

The Crisis of Crisis Management*

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This article explores the unintended consequences of the crisis management of state institutions, as championed since 2007. The article addresses the question of crisis management by using the theoretical background provided by two Keynesian economists, Bator's critique of the free market and Minsky's financial instability hypothesis. This article focuses especially on the markets for sovereign debt at large, i.e., it is especially concerned with the general macroeconomic consequences of problems in these markets. The main claim is that the more state institutions try to manage the financial crisis, the more they generate one. On a theoretical level, the main contribution of this paper is the use of Keynesian economics to strengthen a Hayekian/Austrian position.

After an introduction, the second chapter will analyze the actual practice of different states in dealing with the crisis as well as the theoretical foundations of this management. Then, a third chapter will re-read some aspects of Keynesian theory in order to provide a critique of the failure of government-intervention. In a fourth chapter, an assessment of the global crisis from a Hayekian/Austrian perspective will be presented. The fifth and last chapter provides a set of conclusions.

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*“The case for individual freedom rests largely on the recognition of the inevitable and universal ignorance of all of us concerning a great many of the factors on which the achievements of our ends and welfare depend. It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independent and competitive efforts of many to induce the emergence of what we shall want when we see it.” Hayek, *The Constitution of Liberty*.*

1. INTRODUCTION

Are financial systems ready to deal with sovereign debt? Most observers would be inclined to respond without hesitation: Yes. Are they capable of adapting to increased sovereign risk, default probability, and asset volatility in all markets? Perhaps they are. But even then; are they apt to do so in a high-inflation, protectionist environment? Now, the assertiveness of the first “yes” seems to vanish. The fourth problem will be: Can the worldwide financial system cope with the dirigisme of some of its participants?

These are, namely, the results of crisis management of the past few years: increased sovereign debt, increased uncertainty over states’ budget and financing capacities, volatility of debt, risk of sovereign default, looming inflation, protectionism, and dirigisme. And, on top of this, many states are questioning the very mechanisms of the international financial system they needed and used for crisis management.

As the financial crisis turned into large-scale economic doom, the fate of laissez-faire capitalism was sealed. Keynesians, neo and post, took the stage, and even former advocates of free markets joined them in demanding action from the state. Action here means fiscal stimuli, bail-outs, quantitative easing, and loose monetary policies. Did these measures induce a Keynesian bubble?

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addresses the question of crisis management by using the theoretical background provided by two Keynesian economists, Bator's critique of the free market and Minsky's financial instability hypothesis. This article focuses especially on the markets for sovereign debt at large, i.e., it is especially concerned with the general macroeconomic consequences of problems in these markets. The main claim is that the more state institutions try to manage the financial crisis, the more they generate one. On a theoretical level, the main contribution of this paper is the use of Keynesian economics to strengthen a Hayekian/Austrian position.

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2. THE POINT OF DEPARTURE: KEYNESIANISM

2.1. The Crisis

This chapter intends to give an overview on the crisis and its management. The challenges in describing the 2007-2010 crisis are several. Despite the fact that it is considered by many to have been "unprecedented" (Cassidy, 2009; Roubini, 2010), it is difficult to discern not so much the way in which governments responded to it by using classic Keynesian instruments, but more the boldness of their application. Instead of letting the markets "heal" themselves, a concern for systemic risk, the angst of a prolonged recession, and the threat of record-high unemployment led to bail-outs, stimuli, and different policies on the monetary side. There were two underlying intuitions for all actions: Firstly, that the world economic system needs stabilization,

and secondly, the idea that state-governments are the sole institutions with the capacity to stabilize the world's economy. What happened?

Many summaries of the years 2007-2010 have been presented, and this one is not different. Especially Posner (2010) and Cassidy (2009) gave good accounts of the turmoil. The analytic question remaining is, what types of crisis came together to form the global one? It all was triggered — it may be stipulated — by the subprime default, i.e., by a liquidity crisis on the individual household level. As individuals weren't able — or signaled that they weren't able — to match their short-term payment obligations, this lack of liquidity brought the lack of solvency to the surface and therefore pointed towards a systemic crisis in the overall banking sector.¹⁾ This may seem strange, but the inner logic is simple: Lending on debt turns individual liquidity risk into institutional solvency risk. Since the former materialized, the latter was certain. At the same time, and due to liquidity shortages, households began to refrain from consuming, and firms began with their usual response to the materialization of risks.

Many state and quasi-state actors reacted both ways. On the one hand, in order to ensure enough liquidity, interest rates were lowered, debt-payment renegotiated, and even troubled bank assets were bought by central banks; in other words, money was made. On the other hand, in order to ensure the solvency of financial institutions and the like, many of them were assured government intervention and others even bailed out. Since there was no clarity on the criteria for government-led action, the information sent to markets was too opaque to allow them to recalibrate. Because of massive government action, markets interpreted the crisis as an overall institutional breakdown of banking in its wide sense, i.e., liquidity and solvency, and therefore, all markets began to contract.

Financial markets, being directly hit by the ambiguity of government reactions, transmitted their problems to commodity markets, which at first were considered as the natural counterpart, but then also suffered from the

¹⁾ Propelled by derivatives, especially mortgage backed securities and the collateral debt obligations generated out of them.

spill-over. Hit by the sudden increase in volatility as well as by the seeming breakdown in the informational function of markets, production and consumer's markets as well as the labor markets became dysfunctional. Here again, governments and central banks felt the urge to intervene and did so in a joint effort. By mid-2008, it was impossible to tell the difference between government intervention and instruments used by the central banks.

This, in its own way, had an even more problematic effect on all markets: The crisis, added to the change in the institutional framework, prominently the disappearance of central-bank independence, made it even more difficult for markets to process information. Government spending and the printing of money or, more precisely, the convergence of bail-outs, stimuli, and re-financing of public debt came together as one instrument. The close collaboration between central banks and finance ministries sent mixed signals to the markets, which could not process them adequately. Questions were raised, such as: How is government financing its stimuli programs? What is the relation of the central-bank balance sheet to the stimuli programs? Why and how are central banks buying private debt? What are the responsibilities of the politicians involved in bailing out banks? How can governments increase their debts and at the same time central banks lower the interest rate (which is a premium for risk, especially for risk generated by debt)? These questions remained unanswered, and, as such, the overall strategy in dealing with this crisis remained unprecedentedly opaque. Focusing especially on the last question: Interest rates are a measure of the risks a country faces especially because of its public debt. However, governments were raising the stock of their debt; central banks were consuming their assets by buying private debt and despite all of this interest rates were being lowered.

As a consequence of this opaqueness, markets failed to process the available information, and, in turn, the crisis seemed to show that (i) market-diversification theory is false, (ii) CAPM regressions as a basis for financial planning were wrong (since their measure of systemic and sporadic risk didn't equal the materialization as seen in the crisis), and (iii) markets cannot

heal, let alone regulate themselves. These three elements were at the core of the pre-crisis model of free (financial) markets. The search for new models began.

2.2. Bator and Minsky: The Theoretical Exit-Strategy

The widely acknowledged flaw in market liberalism discussed above drove practitioners and academicians into the open arms of Keynesianism. Despite of all hermeneutics of Keynes' books, the practical policies of crisis management set in place were broadly based on the theories of two rather unknown Keynesian economists: Francis Bator and Hyman Minsky.²⁾

Francis Bator (1957 and 1958) developed a vast analytic array of arguments against laissez-faire capitalism, two of which are important for the actual crisis response. On the one hand (1957), he asks whether welfare maximization withstands in-depth analytic consideration. One of his conclusions is that only with the arbitrary "Austrian" assumption of fixed supplies of total inputs will the strategy of welfare maximization first solve for inputs, outputs, and commodity-distribution, and only subsequently superimpose on this solution the ownership and money-distribution problem (p. 36). Furthermore he analyzed that for a system to be Pareto-efficient, it imposes the condition of at all times being inquired in its one-period, static, efficiency frontier (p. 56). Both these assumptions — central for the argument of market efficiency and the self-regulation of markets — he considers analytically questionable.

On the other hand (1958), Bator mounts his critique of neoclassical markets by directing some observations towards market failure. Once again departing from the Paretian efficiency, he defines market failure as the failure of a system of price-market institutions to sustain desirable activities or to stop undesirable ones. The desirability of an activity is evaluated relative to

²⁾ Posner (2010) and Roubini (2010) show well how concepts introduced and/or studied by these economists framed how the crisis was understood and the reaction mechanisms were designed. The two most important concepts were Bator's (1958) model of market-failure and Minsky's (1974) financial instability hypothesis.

the solution values with respect to an explicit or implied maximum-welfare problem (p. 351). The central theorem of neoclassical welfare economics is the duality theorem, asserting a correspondence between Pareto efficiency and market performance. Here again, the aforementioned problem arises: The system is able to function only because of a previously defined level of inputs and closely delineated variables. However, it is exactly because of this that the system suffers from three types of externalities.

The first of these Bator called ownership externalities; they make owners focus too narrowly on just one input factor, not considering all other influences to their business. Recurring to Meade's "unpaid factor," Bator states that non-appropriation, i.e., the divorce of scarcity from effective ownership, is the main driver of this externality (p. 364). Certain goods with determinate non-zero shadow values are simply not attributed. Today's discussion of CO₂-emissions serves as an example for this type of externality: Either because air is of public domain, or because it is too costly and difficult to evaluate its ownership, producers are able to emit CO₂ without restriction and without paying.

Technical (second) and public-good (third) externalities share a similar basis. Bator's main point is that there is more price information to the system than the market can assess. There are hidden information, hidden cost-constraints, hidden frontiers of participation, and hidden effects of production and consumption. All these taken together cannot be rightly accounted for under the neoclassical model of free market. Bator then comes to the conclusion that static market efficiency is neither sufficient nor necessary enough for market institutions to be the "preferred" mode of social organization, asking whether Pareto efficiency can, in fact, be a social bliss (p. 378). Indeed, some of the European discussions about managers' salaries are good examples for this. On the one hand, a manager is better off being paid 2 million of a given currency than 1 million; all other actors *ceteris paribus*. On the other hand, even if the other actors maintain their levels of income, they consider themselves to be worse-off.

Hyman Minsky's theories are slightly better known than Bator's and seem

to deliver the proof that even if the main assumptions of *laissez faire* (at which Bator's critique is aimed) are accepted; the system as such is at risk, because it has an inherent flaw. This flaw is financial instability according to the financial instability hypothesis.

Minsky (1986 and 1992) starts at a basic level: The capital development of a capitalist economy is accompanied by exchanges of present money for future money. The present money pays for resources that go into the production of investment output, whereas the future money consists of the "profits" which will accrue to the capital asset owning firms (as the capital assets are used in production). As a result of the process by which investment is financed, the control over items in the capital stock by producing units is financed by liabilities — these are commitments to pay money at dates specified or as conditions arise. For each economic unit, the liabilities on its balance sheet determine a time series of prior payment commitments, even as the assets generate a time series of conjectured cash receipts (1992, p. 3).

The financial instability hypothesis is a theory of the impact of debt on system behavior and also incorporates the manner in which debt is validated (p. 4). In contrast to the orthodox quantity theory of money, the financial instability hypothesis takes banking as a profit-seeking activity seriously. Banks seek profits by means of their financing activity. Like all entrepreneurs in a capitalist economy, bankers are aware that innovation assures profits. Thus, bankers (using the term generically for all intermediaries in finance), whether they be brokers or dealers, are merchants of debt who strive to innovate in the assets they acquire and the liabilities they market. This innovative characteristic of banking and finance invalidates the fundamental presupposition of the orthodox quantity theory of money to the effect that there is an unchanging "money" item whose velocity of circulation is sufficiently close to being constant; hence, changes in this money supply have a linear proportional relation to a well-defined price level. Three distinct income-debt relations for economic units, which are labeled as hedge, speculative, and Ponzi finance, can be identified (p. 6).

Hedge-financing units are those which can fulfill all of their contractual payment obligations with their cash flows: The greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge-financing unit. Speculative finance units are units that can meet their payment commitments on “income account” on their liabilities, even if they cannot repay the principle out of income cash flows. Such units need to “roll over” their liabilities (e.g., issue new debt to meet commitments on maturing debt). Governments with floating debts, corporations with floating issues of commercial paper, and banks are typical hedge units.

The second theorem of the financial instability hypothesis (p. 6) is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. In particular, over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge-finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance. Furthermore, if an economy with a sizeable body of speculative financial units is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, speculative units will become Ponzi units, and the net worth of previous Ponzi units will quickly evaporate. Consequently, units with cash-flow shortfalls will be forced to try to make position by selling out position. This is likely to lead to a collapse of asset values (p. 8).

The financial instability hypothesis is a model of a capitalist economy which does not rely upon exogenous shocks to generate business cycles of varying severity. The hypothesis holds that business cycles of history are compounded out of (i) the internal dynamics of capitalist economies and (ii) the system of interventions and regulations that are designed to keep the economy operating within reasonable bounds. In a nutshell, banks are in a fierce competition for the supply of additional capital. With borrowed money, which is increasingly easy to come by, investment spending rises, and so do stock markets and business profit. So does risk-taking behavior, as well. This reinforces businesses’ demand for credit and the willingness of

bankers to supply it. Without a clear sign for stopping, the system drives itself into instability.

It can therefore be shown that if hedge financing dominates, the economy may well be an equilibrium-seeking and containing system. The first theorem of the financial instability hypothesis is that the economy has financing regimes under which it is stable and financing regimes under which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.

The theoretical foundation of today's form of crisis management is simple to assert as having derived from previous theories. First, markets may be Pareto-efficient, but they do not necessarily need to produce desirable social outcomes altogether (Bator). And second, markets have the tendency to drive themselves towards instability, when unprecedented growth is matched with hedge, speculative, or Ponzi finance and the information-processing fails to acknowledge this or different other types of hidden information (Minsky).

Note, however, that neither Bator nor Minsky claim that government intervention could *eo ipso* solve any of these problems, indeed they don't even mention that a central-planning instance could do better than the markets. And still, they are interpreted as having laid ground for bail-outs, stimuli, debt increase, quantitative easing, and heavier regulation. There is, however, an Austrian/Hayekian interpretation of both economists' work.

3. MINSKY, FROM AN AUSTRIAN PERSPECTIVE

In this section, Bator and Minsky's theories are re-read from a Hayekian/Austrian perspective. Their critiques of free markets as well as their logic provide important insights and support to some crucial Austrian theories.

3.1. Markets Adapt to Government Spending

Minsky's exploration of capitalist development was designed to stress that capitalism comes in many varieties — varieties with varying implications for stability, efficiency, and the distribution of market power. “Whereas all capitalisms are flawed, not all capitalisms are equally flawed” (Minsky, 1986, p. 295). Further, in his critique of a general-equilibrium theory, he called capitalist society an “evolutionary beast” that adapts and changes in response to exogenous as well as to endogenous factors. As he considered activities as processes in time, he acknowledged that capitalist dynamics can take many forms (Minsky, 1993, p. 104). If this “evolutionary thesis” is right, why then did public entities suppose that markets evolve during time, adapting to many factors, but may not evolve in responding to government incentives? Following Minsky's observations, markets change as their environment changes. Differently put, the question is; How did public-sector involvement itself change?

As mentioned before, one of the striking changes in government-sector involvement with the economy and the financial markets at large is the end of the sharp division in fiscal and monetary policies. As the financial crisis began under the term “sub-prime,” the focus was directed towards the solvency of different banking, mortgaging, and near-financial institutes. Their potential to honor obligations was severely damaged, and thus the first reaction was to deliberate whether they were worth saving or helping. This could have been the right deliberation to make. But the path taken was different. After some hesitation, the decision to save financial markets by saving these institutions was made. However, as early as in 1988, Alan Greenspan stated that he was willing to “serve as a source of liquidity to support the economic and financial system” (Alan Greenspan as cited in Ferguson, 2009, p. 167). This, in addition to the signaled propensity by governments to help markets, aggravated Minsky's risk-incommensurability cycle. i.e., some institutions, especially governments, central banks, and rating agencies propelled risk-taking by signaling willingness to help,

committing to provide for liquidity and solvency, and by claiming to have premium access to information in order to assess risks.

According to this logic, and if Minsky's hypothesis³⁾ is correct, state-institutions should have remained in Schumpeterian agnosticism, not allowing for signals that could instigate or aggravate risk-taking. If Minsky's hypothesis is correct, central-planning institutions' intervention made the crisis even worse, because it not only facilitated the cycle to spin, it made it spin more rapidly. Instead of setting the limits, government involvement enhanced critical behavior, and the market adapted to this readily. There is even more to come, however. Still remaining on the "Keynesian" grounds as set by Bator and Minsky, government and central-bank interventions were as flawed as the market system was assumed to be. Note here that Minsky's theories lead to a Schumpeterian analysis.

3.2. Flawed Keynesianism

If the crisis was "unprecedented," why then would established — some would say: old-fashioned — Keynesian instruments work? Despite of being known by the market and thus being used by actors as a new sort of constraint, they had a precedent of crisis induction rather than crisis solving (see the examples of South America in the 80es and 90es). The overall intuition about the causes of the crisis was that it grounded in a neo-classic, ill-conceived policy of loose monetary discipline summed to radical deregulation. By blaming neo-classic and libertarian economics, this intuition makes two mistakes. First, it almost casually assumes that the neo-classic approach is wrong, Keynesianism must be right. Second, it misses

³⁾ Note that this chapter is reading Minsky through Austrian lenses. Whereas the essential of Minsky's financial instability theory is that capitalism cannot avoid financial instability and crisis because it is an inherent problem in capitalism, here this theory is being pushed to its next logical step, namely that state intervention cannot avoid financial instability because it is inherent to state intervention. However, according to Minsky himself and before this Austrian development, sustained periods of economic stability tend to produce increasing financial fragility. Thus, Minsky leads to the conclusion that the role of government is stabilizing an unstable economy.

three crucial points. First, although the financial markets have been continuously deregulated, the breakdown originated not only from the most regulated realm of the market, but also in those institutes with heavy government interaction. Fannie Mae, Freddy Mac, and AIG in the US, as well as some institutes in Spain, Germany, and Austria were either government-backed or government-owned institutions. Second, even if not directly regulated, many global enterprises were nudged into their risky behavior by the state. Beginning as early as 2005, some banks and other financial institutions self-labeled themselves “too big to fail,” and government agencies started speaking of systemic risks in the trading-volume as well as in the overall economic significance of some firms. Instead of remaining in what would be even a Bator-compatible position, criticizing a looming breakdown in Pareto-efficiency or starting to deal with systemic risks, government institutions accepted that some banks were actually too big to fail, thus sending signals towards those firms. These, in turn, increased their risky behavior, since they deemed themselves secure in the hands of the state. Third, the higher government indebtedness, the harder is the impact of a crisis. The reason for this is twofold and lies in the pricing of risk. Ideally, long-term interest rates show the associated levels of risk of debt. State institutions, claiming a sort of monopoly not only on financial stabilizations but also on information, are able to raise debt and at the same time lower interest rates. By doing so, they distort the potential information contained in the price for capital, i.e., interest rates, thus leading markets to false assumptions and wrong behavior. Institutionally proving the de-facto interdependency of government spending and central banking, the interest rates cease to inform about the different degrees of risk in a system or market.

But the information is still there, so the question becomes: Where does this information flow to? The answer is that the uncertainty of risk levels is accurately depicted in volatility. Note how this follows from Bator and Minsky’s theories. According to Bator, prices are always incomplete accounts of information — according to Minsky, prices reveal information, but only that that is allowed to be revealed. In the case of government-

induced reduction of interest rates, the information factored into pricing becomes opaque; therefore, each change in an assessment made by the market provokes an over-proportionate change in the range of pricing, hence volatility.

Another inconsistency strikes the eye: In an Arrow-Debreu world, two constraints on consumption apply: Actors cannot spend more than their lifetime income (something that seems not to work for government consumers), and they can't make inconsistent choices. One of the possible outcomes of this model is not stable: If a rise in demand generates more demand (as in financial markets), markets can be prone to wild ups and downs of varying lengths and amplitudes. Government intervention failed to acknowledge this and supposed, wrongfully reading Bator, that states are allowed to spend more than their lifetime-budget. Not paying attention to Minsky, they failed to recognize that exactly this kind of signal sent to the markets would make these incorporate the information as a free pass to continue doing business as usual. These signals make the whole plan of stabilizing a crisis logically impossible.

3.3. Prices Are Information

There are two distinct price levels in a capitalist economy. One is the price level of current output, and the other is the price level of capital and financial assets; i.e., capitalist economies have both a consumer price index and a "Dow Jones" index. These two price levels can and do vary relative to one another. This is so because their proximate determinants are quite different. In capitalist economies, the prices of current output recapture producers' costs and carry profits: They measure unit-labor costs and a realized mark-up. The price level of assets is determined by the views that actors have about future expected incomes, by the current capitalization rates of such incomes, and by the value placed upon the ability to transform assets into cash. Because the ways that money enters into the determination of these two price levels differ, money is not neutral, it is an asset itself and

reveals likes and dislikes for other assets.

Furthermore, there are two sources of liquidity in a capitalist economy. One is the flow of wages, gross profit income, and taxes accruing as a result of the production of the national output. The second source of liquidity originates from selling or pledging assets. The current capitalization rate of assets includes a discount for the risk that the markets in which the selling and pledging of assets takes place will be thin when such actions are necessary.

The development of capital is accompanied by exchanges of present money for future money. The present money pays for resources that go into the production of investment output, whereas the future money consists of the “profits,” which will accrue to the capital-asset-owning firms (as the capital assets are used in production).

Bator and Minsky imply that money is connected with financing through time. Thus, in a capitalist economy the past, the present, and the future are linked not only by capital assets and characteristics of labor force, but also by financial relations. The key financial relationship links the creation and the ownership of capital assets to the structure of financial relations and changes in this structure. Institutional complexity may result in several layers of intermediation between the ultimate owners of the communities’ wealth and the units that control and operate the communities’ wealth. In spite of the greater complexity of financial relations, the key determinant of system behavior remains the level of profits. The financial instability hypothesis incorporates the Kalecki (1965) and Levy & David (1983) view of profits, in which the structure of aggregate demand determines profits.

It is here that both, Bator as well as Minsky, can best be read from an Austrian/Hayekian perspective. Due to the different markets operating at all times and in steady interdependence, it may be that prices do not contain all information that markets need. But they should be free to factor them in. Bator’s critique does not aim at having an institution that analyses prices, but at having prices with more information. Bator wants prices to reveal all relevant information. Minsky, on the other hand, can be read as an account

for risk and therefore as an explanation of how the risk premium must rise, when the structure of aggregate demands weakens or shows signs of uncertainty. Minsky tells the reader when to raise interest rates — this being in itself a signal for market risk and thus correcting overheated market behavior. Both economists accept the pivotal role of transparent prices in the stabilization of an economy.

If this causality cannot hold, and if the Keynesian idea of spending in crisis and accumulating wealth in booms does not equal the time-frame accepted by risk takers, investors are either prone to analyze each information without context — irreducible uncertainty in decision making and resulting influence of personality traits as well as the prevalence of mistakes — or lose their faith in the markets and governments. This is much of the picture of the financial crisis. The near-bankruptcy of states like Greece, Portugal, and Spain as well as highest levels of volatility in the world markets are the witnesses of the crisis of crisis management.

Summing up, the very theoretical basis for most crisis responses advises against the actual policies as they were (are) employed by governments and central banks. Even if Minsky and Bator are read as Keynesians, they don't endorse some of the crucial mistakes made; namely, they acknowledge the nature of efficiency and advocate its maximization as well as urge the separation of financial markets — thus central banking — and government spending. Indeed, if both economists were read in the Austrian/Hayekian context as set here, it would even be highly questionable whether they would have seen government involvement at all. It is from this perspective that the question of how crisis management is to be qualified arises.

4. AN ASSESSMENT: SOVEREIGN-DEBT BUBBLE

In this chapter, a last assessment of crisis management is made from an Austrian/Hayekian perspective. First, it will be shown that markets need time to process the available information, and second, it will be argued that

the sovereign-debt crisis is even more problematic than the original trouble in financial markets and housing that sparked the crisis.

4.1. Slow Markets — Opaque Information

In the 80s and 90s, sovereign defaults were in the center of attention. Even at the beginning of 2000, Latin America and Russia were prone to them. The bottom line of this experience was making the dilemma clear to many economists: Transferring the debt from the private to the public sector was the usual path. However, as the public sector is normally more indebted than the private sector, why should it be more solvent? This question was answered by giving up the independency of central banking. If government spending and central banking were to be united, the question of indebtedness would be solved by supplying money. This apparent logical inconsistency is hidden by the system, and therefore prices (i.e., interest rates) fail to factor this increase in risk.

In 2008 the Federal Reserve was pushing down the federal-funds rate by flooding banks with cash in exchange for short-term treasury securities. It also began buying private debt, such as commercial papers, credit card debt, and mortgage-backed securities, thus operating not just as the nation's central bank but as a substitute for a commercial bank. Here again, the Federal Reserve was acting as central bank, commercial bank, and as government at the same time. On the other hand, the effects of the USD 100 billion stimulus cannot be quantified; it is even possible that it constituted only transitory income. Even the Chinese stimulus, a record-high USD 1.4 trillion, seemed to spill into nothing. But at the beginning and until early 2010, markets were not able to process the consequences of the fusion of government and central banks. In 2010, markets caught up and revealed their assessments.

Here again, the effects of manipulation of information by public actors becomes apparent. Due to the fusion of central banking and government spending, prices, especially interest rates, stopped revealing all information

and started to act as a means of propaganda. In the meanwhile, markets began to adapt to whatever was called the “new normal.” In the short term, markets failed to recognize the missing mark-ups, the long-term indebtedness of government, and the threat of more intensive regulation, to name a few. As these were realized, a new crisis began.

The crisis that began as one in liquidity was treated as a crisis in solvency, and as it evolved to a full-blown breakdown of solvency, liquidity-related mechanisms were employed. This was done in the hope of spiking an immeasurable multiplier of consumption. But the crisis now developed into a sovereign-solvency crisis of even bigger dimensions than the one it began with. The sovereign-solvency crisis, however, imposes some serious risks. By taking a closer look at Europe, there are — on a small scale — important lessons to be learned.

4.2. Deficit in the Euro-zone

Spending, buying private debt, and printing easy money were considered the way to deal with the crisis, but with the debacle of Greece, Ireland, Portugal, and the potential in other countries, deficit is once again high on the priority list. Greece’s deficit is 12.7% of the GDP, the US is around 11%, Ireland has 12.5, growing to 14.7 in 2011, the EU 27 average is around 7. Worrisome are further Luxemburg, Finland, and Germany, which have ratios starting at 2.3, 2.8, and 3.4, respectively, but are climbing to 5% in 2011. China is assumed to have 2.8% deficit of GDP. What about the total amount of public debt? Greece has 120%, the US around 100%, the world average is around 56%, and China shows a healthy 14% (World Bank, 2010).

At the very beginning of the Greek crisis, most EU member states were not willing to participate in a bail-out of Athens, forwarding a correct argument for their position: State bail-outs send even more problematic signals to markets than corporate rescues. According to article 125 of the Maastricht Treaty, collective salvage is forbidden, even bilateral help, and explicitly bail-outs. The idea behind the treaty is to discourage problematic behavior

by the national governments. The argument according to which the Greek GDP only makes below 2% of that of the EU and therefore should be saved without generating further problems does not take into account how this common decision would signal to other countries that they are free as well, to do whatever pleases their constituency.

The problem, however, is not only restrained to Europe. According to a recently published paper by the IMF, the sovereign debt of the G-20 countries will rise from 78% of the GDP in 2007 to 118% in 2014. This is dangerous in two important ways: First, concerning the overall well-functioning of the global economic system, Reinhart and Rogoff's research (2009) shows that a debt-to-GDP ratio passing the 90% threshold diminishes a country's perspective of growth.

Second, the sovereign debt is as such a measure for many other interlinked relationships. The downgrading of sovereign debt has many risks. First, it reflects directly on the market for treasuries: Who will buy them at which price at what interest rate? As Sovereigns are absorbing bad balance sheets and engaging in indebtedness, they are undermining the overall confidence in their ability to repay the debt. Big debt is followed by inflation or devaluation, or both. Investors are not particularly fond of either.

There is yet another threat that looms underneath the surface. Sovereign debt was not only considered the safest form of debt by banks and other practitioners, but also by academia itself. Many models for a wide array of economic applications are built on the implicit or explicit assumption that debtor notes issued by governments are almost riskless. Models defining prices for many infrastructure goods, such as electricity, water, train-tickets, and so on, models calculating the cost of capital, normally split these costs in two, the cost-component of risk equity and the risk-free capital base, which is equal to the interest rate being paid on state bonds. Note, here again, the explicit supposition of sovereign debt as a benchmark for risk-free capital.

Many other financial theories that are readily applied to elementary institutions rest upon this supposition as well. For example health care

policies or pension funds which calculate the minimum interest rate and therefore their path of investment as a function of sovereign debt rate. This is more than just an adaptation of the height of this rate, which all before-mentioned calculations allow. It is about the calculation in itself. Independent of the given value of the government-backed bond rates, the assumption made by the model is that this value is almost risk-free. With the downgrade of sovereign debt to almost junk status, two questions arise: Is there anything qualifying as risk-free to serve as a basis for models? If yes, and since governments seem more and more to be a systematic risk, what else qualifies?

4.3. The Rise of Protectionism

There is still another problem created by the possible breakdown of states due to their sovereign debt: Some countries — the US, Europe, China, and India — are playing with the idea of protectionism. The issue is not about classic trade protectionism, but about resurgent involvement of the state in the economy, in financial regulation, and in technological development. This is born of the financial and economic crisis.

There is a new notion, according to which prosperity, economic security, and success can best be achieved by disengagement and disintegration. As important economies were hit by the crisis and contributed in creating the sovereign-debt bubble, political entities noted that by worldwide disintegration, prices would be easier to manipulate, and therefore their own past mistakes easier to mask. This was the case especially in the US, where ex-post regulations were used to change environments once again and to make it even more difficult for prices to reveal the needed information. This drives regulation protectionism, which is specific for the US and Europe. Under the pretext of wanting to have better and more stable markets, and ill-using Bator's efficiency argument, regulatory protectionism tries to bind all relevant market players to regulation, thus maximizing the power of the state and the means for distorting markets and prices. The developed world

became suspicious of globalization leading to protectionist rhetoric: “You do it your way, I do it mine, but if you want to do business in my country, you have to do it my way.”

State expansion in global economy happens through three different channels. First, state-owned enterprises use their relative weight, solidity, and ability to accumulate capital to growth and dominate worldwide markets. This is specific to India, China, and France. Second, stimuli and spending programs tend to protect national enterprises against internationals. And third, the fusion of central banking and government creates geographic inequalities. The last form of new protectionism is related technology. Either by developing country-specific standards or by designing and enforcing them through laws, once again, fences against free trade are built.

In order to sum up: What effect did state-driven crisis management have? First, it ended the independency of central banking; second, it distorted all prices, risk-propensity, and the informational exchange in the markets by manipulating interest rates; third, by boosting spending, it increased the risk of sovereign default, thus privatizing public debt, boosting inflation, and lowering productivity as well as efficiency; and fourth, it contributed to a revival of protectionist tendencies.

5. CONCLUSION

“La Bêtise est bien plus importante que l’intelligence.” The cat in Gelluk’s comic gets it right; foolery is more important than intelligence. At the end of this article, the question as to what caused the financial crisis has to be addressed. According to one interpretation of the Hayekian theory, prices act as information bundles, revealing all available information to the markets for a given entity. Long since, this view has been criticized by theories of asymmetric information, game theories, and the like. However, it could be that the Hayekian stand again has something explanatory to contribute.

As private debt is being re-shifted to public debt, an important notion is lost; the notion that budget deficits are a causal factor for crisis, and therefore sovereign-debt crisis will most certainly re-shift debt back to the private sphere. Only this time, it will directly hurt Pareto efficiency. Most important of all, government intervention in central banking since the 90s has systematically been distorting the prices for capital — i.e., interest rates — and through this channel distorting all markets. Prices weren't able to function as information hubs, and thus this crisis was created and aggravated by the state. As intervention grew even stronger, the sovereign-debt crisis revealed the crisis of crisis management.

Prices are the sources of all information, provided that they are made by the market, and the market is not nudged into unrealistic positions. The crisis of crisis management consists in the assumption that the dynamic system called “markets” can be designed or even causally influenced by government. An important second-order mistake was made in giving up the separation of different suboptimally functioning institutions, central banking, and the government. These institutions went so far as to combine their efforts in order to falsify prices and scramble all markets. This backfired, and the liquidity crisis of once turned into a full-fledged, long-running worldwide crisis of sovereign debt.

Instead of quoting a cat in a cartoon, public spending should fall back on Hayek: “The curious task of economics is to demonstrate to men how little they know about what they imagine they can design” (1988).

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