

Research Note

Asking Financial Markets for a Viennese Waltz:

Inquiring into the Roots of Current Global Financial Crisis

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Imagine someone would have told you two years ago that mid September 2008 unrivalled stars of Wall Street and international financial markets, e.g. Lehman Brothers, AIG and HBOS, are playing the blues on Wall Street after enjoying years of Viennese waltz. This week such international investors seek shelter as the current global financial gale leaves its mark on all parties. I guess not only your answer, but also the reactions of most analysts from Tokyo to New York would have been something like: “I have got a good gut feeling that you are insane”. Such analysts would most probably have advised you to stop panicking and instead immediately to frequent your psychiatrist. Ironically, exactly the same analysts now may have a strange gut feeling and are seemingly at a loss to explain reasons for the sudden backlash in financial globalisation.

In the meantime, above New York, Frankfurt and Tokyo central bankers are steering helicopters with billions of Dollars, Euros and Yen trying to deliver relief by flooding the war chest of panicking financial intermediaries. However, in this situation a deep drag off the printing press does not seem to still the thirst for liquidity in financial markets. At this stage most analysts, including the ones with distinguished gut feelings, cannot get on grips with their animal spirits and are longing for a financial anchor.

Unfortunately, we cannot deliver yet another financial rescue package and certainly no anchor for analysts’ spirits. However, we may depict a reengineered map for a new financial landscape and particularly for uncharted waters in financial globalisation. The line of reasoning pertains to the writings of, e.g. Böhm-Bawerk, Schumpeter, Mises and Hayek. It is a pity that for some reason many aspects of this ‘Austrian’ thinking on macroeconomics went down the drain and vanished from the arena of mainstream economic thinking. However, at the peak of the current global financial turmoil these approaches may provide a plausible explanation of what is happening right now and of what really went wrong from the beginning.

Under the auspices of a rather ‘Monetary’ Austrian School we want to set forth an alternative line of argument towards understanding modern financial crises and financially induced business cycle swings. The point of departure is to formulate a proper and coherent answer to the provocative

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question of R.F. Kahn, which he asked after Hayek's presentation on business cycles: "Is it your view that if I went out tomorrow and bought a new overcoat that this transaction would increase unemployment?" In response, observers report, Hayek answered that Kahn would be correct that buying an additional coat would hurt the economy and lead to a recession. But which economic mechanism leads to the causal relationship that buying a new overcoat leads to an economic recession and particularly to current financial turmoil?

The answer to this paradox simply follows conventional Austrian thinking in economics: At the outset, entrepreneurs in a Schumpeterian sense, for example, invest in creative destruction processes, which will drive the economy out of a stationary equilibrium into a dynamically growing and innovating process. This process of creative destruction and innovation requires investment and capital. The latter resources have to be attained from financial sector. In this respect, it is valid that the more deregulated a financial market is, the easier it is to get access to resources for financing investment. However, given the credit multiplying function in financial markets this increase in demand for loans does not create an excess demand for credit, i.e. does not lead to rising interest rates in the first place. This is the ordinary pervert credit supply function in monetary spheres. The according excess demand for investment goods may then overstrain the production possibilities in an economy. Usually such economic overheating is reflected in asset price inflation in the real estate sector (i.e. 'land' as the canonical Ricardian factor of production). At this stage, Austrian economists presume that consumers prefer current consumption to future consumption and are thus trying to keep their consumption levels constant by reducing their current savings – such phenomenon (i.e. the buying of ever more new overcoats) has been observed in the US over the past decade. Furthermore, due to an overall increase in production and productivity, real consumption demand also increases as new employment in the production of consumption goods generates income. In the consumption good sector this increase in demand results in an increase in cash-flows and profits, which in turn fuels the demand for credit of consumption good producers. Given the household behaviour of decreasing savings, credit demand leads eventually to a shortage of financial resources to feed this excess demand. The reason is that the credit multiplying function in financial markets is not infinite. This particularly applies to a world of asymmetric information in imperfect monetary spheres. In consequence financial intermediaries start to charge higher interest rates on additional credits, decreasing overall profitability and decreasing returns. At the end of day large write-offs and bankruptcies result, spilling over to other sectors of the economy and thus leading to a recession – in the US excess consumption in the sector for privately owned homes has been this trigger. This process of restructuring comes along with a recession correcting eventually for a sub-optimally large consumption good sector and aggregate demand in the economy.

Here, conventional Austrian thinking in economics blames central banks for their loose monetary policy inducing excess credit demand for investment in the first place. The answer is certainly correct when the credit channel linking central banks to commercial banks would be frictionless. However as laid down in seminal contributions of the incumbent chairman of the US Fed, Ben Bernanke, and his former fellow-travellers this direct relationship is far from trivial. The crux of the mechanism lies more in the credit allocation of banks and other financial intermediaries, who seemingly inelastically supply credit to entrepreneurs relying on rising profits. At this stage, rising cash-flows during a boom imply higher collateral values of entrepreneurs and thus seemingly lower the risk perception of financial intermediaries. This balance-sheet effect in turn is easing access to credit, as improved balance sheets create extra room for manoeuvring even if central banks increase nominal interest rates and/or minimum reserve requirements. In an economic boom phase the balance sheet effect leads to a sufficiently large reduction in risk premia for attaining additional financial funding and thus can be viewed to be sufficiently large to counterbalance the effect of any monetary policy intervention. Thus the central question why financial intermediaries tend to overlending and contribute to financial asset price inflation can be attributed to financial market frictions and imperfections. This 'Monetary' approach to the Austrian thinking of macroeconomics has attained access in economics in terms of the 'financial accelerator mechanism' explaining business cycle fluctuations. It is thus obvious that present 'helicoptering' around with billions of Dollars and other 'hard' currencies on board will not deliver relief to liquidity thirsty animal spirits. Such action will most probably only delay inevitably required restructuring of the real economy. The upshot of this 'Monetary-Austrian' explanation of current financial turmoil is that enfranchised, but naturally imperfect financial markets are the catalyst of boom-bust cycles in the real economy. Though, there is certainly no need to dwell in spitefulness that current global financial crisis is a stinging to greedy financial investors: Financial globalisation is a prerequisite for growth spurs and welfare in the world – unfortunately, the previous stance towards deregulation seems to have abetted overestimations of the real production possibilities, which are due to insuperable imperfections in financial markets.

Knowing about these imperfections the question arises why some countries such as the US practised such laissez-faire towards market regulation possibly putting financial market stability at risk, albeit some observers have already seen the clouds at the horizon? And exactly this is the question, which brings us to the political economy dimension of the roots of current financial turmoil. Laissez-faire in regulatory affairs has been a decision of political rationale, i.e. giving financial markets the leeway to pull out the economy out of recession in the early 2000s instead of the government cleaning up the 'dotcom mess'. This way of privatizing a fiscal burden – which

we recently labelled the ‘selling the drama’ effect – has politically been a free lunch in the short run as increasing home ownership in combination with a ‘seemingly’ booming economy drove home substantial votes for the current US government. In this regard, giving free rein to financial markets can be interpreted as the result of competing political actors representing different interests in society. These parties have refrained from a costly provision of appropriate regulatory schemes which preserve the public good financial market stability. During the recent financial crises financial intermediaries have proved to be not in the position to provide this public good, but to pursue their own interests, which is economically speaking the natural order of things. In turn, we state that current global financial crisis is hardly the result of greedy financial intermediaries’ animal spirits or lax central-banking. The events in September, which turned a shiny Viennese Waltz into a dark blues on Wall Street in 2008, are rather a political failure that now comes at the price of recession. For that reason, pursuing more active macro-prudential economic policies may be a prerequisite for enjoying the economic benefits of another Viennese Waltz on financial markets.