What makes the current crisis unique? Is it overextension of financial instruments?

The current crisis is often compared to the Great Depression of the 1930s (see: Barry Eichengreen, Kevin H. O’Rourke. A Tale of Two Depressions. 6 April 2009 - http://www.voxeu.org/index.php?q=node/3421).

But there is still little evidence that it could reach the same magnitude. So far this current crisis is not unique – neither in terms of the collapse of stock indices (between October 1972 and July 1974 and between January 2000 and July 2002 S&P fell nearly 50% - pretty much like in October 2007- March 2009), nor in terms of the collapse of output (world GDP is projected to fall in 2009 by 1 to 2 % - for the first time in 60 years, but it is not dramatically different from 0.3 growth in 1982 and 0.9 growth in 1975 (see charts below).
There is also a theory that the rates of productivity growth are slowing down after the ICT revolution happened and the stream of innovations started to dry up. But, again, so far the evidence does not support the hypothesis – productivity growth rates since the late 1980s in the US were higher than in the 1970s-80s (chart below). And if Kondratieff long waves do exist, the lowest point of the long cycle should come some time in the 2020-30s, not now (the previous troughs were in the 1870s, 1930s, and 1970-80s).
The expansion of financial sector and derivatives that took place in recent decades is really unique and could be held responsible for the extra-ordinary character of today’s recession. The ratio of total debt – corporate, household, financial and government – to GDP today (since the mid 1980s) is as high as it was never before, except for the 1920s-30s (chart below). And the market in derivatives that virtually did not exist before the 1970s, expanded to astronomical size. As Mario puts it, the current crisis is unprecedented due to “the unregulated degeneration of financial institutions, banks and non-bank intermediaries, the result of twenty years of hyper-liberalism... According to the Basel-based Bank of International Settlements, the global outstanding derivatives – bets on the value of assets, and bets on those bets – have been growing exponentially and reached 1.14 quadrillion dollars… By comparison, the gross domestic product of all the countries in the world is only 60 trillion dollars”. Derivative financial instruments designed to hedge risk, became themselves the source of volatility.

Relative wages in the financial sector (after controlling for education, experience and other usual determinants) in recent years were equally unusually high – as high as they were only in the

Figure 11: Historical Excess Wage in the Financial Sector

However, it could be argued that what was dangerous in the 1920s-30s and led to the Great Depression today is manageable due to the experience and sophistication in applying Keynesian policies of managing aggregate demand. This may be true and may be not, but the fact is that the response to the current crisis by means of monetary and fiscal policy today is really unprecedented. The following two charts borrowed from cited paper by Barry Eichengreen and Kevin H. O’Rourke show that the increases in both the money supply and the budget deficits during this recession were by far more pronounced than in the late 1920s and 1930s.
Money Supplies, 19 Countries, Now vs Then (Source: Bordo et al. (2001), IMF International Financial Statistics, OECD Monthly Economic Indicators)

Government Budget Surpluses, Now vs Then (Source: Bordo et al. (2001), IMF World Economic Outlook, January 2009)
The US federal budget deficit is projected to increase to 12% of GDP in 2009 (from 3.2% in 2008) and stay at a level of 8% of GDP in 2010, so the total US public debt to GDP ratio in several years from now can exceed 100% of GDP from about 70% in 2008. In EU countries the increases in budget deficits are not that dramatic, but also substantial.

The danger with Keynesian policies, of course, that its effects accumulate, the economy gets addicted to stimuli, and the new and bigger doses are needed to get the desired result. This was exactly the problem with the stagflation of the 1970s. And it may well be this same problem is going to build up after enacting the stimuli designed to cope with the current recession.

To prevent this type of recession from happening in the future it would be needed to limit the expansion of the financial markets (derivatives – in the first place) through tighter government regulations. But this is exactly what is very unlikely to happen, as the recent G-20 meeting showed. The analogy would be the global warming. Until several islands in the Pacific would not go under water, it is virtually impossible to mobilize public support for the austerity measures, like the carbon tax.

Until there is a major crash, the new regulations for financial markets are not likely to be adopted. If so, in 10-20 years from now we are likely to find ourselves in a greater trouble, but with less room for managing the problem by means of Keynesian policies.

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