Chapter 1: Introduction[1]

"… the credit crunch of 2007, the financial crash of 2008 and the recession of 2009 are all aspects of a much wider crisis… This crisis can be viewed from a number of perspectives: as a crisis of the banking system, as a crisis of regulation, as a crisis of the continued hegemony of the United States over the global economy and the political crisis of the legitimacy of the global order. Taken together these add up to … the idea of a crisis of capitalism" (Gamble, 2009:42)

On Thursday, August 9, 2007, traders in the international money markets in New York, London and other prominent financial centers experienced a sudden and dramatic surge in interest rates for overnight and term interbank loans. On Friday, August 10th the Federal Reserve Bank of New York infused the market with liquidity resulting in a decline of the overnight rate, but interbank term rates increased even more. It was as if term lending for Libor one- and three-month rates became disconnected from the overnight rate.[2] Banks all of a sudden demanded more liquidity or did not want to lend to one another. The immediate spark igniting the surge in interbank rates was the announcement on August 9th by French bank BNP Paribas that it froze $2.2 billion in three of its investment vehicles. The reason was due to an inability to determine the value of the underlying securities after suffering severe losses the preceding two weeks. This unsettling event followed on the heels of the announcement the previous month by US investment bank Bear Stearns that suffered substantial losses. The cause of these losses and uncertainty was the increasing delinquencies and defaults on subprime mortgage loans in the United States – mortgage loans that have been securitized and were owned by investors and banks all over the world. This surge in interbank term

[1] This study will be written in American English.
[2] "Libor" is the abbreviation for "London Interbank Offered Rate." It is a daily reference rate for interbank loans contracted in the London wholesale money market.

rates was the beginning of a global financial crisis that resulted in what many now refer to as *The Great Recession*.

It is the aim of this study to explain the causes of the 2008 global financial crisis from a political economy perspective.[3] This chapter will review the background, historical context and importance of the crisis. I will formulate a specific research question that will guide the study, offer an explanatory hypothesis regarding the crisis, and outline the theoretical framework within which the crisis will be analyzed. Issues of ontology will be addressed, as well as a discussion of the delimitations and limitations of the study. Lastly the structure of the study will be outlined.

1.1 Background and Importance

The period of time between 1987-2007 is known as the *Great Moderation*. This refers to a trend of reduced volatility in business cycle fluctuations in the advanced economies. It was an extended period of impressive economic growth that was attributed to free-market economic policies and globalization. As Casey (2011) notes, post-war economic history began with the *Long Boom* – 30 years of full employment and unparalleled economic growth. This period was characterized by Keynesian macro-economic policies and the creation of the social welfare state in the developed world. When an economy was in recession Keynesian theory recommended spending; however, many advanced economies, specifically the US, found it hard to stop spending in good times. Increased government spending, especially US spending to finance the Vietnam war, led to higher prices, and lower productivity and profits. The *Long Boom's* end coincided with the oil crisis in the early 70's as well as the end of the Bretton Woods global monetary arrangement in 1971 when Nixon ended gold convertibility.

[3] Since most of the important events of the crisis, including the start of the global recession, occurred in 2008, I refer to the crisis as the 2008 global financial crisis. September 2008 was also the month that the entire global financial system verged on collapse.

The Western world entered the era of stagflation. Governments tried to intervene with more spending which just fueled the inflationary spiral. The Keynesian approach came into disrepute, opening the door for the rise of neoliberalism. Reagan and Thatcher were at the vanguard of a switch from a state led global political economic system to a market led system. Gamble refers to this newly emerging system as the *financial growth model*.

> *"This new financial growth model used tax cuts to stimulate the economy, and it promoted privatization of public assets and deregulation of the private sector, particularly the financial sector. It sought to expand credit, not restrict it, and to enlist the financial sector as the most important driver of growth and competition in the economy. It led to the rise of the investment banks and the rating agencies to their commanding position in the global economy at the beginning of the twenty-first century, and the proliferation of new financial vehicles and instruments, a readiness to 'leverage' every asset whether in the public or private sector, and to make all citizens and organizations 'financial subjects' "* (Gamble, 2009:15).

The Great Moderation coincided with the end of the cold war, reforms in China, increased globalization, and the dominance of monetarist free-market economic theories, fueling an unprecedented economic boom largely driven by new technologies and increased productivity in the US. With communism discredited, capitalism became the dominant global system. From Southeast Asia, India, Eastern Europe, China and Latin America, nations competed to attract investment capital. Even though there were peripheral financial crises, the financial growth model became widely adopted.[4] One of the most salient characteristics of the Great Moderation was *globalization*. Cohen (2008:79-80) defines globalization as follows:

[4] Inter alia, the Finnish banking crisis 1991-1993, Mexico 1994, the Asian financial crisis 1997, Russia 1998, the Argentine economic crisis 1999-2002, etc.

"… globalization is equated with an increasingly close integration of national markets — a fundamental transformation of economic geography. In place of territorially distinct economies, we are said to be moving toward a more unified model, a truly global *marketplace. Production processes and financial markets are becoming more international, transcending space. Economic networks are spreading without regard for distance or borders. Transactions are speeding up, compressing time, and relations are growing more and more intense, deepening linkages."*

The global integration of finance through electronic interconnectivity, facilitated unrestricted capital flows and speculative investments. The financial sector grew disproportionately large compared to other industries. More and more complex and innovative financial vehicles were being created, blessed by the regulators in the US as instruments that will *decrease* risk by spreading it throughout the system. As prosperity continued to spread to hitherto underdeveloped areas, large financial institutions started using leverage and securitization to create astonishing wealth for their organizations. As mentioned there were economic and financial crises during the Great Moderation, but they were easily contained without any major setbacks for global growth. This all came to an abrupt and dramatic end one fateful weekend in September 2008 (Casey, 2011).

The crisis manifested in the global money markets which represent the first stage of the monetary transmission channel where monetary policy connects with the financial system and the global political economy. Term money market rates, like the 3-month Libor, influence a host of rates throughout the economy, and poorly functioning money markets impinges on the availability and cost of credit to businesses and households in the global economy (Taylor & Williams, 2008:1). The three-month Libor Overnight Index Swap (OIS) for August 2007 dramatically illustrates the extent of the developing crisis.[5] The three-month Libor-OIS rate is a measure of what the markets expect the US federal funds rate to be over a three-month period relative to the three-month Libor.[6] The Libor-OIS spread is used to indicate those factors, other than interest rate expectations, that influence interbank rates, such as risk and liquidity (Taylor, 2009:15). Historically, the spread on average was 11 basis points, but on August 9, 2007, the spread surged to 34 basis points, fluctuating wildly between 30 basis points and a maximum of 106 basis points over the following months (Taylor & Williams, 2008:10-11) (see Figure 1).

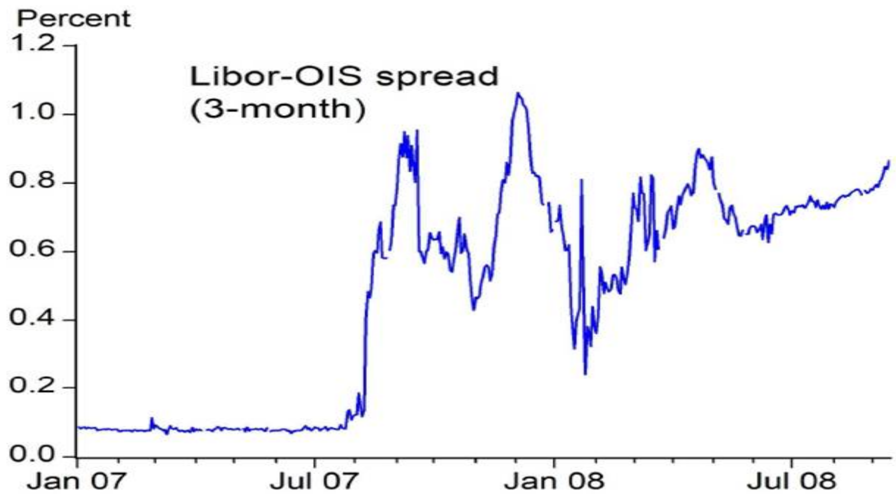

Figure 1: The Libor-OIS spread during first year of the crisis (Taylor, 2009:16)

This surge in interbank rates resulted in the onset of unprecedented deleveraging throughout the global political economy. Global finance was in the grip of a liquidity crisis which eventually resulted in a worldwide economic contraction and recession, accompanied by bank failures, the implosion of the real estate markets in many countries, specifically the US, rising unemployment, and a redefinition of the role

[5] The Overnight Index Swap (OIS) is a derivative used by hedgers to manage their fixed or floating assets and liabilities.

[6] The federal funds rate is the rate that depository institutions charge each other for overnight loans using federal funds at the Federal Reserve of the United States of America. The federal funds target rate is arguably the most important interest rate in world money markets, and is set by the Federal Open Market Committee of the US Federal Reserve System. Federal funds refer to the reserves depository institutions hold at the different Federal Reserve Banks in the US to meet their reserve requirements.

of the state in markets. This was no ordinary crisis – but a crisis of capitalism itself. Through the remainder of 2007 and 2008 the global political economy was marked by unprecedented interventions by world governments and central banks in the operation of their national economies. In March 2008 seventy years of tradition was unilaterally shattered by the Federal Reserve when it lent $30 billion to JP Morgan Chase to buy Bear Stearns for $10 per share. Bear Stearns was one of the pioneering firms in the evolving securitization and asset-backed securities markets, and had a 52-week high share price of $130.20 preceding the take-over (Boyd, 2008). Also in March 2008 the British government had to nationalize Northern Rock, following the first bank run in Britain in over a century. These tumultuous events were magnified by the decision of Federal Reserve Chairman, Ben Bernanke, US Treasury Secretary, Hank Paulson, and President of the Federal Reserve Bank of New York, Timothy Geithner to refrain from intervening to save Lehman Brothers from bankruptcy on September 14, 2008. The Lehman failure brought the global financial system to the precipice of collapse. The bankruptcy filing of Lehman Brothers occurred only one week after the US government seized two investor owned corporations, The Federal National Mortgage Association ("Fannie Mae"), and The Federal Home Loan Mortgage Association ("Freddie Mac").[7] The bankruptcy of Lehman Brothers (the biggest in US history), a revered Wall Street icon founded before the American civil war, led to what was dubbed "The Weekend that Wall Street Died" (Wessel, 2009:2). Within one week, under the leadership of Bernanke, Paulson and Geithner, the US government facilitated the merger of Merrill Lynch to Bank of America; injected $85 billion into AIG, an international insurance behemoth linked to numerous counterparties throughout the global financial system; guaranteed US money market accounts to prevent an investor run; and allowed Goldman Sachs and Morgan Stanley, the only remaining investment banks, to transform themselves into bank-holding companies with access to Federal Reserve emergency

[7] Fannie Mae and Freddie Mac were two government-sponsored enterprises created by the US Congress through a public charter. Although both corporations were investor owned and traded on public stock markets, the US Federal Housing Finance Agency had the legal right to place the corporations under conservatorship if the agency judged the corporations were financially unstable. The legal right to place these two mortgage companies under conservatorship provided an implicit US government backing of their debt (Paulson, 2010).

funds. The transformation of Goldman and Morgan into bank holding companies heralded the end of the investment banking brokerage business model 75 years after the US Congress divided deposit taking institutions from investment banking institutions.

This study's importance lies in its political economic explanation of how credit expansion within a globalized financial system moved investments into real estate loans in many parts of the world through the securitization of mortgage debt, causing a significant increase in the price of real estate, which subsequently collapsed. Doubt about the value of securities linked to mortgages led to the so-called "Black Swan" that landed in the money markets on August 9, 2007. Central banks and governments were key players, especially in the US where the crisis originated, thus, it is essential to understand the critical political decisions that factored into the unfolding of the crisis. The crisis shattered most of the cherished principles of capitalism, truly making it a crisis of capitalism itself. It demolished long held beliefs of government's role in the functioning of the free market, particularly in the West and the United States. In this study the claim will be made that the evolution of unstable credit financing regimes was the key independent variable that caused the 2008 global financial crisis. Although a real estate bubble precipitated the crisis, it was preceded by a credit bubble that led to an increasingly fragile set of credit financing regimes across the globe. At the heart of the crisis was destabilizing credit expansion, and this expansion of credit in the global financial system was both political and economic in nature. Moreover, I will endeavor to illustrate that the evolution of fragile credit financing regimes is endemic to capitalism itself, but even more so in the type of capitalism practiced leading up to the crisis. In trying to stem the tide of the crisis, governments and central banks took unprecedented steps, fundamentally changing the structure of the global political economy. Ultimately, the importance of this study lies in making a small contribution to the way the crisis is perceived. As Gamble (2009:65) argues, the way we perceive a crisis is always a *political* act, since it authorizes certain courses of action to resolve the crisis and restore stability or create a new order.

1.2 Problem Statement, Hypothesis and Theoretical Framework

The central problem of my study will be to answer the following research question from a political economic perspective: *What caused the 2008 global financial crisis?* In answering the research question I will use Hyman Minsky's *financial instability hypothesis*. According to his hypothesis as an economy grows and profits increase those businesses in highly profitable areas of the economy are rewarded handsomely for increasing the amount of debt they use. These profits motivate the use of increased leverage. This feedback loop fuels the creation of credit since lenders are satisfied by the ever increasing profits. However, the feedback loop leading to the expansion of credit also leads to the formation of unstable financing regimes (Minsky, 1975; 1986; 1992; Kindleberger, 2000; Cooper, 2008). According to Minsky (1992:7-8) the first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable, and financing regimes that lead to fragility and instability. The second theorem is that over periods of prolonged prosperity the economy transits from financial relations fostering stability to financial relations that make for an unstable system.

Hyman Minsky's financial instability hypothesis is part of his larger theory of financial instability and capitalist development. The study will provide an in-depth discussion of the theory, including the expansion of the theory by Charles Kindleberger (2000). Although Minsky was a traditional economist within the Keynesian mold, his theories, and the expanded Kindleberger model contain crucial political dimensions in their theorems.

From Minsky's perspective the economy was a complex, time-dependent system. He saw society as an "evolutionary beast," changing in response to endogenous factors. The fundamental determinant of the path of capitalist development is the institutional structure of the political economy. It is this structure that regulates, facilitates, influences and constrains political economic activity. Consequently, capitalism has many varieties. In Minsky's thinking time-dependency is an important structural variable of contemporary capitalism - production precedes exchange, and finance precedes production. Thus, credit creation is at the center of capitalist development (Minsky, 1990). Another important element of Minsky's approach was the importance of profit-driven structural change. The financial system takes on special importance according to Minsky's theory of capitalist development since the system exerts a strong influence on business activity, and is also prone to innovations in profit driven credit production. Furthermore, capitalist development cannot be understood without incorporating government policy. Government policy is an inescapable determinant of the path of capitalist development.

At this junction I would like to define "capitalism." While there is little consensus on a definition, many definitions focus on the fact that capitalism is an economic system characterized by private property rights and the seeking of a profit. The following is a common definition of capitalism.

> *"[Capitalism is a]n economic arrangement, defined by the predominant existence of capital and wage labour, the former consisting of accumulation in the hands of private (i.e. non-governmental) owners, including corporations and joint stock companies, the latter consisting in the activities of labourers, who exchange their labour hours (or, according to Marxian theory, their labour power) for wages, paid from the stock of capital. The capitalist extracts not a wage but a profit, by realizing in a market the value of the goods produced. Capitalism presupposes private property in the means of production, a market economy, and the division of labour"* (Scruton, 1982:52).

What is missing from the above definition is that Minsky's theory of capitalist development imply that contemporary ***capitalism is essentially a financial system***. For Minsky the heart of the financial system, and by extension the heart of the capitalist system, is the money markets. The money market is the place where economic units (individuals, companies, governments, etc.) meet one another to adjudicate their competing needs to refinance. The most critical asset-price in the political economy is the price of refinance – the short-term money market rate of interest. The money market is the place where the coherence of the entire system is tested daily. Capitalism requires credit or financing. Minsky believed there were two fundamentally distinct views of the workings of a market economy. There is the view that internal and inherent (endogenous) processes of markets generate an economic equilibrium, and that business cycles are the result of exogenous shocks. In contrast, Minsky believed that these so-called endogenous economic forces breed financial and economic instability, not equilibrium. Booms and busts are inherent parts of the system.

Minsky identifies three different types of income-debt relationships between economic units and financial intermediaries, namely, *hedge*, *speculative* and *Ponzi* finance.[8] Regarding these three debt regimes Minsky (1992:7-8) states:

> *"It can be shown that if hedge financing dominates, then the economy may well be an equilibrium-seeking and containing system. In contrast, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation amplifying system. The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system."*

Kindleberger (2000) used Minsky's model and expanded on it in his model of financial crisis which Kindleberger applied to the analysis of historical financial crises. The study will utilize the expanded Kindleberger model in applying the five phases of a financial crisis to the 2008 crisis. The five phases according to Kindleberger (2000) are, displacement, euphoria, mania, distress, and revulsion

[8] Minsky's use of the term "Ponizi' does not refer to the more common usage denoting an illegal scheme; however, his Ponzi Financing Units have certain similarities with an illegal Ponzi scheme, but Ponzi Financing Units are entirely legal in modern capitalist economies.

Minsky and Kindleberger's theory of financial instability sees capitalism as dynamic; therefore, no definitive solution exists for government management of the economy. Government policy needs to be fluid and flexible to respond to, and proactively anticipate, changes in the institutional structure of the capitalist economy. The salience of the theory is well expressed by Janet Yellen, then president and CEO of the Federal Reserve Bank of San Francisco, during the crisis:[9]

> "*... with the financial world in turmoil, Minsky's work has become required reading. It is getting the recognition it richly deserves. The dramatic events of the past year and a half are a classic case of the kind of systemic breakdown that he — and relatively few others — envisioned"* (Yellen, 2009).

1.3 Delimitation and Limitations of the Proposed Study

From the study's vantage point the field of study within which the analysis of the 2008 global financial crisis resorts is *political economy*. Political economy is defined as the study of how resources are allocated by humanity. The study will make the argument that there are two primary dimensions of resource allocation, namely the "political" and the "economic." The political dimension of resource allocation relates to the subsystems of power and authority within societies. The economic dimension relates to the subsystems of production and distribution of resources within societies. These two dimensions, or subsystems, are interdependent and interactive.[10] If we look at the entire world as one spatial entity, the global system of resource allocation is characterized by the existence of fragmented subsystems of power and authority — sovereign countries or what Cox (1987) refers to as *state-society complexes*. It is also characterized by the increasing integration of the production and distribution of

[9] Janet Yellen was subsequently nominated on April 28, 2010 to become vice-chairman of the Federal Reserve System. Her nomination was confirmed by the US Senate in July 2010.

[10] The study will define "system" as a group of interrelated, interacting and interdependent components forming a complex whole. I argue that the social components responsible for how resources are allocated within societies form a complex whole – what I call the system of resource allocation. This study will deal with these definitions in the following chapter in-depth. My conception of "resources" includes Easton's (1981) idea of "values."

resources spanning national boundaries. Although political power and authority predominantly rests in the hands of sovereign states and there is an absence of a central governing authority in the world, institutions and regimes play important roles in the system for resource allocation (Keohane, 2002.)

I refer to the study of the global system of resource allocation as *political economy* — and the global system itself, as the *global political economy*. One could also refer to the study of the global system as *international political economy* (IPE) to distinguish it from studying the allocation of resources in one specific region, or within one state-society complex or country. Simply using the term political economy is preferable, in my opinion, as it is a semantic effort to move away from the rigid disciplinary walls academia has constructed. The study will follow Palan (2000) by arguing that the field of IPE must return to its political economy roots. Palan (2000:2-3) quotes Gilpin's 1987 definition of IPE as containing an unsatisfactory implicit assumption, namely that politics and economics are two separate, indeed, parallel realms:

> *"The parallel existence and mutual interaction of 'state' and 'market' in the modern world create 'political economy' ... In the absence of state, the price mechanism and market forces would determine the outcome of economic activities; this would be the pure world of the economist. In the absence of market, the state or its equivalent would allocate economic resources; this would be the pure world of the political scientist."*

According to Palan (2000) this challenge to bridge the divide is responsible for a theoretical realignment occurring in IPE. To answer my research question I will need to bridge the politics-economics divide. The study will argue that this divide has had an overly reductionist impact on the types of answers economists and political scientists produced in explaining social phenomena. Moreover, the financial crisis has upended the discipline of economics. Much criticism has been leveled against the field's failure to predict the global financial crisis, and the shortcomings of contemporary economic theory (The Economist, 2009:11-12). It is outside the study's purview to explore these debates in depth; however, I share the current criticism that contemporary economic and political theories were unable to predict the financial crisis, and this study will argue that part of the problem has been the dearth of *political economic* theory. With the exception, of course, of Minsky's theory of financial instability. In 2009 *The Economist* argued in an editorial for a reinvention of economics (2009:12). I would like to restate their argument as follows (inclusions in brackets are my own words and not the original article's words):

> *Add these criticisms together and there is a clear case for reinvention, especially in macroeconomics* [and political science]*. Just as the Depression spawned Keynesianism, and the 1970s stagflation fuelled a backlash, creative destruction is already under way.* [Perhaps the financial crisis will help bridge the gap between economics and political science.] *Central banks are busy bolting crude analyses of financial markets onto their workhorse models. Financial economists are studying the way that incentives can skew market efficiency. And today's dilemmas are prompting new research: which form of fiscal stimulus is most effective? How do you best loosen monetary policy when interest rates are at zero?* [What are the proper roles of government and government institutions in managing systemic crisis?] *And so on.*
>
> *But a broader change in mindset is still needed. Economists* [and political scientists] *need to reach out from their specialised silos: macroeconomists must understand finance,* [political scientists must understand macroeconomics]*, and finance professors need to think harder about the context within which markets work. And everybody* [including political scientists] *needs to work harder on understanding asset bubbles and what happens when they burst. For in the end economists* [and political scientists] *are social scientists, trying to understand the real world. And the financial crisis has changed that world.*

1.4 Research Design and Methodology

A literature review will be undertaken to contextualize the proposed theoretical framework. Since the 2008 financial crisis is a relatively recent phenomenon that is still unfolding, there is limited academic literature available on the topic. In describing the chronology of the crisis, the study will review and include, where applicable, primary data related to the crisis, descriptive literature on the unfolding crisis, and journalistic coverage of the crisis. The study is then a qualitative study testing the validity of a particular hypothesis by applying it to a single phenomenon. The study will follow a deductive logic in describing the event. By applying the selected hypothesis to explain the event, event characteristics will serve as empirical facts supporting the validity of the hypothesis. The study will make use of a few selected historical occurrences in discussing and applying the theory to the event. However, the study will not be a comparative analysis of the 2008 crisis and financial crises of the past.

1.6 Structure Of The Study

The second chapter will provide a thorough analysis of Minsky's theory of financial instability, and Kindleberger's expansion of the theory. This chapter will also define *political economy*, and the justification for analyzing the crisis as a political economic event. Chapter Three will provide a chronological discussion of the unfolding of the financial crisis within the framework of Minsky's theory of capitalist development and the financial instability hypothesis. Issues of subjectivity in describing the crisis will be discussed in this chapter. Chapter Three will also aim to identify the causal factors resulting in the crisis, and the validity of the hypothesis in answering the research question. The final chapter will summarize the findings of the study, and conclude with the validity and applicability of the financial instability hypothesis as an explanatory model for financial crises.

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