Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez, and Minsky

(Mekanisme Krisis Kewangan dalam Pertumbuhan dan Keruntuhan: Hammurabi, Schumpeter, Perez, and Minsky)

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ABSTRACT

This article provides a historical and theoretical overview of the mechanisms leading up to financial crises and financial bubbles. It suggests that the potentially explosive growth of the financial sector at the expense of the real economy fed by compound interest has – since before Ancient Mesopotamia under the rule of Hammurabi – represented a real threat for such crises. A more modern and additional factor that builds up crises is Joseph Schumpeter’s observation of the clustering of innovations. Carlota Perez has more recently developed Schumpeter’s vision into a theory of techno-economic paradigms which – about midway in their trajectory – produce a build-up to financial crises. The theories of Schumpeterian economist Hyman Minsky, which describe the mechanisms leading to the collapse of financial bubbles, complete the overview. The article ends with recommendations to bring the West out of the present crisis by – once again – putting the real economy, rather than the financial economy, in the driver’s seat of capitalism.

Keywords: Carlota Perez; financial crises; Hammurabi; Hyman Minsky; innovations; John Maynard Keynes; Joseph Schumpeter

INTRODUCTION

Financial crises occur when the relationship between the real economy (the total production of goods and services) and the financial economy (money in the widest sense) comes out of balance in such a way that the financial economy no longer primarily supports the real economy, but takes on an independent life of its own in such a way as to damage the real economy. Modern economics (neoclassical economics, standard textbook economics, mainstream economics) accepts such an imbalance between the real economy and the monetary sphere when it comes to inflation and deflation, but not when it comes to financial crises. This is in sharp contrast to other kinds of economics – the experienced-base type of economics referred to as ‘The Other Canon’ – that traditionally have understood and still understand crises, but have been marginalized.

Financial crises represent imbalances which – in contrast to inflation and deflation – are not immediately visible in the consumer price index as rising or falling prices, but rather in the form of asset inflation and debt...
deflation, which have very important impacts on income distribution. The assets, in which massive incomes from the financial sector are invested, will experience an asset inflation. On the other hand, the falling levels of prices and wages that result from the crises will result in debt deflation, a continually rising real quantity of outstanding debt.

The transfer of income and assets from the real economy to the financial economy is the most important long-run effect of a financial crisis. If these imbalances are not addressed by making big investments in the real economy, any recovery – in that case by definition weak – will be driven by demand from the financial sector and the losses in the real economy may be permanent. This is now occurring in the US and in Europe, where the EU’s ‘internal devaluations’ in the Baltic in some places have reduced real wages by up to 50 per cent, while at the same time unemployment is alarmingly high.

If the financial imbalances in the EU periphery had been addressed by a traditional formula of debt cancellation and devaluation – which was successfully done in Argentina about ten years ago – this would have penalized the financial economy, but in the long run supported the wage level. In the case of the Baltic countries, this would have meant letting the (mostly foreign) banks and the financial (real estate) side of the economy take the losses, while saving the production economy. Instead, Europe made the decision to ‘save’ the financial economy in the short run, which is likely to permanently destroy the wage level. This is why Martin Wolf of the Financial Times is of the opinion that a possible recovery will be a ‘yacht and mansion’ recovery. This article argues that the way the problems of the financial crisis are being solved – under the general heading of austerity – will lead to a permanent domination of the economy by the financial sector at the expense of the real economy, citing examples of similar developments in Latin America in the 1970s and in the former Soviet sphere in the 1990s.

FINANCIAL CRISES WERE UNDERSTOOD FROM LEFT TO RIGHT – BUT UNLEARNED ALL ALONG THE POLITICAL AXIS

The interesting thing is that once upon a time financial crises were a well known and well understood phenomenon along the whole political axis. Karl Marx wrote about them (volume 3 of Das Kapital), and Lenin said that control of the financial economy represented the last stage of capitalism. In the theories of the Austrian social democrat Rudolf Hilferding, financial crises were once a social democratic strongpoint. Joseph Alois Schumpeter and John Maynard Keynes – possibly the most important theoreticians on financial crises – were politically conservative, and the most important Norwegian representative, Torkel Aschehoug, was head of the conservative party. Even though the present loss in the real economy in favor of the financial sector ought to be extremely important for any government, it is still barely visible on the political agenda. Contemporary economics – compared to earlier times – has important blind spots regarding the role of the financial sector, and these blind spots also transfer to the perspective of politicians.

Earlier terminologies, which understood and described the mechanisms of crises, are now largely lacking. Lately, some economists, particularly in the US, have ‘rediscovered’ some of the old theories, such as Irving Fisher’s ‘debt deflation’. However, as this paper argues, many more basic mechanisms and insights should also be rediscovered.

To understand financial crises, terminology distinguishing between the financial economy (what Schumpeter called ‘die Rechenpfennige’, the ‘accounting units’) and the real economy (the production of goods and services, Schumpeter’s Güterwelt) is necessary (See Figure 1). The family tree of today’s mainstream economics, originating in the late 1700s with Quesnay and the Physiocrats, and continuing with the English economics of David Ricardo (1817), did not consider monetary or financial sectors and are therefore generally blind to financial crises, abstaining from studying the relationship between the financial sector and the real economy. In the alternative tradition, The Other Canon in my terminology, this difference has always been important. Starting with the Anti-Physiocrats, who tried to stop the free trade and resulting speculation leading up to the French Revolution, The Other Canon type of economics – where distinguishing between the financial economy and the real economy is a key feature – dominated after the 1848 revolutions. However, as this historical and fact-based economic theory virtually died out after World War II, with it the crisis theories also disappeared along the whole political axis. Under the assumption of perfect competition and in the absence of any conflicts between the financial sector and the real economy, neoclassical
economics models the market economy as a machine where friction is absent: a machine creating automatic harmony. The theories, handed down from Ricardo, do not contain the categories to make possible the understanding of crises. As Thomas Kuhn puts it: ‘A paradigm can, for that matter, even insulate the community from those socially important problems that are not reducible to the puzzle form, because they cannot be stated in terms of the conceptual and instrumental tools that the paradigm supplies’. This is precisely what happened to the neo-classical paradigm in economics.

THE HAMMURABI EFFECT AND ‘DEBT DEFLATION’

The simplest model for understanding imbalances between the real economy and the financial economy originated in Mesopotamia under Hammurabi (2030-1995 BC). Claiming that the roots of civilization were found here is indeed more than an empty phrase.

Hammurabi’s economists calculated that due to compound interest, the financial economy would increase far more than the real economy would be able to absorb. Following normal bookkeeping principles the assets of the financial economy would have their counterparts as liabilities, debt, in the real economy. English economist Richard Price (1769) expressed the force of compound interest, the force that accumulates assets in the financial sector and corresponding debt in the real economy, as follows:

A shilling invested at 6% interest at the birth of Christ would ... have increased to an amount (gold) larger than could be contained in the whole solar system, if this is constructed as a sphere with the diameter of Saturn’s bane around the sun.

As someone must obviously have invested 1 shilling at the time of the birth of Christ, this means that any system permitting compound interest must necessarily break down at intervals: the real economy would drown in debt and people would be reduced to debt peonage. Hammurabi and his advisors took the consequences of this, and with irregular intervals (If the time of debt cancellation was known beforehand, people would speculate in the expected event) cancelled all debt (except short run commercial debt) to avoid the death of the real economy due to ever increasing debt. In the Old Testament we still find references to this system. The years when debts were cancelled were referred to as the Jubilee Years.

Money and gold are conceptually different from the goods and services that can be acquired with the purchasing power they represent. History is filled with warnings against what has been called chrysohedonism, confusing money with what money can buy. The legend of King Midas relates how he was granted his wish that whatever he touched should be turned into gold, only later to discovered that this was a curse because even his food turned into gold. This is a brilliant example of the danger of confusing riches of money and gold with riches of ‘goods and services’. Without the Jubilee Years, the financial sector would end up as a King Midas, with loads of money and gold, but with a real economy extremely weakened – or dead – because of the burden of debt. This is the track we are on now.

The Bible (Matthew 25, 14-30) tells us that coins, or ‘talents’, should not be buried, but invested. In the mid-1300s, early money theorist Nicolas Oresme complained about too much money ending in treasure chests instead of being productively invested. This is not why we created money, he wrote. Around 1600, Francis Bacon wrote that money is like manure, only useful when spread. Throughout the whole history of civilization, we find as a red thread that the ‘financial sector’ is only useful when invested in the real economy.

The Muslim prohibition against interest, referred to as riba, and the Christian prohibition against charging interest up until the 1600s must be seen in this perspective. Amassing fortunes without lifting a finger was seen as qualitatively different from earning money by ‘honest work’, commerce and production. When Western Christianity in the early 1600s started to allow collecting interest, this was with a view – as Francis Bacon’s – of the importance of innovation. Innovations required risk capital, and the acceptance of lending out capital against interest seems to have coincided with the discovery of the role of innovations. Western economists at the time argued that interest was necessary because of the huge amount of capital that was often needed in order to finance new ventures. Capital became, in the words of Keynes, ‘a bridge in time’, as something financed today may last for a very long time.

Here it is important to understand Schumpeter’s theory of capital: if nothing new happens in the world (innovations) capital is theoretically without value. If we again look to the bookkeeping perspective – which is absolutely necessary to understand financial crises – all investments in a world without innovations could be covered by depreciation. The innovations give value to capital. Capital in itself is sterile (cf. the examples of King Midas and that of the buried talents (Matthew 25, 14-30) referred to above.

Financial crises occur when the financial sector stops functioning as a bridge in time for the real economy and starts earning money on itself through the use of pyramid-scheme type constructions. We shall discuss this in the section on Hyman Minsky. In the inter-war period German discourse sharply distinguished between schaffendes-Kapital (capital employed in the creation of goods and services) and raffendesKapital (capital that only accumulates more capital without creating anything). Today, American economist Bill Lazsonick differentiates between wealth creation and wealth extraction. In his Treatise on Money (1931), Keynes sees depression
approaching when money goes from being in industrial circulation to being in financial circulation. Some years later, in 1936, another conservative Englishman, later prime minister, Harold Macmillan, complained that his own party was dominated by casino capitalism.

Even if Lenin, as above mentioned, concluded that financial capital taking command over the system would mark the final stage of capitalism (it would presumably collapse for lack of demand, as we presently witness in Greece), skepticism towards the financial sector – the whole banking system – has been great also among conservatives. Thomas Jefferson, the most conservative of the US founding fathers, was also the one most critical towards banking and finance. To be conservative (rightist) for Norwegian economist Torkel Aschehoug meant that he wanted to protect the real economy from devastating speculations; to be a neo-liberalist (rightist) now means to believe that the market cannot be wrong. In terms of understanding financial crises, conservatives and neoliberal find themselves in strong disagreement. For conservative think-tanks to act as claque for the financial sector is a completely new phenomenon. Neoclassical economics and neo-liberalism have replaced the conservative voices that have traditionally acted as a bulwark against the excesses of the financial and speculative economies. This will most likely make the present crisis both deeper and longer lasting.

Conclusion: History has shown that to have a system permitting compound interest makes financial crises a certainty. Historian Reinholdt Mueller at the University of Venice describes how the Venetian State in the 1200s had to step in and save the whole financial system only a few years after the first financial center had been established. Capitalism had to be saved by the state right at the start! Since then financial crises have been frequent in capitalism, and – as illustrated in Figure 2 – are easy to find by checking the quantity of books published about economics and when. The first international financial crisis in 1720 - which simultaneously hit the large financial centers Paris, London, and Amsterdam – shows the same pattern as today’s crisis.

The book *This time is different. Eight Centuries of Financial Folly*, by Carmen Reinhart and Kenneth Rogoff, gives us an historical perspective on financial crises. However, the book contains more data than it contains theory and analysis.

A symbol-filled illustration from one of the many books published in 1720 – Figure 3 – shows a typical trait of a financial crisis: a stock exchange project artificially kept up by speculators. These are named ‘wind merchants’ because they buy and sell merchandise which can only be bought and sold in a fantasy world, not in the real economy.

**HYMAN MINSKY**

In contrast to Hammurabi’s model with two sectors, the real economy and the financial sector, the American Schumpeterian economist Hyman Minsky (1919-1996) had other sectors: households and non-financial activities, as well as financial intermediaries and government. Recently, US economists have contributed a more precise definition of what we can call the enlarged financial sector: Finance, Insurance, and Real Estate: the FIRE sector.

![Figure 2. Number of Economics Books Published (1715-1723)](source: Own calculations from the holdings of Kress Library, Harvard University)
Hyman Minsky built his theories on earlier insights from Thorstein Veblen, John Maynard Keynes and Joseph Schumpeter. A leitmotif in his career was that ‘it’ (i.e. another financial crisis like the one in the 1930s) ‘can happen again’. Minsky’s two important books were John Maynard Keynes (1975) and Stabilizing an Unstable Economy (1986). Both were, because of the financial crisis, republished in 2008.

Like Schumpeter, Minsky says that innovations in the financial sector differ from innovations in the rest of the economy and that economies that have financial innovations (which are both useful and necessary) will necessarily have crises because financial innovations make debts grow faster than the ability to repay these debts (cf. Hammurabi). In other words the capacity of the financial sector to generate funds through new innovations exceeds the ability of the real economy to absorb these funds in a profitable way, and such crises move income and wealth to a class of rentiers whose tendency to spend is lower than in the real economy (cf. Martin Wolf’s yacht and mansion recovery). This way the demand that is needed to help the countries out of the crisis is not created. A typical example is demonstrated by contemporary US economy. Real wages are roughly at the level they were in the mid-1970s, which means that most fruits of economic growth since that time has gone to the FIRE sector. Any stimulation packages will not work well unless the balance between the FIRE sector and the real economy is adjusted.

One of Minsky’s important contributions was the understanding of the ‘destabilizing stability’, a point we see clearly already in Torkel Aschehoug’s writings: As the good times seem to go on, the banks will take increasingly greater risks. Finally, banks will finance projects so speculative that they will not even be able to serve the interest on the debt. Minsky called such loans Ponzi schemes, and the subprime crisis matched this description perfectly. Loans were granted to home owners who could not even pay the interest on the loans. This creates a bubble in the economy – an imbalance between the financial economy and the real economy – which is bound to burst. Understanding Minsky’s model it was fairly clear that the Terra scandal – a scandal that virtually bankrupted several Norwegian municipalities – might be the start of a serious financial crisis (e.g. my article in newspaper Dagbladet, November 26, 2007).

As Minsky wrote in 1964, ‘At present real estate assets seem to be a more important source of financial distress than stock exchange assets... real estate assets are collateral for an extensive amount of debt, both of households and of business firms, owned by financial institutions... If the price of real estate should fall very sharply, not only will the net worth of households and business firms be affected, but also defaults, repossessions, and losses by financial intermediaries would occur.’

This 1964 paragraph is still an adequate description of what happened during the last financial crisis. It is important to note that in this perspective financial crises are no ‘black swan’ – something happening surprisingly and very seldom. Such crises are endogenous to the technological selection mechanisms of the capitalist system, forming an integral part of the relationship between the innovation cycles in the real economy and the innovations in the financial sector.

Minsky’s idea was that anyone can create money, the only problem is to get that money accepted. Minsky imagined a hierarchy – a pyramid – of different kinds of money, organized by solidity and confidence. Before the last financial crisis there were financial innovations that – probably literally – no one understood, like mortgage-based securities (MBS), collateralized debt obligations (CDO), and credit default swaps (CDS). These financial innovations, securitization, created a systemic risk, as they created a debt significantly greater than the system’s capacity to repay. When the confidence in the less secure financial instruments collapses during crises, people tend to seek the more secure ones, such as cash and gold (which Keynes called ‘a barbaric relic’).

My Chilean colleague Gabriel Palma (University of Cambridge) has quantified the increasing imbalance between the real economy and the financial economy in a paper. Figure 2 of this paper shows the increase in the balance between financial assets and GDP in the period 2002 to 2007, before the financial crisis. Here Schumpeter’s and Minsky’s point is clearly illustrated: financial assets
increased heavily compared to the size of GDP. In a country like Spain financial assets as a percentage of GDP increased from a little over 300% to more than 550% from 2002 to 2007.

Palma’s Figure 3 shows growth in GDP and growth in the debts of households and non-financial business firms in the US from 1950 to 2007. He shows that debt growth and economic growth more or less kept pace until 1982, after which point debt grew at a rate of 3.8% annually, while GDP grew at a rate of 3.4%. In the period between 1982 and 1987, debt grew at a rate of 4.7% annually, while GDP grew at a rate of 3.4%. In the period between 1988 and 2007, debt grew at a rate of 0.5% annually, while GDP only grew at a rate of 2.8%. This could not possibly go on for long.

The moment when the market realizes that the financial economy is a non-sustainable pyramid game is now often called ‘The Minsky Moment’. Another name is ‘The Wile E. Coyote Moment’ after the cartoon figure who has rushed over the edge of an American canyon and – in the moment he starts falling – realizes what has happened.

CARLOTA PEREZ: FINANCIAL CRISES AND TECHNOLOGICAL CHANGE

In his three-volume Social-Oeconomik (1905-1908), Norwegian economist Torkel Aschehoug points out the fact that financial crises have their origins in technological changes. Venezuelan scholar Carlota Perez has developed this reasoning in a way, which in my view, is convincing in her 2003 book Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages. As Perez herself points out in the introduction, The Other Canon conference in Oslo in 1998, referred to in footnote 1, was important for the development of the theory. Her theories build on the works of Russian economist Nicolay Kontratief (1892-1938) and Joseph Schumpeter (1883-1950).

A main point in her theory is that technological revolutions create new firms with high stock exchange value. Through several hundred years, technological revolutions have created financial bubbles, such as the canal bubble the railroad bubble and, lastly, the IT bubble, which burst in 2000. Such bubbles that are a result of a new and revolutionary technology are useful, they seem to be a necessary part of the dynamics of capitalism, and serve to upgrade the whole production system of the real economy.

But what we saw after the burst of the IT bubble was bubbles that did nothing for the real economy, but, on the contrary, weaken it. Figure 4 shows that before the IT bubble burst, 60% of new companies on the US stock exchanges were (IPO = Initial Public Offering) technological companies (ICT = Information and Communication Technology), while only 10% were companies from the financial sector. In 2003 the roles were changed: 60% of all new companies on the stock exchange were financial ones, while only 10% were from the IT field.

To Perez, the rational increase in stock prices of companies with new and revolutionary technologies will spread irrationally to hopeless projects and to pyramid schemes in the financial sector (see Figure 3 and Figure 5). In times when capitalism functions well, the financial
sector and the real economy live in a kind of symbiosis - they support each other. In times of crisis, the financial sector becomes a parasite weakening the real economy. What was rational (investing in new technology) gradually becomes irrational (investing in pyramid games).

An early contribution to this literature was the book ‘Extraordinary Popular Delusions and the Madness of Crowds’ by Charles Mackay, published in 1841. The former head of the Federal Reserve, Alan Greenspan, described this phenomenon as ‘irrational exuberance’. Figure 5 shows how a cartoon author (Dilbert 1999) understood the irrationality of the stock exchange bubble a year before the burst of the bubble. Note the similarity of this to the idea behind the drawing in Figure 3.

Defending capitalism as being ‘rational’ has been a serious hindrance for the economics profession’s understanding of financial crises. The present Chairman of the Federal Reserve, Ben Bernanke, wrote a book about the 1929 crisis and the Great Depression. There he mentions Hyman Minsky once, but just in order to dismiss him because Minsky ‘had to depart from the theory of rational economic behavior’. To be a ‘mainstream’ economist the last 30-40 years has meant not to accept mechanisms that doubtlessly are very important in a financial crisis because they were in conflict with the fundamental assumptions of standard economic theory. In this way even the people with the main responsibility for handling the crisis have been isolated from the most relevant theory of crisis.

It is quite clear that for a single individual earning money in the financial sector, without at the same time creating real economy values, the speculative build-up towards a financial crisis is rational. The important thing is to be close enough to the door to get out before the rest when ‘the Minsky Moment’ strikes. That this should be rational from the viewpoint of society is something completely different. Here the markets fail and regulations are needed. During Clinton’s presidency, and with Ayn Rand pupil Alan Greenspan at the Head the Federal Reserve, the very wise and well-built institutional defenses against financial crises that had been erected after the crisis of 1929 (Glass-Steagall Act) were removed. The main argument for dismantling the defenses was that there were no crises, so the defenses were not needed. The obvious fact is that the regulations that were removed were indeed the very reasons that there had been no crises.

The tulip bubble in Holland in 1636-1637 was also a bubble, where the tulip bulbs from far countries – this
was indeed an innovation – played the role of ‘new technology’ (see Figure 6).

SAVE THE FINANCIAL ECONOMY OR SAVE THE REAL ECONOMY?

Joseph Schumpeter was of the opinion that governments should not intervene in a financial crisis, as such a salvage operation would strengthen the very forces which had created the crisis in the first place. The crisis should burn out by itself. Today, we see the wisdom of that. But the crisis became so serious that governments had to do something, as Keynes suggested. But we see that Schumpeter’s intuition on one level was correct: it is hard to do this without encouraging new speculative bubbles. The huge financial packages that were made to save the real economy by saving the banks, effectively failed to reach the real economy in many countries. At the moment (2012), both banks and large corporations are left with huge cash balances, while lacking demand and consequently lagging investments are preventing a healthy recovery.

Financial crises both create and are results of imbalances. During the Bretton Woods-discussions, Keynes suggested a ‘tax on imbalances’. As the world’s imports must equal its exports, Keynes suggested an international tax on export surpluses over a certain amount. This would avoid international imbalances and prevent some nations from savings glut – oversaving – while others built up enormous debts. It would also serve as an incentive for nations not to keep their exchange rates artificially low, as China has been doing. The suggestion was blocked, mainly by the US, but if Keynes had had his will, the United States would today have been saved from their own irresponsibility, saved from building up such enormous debts to the rest of the world as they have done.

Classical crisis theories operate with the terms ‘overproduction’ and ‘underconsumption’. An important part of today’s financial crisis is the Global Savings Glut (GSG). ‘Real’ saving may be said to occur when it is matched by a dis-saving, in the form of investment or consumption, as a bookkeeping counterpart. In the absence of investment or consumption, without a dis-saving, saving becomes unproductive hoarding. The Quantitative Easing – the creation of huge amounts of money – on both sides of the Atlantic, matched with austerity policies simultaneously reducing demand, are creating the conditions that the Bible (idle ‘Talents’), the Midas legend, Oresme and Lenin all warned against. These all represent a wisdom which cannot seemingly be captured by today’s mainstream economics, apparently unable to perceive the financial economy as being something other than the mirror image of the real economy.

The lack of balance between the financial economy and the real economy can only be solved by one party – or both – being adjusted. One can choose to protect the inflated financial sector, or protect the real economy. Often, as during the Asia crisis, production units are left to go broke to save the banks. The Argentine crisis at the end of the 1990s ended up reducing real wages by more than 40%.

The EU’s handling of the crisis shows us the choices. The deficits in the PIIG countries (Portugal, Italia, Ireland, and Greece) would traditionally have been solved by the countries devaluing, so the local production systems would restore their competitiveness. At the same time the debt, traditionally often in local currency, would be reduced, leading to a loss for foreign creditors.

The alternative to this is what is called internal devaluation. This means that wages are pressed downwards, without touching the exchange rate, while, at the same time even, larger loans are taken up, to service the debt. This will let the real economy take the whole loss, while downward spirals of lessened buying power and lessened national production start.

The Estonian example shows that these are mechanisms that can also be initiated without the country in question being in debt. The country has had an internal devaluation reducing wages by more than 20%. Wages have fallen for 9 quarters in a row and unemployment is high. What gives food for thought is that such internal devaluations now seem to also be the model for the larger countries in the EC periphery. It seems likely that the downward adjustment of people’s buying power – the buying power of whole nations – may be permanent.

Traditionally it has been possible to differentiate between two models for economic adjustments, the European model and the American one. The European model had adjusted exchange rates. In the US, the whole country of course has the same currency. When one of the states has an economic crisis, like Michigan with its car industry, the adjustment mechanism is that people move to other states. By not giving up the Euro to let countries in crisis devaluate, Europe has in effect chosen
the American model. Greeks will have to move to Germany, even though neither Greeks nor Germans see this as an optimal solution. Europe is probably not prepared for the demographic movements which will be the result of the ongoing crisis.

THE GROWTH OF THE FIRE SECTOR DISPLACES THE REAL ECONOMY

We have earlier referred to Gabriel Palma’s article, which shows the disproportionate growth in the financial economy over the real economy. This is a phenomenon that has already started in the 1970s in the economic periphery of the world. The period from 1950 to 1973 registered the highest economic growth ever in the world, but after 1973 there was a change in political economic ideology that (consciously) led to a market and free trade shock which again led to the FIRE sector taking over a larger part of the total value of GDP at the expense of wages and the income of the self-employed. Figure 7 shows the changes in GDP growth rates in certain countries in the Second (ex communist) World and the Third World.

Asia in general, but particularly China and India, avoided this development because of what can be called ideological inertia. While shock therapy and free market logic became the fashion in the rest of the world, China and India stuck to the same conscious industrial strategy they had followed since the end of the 1940s. The markets opened, but slowly.

THE FIRE SECTOR TAKES OVER: THE THIRD WORLD

From the mid-1970s Latin America and Africa were the victims of a so-called structural adjustment policy. In several of these countries, real wages were more than halved in a very short time. We shall take Peru as an example. The structural changes led to a rapid fall in wages, as a very quick opening up for free trade killed the industry and weakened the unions.

Real wages were more than halved, but, on the other hand, exports increased rapidly (see Figure 8).

The interesting thing here is that by looking solely at GDP, things do not seem too bad in Peru. However, Figure 8 shows that the apparent export success was combined with real wages being reduced by more than 50 per cent. To Peruvians, globalization meant maximizing foreign trade while cutting the standard of living dramatically. This development would necessarily dramatically change the composition of this GDP: the FIRE sector has taken over an ever larger percentage of GDP (Figure 9).

The data from Peru’s central bank show that in 1972, wages represented 51.2% of GDP, and the income of self-employed 26.5%, total 77.7%. Figure 9 shows how this percentage fell with deindustrialization. In 1990, the last year Peru’s central bank produced such statistics, the wage portion of GDP was almost halved, while the portion representing the self-employed had fallen to 15.9%. In total wages and income of the self-employed had fallen by 45% from 77.7% of GDP to 42.4%.

**FIGURE 7. Economic Growth Falls Drastically, Except in Asia**

Source: Rainer Kattel, Tallinn University of Technology
I spent much time in Peru during the time in which wages were halved and saw poverty increase dramatically. My wife commented that the same children outside the Lima supermarket, who had usually begged for sweets, now begged for canned milk and other food. To me, it has always remained a mystery that this development was not regarded as interesting and why such a dramatic theme has not shown up on an academic or a political agenda.

With Europe’s internal devaluations, these same dramatic mechanisms have started in Europe. We get a permanent fall in wages and self-employed income as part of GDP and in absolute numbers. In the short run, this can look good for industry, as wage costs fall. However, industry as a whole will suffer, as demand contracts dramatically. In Peru, the halving of wages led to a brutal closing down of newspapers (before the age of internet). High wages are in many ways very important for development because not only do markets grow through higher demand, the rising cost of labor compared to the cost of capital is a major force driving technological development. With the wage reductions Europe now experiences, we risk Hyman Minsky’s ‘financial fragility’ creating a ‘technological fragility’: Cheap labor is a deterrent for investments in new technology.
THE FIRE SECTOR TAKES OVER: THE SECOND WORLD

In 2000, I was invited to a conference in Parliament in Mongolia’s capital, Ulaanbaatar, and was asked to prepare a report on the economic development of the country. Again, I found the same pattern as in Latin America: real wages were more than halved. The real interest level was 35%, which made it virtually impossible to start any production, while there was much gain in moving money into the country. This money was not invested in the real economy. I was told that the high real interest was necessary to avoid a financial crisis.

Figure 10 shows the fall in production in a typical ex-Soviet republic, Latvia. Production was more than halved, but when this graph was made, in 1994, everybody believed growth would return rapidly. Time has shown, though, that most of the growth in the Baltic has actually consisted of housing bubbles. Growth after 1994 demonstrates the same pattern as in Latin America: the wage part has fallen.

Russia also shows a similar type of development (Figure 11). Real wages were halved, but as Russian GDP now gets closer to the 1989 level, income distribution is totally different. Particularly interesting is the observation that a strong overvaluation of the Ruble in the mid-1990s...
is closely connected to the fall in production and in real wages.

It is worth noting that democracy arrived in Russia at the same time as real wages were halved. The ‘oligarchs’ who had the economic power earned their money in the financial sector, while the real economy plummeted. A revaluation of the Ruble made it easy to transfer the oligarch’s booty from financial speculations abroad at a very high value in dollars or pounds. But this reevaluation at the same time weakened the production economy even more, as Russian produced goods became very expensive and imports became cheaper. As in many other instances, the financial sector and the real economy have opposing interests.

THE FIRE SECTOR TAKES OVER:
THE FIRST WORLD

The finance sector’s dominance over a significant portion of GDP started in Latin America in the 1970s, hit the earlier Soviet sphere in the 1990s, and is now badly affecting US and Europe. The destructive effect of overrated currencies is a common element for them all. The Euro, as a straight jacket, sets off the same mechanisms in Greece and Spain now as they did in Russia in the 1990s (see Figure 11), but through internal devaluations.

Carlota Perez sees these as cyclical movements: during financial crises, income is badly distributed; while
in times when technological development hits the real economy, income distribution improves (see Figure 12). Before the financial crises of 1928 and 2006, the wealthiest 1% of the taxpayers possessed about 25% of the US’ total personal income. In times when technology and the real economy are seen as important, this number falls to about 10%. This will not happen without strong political pressure, as with Roosevelt and his economists’ New Deal in the 1930s. The kind of political pressure that was built up during the crisis of the 1930s so far seems to be missing in today’s crisis.

Figure 13 shows that the financial sector’s portion of the GDP in the US is under 10%, while Figure 14 shows that the financial sector of the US has at times constituted 45% of the total income of the US.

**CONCLUSION: THE MENTALITY THAT CREATED THE CRISIS, ITS CONSEQUENCES AND POSSIBLE REMEDIES**

The crisis was made possible by an economics profession that no longer differentiates between the financial economy and the real economy. Influential economists even came to believe that the financial economy was the real essence of the economy. Larry Summers’, one of Obama’s main advisors, favorite expression is ‘Financial markets do not just oil the wheels of economic growth. They are the wheels.’ Summers is then getting close to what we have called *chrysohedonism*, to confuse money itself with what money can buy. The financial economy became more real than the real economy. Important economists’ close connection and common vested interests with the financial sector have become a theme in the discussions about the financial crisis, e.g. in the documentary film *The Inside Job*. Another documentary movie on the crisis, *When Bubbles Burst* (2012), bases its understanding on the traditions emphasized in this paper: Schumpeter, Keynes, Veblen, Minsky and Perez.

The counterweight to this understanding is found in German and American traditions prior to World War II. This tradition was cross-disciplinary and covered economic theory and money theory, finance, law, philosophy, and political science, all within the same volumes. Examples are Georg Friedrich Knapp’s *The State Theory of Money* (1905), Georg Simmel’s *Philosophy of Money* (Philosophie des Geldes), and Karl Elster’s *The Soul of Money* (Die Seele des Geldes). Schumpeter contributed to this debate with an article from 1917 (‘Das Sozialprodukt und die Rechenpfennige’, roughly translated as ‘GDP and the Accounting Units’) and his book *Das Wesen des Geldes* (*The Nature of Money*) written in the late 1920s, but not published until 1970. Schumpeter draws the line between financial economy (the Rechenpfennige, accounting units) and the real economy (the Güterwelt, ‘the world of goods and services’), concepts that are integral to understanding financial crises (Figure 1).

The old American institutional school of economics, founded by Norwegian-American Thorstein Veblen, also made important contributions to the study of business cycles and crises. Veblen – who predicted the crisis of 1929, but died a couple of months before it started – sharply differentiated between people in ‘industrial activities’ (‘engineers’) and speculators who peripherally contributed to production. He viewed speculators as the last remnants of the pirates and robber barons of earlier times. In his classic bestseller, *The Theory of the Leisure Class* (1899), Veblen ridiculed what he deemed a completely unproductive class, and its rituals, which he compared to the rituals of primitive races.

The US institutional school literally produced massive volumes on financial crises. Veblen’s student, Wesley Clair Mitchell, wrote a huge volume on *Business Cycles*. Joseph Schumpeter moved to the US and Harvard in the early 1930s, and his *Business Cycles* fills two heavy volumes. Mitchell’s student, Arthur F. Burns, was the last representative of the old US institutional school to head the Federal Reserve, from 1970 to 1978. His presidency was dominated by a financial crisis – the so-called oil crisis – and, under Burns’ chairmanship, this crisis was solved by saving the real economy, production and real wages, at the expense of the financial sector (through inflation and negative real interest rates). The negative real interest rate forced money out of banks and into productive investments.

In his 1949 book, *The Veil of Money*, Cambridge professor Cecil Pigou described the seesaw of sequential domination of the financial economy with corresponding crises and the real and productive economy: ‘During the 1920s and 1930s ... money, the passive veil, took on the appearance of an evil genius; the garment became a
The West itself is being overtaken by mistakes made long developed world. will take over for a long time and the fall in real wages will fraction is successful – as it seems to be – financial capital, overlap with the interests of financial capital. If this group/new Deal reforms. The vested interests of this group powerful political group in the US with the goal to reverse economists of that kind have any power today. There is explaining the crisis, while Keynes delivered the cure. It could be said that Schumpeter delivered the theory only Keynes and Schumpeter, played an important part. though often politically conservative – economists, not was solved, it is clear that several theoretically radical – is hard not to expect the crisis to go on, and deepen.

If we take a look at how the crisis that started in 1929 was solved, it is clear that several theoretically radical – though often politically conservative – economists, not only Keynes and Schumpeter, played an important part. It could be said that Schumpeter delivered the theory explaining the crisis, while Keynes delivered the cure. American economist Rexford Tugwell (1891-1979) was an important adviser to Roosevelt and his New Deal. No economists of that kind have any power today. There is no conspiracy, but it seems clear that there exists a powerful political group in the US with the goal to reverse the New Deal reforms. The vested interests of this group overlap with the interests of financial capital. If this group/fraction is successful – as it seems to be – financial capital will take over for a long time and the fall in real wages will be permanent, in the developing world and in the developed world.

The process of falling wages and an increasing FIRE sector as a percentage of GDP described in this paper, which started in the economic periphery in the 1970s, is now found all over the world. The processes in the periphery have been totally neglected and now, as the Americans say, the chickens are coming home to roost. The West itself is being overtaken by mistakes made long ago and far away. The crisis theories presented in this paper are based on observations of historical facts – what I refer to as The Other Canon of Economics – and have been marginalized by theories which tend to treat the financial sector as a mere mirror image of the real economy. Instead, in the Other Canon tradition, the financial sector may abruptly change from being a faithful servant to the real economy – living in symbiosis – to a parasitic monster feeding on possibly permanent cuts in wages, production, and human welfare, such as Greece is experiencing at the moment. Capitalism needs purchasing power and to remove so much purchasing power from the majority of the population, as is now being done, will sooner or later destroy capitalism as we have known it since World War II. What we may be creating in its place is a kind of post-industrial feudalism.

This article is written from the point of view of an oil-rich Norway. The financial crisis will probably force Norway to reconsider the strategy behind the oil fund. When visiting Oslo in 2008, Martin Wolf was already of the opinion that the Norwegian oil fund was part of GSG, The Global Savings Glut. Our first Nobel Prize winner in economics, Ragnar Frisch, once wisely wrote something which is not obviously understandable except in the setting of a financial crisis, as experienced in the 1930s: ‘Savings from the point of view of an individual and from the point of view of society as a whole are two entirely different concepts. They ought to be distinguished by using two different labels, not the same as now. This just causes confusion. Society as a whole can only save through productive investments’.

This is because financial savings in times of financial crisis will easily lose much of their value. Norway’s first reserve fund for a rainy day was established in 1904 and invested in government bonds – which everybody thought was the safest investment. Most of the investments were lost during the crises following World War I. Particularly during times of financial crisis, Ragnar Frisch’s advice should be followed: More should be invested in productive investments and less in financial markets. When, sooner or later, the financial sector receives ‘a haircut’ from nations defaulting on their debts, while at the same time share prices fall because of diminishing purchasing power (a result of falling wages), part of the Norwegian oil fund will be lost. If the mechanisms of financial crises are properly understood, it is also easy to see that, in the long run, the oil fund takes on the characteristics of ‘Monopoly’ money. There are times when savings are counterproductive in all their aspects and the wisest thing to do is to spend money before it loses too much of its value.

The crisis in Europe will probably pass through the same stages as the one in Argentina in the 1990s. Right now we are at the stage of rigidly holding on to the currency exchange rates, while wages are falling (in Argentina this was an exchange rate at 1:1 with the dollar.) Sooner or later the nations of the European periphery will
have to do as the Argentines did, default and at the same
time devalue. When the crisis in Argentina was over, real
wages had fallen by 40%. The longer one waits, the worse
it gets, because the productive sectors of the crisis
economies are gradually destroyed over a period of time.
Markets dwindle and machines physically rust while the
best brains leave the crisis countries.

During the crisis of the 1930, selective protectionism
– so called Trade Wars – prevented a very uneven
outcome of the crisis among the developed countries.
This policy measure prevented a winner-takes-it-all
outcome where the developed world avoided being split
into one camp of winners and one camp of losing nations.
The Marshall Plan after World War II completed this work,
before Europe again could start growing under a
symmetrical free trade regime (among industrialized
countries at similar levels of development). Today the
mistaken idea that protectionism caused the crisis is
widespread and, instead of Trade Wars, the world is
embarking on Currency Wars. An important difference
between Trade Wars and Currency Wars is that while the
former primarily creates jobs, wages, and income in the
real economy, the latter primarily creates rents to the
financial sectors from bids and speculations. Trade Wars
aimed towards symmetrical industrial development are
infinitely superior to Currency Wars. This financial crisis
may represent a permanent blow to Western economies,
with Asia being the winner that takes it all.

The last period of big shifts in the economic ranking
between European states was the 1700s, when small city
states were forced to yield economic power to strong
nation-states. Venice and Amsterdam declined, while
England and France rose. Faced with a growing real
economy in Asia and, at home, a vicious circle of financial-
sector growth and productive-sector decline, the West
now has to choose between declining like Amsterdam –
relatively, but keeping a healthy productive sector – or
decending like Venice – declining absolutely, first losing
the productive sector and then the financial sector – in
order to become a museum. The former will requires the
resurrection of policy instruments which went out of
fashion in the 1970s and started the trend of falling real
wages: first in the Third World, then in the Second World,
and now in the First World: the West.

Capital – without possibility for investments – is
stere. If the possibilities for investment are lacking,
amassing capital will be counterproductive and prolong
the crisis. The world economy is – as it was in 1929 – a
pyramid game or Ponzi scheme, which collapses under
increasing debt deflation if we do not maintain and
increase the speed of innovation in the real economy. In
the US, the GDP level from 1929 was not reached again
until mid-World War II. The US stock market did not regain
its 1929 level until the early 1950s. War is the ultimate
Keynesian machinery for investment and consumption
because it creates a situation where political and economic
worries about inflation disappear and enormous amounts
of money are invested and spent in the real economy.
The world does the opposite by over-saving, it dis-saves.
War is also an important driver for technological change,
because the state wants and demands products at the
limits of what is technologically possible, thus advancing
the frontier of knowledge. If these mechanisms are
properly understood, it is possible to invest more in the
real economy by declaring war against environment
pollution and old fashioned energy forms, while obtaining
the same economic boom that has always been the result
of conventional wars. Such massive investments in
renewable energy and green technology, in my view,
represent the only way out of the present crisis.

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