The Current Financial Crisis
A New event or history repeating itself?

Financial crises happen time and again, each time exhibiting a fundamental similarity in their origins and the way in which they unfold, but also in their own specific characteristics. All financial crises take at least one of three canonical forms which history has regularly taught us since the 19th century, at least. Often they take on and combine each of the three forms successively or simultaneously. Let us analyse them, with particular reference to the works of Michel Aglietta and the economists at the Bank of International Settlements.

The first and oldest of these forms is the speculation crisis. Why do property assets (shares, real estate...) become the subject of speculative bubbles? Because their price, in contrast to goods, industrial services or repeatable trade, does not depend on their production cost. That is why their price can be some way off their manufacturing costs. The price of a financial asset depends fundamentally on the confidence we place in it based on the future returns it can bring as forecast by its issuer. But the determination of price also depends on what everyone anticipates regarding the confidence placed in this promise by others. Everyone reasons in this way.

If the information is not fairly shared (between lender and borrower, the shareholder and the management, or between the market actors themselves), coupled with the fact that the future is difficult to predict, these information asymmetries and the fundamental uncertainty favours mimicry in the parties.
So it is in fact very difficult to know the fundamental value of the asset in consideration, and so also to bet on it. In this case, the direction of the market is decided by the others because it is the pure product of expression of the majority opinion which then becomes clear. So the parties understandably imitate each other, hoping to try and anticipate and go with market trends in a totally self-referring manner. Thus these bubbles can burst suddenly, with the reversal of the majority opinion, in an even stronger movement than that which characterised the previous phase.

The second form, the credit crisis, stems from the fact that over a prolonged growth period all parties (banks and borrowers) progressively forget about the possibility of crisis occurring and end up expecting unbounded growth (an effect of “disaster myopia”) . In this euphoric state, lenders dangerously lose their sensitivity to risk and the level of leverage (debts on the level of wealth or of household revenue or of net assets for businesses) and end up increasing excessively. Besides, this phenomenon is considerably amplified where lenders no longer gauge the solvency of the borrowers against the yardstick of their likely future revenues, but against the yardstick of the expected value of the financed assets (notably shares or property) or which serve as collateral. In the end, and more often than not, during this phase they accept margins that do not cover the cost of risk of forthcoming credit, as is the competitive nature of the game.
The financial situation for the economic agents proves very vulnerable during the next economic reversal. Also, while the crisis is happening, the lenders (banks and markets) carefully reconsider the level of risk they are running, and by a symmetrical effect of the precedent, they sharply reverse their practice of credit grants, as much in terms of volume as margin, until they provoke a “credit crunch” which will itself reinforce the economic crisis that it has created.

The third canonical form of crisis; the liquidity crisis. During a certain dramatic sequence of financial crisis events, a contagious wariness appears as we are witnessing with today's financial and banking crisis. For certain banks this defiance induces a fatal rush in their clients to withdraw their deposits. It can also lead to a rarefaction, even a disappearance of willingness with the banks to lend to each other for fear of a chain of banking bankruptcies. But this illiquidity in the market of inter-banking finance – without the last resort intervention of the central Banks in the role of lenders – produces these bankruptcies which are so dreaded. Apart from this, other forms of illiquidity can be produced.
Certain financial markets which yesterday were fluid can suddenly become illiquid; so much so that the concept of market liquidity is still highly self-referential, as André Orléan has analysed. A market is only liquid if all the parties involved believe it to be. If suspicion arises as to its liquidity, as was recently the case with the ABS market for example, all parties will find themselves selling to get out of the market, at the same time provoking its illiquidity in an endogenous fashion.

These three types of crisis are often interlaced and mutually lead to an extremely critical situation. As an example, credit can quickly grow excessively by virtue of the unusually high growth in the price of property assets which act as guarantees to these funds. And the prices of these assets shoot up themselves since easier credits allow for additional purchases. Here we end up faced with a self-maintaining and potentially long-lasting phenomenon in markets which do not stabilise themselves at normal levels. Likewise the liquidity crisis is generated, for example, by a sudden fear over the value of bank debts and the financial assets which the financial organisations possess. In the search for liquid assets the banks will finance the economy less and try to sell their assets, which in turn worsens the speculative crisis as with the credit crunch.
The major crisis which began in 2007 is a combination of these three forms. Firstly a speculative property bubble, notably in the US, the UK and Spain. Next, a credit crisis due to a dangerous rise in the levels of household debt in these same countries, and to a very high leveraging from the investment banks, businesses in leverage buyout and hedge funds in particular. Finally a liquidity crisis in the securities products and inter-bank refinancing markets. Each crisis reinforces the other two in a self-maintaining process.

The idiosyncratic element of the current crisis lies in the rapid development in securitisation of bank debts in recent years.
Securitisation comes from the credit organisation report of bank debts for individuals, businesses and local authorities. These debts are often grouped in a heterogeneous manner into supports with a high leveraging effect themselves, revenue supports to other banks, to insurers and to displacement funds, in other words ultimately for everyone.
Securitisation has therefore enabled significant growth in the financing of the global economy since it allows the banks to make much more funding than if they'd kept them in their balance sheet. But this technique, which is not controlled, has also incited the banks who use it most (particularly in the US) to considerably lower their selection standards and their monitoring of borrowers, and to agree to lend to increasingly insolvent borrowers because they then run no more risk after securitisation. So, for example it's in this way that sub-prime credit liabilities multiply, significantly increasing the credit crisis which has come about following the bursting of the property bubble. Non-regulated securitisation has then considerably aggravated the credit crisis, but also the liquidity crisis. In effect the difficulty in tracking these funds and the mixture of good and bad credits in the same supports, like the opaqueness and complexity (CDO...) of securities products, have in turn worsened the extent of the crisis itself. With everyone losing all confidence in the quality and even in their understanding of

this kind of investment, their liquidity has in fact found itself suddenly dried up. In fear of the assets then being held in the banks' balance sheet, and so those of the insurers, at the same time this has led in particular to an inter-bank liquidity crisis of a gravity that we thought had been consigned to the past. For public authorities the difficulty in resolving the problems which have arisen has increased.

Finally, the credit-rating agencies, armed with unappreciated mathematical models based on restrictive hypotheses and the exclusive analysis of past series, have accorded a quality grading (grade AAA) to sections of the supports in question. And yet this seal of approval has revealed itself little by little, as the crisis unfolds, to be of very poor quality. These grades, which moreover do not account for the risk of liquidity, have led many investors including bankers to reassure themselves of getting off lightly, and in the end wrongly, on the quality of their financial assets, without asking themselves overly about the reasons for which an AAA investment quotation could be so well compensated.

The entanglement of these three canonical forms of financial crisis, other specific elements and the current crisis explain the extreme seriousness of today's situation, with its procession of banks in distress, the panic of investors, the "credit crunch" in process, and finally the powerful economic crisis. Only the strong actions of the authorities, at the precise moment when everyone doubts each other, has recently been able to begin to calm the inter-bank market a little and to avoid a total collapse of the financial system.
All that remains is to watch for, and try to counter, the economic consequences of the most serious financial and banking crisis since the '30's. And to hope that the resultant risk of credit to businesses and households does not revive the banking crisis in a vicious circle which would once again exacerbate the coming recession.

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