assets as a cause

This brings us to a cause of the crisis that has received too little attention up until now in my opinion, especially in the Netherlands, and which I consider important, i.e. the drastically changed distribution of income and assets. Investors shall not invest in the real economy, because the profits are lower than elsewhere. But why have the profits and turnover expectations in the real economy decreased? Because a part of the population earns too little to account for that part of the demand for goods and services that is necessary for complete employment or growth, whereas another (smaller) portion of the population earns so much that it couldn't possibly spend all of its money in the real economy, even if it wanted to. The result is a decreasing demand. Under "privatized Keynesianism" this gap in the demand could be filled up (artificially) by private debts. In the long run, however, under consumption cannot be avoided when there is a strongly diverging distribution of income and assets. The increasing inequality in income is visible worldwide. The income differences between the First and Third World have never been this great (OECD, 2008). As Atkinson (2009) put it aptly, not all countries have profited from the high growth figures: "A rising tide does not necessarily raise all boats".

From the middle of the 1980s the real income per capita in the rich countries (with prices kept constant at the 2000 level) has gradually increased up to an average of 30,000 dollars, whereas the per capita income in poor countries is around 500 dollars on average. The gap between the First and Third World is becoming larger. As a result, a large potential for demand is lost for the world market and especially for the rich countries, because poor countries have too little income to buy goods from the rich countries. A crisis arises – whether it is a financial crisis or another type of economic crisis - when those who have income and assets possess so much that there is no way in the world they could spend it, whereas those who could consume don't have the money for it. Also the current crisis is, in my opinion, a crisis of underconsumption that can be traced back to a large inequality in the distribution of income and assets.

Figure 3: GNP per capita, high income countries versus low income countries.



Source: World Development Indicators, 2009

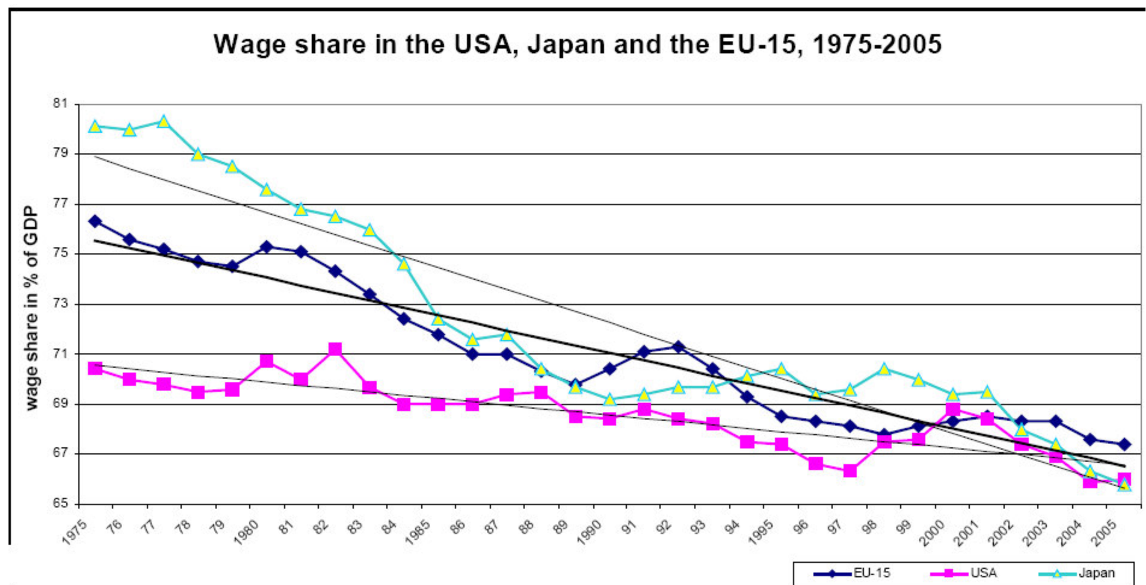
Low income group aggregate. Low-income economies are those in which 2007 GNI per capita was $935 or less.

High income group aggregate. High-income economies are those in which 2007 GNI per capita was $11,456 or more.

However, also amongst the richer countries the gap is widening, which increases the possibility of a crisis. The functional income distribution in the United States, Japan and 15 EU countries has shown a clearly decreasing development of the wage share since 1975. Whereas in 1975 the wages still formed almost 75% of the GNP, in 2005 their contribution was only 67%. Since employees form the group with the most purchasing power, the wage restraint of the past 30 years has led to a decreasing demand on the goods market. As long as the growth results were positive, the demand for goods grew, but not strongly enough to fill the gap in the demand. The profits from businesses were, for the most part, not used in such a way that the demand was stimulated, but were saved and invested in the financial market. At first the shortage in the demand was compensated artificially with loans to employees, but in

the long run the wage share in the national income has to increase again in order to insure sufficient demand. The additional income of employees is insufficient to achieve this.

Figure 4: Wage share in the USA, Japan and the EU-15, 1975-2005.



Source: Huffschmid (2007)

However, the personal income distribution in most countries has also deteriorated. Since poor people spend their entire income, whereas rich people save a part of their income, an unequal income distribution carries an even greater risk, namely that planned savings are not converted into planned investments. After all, businesses will only invest if they can also sell their products, and that becomes increasingly improbable when incomes are distributed unequally. The danger of a crisis arises when the inequalities become so great that the rich are so rich that they can't possibly spend their income on consumption purposes, whereas the poor become so poor that they can no longer buy the consumer goods. Thriftiness of the rich is only a virtue if there are businesses that spend the saved resources on real investments. When the expected turnover is too small as a result of the insufficient purchasing power of the poor, the only alternative left is to invest the saved resources in a "cyberworld", namely the financial market, until it collapses. When the inequalities become so great that the actors no longer have the adequate standards and expectations to stabilize the system because they aren't compatible and consistent with each other, the possibility of a crisis is also present in European countries. The social problems and increased crime resulting from inequality have frequently been discussed. But inequality also implies the inherent economic problem of a declining demand, which Keynes (1936), with his concept of decreasing marginal propensity to consume, has warned us about. A recent study by the OECD (2008) compares the Gini coefficients as a measure for inequality in personal income distribution over time. Since the mid-1980s almost all OECD countries (with the exception of Belgium, France, Greece and Ireland, for which the Gini coefficient has decreased) show an increased inequality in income distribution.

Table 1: Inequality in personal income distribution (Gini coefficients).

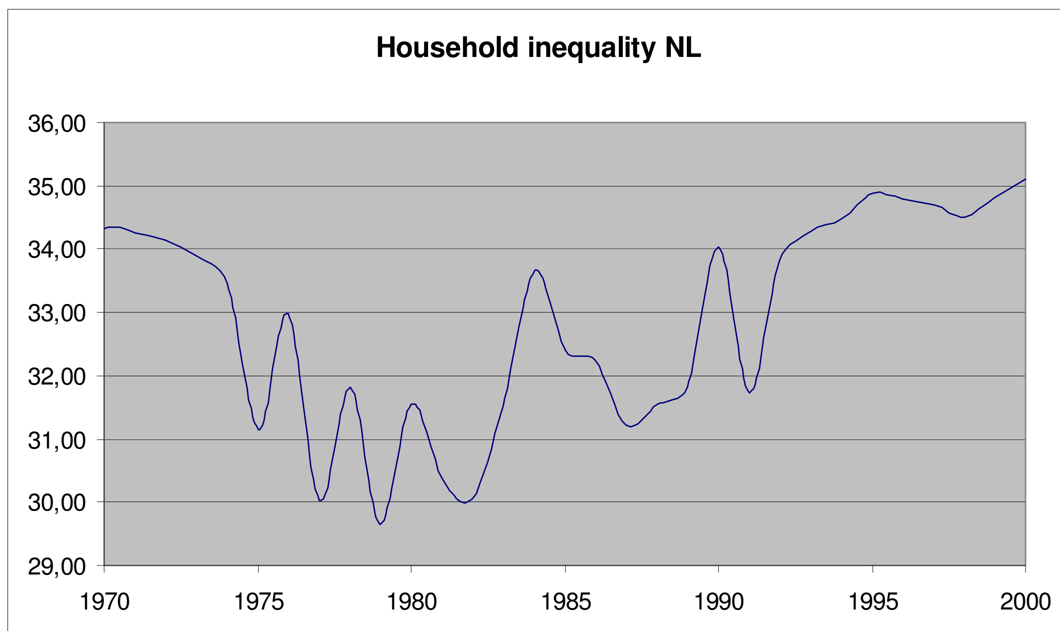
	Mid-1970s	Mid-1980s	1990	Mid-1990s	2000	Mid-2000s	Change over last

							20 years
Australia				0,309	0,317	0,301	..
Austria		0,236		0,238	0,252	0,265	0,029
Belgium		0,274		0,287	0,289	0,271	-0,003
Canada	0,295	0,287		0,283	0,301	0,317	0,030
Czech Republic		*0,232*	0,232	0,257	0,260	0,268	0,036
Denmark		0,221		0,215	0,226	0,232	0,012
Finland	0,235	0,207		0,228	0,261	0,269	0,062
France		0,300	0,290	0,270	0,270	0,270	-0,030
Germany		0,257	0,258	0,272	0,270	0,298	0,041
Greece	0,413	0,336		0,336	0,345	0,321	-0,015
Hungary		*0,273*	0,273	0,294	0,293	0,291	0,018
Iceland						0,280	..
Ireland		0,331		0,324	0,304	0,328	-0,002
Italy		0,309	0,297	0,348	0,343	0,352	0,043
Japan		0,304		0,323	0,337	0,321	0,016
Korea						0,312	..
Luxembourg		0,247		0,259	0,261	0,258	0,011
Mexico		0,452		0,519	0,507	0,474	0,021
Netherlands	0,251	0,259	0,278	0,282	0,278	0,271	0,012
New Zealand		0,271	0,318	0,335	0,339	0,335	0,064
Norway		0,234		0,256	0,261	0,276	0,042
Poland					0,316	0,372	..
Portugal	0,354	*0,329*	0,329	0,359	0,385	0,385	0,056
Slovakia						0,268	..
Spain		0,371	0,337	0,343	0,342	0,319	-0,052
Sweden	0,212	0,198	0,209	0,211	0,243	0,234	0,037
Switzerland					0,279	0,276	..
Turkey		0,434		0,490		0,430	-0,004
United Kingdom	0,282	0,325	0,373	0,354	0,370	0,335	0,010
United States	0,316	0,338	0,349	0,361	0,357	0,381	0,044
							..
OECD-24		0,293		0,310		0,313	0,020
OECD-22		0,279		0,293		0,300	0,021

Source: OECD (2008) and (2009) http://statlinks.oecdcode.org/812009011P1G031.XLS

In an international context, the Netherlands indeed belongs to the more successful countries when it comes to an even income distribution. However, since the 1980s even here a clear shift towards a more unequal income distribution amongst households is visible (see figure 3). The distribution of assets is clearly more unequal than the income distribution (for the Netherlands in 2002, see CBP (2009). This means that here too the possibility of a crisis occurs.

Figure 5: Household income inequality in the Netherlands.



EHII2008 are estimates of gross household income inequality, computed from a regression relationship between the Deininger & Squire inequality measures and the UTIP-UNIDO pay inequality measures, controlling for the source characteristics in the D&S data and for the share of manufacturing in total empl

The financial crisis has put even more pressure on the income distribution. Atkinson (2008) notes that also historically a financial crisis leads to further income inequality. The winners of the current financial crisis are investors who have foreseen the bursting of the real estate bubble in time. Top earner is the hedge funds manager John Paulson. In July of 2006 he set up a hedge funds whose only strategy was to speculate on the collapse of the real estate market. Although he ignored the then rating of the credit rating agencies, his fund increased 590% in worth in 2007. John earned 3.7 billion dollars that year. A lot of others, however, have lost income and assets.

Axel Leijonhufvud (1978) spoke about a "corridor" within which economic variables should be kept. When this "corridor" is vacated, the bandwidth within which variables such as wage shares, national debts and inflation figures should be contained, then the system explodes and it is difficult to find the way back to stable, full employment. After all, outside this corridor actors no longer have the adequate and mutually consistent standards and expectations to stabilize the system.

In conclusion

The financial crisis is thought to have been caused by the United States. However, imbalances that have occurred between the real and financial sector, between wages and profits, and between personal incomes and assets, have made the economic system vulnerable to crises in the last 25 years. The boundaries of Leijonhufvud's corridor, within which the economic variables should develop in order to avoid crises, have thus been exceeded. If the bubble would not have burst in the United States, then the inherent lack of demand within the system would have led to a crisis somewhere else.

Is it possible to get back inside Leijonhufvud's corridor, and how?

Leijonhufvud (2009) himself does not think that a return to traditional Keynesianism, by means of a "balance sheet recession" as he calls it, would help, because not only should the

income positions be taken into account but also the asset positions. What we should borrow from Keynes, in his opinion, is first and foremost the role of social responsibility and a critical monitoring of the prevailing theory.
When there are crises or problems the Dutch usually install a committee that must analyze the problem and come up with proposals. This also happened in the case of the financial crisis. The "Maas Committee" (2009) recommended that banks should revert back to their original tasks. "Banks must focus primarily on the interests of the customer again and less on those of shareholders". The committee also speaks out against the nationalization of banks and in favor of limiting bonuses. However, it does not treat more fundamental causes of the crisis and how these should be addressed. The unequal distribution of income and assets isn't even an issue in this regard. And the same goes for a somewhat more far-reaching model for the regulation of the financial market, as developed by Keizer (2009) for example, in which he proposes a polder model for the financial market.
Now that the government has spent so much money on the rescue of banks and on business cycle measures, hopes have been aroused that resources shall also come available for education, youth, the lowest incomes, healthcare and the insurance of jobs (Atkinson, 2008). Therefore, reducing the income inequality is necessary for the stabilization of the system as well as for the political legitimization of governments.

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