

## After The Crisis – What Next?

***The global financial crisis has been widely described as the worst economic event since the Great Depression of the 1930s. What can we learn from such events, and what can we expect in the aftermath? In this article we draw on the wisdom of three well-respected books on the history of crowd behaviour in relation to finance.***

The global financial crisis (GFC) has been frequently compared in the media to the Great Depression of the 1930's. However the recovery of financial markets to date has not followed the same pattern of that period, largely because of the stimulus packages implemented by governments. Historically, large financial events of this kind are followed by long deep recessions, which are in turn followed by long slow recoveries.

There is some evidence in recent times, according to the International Monetary Fund (IMF), that boosting government spending shortens the recovery period. Australia certainly avoided a recession in the first place and is now recovering faster than any developed economy, mainly due to the twin benefits of a large per capita stimulus package and our export relationships with China and India.

### **Will the 'Keynesian' approach work?**

However there is also much debate about the long-term effects of this 'Keynesian' approach to financial policy. Economist John Maynard Keynes was born in 1883 and lived through World Wars I and II as well as the Great Depression. He is widely considered the father of the economic theory that during a downturn governments should spend money to stimulate growth in economies, paying back that debt from the ensuing economic growth.

Keynes was also famous for advising students of finance that: "(financial) markets can remain irrational for far longer than you or I can remain solvent."

### **A history of folly**

Even the most cursory glance at the history of financial markets shows that the madness of crowds has been linked to money since before 'paper' was even printed. Markets can be irrational simply because investors build bubbles and then burst them, breaking banks and crashing markets in the process.

Markets themselves can become vastly over-inflated with almost any asset – take as an example the tulips of Holland in the seventeenth century. In *Frozen Desire: An Inquiry into the Meaning of Money*, author James Buchan points out that the passion for tulip bulbs, traded on stock markets, grew so high 'on paper' that a single bulb could be traded as having equal value with a large house with land in Amsterdam. Buchan recounts an anecdote in which a foreign sailor, coming across such a bulb in a merchant's house and mistaking it for an onion, sliced up the priceless asset and ate it.

## Mississippi madness

Both Buchan and James Mackay, author of *Extraordinary Popular Delusions and the Madness of Crowds* also detail the Mississippi Scheme. This occurred at a time when the French economy was 3000 million livres in debt, incurred during the monarchy of Louis XIV (who had recently died). The national revenue was just 145 million livres, and the expenses of the government, 142 million.

Firstly the currency was debased in an attempt to gain some ground. Lighter coins were issued at 'face' value to replace the previous coinage, whose weight in precious metal *was* its worth. However this and other methods having failed to make a dent in the enormous debt, John Law, a Scotsman, proposed paper bills to settle accounts between merchants. With the support of the Duc d'Orleans, who was regent at the time, Law was allowed to set up The Banque Générale to issue such currency.

Within two years, Law set up the Mississippi Company to trade with the East Indies, China and the South Seas. Law promised a yearly dividend of around 120 per cent profit and trade in company stocks increased at a frenetic pace. Stock prices rose from 500 livres to 18,000 livres in just three years. More bank bills were printed (by Law's bank) to keep pace. These bills were by now legal tender, and in fact it became a crime to own more than 500 livres in coins. The money supply in Paris doubled in two years and the prices for commodities and property increased in turn. There were whole industries created to supply, entertain and fleece the newly wealthy and by many accounts more than 300,000 people flocked to Paris during this period.

Long story short, the crash, when it came, caused more than 12 people to be crushed to death "at the bank doors". No more than a sixteenth of the bank's equity capital was subscribed in cash and few received any value for their worthless paper.

## This time is different?

The authors of *This Time is Different: Eight Centuries of Financial Folly*, Carmen M. Reinhart and Kenneth S. Rogoff would call Law's effect on French currency an 'inflationary crisis'. As they point out in their comprehensive overview of the types, effects and aftermaths of financial crises dating back to the thirteenth century, inflation is a common denominator of emerging economies. In 1799, they assert, inflation in the United States approached 200 per cent.

What allows history to repeat itself so often is what the authors call the 'This Time is Different Syndrome'. People always believe that 'financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes.'

The book points out that in the lead-up to the emerging markets defaults that caused the Great Depression, people believed there would never again be a world war. The 1920s were a decade of what the authors call 'relentless financial optimism, not dissimilar to the five-year boom that preceded the worldwide financial crisis that began in the United States in mid-2007'.

The fact that Australian financial markets had enjoyed two decades of growth prior to the GFC may have clouded the ability of investors to take note of history. *This Time is Different: Eight Centuries of Financial Folly* details no less than eighteen post-World War I banking crises. The aftermaths of the various crises are examined, and the authors note that previous crises have been characterised by deep and lasting effects on asset prices, output and unemployment.

Because of the more aggressive measures in the current circumstances (by governments across the world using Keynesian methods and borrowing to spend), the positive effects on long-term recovery may be significant. However due to the global nature of this crisis, the authors note that when many economies are simultaneously experiencing banking crises, defaults tend to rise sharply. They refuse to definitively predict that 'this time is different' in terms of recovery. It seems the caveat of 'past performance is not necessarily an indicator of future performance' applies both in the case of expected investment returns and in predictions of economic recovery from a financial crisis.

In our next occasional article we look in more detail at the way assets can change according to their marketplace. From 'tech' stocks at the beginning of the internet boom, to mortgages owned by people without jobs in the USA pre-GFC. We also look at the GFC's 'once-in-100-years' impact on asset prices, listed and unlisted.

This Time is Different: Eight Centuries of Financial Folly Carmen M. Reinhart & Kenneth Rogoff.

Extraordinary Popular Delusions and the Madness of Crowds Charles Mackay.

Frozen Desire: An Inquiry Into the Meaning of Money James Buchan.

