

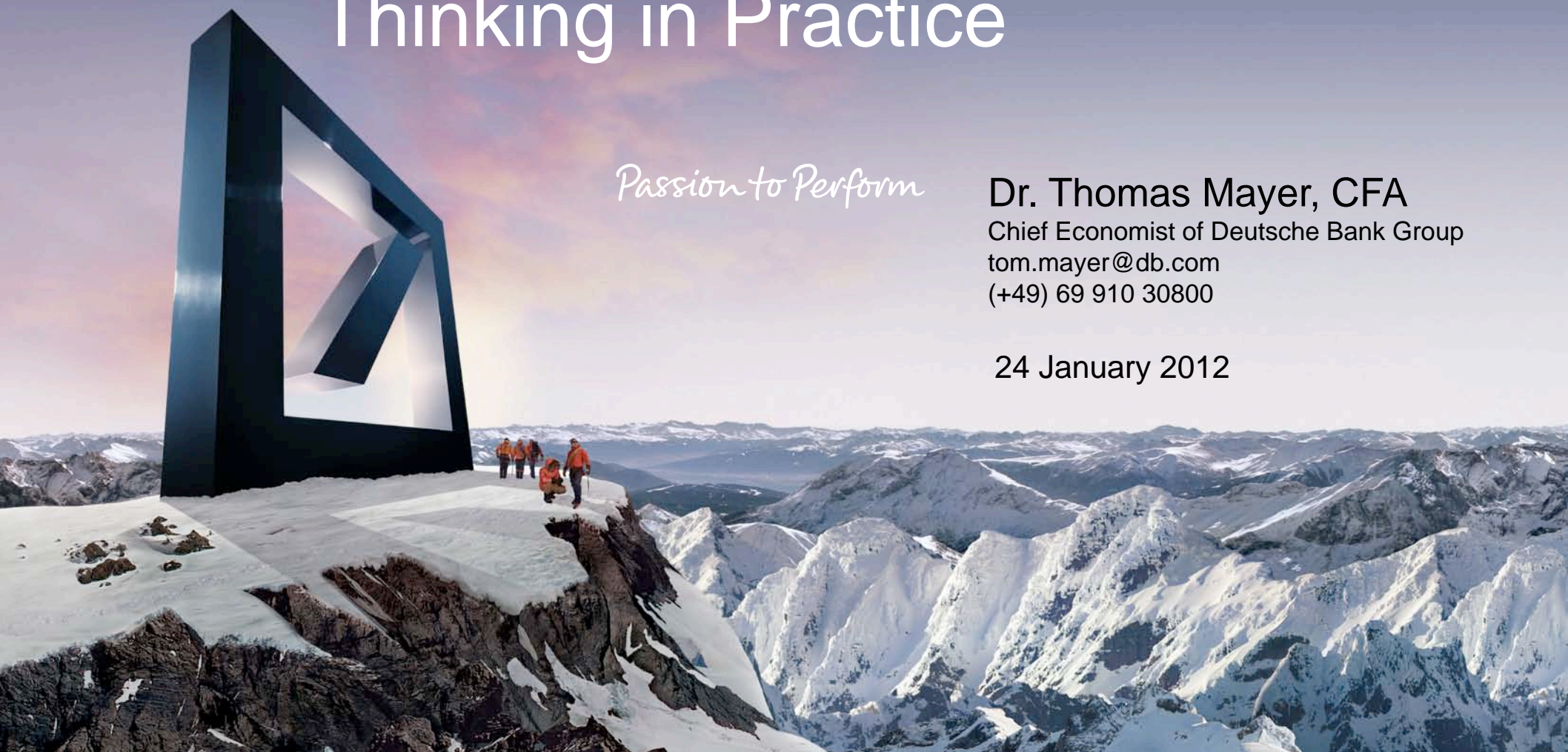


# The Challenges of Economic Thinking in Practice

*Passion to Perform*

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# My main points



- Conventional economics did not anticipate the financial crisis, cannot explain it, and cannot make recommendations on how to overcome it, because it does not understand the credit cycle.
- To understand the credit cycle practitioners had to study economic history and dig up old economic theories long discarded by the mainstream.
- „Rethinking economics“ requires that we shift the focus from „deduction“ (like in natural sciences) to „induction“ (like in social or historic sciences) for the development of economic theories.



# The macroeconomic consequences of conventional economics

- Theory of rational expectations
- Theory of efficient markets



Monetary policy should target inflation



Asset prices can be ignored



Regulation can be „light“

# 1. Control illusion

"If you want a simple model for predicting the unemployment rate in the United States over the next few years, here it is: It will be what Greenspan wants it to be, plus or minus a random error reflecting the fact that he is not quite God."

Paul Krugman in late 1990s



# The financial market consequences of conventional economics

- Theory of rational expectations
- Theory of efficient markets
- Probability distribution of financial market prices known (and ideally normal)



Modern portfolio theory



Value-at-risk



Leverage

## 2. Control illusion



“At the beginning of 1998, the firm (Long-Term Capital Management) had equity of \$4.72 billion and had borrowed over \$124.5 billion with assets of around \$129 billion, for a debt to equity ratio of over 25 to 1. It had off-balance sheet derivative positions with a notional value of approximately \$1.25 trillion, most of which were in interest rate derivatives such as interest rate swaps.”

Source: [http://en.wikipedia.org/wiki/Long-Term\\_Capital\\_Management](http://en.wikipedia.org/wiki/Long-Term_Capital_Management)



But:

What if these theories do not appropriately describe the behaviour of humans and markets?



The (probably) biggest credit bubble of all times



# The burst of the credit bubble

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- US sub-prime credit crisis (early 2007)
- Money market crisis (mid-2007)
- Banking crisis (2008-09)
- Public debt crisis (2009-?)
- Euro crisis (2010-?)

## Next

- Monetary crisis?

# Business cycle theories where credit plays a key role

## Post-Keynesian economics (Minsky)

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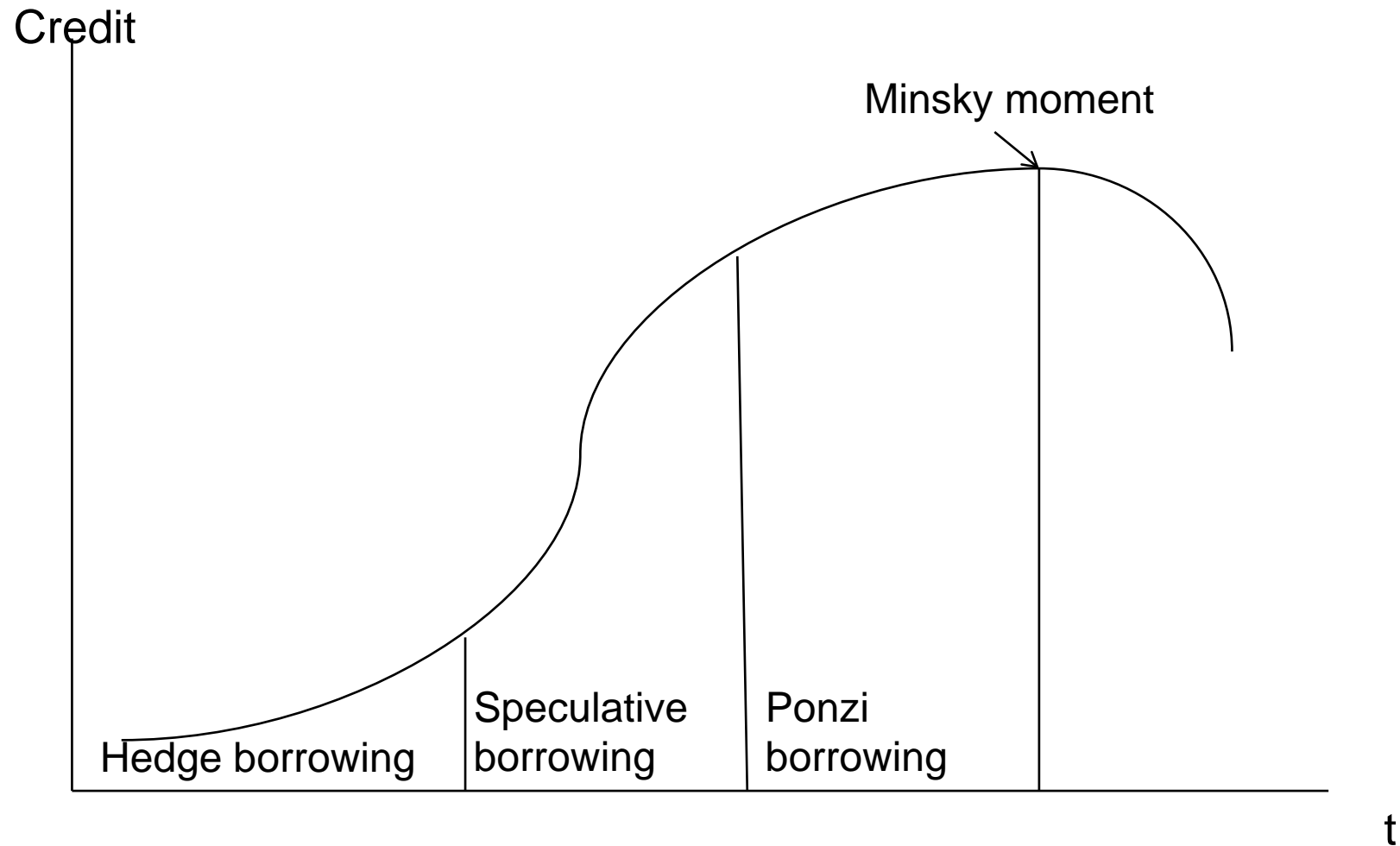
- Hedge borrowing
- Speculative borrowing
- Ponzi borrowing

## Austrian economics (von Mises, Hayek, Schumpeter)

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- Credit expansion phase - investment boom
- Credit contraction phase - investment bust

# Minsky's financial instability theory



# Minsky's error

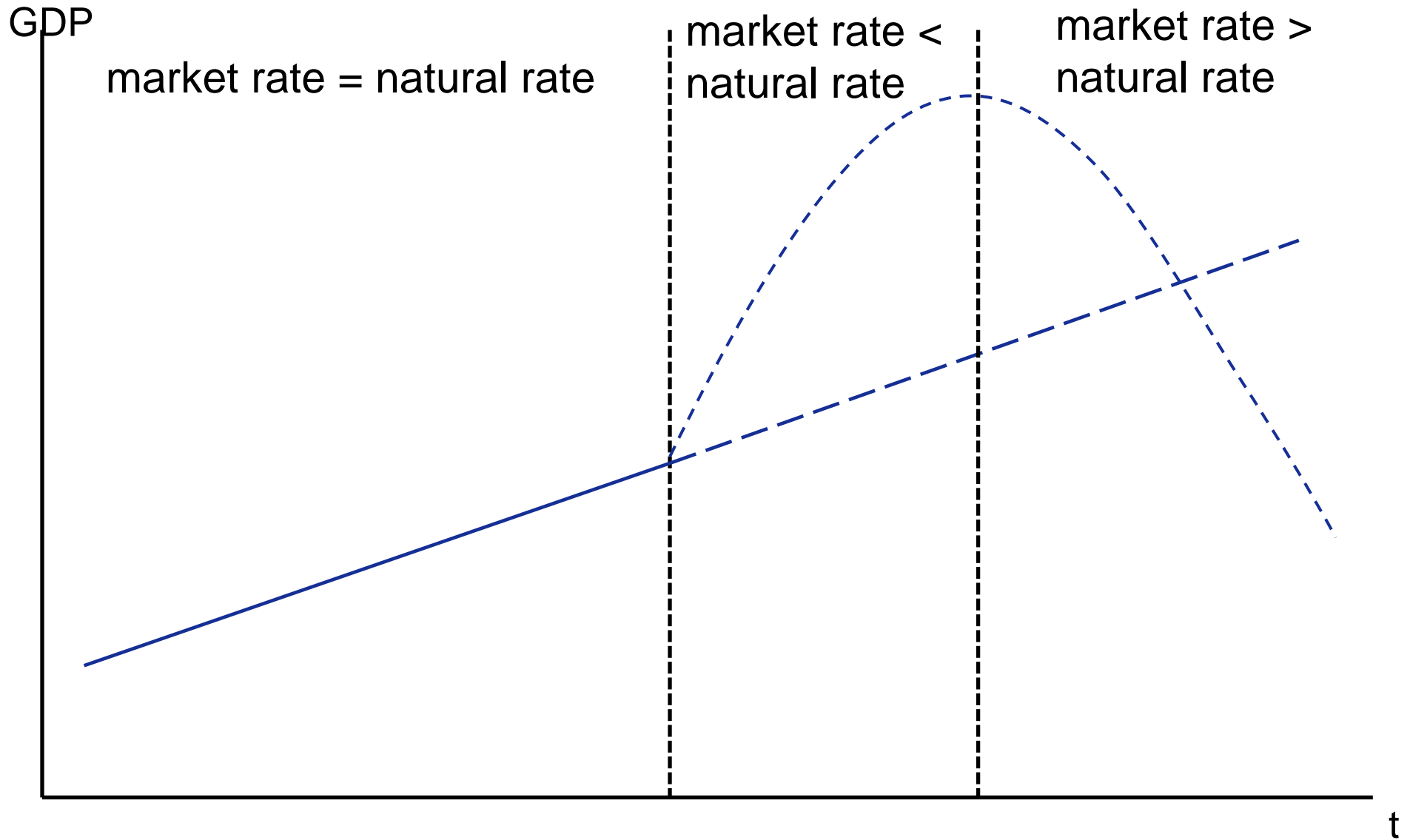


Financial regulation can help stabilise the economy  
Fiscal and incomes policies can help stabilise the economy



But:  
Regulation and economic policies have been  
more often pro- than anticyclical

# The Austrian business cycle



# The liquidationists' error



"...liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people."

Andrew Mellon, US Secretary of the Treasury, 1921-1932

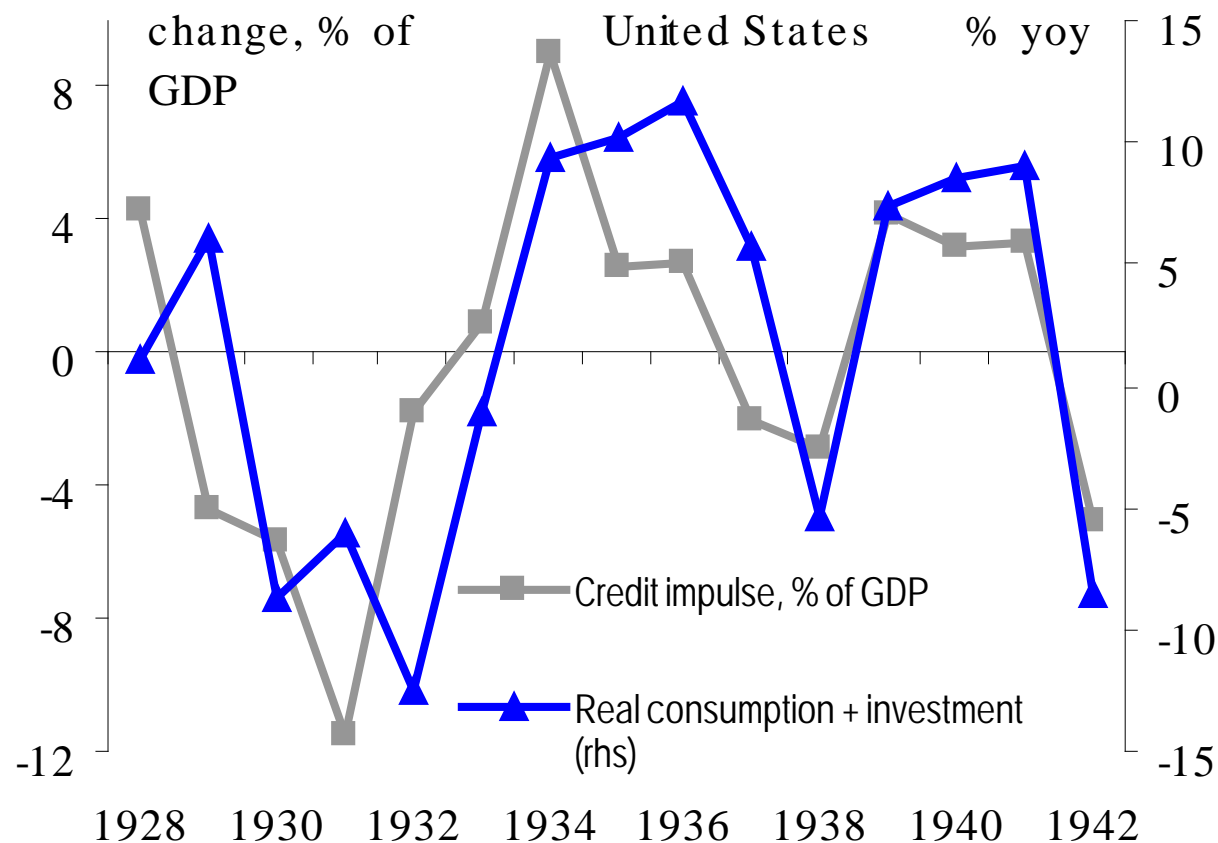


But: What if rising risk aversion keeps the market rate above the natural rate?



Economic policy needs to reopen the credit channel

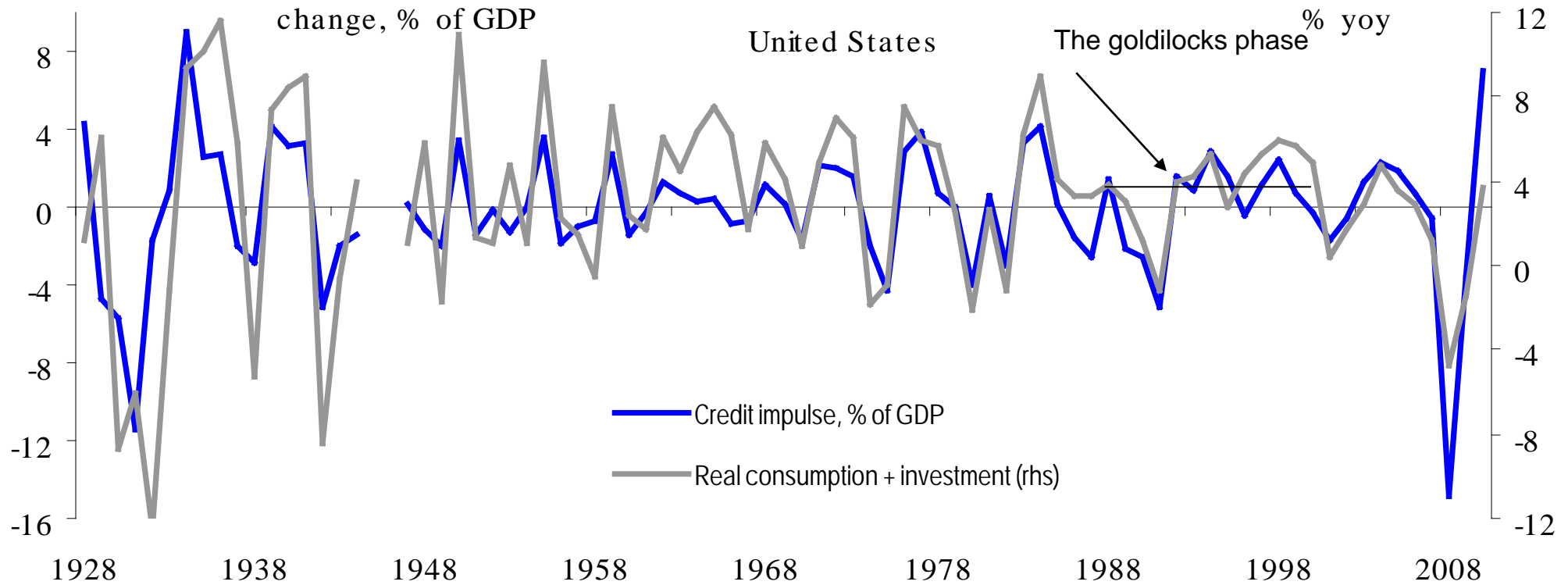
# Overcoming the “fear of fear itself”



Source: US Federal Reserve, DB Global Markets Research

Notes: Credit impulse := change in net lending flows from financial to private non-financial sector in % of GDP; Real C+I := real private consumption + investment

# The power of credit



Source: US Federal Reserve, DB Global Markets Research

Notes: Credit impulse := change in net lending flows from financial to private non-financial sector in % of GDP; Real C+I := real private consumption + investment

# Understanding the nature of credit



- Where there is trust economic relations are based on credit, where there is no trust economic relations are based on the exchange of money (David Graeber).
- Modern finance pretended that trust can be replaced by financial engineering. Financial engineering has flopped, trust has disappeared, and credit is being replaced by money.
- But will the replacement of credit by fiat money eventually lead to a crisis of the fiat money system?

# Forty years of flat money



# What are the new challenges for economists?



- We need a better understanding of the credit cycle and the nature of credit in macroeconomics
- We need to develop modern finance for a world of „Knightian uncertainty“ with lots of „unknown unknowns“
- We must become more inter-disciplinary with input from history, psychology, sociology and anthropology
- We must rely less on developing theories by „deduction“ (like in natural sciences) and apply more „induction“ (like in social and historical sciences)

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