The History of Financial Crises

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Introduction

Review of the Main Economic Theories
Financial Crises

♦ Week#1: Introduction
♦ Week#2: Financial Crisis 1792
♦ Week#3: Financial Crisis 1825
♦ Week#4: Financial Crisis 1857
♦ Week#5: Financial Crisis 1903
♦ Week#6: Financial Crises 1929 and 2008
Ancient times

♦ Finance didn’t exist as a special field of study in Ancient times.

♦ Economics did exist but more as philosophical and metaphysical questions

♦ However, several ancient Greek thinkers made various economic observations, especially Aristotle and Xenophon
The word "economics" is derived from “oikonomikos”

**Definition:** skilled in household management

The discipline of economics as we understand it today is a relatively recent development.

Modern economic thought emerged in the 17th and 18th centuries as the western world began its transformation from an agrarian to an industrial society
Aristotle used the labels of **natural** and **unnatural**.

**Natural** transactions were related to the satisfaction of needs and yielded wealth that was limited in quantity by the purpose it served.

**Unnatural** transactions aimed at monetary gain and the wealth they yielded was potentially without limits. He explained the unnatural wealth had no limits because it became an end in itself rather than a means to another end—satisfaction of needs. This distinction is the basis for Aristotle’s moral rejection of usury.
Xenophon analyzed and compared the subjective personal value of goods with exchange value.

Xenophon uses the example of a horse, which may be of no use to a person who does not know how to handle it, but still has exchange value.
Muslim Thinkers

- Abu Yusuf (731-798): chief jurist of Harun Al-Rashid. He wrote the Book of Taxation where he discussed proportional tax on produce instead of fixed taxes on properties.

- Al Ghazali (1058-1111): classified economics as a science connected to religion but this connection didn’t cause the economic thought to stay static.
More thinkers

- Ibn Taymiyyah (1263-1328) “If desire for goods increases while its availability decreases, its price rises. On the other hand, if availability increases and the desires for it decreases, the price comes down”

- Ibn Khaldun (1332-1406) “When civilization population increases, the available labor again increases. In turn, luxury again increases in correspondence with the increasing profit and the customs, and needs of luxury increase. Crafts are created to obtain luxury products. The value realized from them increases and as a result profits are multiplied in the town. Production there is thriving even more than before. And so it goes with the second and third increase. All the additional labor serves luxury and wealth, in contrast to the original labor that served the necessity of life.”
Middle Ages
Thomas Aquinas 1225-1274

- Thomas Aquinas was an Italian theologian and writer on economic issues. He taught in both Cologne and Paris.

- In the treatise *Summa Theologica*, Aquinas dealt with the concept of a **just price**, which he considered necessary for the reproduction of the social order.

- Bearing many similarities with the modern concept of long run equilibrium, a just price was supposed to be one just sufficient to cover the costs of production, including the maintenance of a worker and his family. He argued it was immoral for sellers to raise their prices simply because buyers were in pressing need for a product.
Mercantilism

- Mercantilism was the economic philosophy adopted by merchants and statesmen during the 16th and 17th centuries.

- Mercantilists believed that a nation's wealth came primarily from the accumulation of gold and silver.

- Nations without mines could obtain gold and silver only by selling more goods than they bought from abroad.

- Accordingly, the leaders of those nations intervened extensively in the market, imposing tariffs on foreign goods to restrict import trade, and granting subsidies to improve export prospects for domestic goods.
Mercantilism

- Mercantilism was a political movement and an economic theory that advocated the use of the state's military power to ensure local markets and supply sources were protected.

- Mercantile theorists thought international trade could not benefit all countries at the same time.

- Because money and gold were the only source of riches, there was a limited quantity of resources to be shared between countries.
Therefore, tariffs could be used to encourage exports (meaning more money comes into the country) and discourage imports (sending wealth abroad).

In other words a positive balance of trade ought to be maintained, with a surplus of exports.
British Enlightenment
John Locke
1632-1704

♦ John Locke was educated in London and Oxford.

♦ Locke believed that people contracted into society which was bound to protect their rights of property.

♦ He defined property broadly to include people's lives and liberties, as well as their wealth.

♦ When people combined their labour with their surroundings, then that created property rights.
Hume denounced mercantile assumptions. His contributions were set down in Political Discourses (1752), later consolidated in his Essays, Moral, Political, Literary (1777).

Hume held that any surplus of exports that might be achieved would be paid for by imports of gold and silver. This would increase the money supply, causing prices to rise. That in turn would cause a decline in exports until the balance with imports is restored.
Physiocrats, the 18th century

- A group of French economists who believed that agriculture was the source of all wealth. They also stressed the necessity of free trade.

- Francois Quesnay is a member of the Physiocrat.

- In 1758, he published the *Tableau Économique* (Economic Table), which provided the foundations of the ideas of the Physiocrats.

- This was perhaps the first work to attempt to describe the workings of the economy in an analytical way, and as such can be viewed as one of the first important contributions to economic thought.
Tableau économique

<table>
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<th>Tableau Économique</th>
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<tbody>
<tr>
<td><strong>Objets à considérer.</strong> 1°. Travaux de la dépendance; 2°. leur source; 3°. leurs causes; 4°. leurs distributions; 5°. leurs effets; 6°. leur reproduction; 7°. les rapports de l'atelier; 8°. leurs rapports avec la population; 9°. avec l'Agriculture; 10°. avec l'industrie; 11°. avec le commerce; 12°. avec la masse des riches d'une Nation.</td>
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<tr>
<th><strong>Dépenses Productives</strong></th>
<th><strong>Dépenses du Revenu</strong></th>
<th><strong>Dépenses Steriles</strong></th>
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<td>relatifs à l'Agendaire, Etc.</td>
<td>L'Emploi public, le partage avec Dépenses productives et avec Dépenses steriles.</td>
<td>relatifs à l'Agendaire, Etc.</td>
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- Années annuelles
  - pour produire un revenu de 6000 ha ou plus
  - leur production est
  - prod., annuel: 3000 ha

- Production
  - Le total solaire est
  - total annuel

- 75% de l'annuaire est

- 25% de l'annuaire est

- 12 x annuels est

- 2 x annuels est

- 3 x annuels est

- 1 x annuels est

- 0.5 x annuels est

- 0.25 x annuels est

- 0.125 x annuels est

- 0.0625 x annuels est

- 0.03125 x annuels est

- 0.015625 x annuels est

Réproduit total: 6000 ha de revenus de plus, les frais annuels de 6000 ha et les intérêts des annuaires primaires de l'Agendaire, de 300 ha, que la terre rende.

Aussi la reproduction est de 1500 ha et compris le revenu de 6000 ha qui est la base du calcul, abstraction faite de l'impôt prélèvement, et des annuaires qu'occupe sa reproduction annuelle, Etc. Voir l'explication à la page suivante.
The Classical School of economics was developed around 1750 and lasted as the mainstream of economic thought until the late 1800’s.

Adam Smith's Wealth of Nations, published in 1776 can be used as the formal beginning of Classical Economics.

Adam Smith (1723-1790) is recognized as the originator of Classical Economics. John Stuart Mill (1806-1873) is often regarded as the synthesizer of the school.
Classical economists

- These economists had seen the first economic and social transformation brought by the Industrial Revolution:
  - rural depopulation,
  - precariousness
  - poverty
  - apparition of a working class.
Questions asked by classical economists

- They also asked many fundamental questions about:
  - the source of value, the causes of economic growth and the role of money in the economy.
  - They supported a free-market economy, arguing it was a natural system based upon freedom and property.
Some divergence

- Some school argued for government action to mitigate unemployment and economic downturns, and it was an intellectual predecessor of what later became Keynesian economics in the 1930s.

- Another notable school was Manchester capitalism, which advocated free trade, against the previous policy of mercantilism.
Adam Smith

- He argued against Mercantilism
- He is the father of modern economics
- He is a proponent of the “Laissez-faire” economic policies and the father of free trade.
- “It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest,” Smith wrote.
Main ideas of Adam Smith

- Laissez-faire philosophies, such as minimizing the role of government intervention and taxation in the free markets
- The "invisible hand" guides supply and demand
- These ideas reflect the concept that each person, by looking out for herself, inadvertently helps to create the best outcome for all.
Mill pointed to a distinct difference between the market's two roles: allocation of resources and distribution of income.

“The market might be efficient in allocating resources but not in distributing income”, he wrote, making it necessary for society to intervene.
The rise of Neoclassical school in 1800s

- The belief in the efficacy of a "free market" is central to both classical and neoclassical ideology.

- An approach to economics that relates supply and demand to an individual's rationality and his or her ability to maximize utility or profit.

- Neoclassical economics also increased the use of mathematical equations in the study of various aspects of the economy.
Léon Walras

♦ French mathematician

♦ He is one of the first who developed the general equilibrium theory in economics.

♦ He also called for the nationalization of land believing that the value of land would always increase.
Capitalism

- Societies with a small-scale commodity production
- In a society founded on small-scale commodity production, two kinds of economic operations are carried out. The **peasants** and **artisans** who bring their products to market to sell goods.
- The **use value** of the goods is crucial in order to obtain money, means of exchange, for the acquisition of other goods.
Pre-Capitalist Market

✧ Selling in order to buy

✧ Commodity-Money-Commodity

✧ Alongside the artisan and small peasant, another personage, who executes a different kind of economic operation.
Pre-Capitalist Market

♦ Instead of selling in order to buy, he buys in order to sell. This type of person goes to market without any commodities; he is an owner of money.

♦ Money cannot be sold; but it can be used to buy, and that is what he does: buys in order to sell, in order to resell:

♦ Money- Commodity-Money
Capital and Capitalist

The surplus value included in the commodity and that is different than its use value is the capital.

According to this definition, capital existed for thousand of years.

- It is necessary to distinguish very clearly between the life of capital and that of the capitalist mode of production, of capitalist society.

- Capital is far older than the capitalist mode of production. The former probably goes back some 3,000 years, whereas the latter is barely 200 years old.
Capital and Capitalist

- In ancient societies: capital was **usury or merchant**

- In the capitalist mode of production, capital takes over the means of production and penetrates directly into **production** itself.

- Basically, the entire history of trade between the sixteenth and twentieth century is the history of a progressive transformation from trade in luxury **goods** into trade in mass **consumer goods**; into trade in goods destined for an **ever increasing portion of the population**.
Example: sugar

- In the medieval times, sugar was very expensive.
- It was considered as a fine spice.
- In the 16th century, technological improvement and New World colonies made sugar more available and less expensive.
Progress of Capitalism

♦ What practical method does the capitalist have for sharply cutting his production costs and simultaneously sharply increasing his production?

♦ It is the development of mechanization, the development of means of production, mechanical instruments of labour of ever increasing complexity, originally powered by steam power, then by gasoline or diesel oil, later by electricity and today by the internet.
Marxian Economic Theory in the mid 19th century

- Capitalism breeds problems:
  - Monopoly
  - Wage slavery
  - Karl Marx believed that capitalism would ultimately destroy itself and be succeeded by a world without private property.
Marx and his criticism of capitalism

- He was heavily critical of the current socio-economic form of society, capitalism, which he called the "dictatorship of the bourgeoisie",

- He accused capitalism to be run by the wealthy middle and upper classes purely for their own benefit, and predicted that, like previous socioeconomic systems, it would inevitably produce internal tensions which would lead to its self-destruction and replacement by a new system, socialism.
Marx and his ideas

♦ Under socialism, he argued that society would be governed by the working class

♦ In what he called the "dictatorship of the proletariat", the "workers state" or "workers' democracy".

♦ He believed that socialism would, in its turn, eventually be replaced by a stateless, classless society called pure communism.
The 20th Century
War and Revolution

- **Alfred Marshall** was still working on his last revisions of his Principles of Economics at the outbreak of the First World War (1914–1918). For four years the production of Britain, Germany and France was geared entirely towards the war economy's industry of death.

- In 1917 Russia crumbled into revolution led by Vladimir Lenin's Bolshevik party. They carried Marxist theory as their saviour, and promised a broken country "peace, bread and land" by collectivising the means of production.
Also in 1917, the United States of America entered the war on the side of France and Britain, President Wilson carrying the slogan of "making the world safe for democracy". He devised a peace plan of Fourteen Points.

In 1918, Germany launched a spring offensive which failed, and as the allies counter-attacked and more millions were slaughtered, Germany slid into revolution, its interim government suing for peace on the basis of Wilson's Fourteen Points.
War and Reconstruction

- Europe lay in ruins, financially, physically, psychologically, and its future with the arrangements of the Versailles conference in 1919. **John Maynard Keynes** was the representative of Her Majesty's Treasury at the conference and the most vocal critic of its outcome.

- Keynes argued that if the victors forced war reparations to be paid by the defeated Axis, then a world financial crisis would ensue, leading to a second world war.
War and Economics

Keynes finished his treatise by advocating:

- first, a reduction in reparation payments by Germany to a realistically manageable level, increased intra-governmental management of continental coal production and a free trade union through the League of Nations;

- second, an arrangement to set off debt repayments between the Allied countries;

- third, complete reform of international currency exchange and an international loan fund

- and fourth, a reconciliation of trade relations with Russia and Eastern Europe.
But Keynes believed in the 1930s, conditions necessitated public sector action.

Deficit spending, said Keynes, would kick-start economic activity.

The New Deal program in the U.S. had been well underway by the publication of the General Theory. It provided conceptual reinforcement for policies already pursued. Keynes also believed in a more egalitarian distribution of income, and taxation on unearned income arguing that high rates of savings (to which richer folk are prone) are not desirable in a developed economy. Keynes therefore advocated both monetary management and an active fiscal policy.
John Maynard Keynes

♦ Keynes passed away little more than a year later, but his ideas had already shaped a new global economic order, and all Western governments followed the Keynesian prescription of deficit spending to avert crises and maintain full employment.

♦ After World War II, the United States had become the pre-eminent global economic power.
Criticism of Keynes

- The institutional economists had been largely critical of the "American Way" of life, especially regarding conspicuous consumption of the Roaring Twenties before the Wall Street Crash of 1929.

- After the war, however, a more orthodox body of thought took root, reacting against the lucid debating style of Keynes, and re-mathematizing the profession.

- The orthodox centre was also challenged by a more radical group of scholars based at the University of Chicago. They advocated what they called "liberty" and "freedom", looking back to 19th century-style laissez-faire governments.
Monetarism and the Chicago school

- The interventionist monetary and fiscal policies that the orthodox post-war economics recommended came under attack in particular by a group of theorists working at the University of Chicago, which came to be known as the Chicago School.

- This more conservative strand of thought reasserted a "libertarian" view of market activity, that people are best left to themselves, free to choose how to conduct their own affairs.

- More academics who have worked at the University of Chicago have been awarded the Nobel Prize in Economics than those from any other university.
Milton Friedman
1912-2006

◆ Nobel Prize 1976

◆ A major advisor to Ronald Reagan and Margaret Thatcher

◆ Free market with minimal intervention

◆ His ideas about taxation, deregulation and privatization influenced the policies of the 80s.

◆ He believes in the control of money supply as a measure to influence the economy.
Joseph Stiglitz
1943

- Nobel Prize 2001
- One of the most influential economist in the world.
- Advised Clinton and Obama administration.
- His works focuses mainly on income distribution, asset management, international trade and corporate governance.

"What is needed is stronger norms, clearer understandings of what is acceptable - and what is not - and stronger laws and regulations to ensure that those that do not behave in ways that are consistent with these norms are held accountable"
Paul Krugman 1953-

- Nobel Prize 2008
- The main focus of his work is on international economics, liquidity traps, and currency crises
- After the financial crisis 2008, he is a strong advocate of the Keynesian resurgence.
- “I believe in a relatively equal society, supported by institutions that limit extremes of wealth and poverty”