Unit V 18: Financial bubbles and overproduction crises

1. Summary

There are parallels between the major economic crises, but also differences. Often there is an economic bubble at the beginning, the bursting of which leads to a stock market crash and to recession and/or unemployment. Experience shows that in crisis situations it is often not common sense that prevails, but herd behavior, irrationality or even panic. Within the framework of behavioral finance, attempts have been made to integrate psychological aspects in investment behavior more strongly into the economic perspective.

2. Financial crises in recent years

To better understand what happens during financial crises, it is worthwhile to study the main economic crises in recent history.

2.1 The Great Depression of 1929

A prime example of capitalist financial and economic crises is the Great Depression of 1929. After World War I, the U.S. quickly recovered from the consequences of the war and the country became the leading economic power. Euphoria and the belief in unlimited prosperity led to an economic boom in the USA. Between 1921 and 1928, industrial production in the U.S. grew by 4% annually. From 1928 to 1929, the increase was as high as 15% (Bloss et al. 2009:30). As a result of industrial mass production, new manufacturing companies and industries emerged. Due to serial production and rationalized production processes, corporate profits increased enormously. More and more people benefited from industrially manufactured products. From 1926 to 1929, the Dow Jones Index recorded price gains of over 100% (Bloss et al. 2009:30).

Due to rising prosperity and growing optimism, stocks found increasing interest. Hoping for high price gains, investors borrowed and purchased stocks. To a large extent, only 20% of stock purchases were covered by own funds. Loans were granted without collateral, and investors wanted to repay them from the price gains they thought were secure. In the process, interest rates rose ever more sharply.

To put an end to the speculative transactions, interest rates would have had to rise, and by a considerable amount. But the Fed was afraid that this would stifle the economy. Therefore, banks cut off credit for long- and medium-term stock speculation, but extended short-term credit. Therefore, interest rates on short-term loans rose rapidly (Bloss et al. 2009:31). The high demand for money and rising interest rates resulted in a deflationary effect. Liquidity shortages occurred and the M2 money supply (see ► Unit V 7: "Theories of Money") declined.

In the summer of 1929, the U.S. economy fell into recession. Steel production fell from June 1929, and railroad freight fell sharply in October 1929 (Galbraith 2005:105). Housing construction-although a very vibrant industry-had been declining for several years. And finally, the stock market turned around. However, the decline in business activity in the economy was relatively moderate. According to Galbraith (2005:107), until the market collapsed, "it was reasonable to assume that the downturn would soon end and the market would turn again. Examples of such developments include 1927 and later the events of 1949" (Galbraith 2005:107).

As a result of the decline in demand in the real economy and falling corporate profits, investors were unsettled. Individual investors began to sell, and others followed. By the end of 1929, there was panicked mass selling of stocks, and the Dow Jones Index and the credit-financed system collapsed. Galbraith (2005:130) commented, "In the first week, only the naive and the innocent fell victim to the crash. Then, in the second week, it was the smart and the wealthy who went down in the maelstrom. This collapse, in terms of its size and its terrible effects, can be compared to the social landslide that Lenin had unleashed a decade earlier. The size of the blocks of shares on offer showed that the big speculators were now selling, or rather had to sell. The stock markets were now almost empty" (Galbraith 2005:130).

But what happened next?

Europe's central banks pursued a high interest rate policy to safeguard the gold standard. This increased liquidity pressures. As a result, banks around the world collapsed because banks could no longer obtain credit that was essential for survival. Between December 1929 and December 1933, the number of banks in the U.S. alone fell from 24,633 to 15,015 (Bloss et al. 2009:33).

The restrictive money supply and interest rate policies also led to a tightening of the M2 money supply in the U.S., which declined by about 20% from 1929 to 1932.

In the years that followed, the central banks and in particular the U.S. Federal Reserve (FED) tried to counteract the lack of liquidity in the market by lowering the discount rate. From today's perspective, it can be said that at the time, money supply and interest rate policies were too restrictive for a long time to counteract such a major crisis (Bloss at al. 2009:32).

As a result of the enormous economic boom in the 1920s, much foreign capital was invested in the United States. Thus, the backing of currencies with gold reserves and fixed exchange rates led to the U.S. accumulating a large part of the world's monetary gold reserves due to its high payment surpluses (cf. Bloss et al. 2009:34): "In order to protect gold reserves in Europe, the countries concerned sold their domestic assets and raised interest rates." In 1920, the Fed - that is, the U.S. Federal Reserve - held 40% of the world's gold reserves (cf. Engdhal 2009:105): "The Fed had accumulated this amount of gold because it could pay the world's highest price for monetary gold at a time when England and continental Europe were paying America large war reparations and had to settle war debts" (Engdahl 2009:105). As a result, liquidity constraints continued to increase. The withdrawal of American loans also pulled the European banking system, which was heavily leveraged, into the crisis vortex. As a result of the financial world, which was already highly interconnected at that time, the American economic crisis expanded into a global economic crisis. Worldwide, the stock indices of industrialized nations - including Germany - fell by more than a third (Bloss et al. 2009:34). As a result of a concatenation of circumstances, a Great Depression occurred, and not just a stock market collapse or recession for commodity producers: "The desperate situation of commodity producers, together with Germany's problems caused by reparations burdens, triggered a domino effect" (James 2005:59). Between the spring and summer of 1931, three Central European crises converged: First, the Austrian banking crisis, which developed into a currency and budget crisis; second, the Hungarian budget crisis, which resulted in a run on the foreign exchange market and grew into a banking crisis; and third, the budget and banking crisis in Germany, which in turn triggered a currency crisis. Europe thus experienced a "triple crisis" (James 2005:90).

This development made it more difficult to grant corporate loans. Declining demand, credit rating losses and the insolvency of a growing number of companies further exacerbated the crisis. In Europe in particular, the economic downturn worsened. In addition, deflation made it more difficult to borrow because everyone hoarded their cash and was not interested in investing or issuing loans and bonds. In the U.S., between 1929 and 1934, the average cost of living decreased by 21%, and prices for retail and wholesale goods, agricultural products, and for energy fell. Prices for agricultural goods fell by 75% in the U.S. alone. Industrial production also fell between 1929 and 1932, for example by 44.7% in the U.S. and 40.7% in Germany (Bloss et al 2009:343). Mass unemployment occurred. In the Western industrialized countries, unemployment peaked in 1932. In the U.S., unemployment in industry rose to 36.8% and in Germany to 43.8% (Bloss et al. 2009:35).

The loss of wages further reduced the demand for consumer goods - and the result was further declining investment and corporate insolvencies.

Graphically, one could depict the development during the global economic crisis as follows:

- □ Overheating of the economy
↓
- □ Stock market crash
↓
- □ Liquidity squeeze
↓
- □ Economic collapse
↓
- □ Mass unemployment
↓
- □ Depression
↓
- □ .....

The economic crisis of 1929 to 1932 was reflected in a deep collapse of gross domestic product, by almost 40% in Germany and even more than 40% in Great Britain and France (1931 and 1932; cf. Bloss et al. 2009:37).

The economic collapse between 1929 and 1933 led to a significant decline in the volume of world trade. For example, imports of 72 countries decreased from a total of $3.0 billion to $0.9 billion between 1929 and 1933 (Bloss et al 2009:36). Export-oriented countries lost more than 2/3 of their revenues, and increasing protectionism further hindered world trade. Partly responsible for this serious development between 1929 and 1933 were, according to Bloss et al (2009:36), inadequate supervisory mechanisms at the national and international level, rigid monetary policy systems and short-term thinking by many investors.

During the Great Depression, a number of countries became insolvent, particularly in Latin America and Europe: Bolivia detached its currency from gold in 1930 and stopped servicing its debt in January 1931. Peru followed in March, Chile in July, Brazil and Colombia in October of the same year. "Then it was Europe's turn: foreign exchange controls in Austria, Hungary, and Germany in 1931, and the default of Hungary, Yugoslavia, and Greece in 1932 and Austria and Germany in 1933" (James 2005:82).

2.2 The Japan Crisis

In the 1980s, monetary policy measures by the Bank of Japan, among others, led to a strong economic upswing. The sharp drop in key interest rates between 1985 and 1988 benefited the export industry in particular, such as the electrical and automotive industries. There was also a parallel between low interest rates and the emergence of a stock and real estate bubble. To slow the overheated economy and reduce access to real estate loans, the Bank of Japan raised key interest rates from 2.5% to 6% between 1988 and 1990. But the first two rate hikes went virtually unnoticed by the market. Overheating increased. It was not until the third rate hike that a crash occurred, causing assets to lose massive value. In early 1991, the Bank of Japan lowered the key interest rate to avert the looming recession. But instead of the hoped-for stimulus, inflation fell. Businesses and households failed to gain confidence, and demand did not rise. From 1991 to 1995, the Bank of Japan lowered the discount rate from 6% to 0.5%, but real interest rates fell only from 2.9 to 1.2% during this period. Especially in the critical years from 1990 to 1992 - i.e. after the bursting of the asset bubble - the reductions in the key interest rate virtually fizzled out. Real interest rates remained virtually unchanged (Bloss et al 2009:39). As a result of the bursting of the asset bubble, financial institutions in particular recorded high losses. The strong presence of banks in the real estate sector and high loan write-offs led to liquidity shortages. Between 1985 and 1995, loan losses more than doubled, from 4,184 billion yen to 9,034 billion yen (Bloss et al. 2009:39). Accordingly, bank lending to businesses and households fell sharply. Rising deflation exacerbated the banks' earnings situation from 1990 onward. The situation was characterized by low economic growth, price declines and high real interest rates (i.e. nominal interest rates minus the inflation rate, see also ► Unit V 26: "The Interest Rate Problem"). Because real interest rates rose, banks were only able to charge low nominal interest rates for loans; at the same time, savings and cash investments generated significantly higher real interest rates. The differential business, i.e. the banks' spread between deposit and lending rates, was doing poorly and lowered banks' willingness to lend. It became more difficult for banks to borrow, which increased the lack of liquidity. The number of bankruptcies in the industry increased and the declining creditworthiness of companies and individuals seeking credit led to a drop in lending. As a result of the strong yen against the dollar, the export industry recorded falling profits, which led to declining creditworthiness vis-à-vis banks. The export price index, which includes all major export industries, declined by 20% from 1990 to 1995. After 1989, the liquidity of large enterprises collapsed drastically with the credit crunch, on the one hand because of the decreasing credit supply from banks, and on the other hand because of the massive increase in the cost of credit as a result of rising real interest rates. Large companies refrained from investing, which in turn affected small and medium-sized suppliers and households. Accordingly, the production index fell from 100.4 to 95.5 points between 1991 and 1995 (Bloss et al 2009:40). At the same time, deflation increased the real debt burden of companies that had borrowed recklessly during the boom phase. The balance sheets of many companies deteriorated massively and corporate collapses occurred, especially among large credit-financed companies. Small and medium-sized companies, which were heavily leveraged, lost some of their collateral and thus access to bank loans due to the devaluation of real estate as a result of the crash. The number of bankruptcies increased by 59% in 1991 compared with the previous year. From 1989 to 1992, the number of insolvent companies with capital of less than 1 million yen increased from 5102 to 11064 (Bloss et al. 2009:40).

Household debt, which by 1990 had risen to consumer debts of up to 130% of GDP at times, also proved catastrophic during the period of deflation. The high consumer credit debts were mainly due to the use of credit cards. The resulting need for private individuals to reduce their debts dampened households' propensity to consume during the crisis, which further exacerbated the deflationary situation. The household savings rate actually rose from 32.2% to 34.5% in the years from 1985 to 1991 (Bloss et al 2009:41). However, the savings rate subsequently declined massively. While in 1999 the savings rate was still 11% of disposable income, in 2010 the savings rate was just 3% (Neue Zürcher Zeitung, March 15, 2010). This is all the more serious because Japanese government bonds are largely held by Japanese creditors - not least for this reason, Japan's debt was for many years considered to be an isolated problem limited to Japan. But in view of the fact that Japan will have to refinance 213 trillion yen (= 2.48 trillion Swiss francs) in 2010 alone, the future prospects appear anything but rosy. This is why the Neue Zürcher Zeitung headlined on March 15, 2010: "Japan is in danger of running out of investors".

According to Bloss et al. (2009:37), the course of the Japan crisis can be depicted as follows:

□ Asset bubble
↓
□ Stock market crash
↓
□ Liquidity squeeze
↓
□ Economic collapse
↓
□ Household over-indebtedness
↓
□ Creeping depression
↓
□ .....

What can we conclude from this? In Japan, banks partially lost their financing function for industry and households during the crisis. Investment and consumption failed to materialize. An important factor was the lack of confidence among banks, companies and private individuals: "The lack of investment and private consumption, i.e. the lack of demand, can therefore be seen as the cause of the crisis in the real economy. However, a lack of supply-side reforms and the deflationary spiral also contributed in turn" (Bloss et al. 2009:41/42).

2.3 Conclusions

As studies have shown - see Roger M. Kunz in the Neue Zürcher Zeitung of 2.2.2010 - stock market crashes are not that rare. On average, a financial bubble bursts every 10 years.

After the crisis of the 1930s, when the Dow Jones Index lost almost 90% of its value in just under three years, it took a full 25 years to reach the peak of 1929 again. After the 1973/74 recession, it took 10 years to regain the pre-crisis stock index.

According to Schumpeter, it is possible that during upswings, expectations cause the prices of stocks and other real economic assets such as real estate to become detached from actual economic developments. A speculative wave develops: "In this secondary wave ... speculative anticipation finally gains significance of its own, the symptom of prosperity finally becomes itself a factor of prosperity again in the familiar way" (quoted from Bloss et al. 2009:62). Bloss et al. (2009:62) conclude: "The result is bubbles driven by irrationality, which attract more investors the larger the dimension. The boom in the real capital goods sector is followed by asset exuberances driven by irrational exuberance. Rising wages and speculative profits trigger a wave of consumption and, finally, consumer prices rise."

Within the framework of behavioral finance (cf. Bloss et al. 2009:73ff), attempts were made to integrate psychological aspects of investment behavior more strongly into the economic perspective. The previous paradigm of a rationally acting "homo economicus" was thereby increasingly questioned. Sewell (quoted from Bloss 2009:73) defined the new approach as follows: "Behavioral finance is the study of the influence of psychology on the behavior of financial practitioners and the subsequent effect on markets." Some of the psychological aspects of investor behavior studied in behavioral finance were:

- **The anchor and reference value problem**: Investors choose a reference point - for example, the purchase price - when buying a stock and measure profit or loss against it. Over time, highs or lows are seen as the new reference point.
- **Herd behavior**: When external factors lead individual investors to act in a certain way, a large number of other investors may subsequently behave in the same way, reinforcing price trends upward - investment euphoria and financial bubbles - or downward - to the point of panic selling.
- **Asymmetric and imperfect information**: It has been observed that many investors tend not to get their information from effective and in-depth data - for example, about the business performance of a company - but they go by the much more easily perceived price developments. "So if no one, even top managers, relies on their own

information anymore, but only on price developments, it happens that more weight is given to the price than to their own information, Thus prices are no longer informative, move away from their real value, and a bubble can develop. Over time, investors realize that they have followed the uninformative price and exit, and thus the price bubble bursts" (Bloss et al. 2009:82).

3. Control Questions

1. Outline the course of the economic crisis of 1929 - 1932.
2. Sketch the Japan crisis of the 1980s and 1990s.
3. What is the purpose of the behavioral finance approach?
4. What four aspects of behavior have been studied in behavioral finance?

4. Links

Börsencrash im Oktober 1929
http://www.bwinvestment.de/crash.html

Börsencrashs: Auf der Suche nach der Blase
Text von Patrick Bernau.
http://www.faz.net/aktuell/wirtschaft/wirtschaftswissen/boersencrashs-auf-der-suche-nach-der-blase-1908375.html

Börsencrash 1929 und Beginn der Wirtschaftskrise aus sozialistischer Sicht
http://www.sozialismus.info/2009/10/10089/

Börsencrashs in den "USA" 1873, 1882, 1893 - chancenlose Indianer gegen weisse Spekulanten
http://www.med-etc.com/soz/buch-hoelle/02_spekulieren-boerse-indianer.htm#3

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