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Macroeconomics II

Lecture 14

Innovation
Crises and cycles

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Theoretical Lecture 14

Innovation, crises and cycles

- The 1929 crisis and the long depression
- The 2007 subprime crash and the following recession
- Why are there crises and economic cycles?
- Different theories of cycles? Equilibrium, disequilibrium and evolution

Readings

Louçã and Ash (2017), ***Sombras***, chaps 9 and 11

Beta 17: Core Project, ch 17

Different recessions through time

the Great Crash and depression from 1929;

the 1974 crisis;

the recent subprime crisis of 2008-2009

and then the sovereign debt crisis after 2011

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Poverty and misery in the 1930s

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The Great Depression and how economists got it wrong

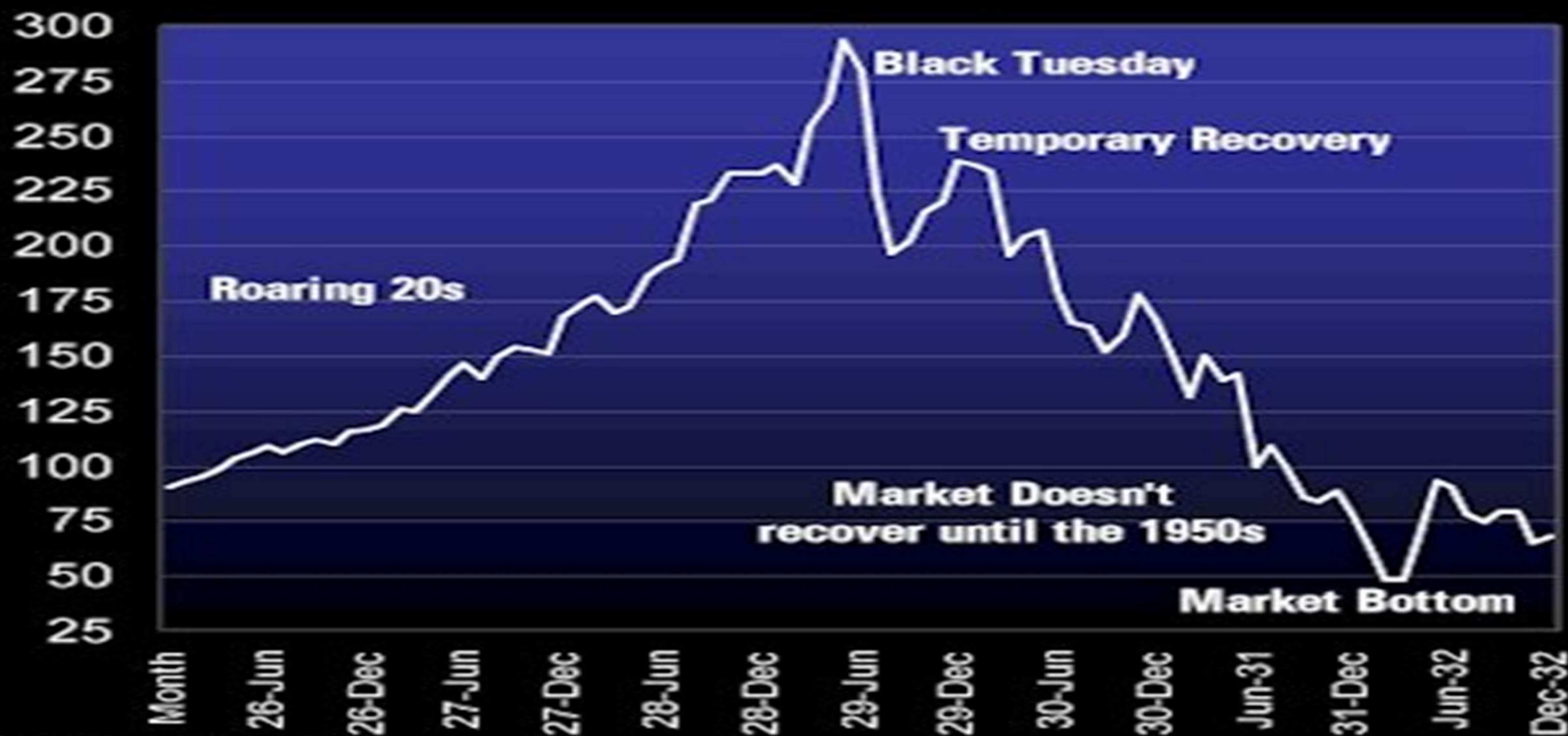
- **Irving Fisher**: «Stock Prices are low», they reached a "permanent plateau" *(New York Times*, October 22, 1929), but instead:

October 24th: **Black Thursday** Stock market crash

October 29th: **Black Tuesday** A new crash

Then, 25% of unemployment; 25 years until a full recovery of the stock market (only 1954)

Irving Fisher (1867-1947)


1929 Crash Using S&P 500 Data
Growth of $100
300
275
250
225
200
175
150
125
100
75
50
25
Black Tuesday
Temporary Recovery
Roaring 20s
Market Doesn't
recover until the 1950s
Market Bottom
Month
26-Jun
26-Dec
27-Jun
27-Dec
28-Jun
28-Dec
29-Jun
29-Dec
30-Jun
30-Dec
Jun-31
31-Dec
Jun-32
Dec-32
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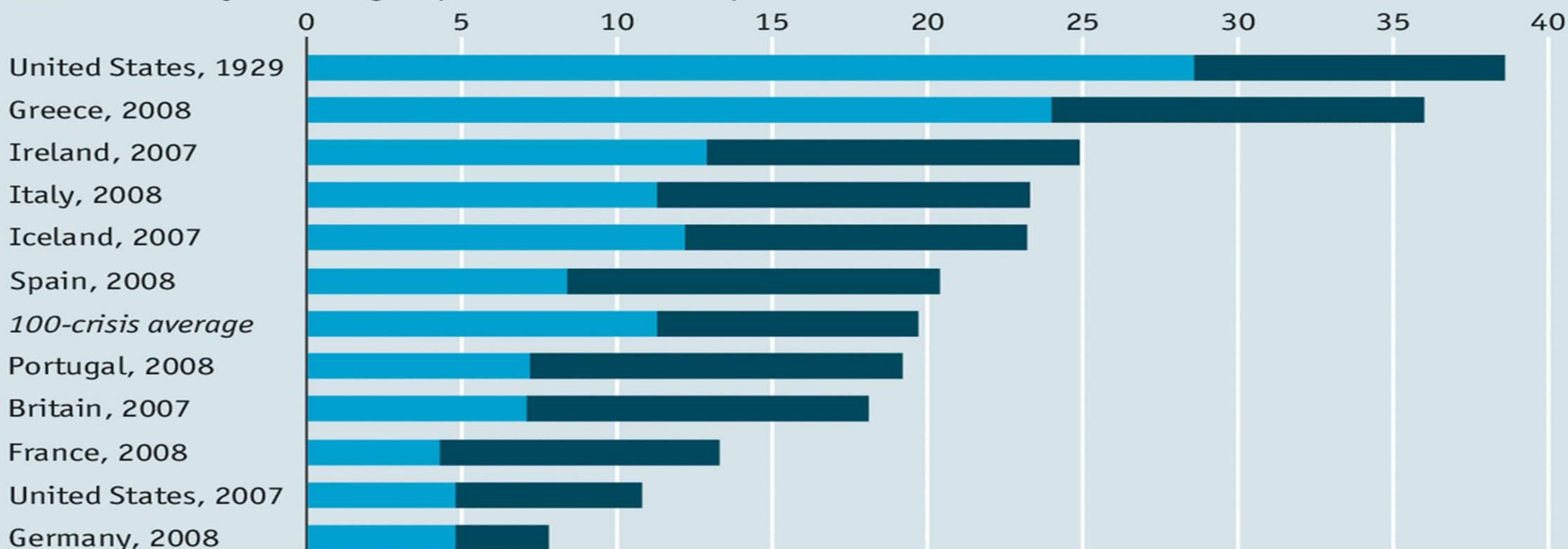
21st century crises (before Covid19) compared to that of 1929



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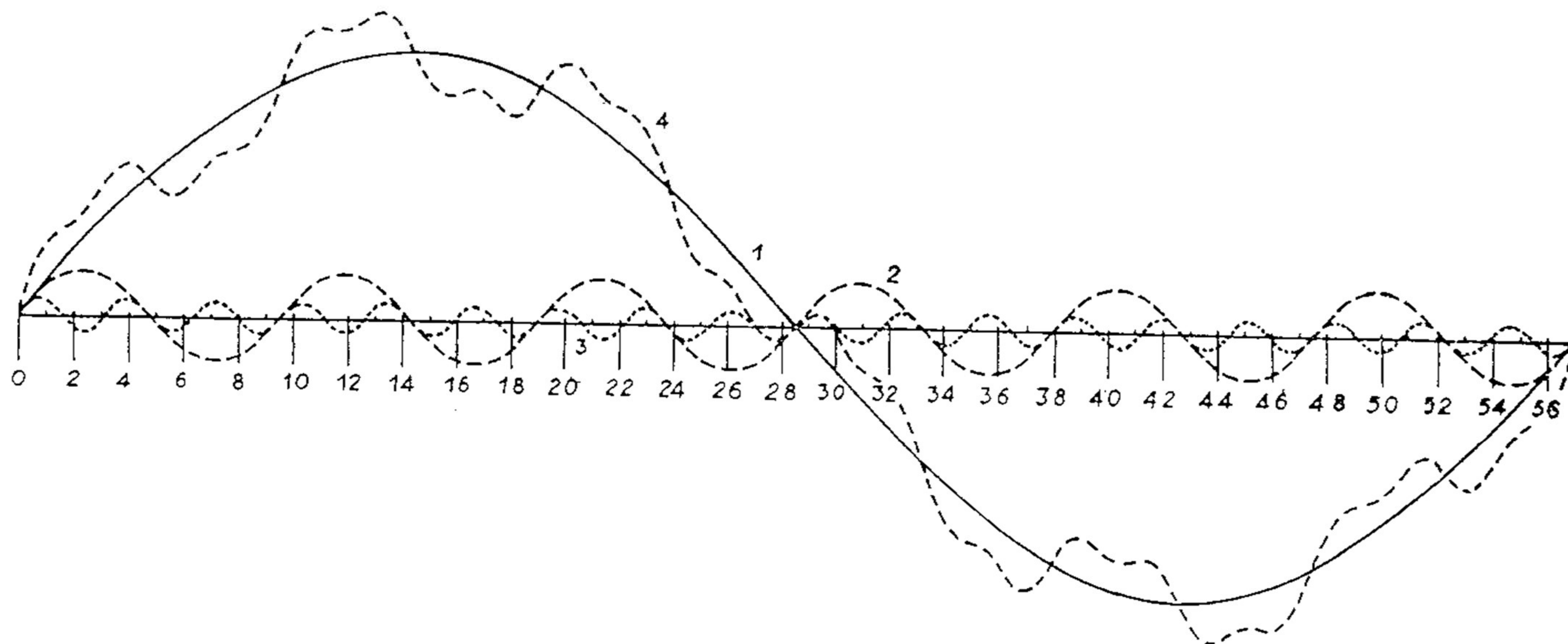
Economic cycle (a representation by Schumpeter, 1939)



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Schumpeter on capitalism

"industrial mutation – if I may use the biological term – that incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of **Creative Destruction** is the essential fact about capitalism."(1942: 83)

But not just speculative crises, right? A lot of debt

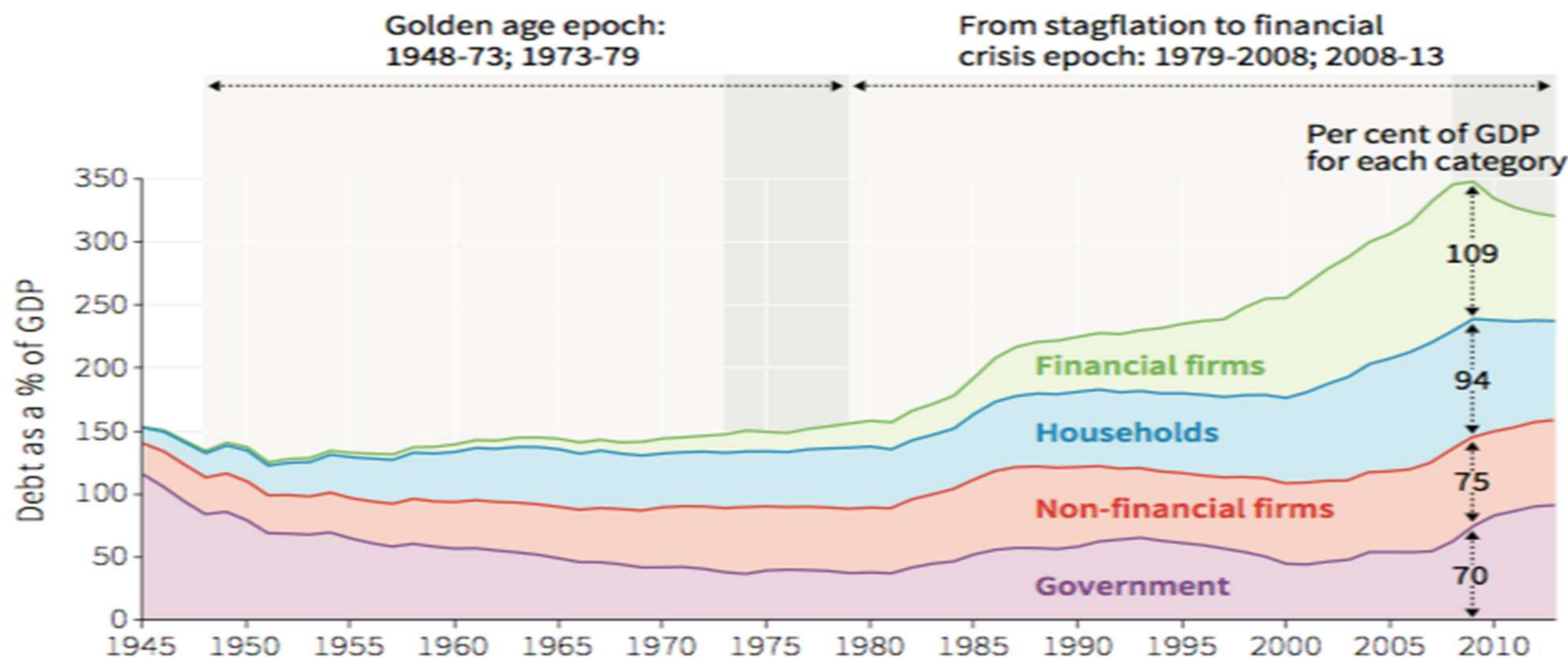

Figure 17.4 *Debt as a percentage of GDP in the United States: Households, non-financial firms, financial firms and the government (1945-2013).*

Source: *US Federal Reserve. 2015. 'Financial Accounts of the United States, Historical.' December 10; US Bureau of Economic Analysis.*

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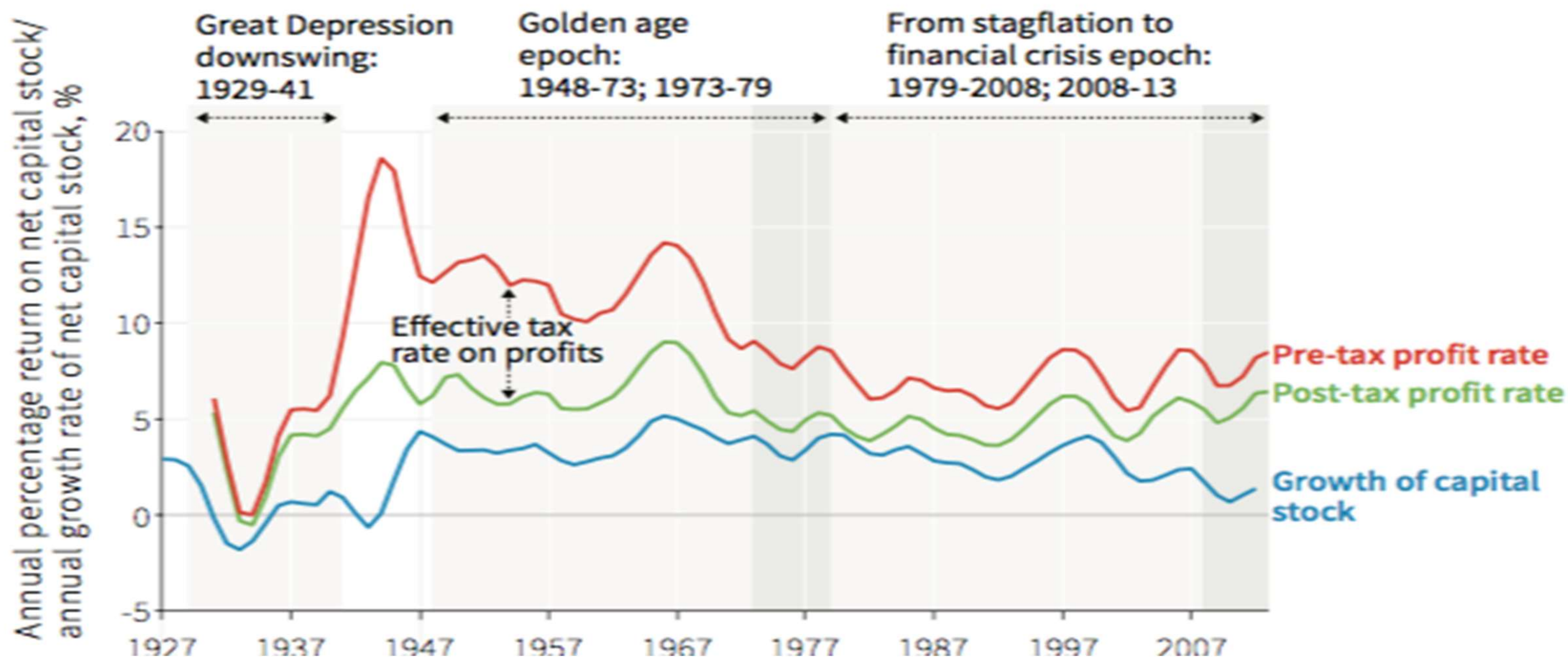
Low taxes support profits:
a political decision (but then there is a fiscal deficit)



How did the US bubble develop in the 2000s?

Financialisation & Subprime bubble

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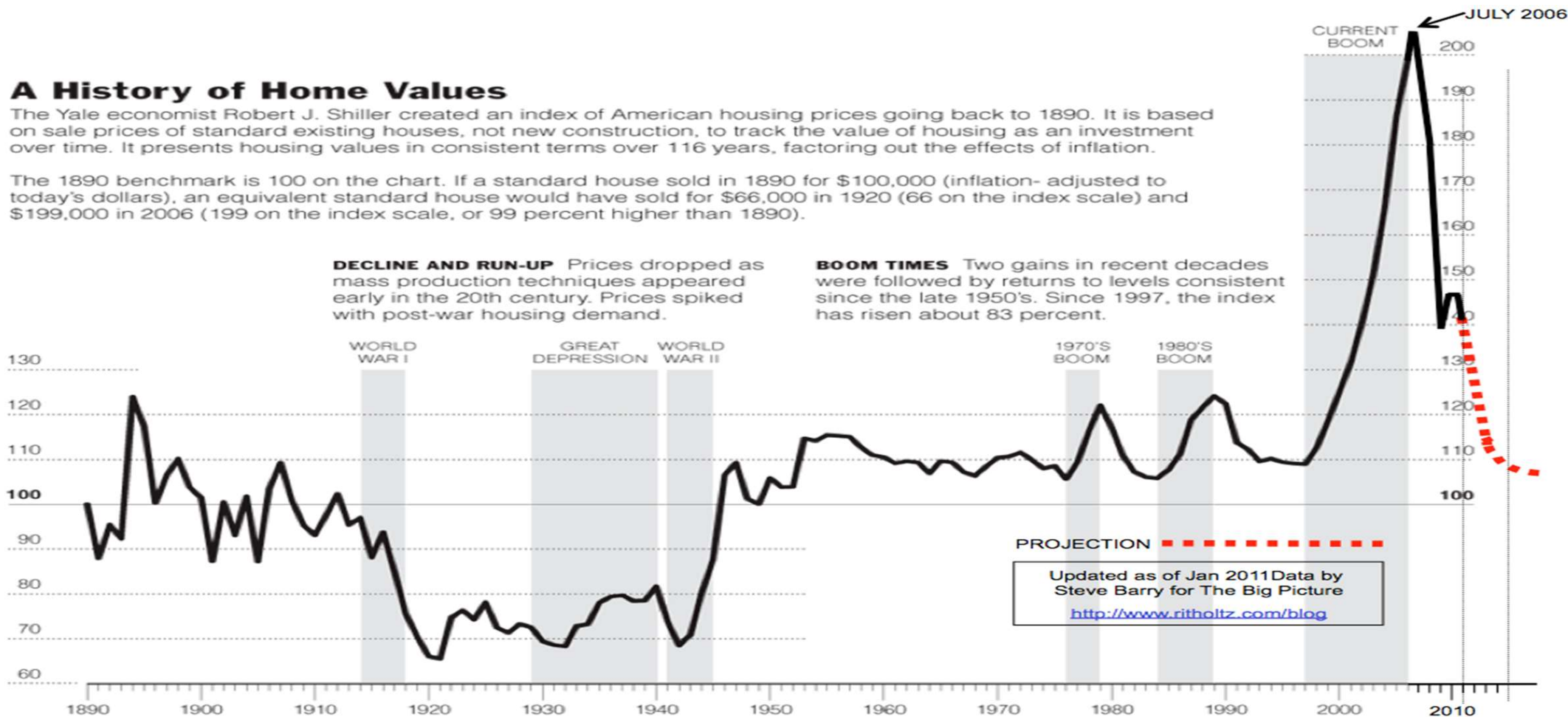
What were you waiting for?



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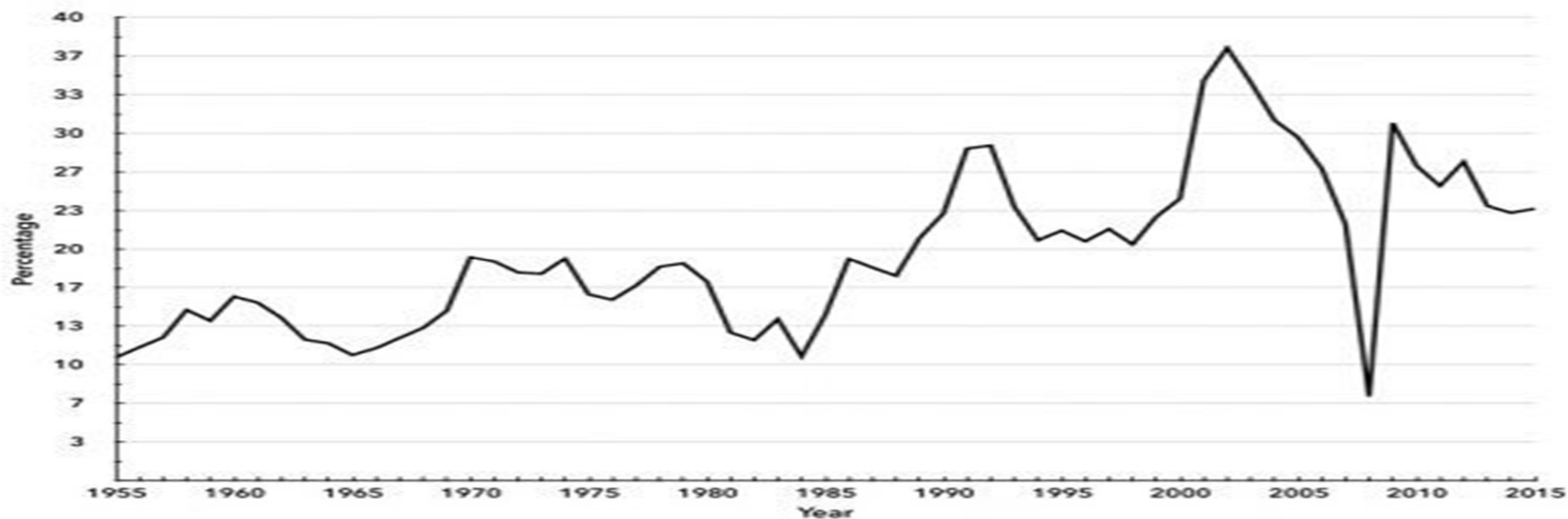
U.S. Financial Profits as Percentage of Corporate Profits of Domestic Industries, 1955–2015



“Table 1.14. Gross Value Added of Domestic Corporate Business in Current Dollars and Gross Value Added of Nonfinancial Domestic Corporate Business in Current and Chained Dollars”; “Table 6.1. Current-Cost Net Stock of Private Fixed Assets by Industry Group and Legal Form of Organization”; “Tables 6.16A, 6.16B and 6.16C: Corporate Profits by Industry,” National Income and Product Accounts (NIPA), U.S. Bureau of Economic Analysis (BEA).

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Rate of profit 1955-2015, US

In spite of the increase in the rate of profit, accumulation (investment) went down.

What is a possible explanation?

The explanation is that money flowed to the financial markets.
In that sense, the action of the central banks (ECB, Fed) after the subprime crisis, although it prevented a deeper recession, created financial inflation.

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The euro problem

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What happened with public debt interest rates with the euro?

Interest Rate Convergence in the Euro Area

Government bond yields, 10 years maturity

30.00
25.00
20.00
15.00
10.00
5.00
0.00

1990 1990 1991 1992 1993 1993 1994 1995 1996 1996 1997 1998 1999 1999 2000 2001 2002 2002 2003 2004 2005 2005 2006 2007 2008 2008 2009 2010 2011 2011

Austria
Belgium
Finland
France
Germany
Greece
Ireland
Italy
Netherlands
Portugal
Slovakia
Slovenia
Spain

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The difficulty with the euro

- If an economy with a large trade deficit has no means to use the exchange rate, when in a recession the only available tool is the **internal devaluation** (meaning reducing wages and pensions, or internal demand, and therefore aggravating the recession)

- When this is combined with a crisis of public debt (larger interest rates) the recessive policy is aggravated by raising taxes (again, aggravating the recession and reducing aggregate demand)

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The Draghi Plan (pursued after he left the presidency of the ECB, late 2019)

Quantitative Easing:

monetary emission for the purchase of financial assets, including public debt (but **not to the national States**) and private debt

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The effect of the Draghi Plan at the ECB: injections of liquidity and negative interest rates