CIGLOB
CENTRO INTERNACIONAL DE
GLOBALIZACIÓN Y DESARROLLO
International Center for Globalization and Development

Documento de Trabajo
Working Paper
N°18

Capitalism and Financial Crises

Andrés Solimano

Diciembre 2013

www.ciglob.org
Contact us / Contáctenos:
contact@ciglob.org
Santiago – Chile

Chapter 13, in Damill, M., M. Rapetti and G. Rozenwurcel *Macroeconomics and Development, Roberto Frenkel and the Economics of Latin America*, Columbia University Press, New York, 2016.

Capitalism and Financial Crises in Long Run Perspective

Andrés Solimano[1]

International Center for Globalization and Development, CIGLOB

Early version: December 6, 2013

Final Version: 2016

[1] Comments by Martin Rapetti, Ramiro Albrieu, Mario Damil and Guillermo Rozenwurcel to an earlier draft are appreciated.

1. Introduction.

Capitalism has a considerable capacity to create material wealth and spur technical innovations but this process is often far from smooth. In fact, the history and present of capitalism shows that wealth creation often comes along with inequality, booms and recessions and recurrent financial crises.

Con formato: Justificado

Financial crises, a theme of great interest to Roberto Frenkel throughout his professional life, are costly in several respects.[2] They stop the normal flow of credit, (the lifeblood of any economic system) and deepen recessions, creating unemployment, reducing real wages and leading to wealth destruction. Economic and financial crisis were behind the rise of nationalism and xenophobia in Europe in the 1920s and 1930s and also accompanied the turn to authoritarianism in Latin America in the 1970s and 1980s. Today, in crisis-ridden Europe, we see, again, the emergence of xenophobic

[2] See for example Frenkel and Rapetti (2009).

parties trying to mobilize in their favor the social discontent and frustration associated with high unemployment and diminished expectations.

The Great Financial Crisis of 2008-2009 in the USA and Europe has challenged the view the world is divided between a financially stable core (the mature capitalist economies of North America and Europe) and a chronically unstable periphery (developing countries in Latin America, Africa and Asia).

This time the crisis also hit the core and its closer periphery formed by countries such as Iceland, Ireland, Portugal, Greece, Spain and Italy while developing countries have continued to growth at respectable rates after 2008.

The current spate of financial crises in advanced capitalist countries is, in a sense, also a crisis of economic theory build around the assumption of the "rational economic man" of neoclassic theory. A variety of free market theories such as the efficient financial market hypothesis (EMH), monetarism, supply side economics and real business cycle have been very influential in shaping the views and polices of Central Banks and Finance Ministers since the 1970s and 1980s with generally deleterious effects on the economy and society.

Economic and financial crises come in various shapes but all involve a disruption of the "normal" working of an economy. A number of crisis-type can be identified, such as: (a) a crisis of "overproduction" involving unused productive capacity and unemployment of labor, (b) inflationary crisis accompanied by high fiscal and balance of payments deficits and massive exchange rate depreciation, (c) crisis

with an important financial component involving the illiquidity or insolvency of banks, a debt crises, "sudden stops" in the inflows of external financing and defaults and the rescheduling of outstanding public and private debt.

This paper is organized in four sections included this Introduction. Section 2 takes a look at several episodes of economic and financial crises throughout history in the 19th, 20th and early 21st centuries; Section 3 interprets the historical perspective on crisis regarding links between macro conditions and financial instability, the nature of the social contract and various regularities about the causal factors of different crisis and the role of debt in making them more protracted. Section 4 examines the current (mis) direction of mainstream economic analysis and points to the flaws of the IMF and Central Banks in the run –up to the 2008-09 crises along with the pitfalls of austerity. Section 5 concludes.

2. Economic and Financial Crises from the 19th to the 21st Century: A Brief Overview.

The historical evidence shows that the incidence of financial crises was higher in the eras of *unregulated capitalism*: the long 19th century up to 1913 (regime of *liberal* capitalism) and the second wave of globalization in place since the 1970 and 1980s, this could be considered as a regime of *neoliberal* capitalism. In contrast, the frequency of financial crisis with international contagion effects was severely reduced or disappeared during the period of regulated capitalism of the Bretton Woods period (1944-1971). This regime of regulated capitalism constrained private capital movements at international levels and promoted national policies oriented to

guarantee full employment and economic security and universal access to education, health, housing and pensions through the welfare state in advanced capitalist economies.

In contrast, neoliberal capitalism has promoted the relocation of production towards low-wage countries, the privatization of state owned enterprises, banks and social services and the expansion of global financial markets. As a result of these policies, income and wealth has concentrated in the hands of global and national economic elites, to unprecedented levels (Solimano, 2014).

The first wave of globalization (c.1870-1913)

The British Empire, the hegemonic power of the long 19th century, fostered free trade and free capital mobility under its own rules. London was the financial center of the world and the British pound (sterling) the dominant currency under the international gold standard. Economic historians have called the period running from c.1870 to 1913 the "first wave of globalization". This period was also of large flows of international migration between Europe and the New World in a migration regime of virtually no passports and visas --the "age of mass migration" -- (Hatton and Williamson, 1998 and Solimano, 2010).

The first wave of globalization, helped by the gold standard, was an age of low inflation in the price of goods and services: nevertheless, this was a period also of speculative bubbles in asset prices and financial crashes. In fact, banking crises and debt crisis were pervasive both in the center of the world economy and in countries of Latin America, Asia, British off-shores, Russia and others (periphery). In most cases the crises were followed by a contraction

in economic activity, unemployment and bankruptcies of firms and banks. Noted episodes included the debt crisis that took place after the French-Prussian war, the Long Recession of 1873-1896, the Baring crisis of the 1890s and the panic of 1907. Earlier crises in the 19th century were the 1825–26 crises in London and the crises of 1837 and 1857 in the United States.[3]

The Inter-War Years

The sophisticated and financially interconnected world preceding 1914 came to an abrupt and tragic end with World War I. The war interrupted the process of economic integration of labor and financial markets across countries (with its benefits and costs) that characterized the first wave of globalization. After the war, the main European empires collapsed: the Romanov dynasty following the Russian revolution of 1917, the Ottoman Empire and the Austro-Hungarian Empire of the Habsburg monarchy and the Kaiser in Germany (Solimano, 1991 and 2010).

The 1920s and 1930s were very unstable decades. This was a period of de-globalization, high inflation, and exchange rate volatility, disintegration of capital markets, financial crisis, depression and political turbulence. In the early 1920s the monetization of big fiscal deficits in Austria, Hungary, Germany and Poland led to high and explosive inflation along with massive depreciations of the domestic currency. Recomposing a stable economic and geo-political equilibrium proved to be exceedingly complicated.

[3] There is a vast literature on this period, references are Musson (1959), Marichal (1989), Bordo and Mesisner (2005), Brunner and Carr (2007), Reinhart and Rogoff (2009), Walton Newbold, J.T. (1932) and Solimano (2014).

War reparations, imposed against Germany by the Treaty of Versailles and denounced in 1919 by John Maynard Keynes in his book *The Economic Consequences of Peace,* severely injured the Weimar Republic and paved the way for the rise of Nazism to power through manipulating national resentment and feelings of defeat. In most European countries workers movements engaged in distributive conflict with rich economic elites that did not want to lose their economic privileges. In this socio-economic and international context the margin for adopting coherent macro policies was rapidly eroding. The restoration of the economic order of the *belle époque* (period before 1914) was virtually impossible after major shocks like the stock market crash of 1929, the Great Depression and the massive bank failures of the early 1930s .

The Bretton Woods System of 1945–1971/73

After World War II new institutions were needed at domestic and international level for avoiding further self-destruction of capitalism and to support economic reconstruction in Europe and decolonization and development in the periphery of the world economy. For that purpose, the British and the Americans agreed to the creation of the United Nations oriented to preserve international peace and the Bretton Woods Institutions formed by the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (the World Bank) to ensure global economic stability and development. The IMF received the mandate of providing financing and policy assistance for an orderly resolution of balance of payments imbalances of deficit and surplus countries. In turn, the World Bank was to support capital formation (initially) in Europe and in developing countries. Both institutions

were located in Washington DC close to the US Treasury Department.

At domestic level, the emerging system of regulated capitalism in America and Europa rested on four main pillars: (a) active macroeconomic policies oriented to dampen the business cycle and ensure full employment; (b) the welfare state (less so in America) aimed to provide universal social protection and access to education, health, housing and pensions to the majority of the population, (c) controlled private capital markets at national and international levels under a system of fixed exchange rates and (d) a reasonable balance of power between organizations representing the interests of capital and labor unions.

The period 1950-1973 was of steady growth, moderate inflation and came along with a low frequency of financial crisis, high employment, economic security and reasonable social peace. This era has been called the "golden age of capitalism" or "age of shared prosperity".

Neoliberal Globalization.

In the late 1960s and early 1970s the Post World War II consensus of full employment, control of capital flows, the welfare state and balanced relations between capital and labor started to show signs of exhaustion. Keynesianism was on retreat and monetarism and neoliberalism on the rise. Milton Friedman and Friedrich Hayek convinced, through their writings and/or personally, some key political leaders such as Thatcher, Reagan and Pinochet, that the way to progress was based on free markets, deregulation, privatization and international integration. In the USA and the UK,

"shared prosperity" between capital and labor had to be sacrificed for the needs of neoliberalism. To enable this, the power and the influence of labor unions had to be abridged and capital strengthened. In the case of Pinochet, democracy was sacrificed in the name of the free market and also to repress social movements and left-wing parties.

In the 1970s major changes took place in the international monetary system. A key turning point in the shift from a world of fixed exchange rates to a system of flexible exchange rate among main currencies was the abandonment of the free convertibility of the U.S. dollar to gold in 1971. The exit from the "dollar window" was not smooth and the two oil shocks of 1973 and 1979 further complicated the transition to an orderly system of flexible exchange rates.

The world economy became much more open to capital movement and trade than in any previous decade since the *belle époque*. Global capital markets expended further with the reduction of capital controls and very importantly, with the collapse of communism in the late 1980s and early 1990s and the active promotion of free-market economics by the United States government, the World Bank, the IMF and mainstream academia.

A distinctive feature of the second wave of globalization has been the high frequency of financial crisis involving debt defaults and debt rescheduling. This was a period of a number of financial and political crises around the globe: the debt crisis of Latin America in the 1980s, affecting Mexico, Brazil, Chile, Argentina, Peru and other countries of the region; the debt problems of the Philippines and

Turkey in the 1980s. At the same time, financial problems were also present in advanced capitalist countries: in the United States there were some 1400 savings and loan institutions and 1300 commercial banks failures between 1984 and 1991 (Reinhart and Rogoff, 2009). In October of 1987 a main decline in the US stock exchange market resembled the crash of October of 1929 and in the Far East, significant banking problems emerged in Japan in 1989-90.

Europe was not shielded from instability either. Scandinavian countries, in the early 1990s, had problems in their banks and the Exchange Rate Mechanism suffered severe strain in 1992–93 when the Bank of England had to let the sterling to depreciate in face of insurmountable speculation against the currency, a move that affected also the Italian lira, the French franc and other European currencies.

In Mexico, a currency crisis erupted before the presidential election of 1994 that was contained through a mega-loan (by the standards of the time) of U$ 50 billion provided by the US government. [4] In 1997 the virus of crisis also reached Korea, Thailand, Indonesia and other countries of the region that suffered currency crisis, financial turbulence and recession in what was known as the East Asian financial crisis. In turn, post-soviet Russia underwent a sharp depreciation of the ruble and a banking crisis in 1998. In the same year, in the USA the Long-Term Capital Management Fund (LTCMF), that had some Nobel Prizes in Finance in their advisory staff, failed.

[4] The exchange rate and financial crises in Mexico was accompanied also by political instability. Early in 1994 there was the Zapatista uprising in the south of the country and in March of that year Luis Donaldo Colosio the Presidential candidate of the PRI, *Partido Revolucionario Institucional*, was assassinated in unclear circumstances.

In Ecuador, a full blown banking and currency crisis developed in 1999 that led, in early 2000, to the replacement of the national currency, the Sucre, by the US dollar as the legal tender in a bold move aimed to arrest explosive monetary instability in this country.[5] Argentina, in 2001-2002, was affected by severe financial and macroeconomic crises when the country abandoned a ten-year-old currency board that had established a one to one parity between the Argentinean peso and the US dollar. To cope with the crisis, the government expropriated deposits in failed banks—an action called the "*corralito*". Another serious macro-financial crisis erupted in Turkey in 2000-2001 accompanied by large fiscal deficits, a fragile banking system, high inflation and unstable exchange rates (Yeldan, 2002).

In the mid to late 1990s the US economy experienced a rapid increase in the share price of technology firms -- the "dot-com bubble" –that eventually prickled in 2000. To jump-start the economy, the Federal Reserve lowered interest rates contributing to create a new price bubble, this time in the real estate market.

The continued expansion of complex financial instruments (derivatives, Debt Equity Swaps, Collateralized Debt Obligations) littered with toxic assets the portfolios of banks and other financial intermediaries and complicated further the management of the crisis of 2008-2009 in what turned –out to be the worst financial crisis since the early 1930s. The US crisis had serious reverberations in Europe that has suffered severe stagnation and economic

[5] The economic crisis had political reverberations and constitutionally elected President Jamil Mahuad that announced official dollarization was toppled in January 2000, by a conspiracy of army generals helped by a radicalized indigenous movement, see Beckerman and Solimano, (2000).

contraction in the countries most affected by the crisis for half a decade. Average unemployment rates have been over 25 percent of the labor force in Spain and Greece, while youth unemployment climbed over 55 percent in the two countries.

3. Interpreting the Experience with Financial Crisis.

From a historical perspective, the series of financial crisis of the last quarter century resembled both the crises episodes of the first wave of globalization (c. 1870 to 1914) and the financial turbulence of the late 1920s and early 1930s.

It is interesting to notice that the two spells of globalization of the late 19th/early 20th century and late 20th/early 21st century displayed apparently stable macroeconomic conditions of low inflation and steady growth. However, these macroeconomic outcomes were not sufficient to guarantee *financial* stability in the two eras of globalization.

Complacency with tranquil macroeconomic conditions and neglect of incubating financial crises was behind the crash of 2008-09. Advanced capitalist countries largely underestimated the possibility of financial crises so frequent in developing countries and emerging economies. The prevailing view among Central Bankers, Ministries of Finance and mainstream macroeconomists was that the global economy was enjoying a "*Great Moderation*". Many papers were written in the 1990s and 2000s claiming that we were living in a new state of macroeconomic stability thanks to the wisdom and prudence of Central Banks and Finance Ministers. Reality showed, however, the mystifying nature of those claims.

As mentioned before, the instability of the 1920s and 1930s is also relevant for understanding the recent spate of crisis. The unchecked financial speculation of the second half of the 1920s preceded the wave of bank failures of the early 1930s; likewise, the financial speculation of the early to mid-2000s preceded the financial crash of 2008-09. In turn, wild trajectories in asset prices were present both in the roaring 1920s and in the many crisis of the 1990s and 2000s.

Financial crises develop under a certain socio-politic context. The social contract of the pre 1914 period was dominated by capital (an alliance of big banks and big corporations, so vividly described, in the early 20th century, by authors such as Hobson, 1902 and Hilferding, 1910). In contrast, labor unions were relatively weak and social legislation light. Nearly a century later, in the neoliberal era of the late 20th century the social contract is also strongly biased in favor of capital, particularly *financial capital* that dominates over the interests of industry, workers and the middle class.

In the 1970s, conservatives blamed, mainly in the UK and the USA, strong labor unions and accommodative macro policies for their state of stagflation and relative economic decay. In contrast, in the 2000s the problem was that capital was too strong. After two decades of deregulation, privatization and financialization that led to high profits to capital-owners and financial speculators, the deregulation frenzy proved to be highly destabilizing for the economy and society as a whole.

In the 1920s and 1930s achieving a stable socio-economic equilibrium proved to be very difficult. Labor unions and

communist parties' embattled fascism and Nazism in Europe and the scope for social consensus and sensible economic policies in that period was difficult. In the 2010s, again, the rise of extremist right-wing political parties shows that severe economic crisis, high unemployment and economic insecurity can engender intolerant and aggressive social responses against immigrants and the integrationist framework of the European Union.

Regularities in Financial Crisis

The varieties of financial crises we have reviewed here provide a very rich material to study the factors that cause financial crisis and possible cures to them. Somme common patterns and regularities can be highlighted:

(a) Crises need to be viewed in historical and systemic terms. They are manifestations of some fundamental malfunctioning of the economic system and, indirectly, of the institutional and political framework surrounding it. The historical record shows those crises are more common in periods of integrated capital markets, high corporate power and weak regulation of financial markets.

(b) There is a wide variety of "igniting factor(s)"of financial crisis such as new innovations, railway development and urbanization, the end of war, and the discovery of valuable natural resources (19th century and early 20th century). In the neoliberal era (late 20th century and early 21st century) relevant igniting factors include financial liberalization, privatization and information technology breakthroughs.

(c) Financial crisis can occur under a broad variety of monetary and exchange rate regimes. The financial crises of the first wave of globalization developed under the gold standard and the financial crises in the second wave of globalization developed under flexible exchange rates in a fiat money system and under a monetary union (the Euro area). In emerging economies and developing countries financial crisis have taken place under fixed exchange rates, currency boards and adjustable pegs. Moreover, several episodes of financial crises occurred under situations of large fiscal imbalances while others crises were originated by imbalances in the private sector rather than in the public sector.

(d) Economic cycles tend to be amplified when accompanied by unsustainable increases in credit and debt, making the burst after a boom more severe and the recovery more protracted. Irving Fisher underscored this point in a classic article entitled "The Debt-Deflation Theory Great Depressions" published in *Econometrica* 1933. [6]

(e) Central Banks and regulators have often a hard time in detecting a bubble in asset prices and acting accordingly. However, this policy stance of refraining to intervene during the development of a price bubble can prolong an unsustainable cycle and make it more difficult to recover from it.

(f) The political economy of financial crisis suggests that in elite-dominated capitalism cozy relations often develop between politicians, public policy officials and bankers and the interests of

[6] For recet treatments of the role of debt in economic cycles, see Reinhert, 2012.

financial elites can receive overdue importance against the interest of depositors, savers and the population at large that suffer most of the costs of financial crisis. In the booming phase of the cycle financial elites push for deregulation and in the crash phase they ask for generous rescue packages.

(g)Debt defaults and forced rescheduling through history have been common features in the aftermath of financial crashes. They are often adopted after government's attempts to generate resource surpluses to serve external debts at high social cost in terms of growth and employment losses and cuts in real wages and social benefits.

4. The Disturbing State of Economic Science

Economic and financial crisis pose important challenges for Neoclassic Economic theory. In this paradigm, the economy is viewed as a set of interlocking markets with effective mechanisms – prices-- for correcting disequilibria. The underlying assumption is that individuals are "rational" and have a significant capacity to weigh the benefits and costs of their decisions. The world is seen as the arena of optimal choices, rational expectations, and efficient financial markets. In contrast, crises show, now and then, the destructive forces of myopia, short horizons, manias, manipulative behavior and other patterns of irrational human behavior that startlingly departs from the idealization of self-correcting markets of mainstream textbooks of economics.

In recent decades, economists have become very influential in policy formulation albeit the economic record of their advice in terms of growth, equality and financial stability is far from

encouraging in several parts of the world. Economics has become a field increasingly detached from reality; a dry subject obsessed with "formalization": say the use of mathematic formula and models to understand complex social phenomena. Formal models are prized over realism, relevance and common sense. In a sign of the times, teaching and research in economics has sharply departed from the old classic traditions of situating economic analysis in its proper historical, institutional and political context. De-contextualization may lead to serious mistakes in policy-making and induce researchers to spend their time and talent into issues of lesser interest and relevance.

The public discourse of economists rationalizing individualism, greed and promoting narrow concepts of rationality seem very odd to common people. Unfortunately this is the standard training economists have been receiving in the last thirty years or so from Economics Departments at US universities, a tendency that has grown rapidly in Europe, the OECD and a score of developing countries.

An example in this line is that, in spite of the ample historical and current evidence of irrationality in the behavior of financial markets and the devastating effects of financial crises, economists and financial theorists since the 1970s have looked for ways to demonstrate that financial markets are, essentially, efficient mechanisms for allocating savings to productive uses and effective tools for properly pricing risk.[7] [8]

---

[7] The efficient markets hypothesis became the theoretical justification for the deregulation and development of national and global capital markets in the 1970s and 1980s. It posits that in buying and selling assets, investors and market participants use all relevant information --the random

The quest for demonstrating the inherent rationality of financial markets represented a strong departure from the views and writings of John Maynard Keynes, who was, himself, both a successful participant in the stock market and a privileged witness and actor of the volatile and crisis-prone decades of the 1920s and 1930s. Those experiences in the real world strongly shaped his views and led him to stress the role of "animal spirits" and volatile expectations in economic processes rather than optimal pecuniary calculation. Keynes recommended *not* entrusting financial markets with the delicate task of guiding inter-temporal resource allocation in the economy.

The IMF

Key actors in the financial drama of recent years were the IMF and Central Banks. The failure of the IMF to anticipate the financial crisis of 2008-09 and enforce its surveillance mandate on large member countries running sizeable fiscal imbalances and bank excessive leverage (like the USA and the UK) point to a discouraging role of the Fund in the run-up to the crisis. In particular, the IMF refrained from explicitly warning, clear and loud, that a financial crisis was a real possibility in those economies. In addition, its role in imposing very costly austerity programs to medium-size economies such as Greece, Spain, Portugal and Ireland has affected

---

walk hypothesis for asset prices-- in making their financial decisions: in that sense these decisions are "rational".[7] The theory could be somewhat relevant for the decision problem of an individual investor but applying it for inferring rational outcomes in *macro-markets* is bound to be a largely misguided claim; for expositions and evaluations of the EMH see Beechy, Gruen and Vickers (2000), Fama (1970s) and Samuelson (1965)

[8] Alan Greenspan, Chairman of the US Federal Reserve between 1987 and 2006, was a believer of efficient markets theory and proclaimed, before the 2008 crisis that financial markets have strong self-equilibrating mechanisms. The massive market failures evidenced since 2007-08 in advanced capitalist countries of North America and Europe have reduced the credibility of this theory.

further the credibility and public appreciation of the institution. The Fund, certainly, should revise its conceptual framework that underestimates the economy-wide risks of financial vulnerability, while focusing mostly on traditional macroeconomic aggregates. Besides, the Fund is (rightly) perceived as complacent with fiscal imbalances run in large countries but rough and uncompromising with small and medium size economies when they have to adopt adjustment programs.

In the meantime, some soul searching has started within the Research Department of the Fund on what may have gone wrong with the type of macroeconomics practiced at the IMF.[9]Furthermore, the IMF´s Internal Evaluation Office (IEO) that reports to the Board of Directors and not directly to management has acknowledged, in various reports, the lack of diversity in conceptual approaches at the IMF and a deeply ingrained in–house corporate culture largely unwilling to consider alternative approaches in macroeconomics.[10] The fact that unregulated market economies are prone to experience financial crises is rarely mentioned explicitly in Fund reports. These crises are considered more as *outside events* rather than endogenous outcomes of economies with large macro imbalances and insufficiently regulated financial systems.

Central Banks

[9] See for example Blanchard, Dell´Aria and Mauro (2010).

[10] The IEO has made the point that Fund´s research on macroeconomics and finance before the crisis of 2008-09 largely ignored the work of important scholars such as Hyman Minsky, on instability and fragility in financial markets (the author is rarely cited in Fund´s research and policy papers in the years before 2007-2008), see Solimano (2010a).

In recent years or decades, several Central Banks have adopted the view -- reflected in their formal chart of objectives --, that the control of inflation in the price of goods and services (but *not* inflation of asset prices) is their only mandate besides guaranteeing normal internal and external payments. Traditionally important targets such as contributing to full employment and real exchange rate stability have been either excluded from their list of mandates or considered as of second or third order of importance.

Policy formulation in Central Banks is increasingly informed by "stochastic dynamic general equilibrium (DSGE) models". This family of empirical macro models is based on the assumptions of optimizing and forward-looking agents, rational expectations, and market-clearing.[11] Common sense and economic realities would suggest that models resting on these premises will hardly be the most appropriate analytical and empirical tool for analyzing financial cycles of destabilization and crises and for proposing appropriate policies to restore stability and growth. The DSGE strategy of modeling and empirical calibration has serious drawbacks. First, it is apparent that these models may be more useful (if at all) for simulating *incremental* policy changes and *small shocks* than for exploring the causes and consequences of boom and bust cycles, recessions, and financial crises—which constitute large disturbances when the whole economy, or large markets, are out of equilibrium. Second, it is unclear how well these models deal with volatile expectations, herding effects, large departures of asset prices from fundamentals, and other disequilibrium paths. Third,

[11] In a concession to realism, these models incorporate in their practical applications, (light) Keynesian features such as price stickiness and nominal rigidities of wages and other "frictions".

an additional shortcoming of this family of models is its strong built-in tendency to *quickly restore equilibrium* in the wake of large shocks.

5. Concluding Remarks.

Financial crises need to be understood in a historical perspective and in systemic terms rather than as isolated episodes due to unchecked greed by economic agents or to massive mistakes of economic calculation by financial participants in the market, albeit these elements have been also present. Historically, financial crisis have been more frequent in periods of unregulated capitalism, both in its liberal and neoliberal varieties of the last two hundred years. In contrast, financial crisis with international propagation effects were virtually absent in the era of regulated capitalism (from the early 1950s to the early 1970s).

The notion that we were living in an era of "great moderation" was promoted by mainstream macroeconomists and policy officials of advanced economies in the 1990s and 2000s. However, the crisis of 2008-2009 showed that low inflation and relatively steady growth were not sufficient conditions to guarantee financial stability and ensure lasting prosperity, a situation also present in the first wave of globalization of the late 19th century. In turn, at the level of financial sector policy, the influence of the efficient market hypothesis was significant in the United States and the UK and other nations. In hindsight, it is clear that this doctrine encouraged complacency with financial market excesses such as high leverage, the proliferation of complex financial instruments and the growing

indebtedness of families, firms and government all factors that contributed to trigger the financial crisis.

The recent episodes with irrationalities and volatility of financial markets cast serious doubts on the validity and relevance of the efficient market hypothesis. A sensible macro-financial research agenda in the years ahead should focus on understanding better the role played by financial accelerators, changes in expectations, bounded rationality, and herd behavior in propagating financial shocks and then reverting to financial distress and recession. Also we need to know more about the behavior of hedge funds and derivatives and the nature of the political connections between large financial intermediaries and government.

The crisis also indicates the urgent need to revise the dominant ways of doing research, teaching and offering policy advice by economists. Policy makers are informed by a profession that holds an idealized view of markets, omniscient consumers and producers and stable expectations that bear little resemblance with the real world. No wonder serious policy mistakes are made and costly crisis erupt affecting the lives of millions of citizens.

This paper also highlights the serious conceptual and operational flaws of two key institutions in charge of monetary and financial stability such as the IMF and Central Banks and highlights the need for more democratic control of technocratic Central Banks and for curbing the power of the IMF in dictating the terms of austerity programs around the world.

Repeated bail-outs of commercial banks and large financial intermediaries have reduced the legitimacy of financial capitalism,

increasingly viewed as a system in which profits are privatized in booming years and losses are socialized during crisis. This illegitimacy crisis is also relevant to recent austerity programs in peripheral Europe, and, in the near, past in Latin America and other continents in which the cost of adjustment are mostly borne by workers, the middle class, public sector employees, the youth and the elderly, while shielding rich economic elites of the effects of austerity imposed by governments and international organizations representing the interests of rich creditors.

References.

Beckerman, P. and A. Solimano (2002) *Crisis and Dollarization in Ecuador*. Directions in Development. The World Bank, Washington DC.

Beechey, M., D. Gruen, and J. Vickrey (2000), "The Efficient Markets Hypothesis: A Survey." Reserve Bank of Australia.

Blanchard, O., G. Dell' Ariccia, and P. Mauro (2010), "Rethinking Macroeconomic Policy." *IMF Staff Position Note*. February, SPN/10/03.

Bordo, M. and C. Meissner (2005) "Financial Crises, 1880-1913: The Role of Foreign Currency Debt" *NBER Working Paper* 11173.

Brunner, R. F., and S.D. Carr (2007), *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*. Hoboken, NJ: John Wiley and Sons.

Fama, E. (1970), "Efficient Capital Markets: A Review of Theory and Empirical Work," *Journal of Finance* 25: 383–417. doi:10.2307/2325486.

Fisher, I. (1933), "The Debt-Deflation Theory of Great Depressions," *Econometrica* 1(4): 337-357.

Frenkel, R. and M.Rapetti (2009) "A developing country view of the current global crisis: what should not be forgotten and what should be done" Cambridge Journal of Economics 2009, 33, 685–702.

Hilferding, R. (1910), *Finance Capital: A Study of the Latest Phase of Capitalist Development*, Ed. Tom Bottomore, Routledge & Kegan Paul, London, 1981.

Hobson, J. A. (1902[2011]), *Imperialism: A Study*, Russell Press, London.

Marichal, C. (1989), *A Century of Debt Crises in Latin America. From Independence to the Great Depression, 1820–1930*. Princeton, NJ: Princeton University Press.

Walton Newbold, J.T. (1932) "The Beginnings of World Crisis, 1873-1896" *Economic History*, 2, # 7, January.

Musson, A.E. (1959) "The Great Depression in Britain, 1873-1896 " *Journal of Economic History* 19, # 2.

Musson, A.E. (1959), "The Great Depression in Britain, 1873–1896," *Journal of Economic History* 19 (2).

Reinhart, C., and K. Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press.

Reinert, E. S. (2012) "Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez and Minsky" Working Papers in Technology, Governance and Economic Dynamics, 39. The Other Cannon Foundation, Norway.

Samuelson, P. (1965), "Proof That Properly Anticipated Prices Fluctuate Randomly, *Industrial Management Review* 6: 41–49.

Solimano, A. (1991), "The Economies of Central and Eastern Europe: An Historical and International Perspective." In V. Corbo, F.

Coricelli, and J. Bossak, eds., *Reforming Central and Eastern European Economies. Initial Results and Challenges*. A World Bank Symposium. Washington, DC: World Bank.

------ (2010) *International Migration in an Age of Crises and Globalization.* Cambridge University Press, United Kingdom and the United States.

------ (2010a) “Financial IMF Research on Macro-Financial Linkages: Context, Relevance, and Diversity of Approaches” *Paper* prepared for the IEO-IMF.

----- (2012) *Chile and the Neoliberal Trap. The Post-Pinochet Era*. Cambridge University Press, United Kingdom and the United States.

----- (2014) *Elites, Crisis and Economic Democracy*, Oxford University Press, Forthcoming.

Yeldan,E. (2002) “Behind the 2000/2001 Turkish Crisis: Stability, Credibility, and Governance, for Whom? *Paper* Bilkent University,Department of Economics, Ankara. Turkey