# Some Theoretical Considerations about the Nature of the Present Crisis

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It is yet difficult to say that economic science has more or less clearly sorted out the current crisis. Too little time has passed to recapitulate or generalize. Still, both practitioners and theorists have already reacted to the crisis in some way or other.

For example, most of the developed countries have adopted government recovery programs, including nationalization of assets, unprecedented public support for the financial sector and real economy, reduced tax burdens and job creation while taking no heed of the fact that the 3% budget deficit ceiling has been topped three or four times over.

Alongside criticisms of the governments' earlier policies, it is argued that the economy has faced "market errors" rather than "government errors." In the current situation not all traditional instruments have behaved predictably: a drop in refinancing rates has failed to beef up activity, liquidity injections have failed to stabilize the stock market, and derivatives designed to control risk have in fact increased it.

I can see two fundamental reasons for that. First, the controversy produced by the objective trend toward corporate consolidation when the interests of top management do not fully fit with the interests of owners has increasingly come into play. As far as I can judge, few are attributing the current crisis to the different motivations of owners and managers. One reason is that key financial players, i.e. investment banks or rating agencies are least susceptible to divergent interests between management and shareholders because a lot of capital is in the hands of the "partners" who effectively manage the banks. Furthermore, economic theory seems to possess tools to analyze the behavior of management that has its own interests to follow. Such standard tools that theorists can employ include the principal-agent theory, moral hazard or adverse selection *(Akerlof (1970); Stiglitz (1987); Murtishaw, Sathaye (2006))*.

Still, it seems to me that these theories pay less attention than is due to the phenomenon of increased risk in the behavior of managers interested in increasing company returns. I would hypothesize that the enhanced role of managers with interests differing from owner interests causes management risks to grow and constitutes one of the fundamental reasons for the current crisis.

Few specialists have pointed out the fact that risks have increased in "management behavior": pledge issuers are not liable for default risk, banks try to circumvent equity adequacy requirements, and rating agencies refuse to assume responsibility to analyze source data. Another problem is that managers are paid bonuses for short-term transactions *(Crouhy, Jarrow, Turnbull (2008)).* These appear to be the only examples demonstrating the same logic as the argued importance of the increasing gap between owner and management interests.

One has to add the obvious failure of rating agencies which are delivering poor-quality information products resulting in wrong risk assessments for financial market players. There is a theory that describes product markets with information asymmetries (*Stiglitz, Weis (1981); Samuelson (1984); Bester (1984))* but it hardly pays any attention to the problem of "experts" who provide information to buyers of financial products. Rating agencies are exactly experts of this kind.

Secondly, bank lending is beginning to "work" as a generator of overproduction amidst increasing "management risks." Financial resources are easier to access and in an effort to generate more returns managers are prepared to take out higher-risk loans, which results in fictitious demand, encourages surplus supply and produces an equilibrium that is not backed by incomes, a "debt" equilibrium. It is impossible to set a reasonable debt limit. I think this is a new kind of "market error" which calls for some kind of government intervention. It is unlikely that the overproduction "market error" can be corrected simply by injecting liquidity.

The subprime mortgage crisis in United States, which in effect provoked the global downturn, can serve as an example. Some analysts claim that it was just a routine "overheating cycle" which has been observed in financial markets many times. Some economists even argue that structurally the current crisis is not different in principle from the 18 other crisis that industrialized nations have experienced in the postwar period. They say the only thing about the current crisis is its scale which is a function of the shock that the financial system has experienced, and of the effectiveness of government policies *(Reinhart, Rogoff (2008)).*

A number of economists conclude that the subprime crisis has a logic similar to the crisis the United States faced in the late 1980s and to the crisis that Asia faced in the 1990s but the financial innovations of last few years have clearly added to the gravity of the system failure. They point out a number of factors: (1) wrong assessment of the risks resulting from very low interest rates, great moderation and excessive support of the financial markets from the Federal Reserve, which led to a moral hazard; (2) numerous financial innovations exacerbating the problem, (3) wrong assessments by the rating agencies, and (4) liquidity shortfalls *(Goodhart (2008)).* In addition, weak monetary policies, excessive deregulation and all kinds of imbalances produced by the growth period and attended by "bubbles" are all structural factors contributing to the crisis *(Lim (2008))*.

Almost all experts note that the quality of market liabilities has dramatically dropped in recent years. Market growth in the real estate market, however, caused a "myopia" in many market players. As a result, most players overlooked the risks *(Demyanyuk, van Hemert (2007)).* I should underline that the key reason for subprime market expansion that triggered off the crisis was the excessive supply of financial instruments, not increased incomes of consumers or price growth expectations in the real estate market *(Mian, Sufi (2008))*. In other words, we are talking about an extremely costly "error." I should say that this conclusion fully agrees with the fundamental reason I mentioned earlier.

Other specialists come to the same conclusion as they talk of a combination of "excessive optimism of the players in assessing risks and of excessive liquidity and the appearance of a "financial bubble" *(Ryan (2008)).* What contributed to the crisis was the current system of system risk safeguards which largely focuses on the banking sector and overlooks the financial markets which are playing an increasingly more important role *(Schwarz (2008)).*

A widespread view is that the current crisis is the result of the evolution of subprime institutional regulation and wrong incentives appearing in the system *(Kregel (2008))*. A number of experts examining the question of whether asset securitization results in impaired quality of borrower analysis have answered it in the affirmative *(Keys, Mukherjee, Seru, Vig (2008)).*

I will repeat that too little has yet been done to study the crisis in terms of the inadequacy of general market theory. This could be the inertia of erstwhile views or maybe the time is not yet ripe. Only a few authors believe that the current crisis signals the "intellectual bankruptcy" of the theory of dynamic stochastic overall balance and that Keynesian economics (both its older and newer modifications) does not give an answer to the current problems *(Leijonhufvud (2008)).*

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The overall feeling is that the crisis has laid bare the differences that have built up over the years between mainstream views of the capitalist model (general market theory) and real economic life. So one should expect theoretical papers to be written shortly about ways to modernize the current model of capitalism. I think that the dominant thing about this modernization should be the government's enhanced role in the economy.

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