Caius Economics Essay

Are financial crises inherent to modern economic growth?

An essay examining the necessity of the existence of financial crises with regards to modern financial system-driven economic growth

Economic growth has defined life following the Industrial Revolution. As a means of achieving this, modern global financial systems were established in order to supplement a fast-growing population's need for resources and order; the extent to which global interconnectedness and any subsequent consequences would occur was foreseen by few. In this essay, I argue that, while the modern financial system serves its purpose well, supporting economic growth, in the forms of assets, loans, and opportunity, its detrimental side-effect, namely, the financial crisis, is not a necessary component of such growth, instead being due to negligence, frenzy, or unsustainably changing market conditions. Several examples elucidate my point, including the global crisis, Asian crisis, and the existence of bubbles.

Firstly, it is essential to define a financial crisis. Claessens and Kose, of the International Monetary Fund, suggest that 'financial crises can take various shapes and forms'[1], including: currency crises, wherein a speculative attack on a currency results in a devaluation or sharp depreciation; sudden stops, where a large fall in international capital inflows often results in a loss of investor faith and trade deficit; a foreign debt crisis, where a country does not service its foreign debt; domestic public debt crises, when a country does not honour its domestic fiscal obligations, by defaulting or devaluing its currency; and systemic banking crises, the most well-known, where potential or actual bank runs induce governments to support banks, creating moral hazard. Reinhart and Rogoff distinguish between the former two being quantitative and thus easily measurable, whereas the latter few lend themselves towards qualitative methodologies of classification.[2] This is a relatively important distinction, as it allows for the realisation that financial crises are, inherently, complicated and multifaceted; they are not restricted to a certain set of occurrences, although some instances tend to characterise them. The ultimate conclusion is, however, that there exists conditions which we would ascribe the term 'financial crisis' to; Kenton describes it as a situation in which 'asset prices see a steep decline in value, businesses and consumers are unable to pay their debts, and financial institutions experience liquidity shortages'.[3]

Economic growth, on the other hand, is not so easy to define. If one considers GDP (PPP)(/capita) to be an accurate indicator of a country's economic potential, this may seem a concept surprisingly

---

[1] Kose, Ayhan, and Stijn Claessens. "Financial Crises Explanations, Types, and Implications." *IMF Working Papers* 2013, no. 028 (2013): 1. https://doi.org/10.5089/9781475561005.001.

[2] Reinhart, Carmen M., and Kenneth S. Rogoff. 2009. "The Aftermath of Financial Crises." American Economic Review, 99 (2): 466-72.

[3] Kenton, Will. "Financial Crisis: Definition, Causes, and Examples." Investopedia, 2019. https://www.investopedia.com/terms/f/financial-crisis.asp.

simple to quantify; however, Raworth's argument of this being merely a 'cuckoo' goal[4], obscuring the true factors of economic growth, cannot be ignored. For the purposes of this essay, however, GDP increase is a satisfactory definition of economic growth. Globalisation and economic liberalisation must also be considered when discussing economic growth, for trade is the largest contributor to GDP increase, according to Were, ignoring the fringe cases of LDCs.[5]

Now that both terms have been clarified, the relationship between them can be analysed. Upon first glance, it would seem that crises are inevitable results of economic growth; as a country develops, its capital inflows increase, bolstering investor confidence, leading to exaggerated growth, resulting in a crash. Additionally, the unpredictable nature of external shocks, leading to contagion, suggests that financial crises cannot be prevented. However, I argue that this is not true - financial crises arise from irrationality. In the case of bubbles, times of inflated asset value (which are followed by large crashes, as in the case of the dotcom bubble bursting in 2000, or the housing bubble, the latter of which crashing causing the global financial crisis of 2007-9, as a result of subprime mortgages and complicated financial instruments), the crisis arises from investor frenzy to make profits, whilst ignoring the potential, inflated risks caused by the bubble. The existence of bubbles, and subsequent crises, is not a result of economic growth or the financial system; it is due to investor negligence and irrationality. The free flow of capital provided by the financial system does not cause the bubble; it merely provides some conditions necessary - the real issue comes from market frenzy. Janeway argues that bubbles are actually beneficial, as they help to generate the scale of investment required for strong innovation.[6] He quotes DeLong: "Investors lost their money. We will now get to use their stuff."[7] He gives the examples of the British canals, and, later, railways, and American railways; investors created large bubbles within each area, thus providing the capital necessary for large expansions of each, and, while investments later lost their value, the physical benefits remained. This is a perfect example of the link between a crisis and economic growth, without suggesting causality: economic growth occurred as a result of the bubble, *as well as* a financial crisis. Economic growth did not spark the bubble.

Kindleberger holds a different, more Keynesian view.[8] He blames bubbles and currency crises for creating huge crises, citing examples of Japan in the 1900s, the mid-1997 Asian financial crisis, where most banks in South Korea, Malaysia, and Thailand went into insolvency following a

---

[4] Raworth, Kate. 2017. Doughnut Economics: Seven Ways to Think Like a 21st Century Economist. White River Junction, Vermont, Chelsea Green Publishing.
[5] Were, Maureen. "Differential Effects of Trade on Economic Growth and Investment: A Cross-Country Empirical Investigation☆." Journal of African Trade 2, no. 1–2 (2015): 71. https://doi.org/10.1016/j.joat.2015.08.002.
[6] Janeway, William H. "Doing Capitalism in the Innovation Economy: Reconfiguring the Three-Player Game Between Markets, Speculators and the State." 2nd ed. Cambridge, United Kingdom ; New York, NY: Cambridge University Press, 2018.
[7] J. B. DeLong, "Profits of Doom," Wired, 11(4) April (2003).
[8] Aliber, Robert Z., and Charles P. Kindleberger. Manias, Panics and Crashes: A History of Financial Crises. 7th ed. Houndmills, Basingstoke, Hampshire ; New York: Palgrave Macmillan, 2015.

contagion caused by the collapse of the Thai Baht, as well as writing of the Mexican and Scandinavian crises. He sees no economic growth stemming from such occurrences, but, crucially, does not blame economic growth as leading to financial crises - 'every mania is associated with a robust economic expansion, but only a few economic expansions are associated with a mania.' The economic expansion caused by mania is only fleeting. Eichengreen analyses the Asian crisis, concluding that international capital flows support make international trade possible, but also create financial instability.[9] Once again, the financial system and subsequent economic growth are not the culprit, but, rather, human action is the root cause of the financial crisis.

To conclude, the financial system offers easily-accessible, and controllable, economic growth. The financial crisis has often been tied to economic growth, but I argue that the latter is not a cause of the former; while the financial system provides the circumstances in which a crisis can occur, the crisis itself is caused by the gradual, cumulative actions of investors, which lead towards dangerous bubbles and defaults. It may even be considered that investor irrationality is the root cause of all financial complication, for, ultimately, the system was constructed by humans, for humans, and at no point do I believe the system has, or will, ever grow to a level at which human fallacy is irrelevant to a crisis.

Sampanna Raut, 2023

Bibliography

Aliber, Robert Z., and Charles P. Kindleberger. "Manias, Panics and Crashes: A History of Financial Crises." 7th ed. Houndmills, Basingstoke, Hampshire ; New York: Palgrave Macmillan, 2015.

Astley MS, Giese J, Hume MJ, Kubelec C (2009) "Global imbalances and the financial crisis." Bank of England Quarterly Bulletin 49:178

Bricco, Jana, and TengTeng Xu. "Interconnectedness and Contagion Analysis." *IMF Working Papers* 19, no. 220 (October 11, 2019). https://doi.org/10.5089/9781513516226.001.

Caldera-Sánchez, Aida, Filippo Gori, and Alain de Serres. "Strengthening Economic Resilience." *OECD Economic Policy Papers*, 2017. https://doi.org/10.1787/6b748a4b-en.

[9] Eichengreen, Barry J. Globalizing Capital: A History of the International Monetary System. 3rd ed. Princeton ; Oxford: Princeton University Press, 2019.

Carson, Michael, and John Clark. "Asian Financial Crisis | Federal Reserve History." *www.federalreservehistory.org*, November 22, 2013. https://www.federalreservehistory.org/essays/asian-financial-crisis.

Caulfield, J. (2022, December 05). "Creating a Chicago Style Bibliography | Format & Examples." Scribbr. Retrieved July 26, 2023, from https://www.scribbr.com/chicago-style/bibliography/

De Bonis, Riccardo, and Alberto Franco Pozzolo, eds. "The Financial Systems of Industrial Countries," 2012. https://doi.org/10.1007/978-3-642-23111-7.

Don-Siemion, Thea . "Caius Explore Economics." cai.cam.ac.uk, 2023. https://www.cai.cam.ac.uk/sites/default/files/Economics%202023.pdf.

Eichengreen, Barry J. "Globalizing Capital: A History of the International Monetary System." 3rd ed. Princeton ; Oxford: Princeton University Press, 2019.

Greenspan, Alan. "We Need a Better Cushion against Risk." www.ft.com, March 26, 2009. https://www.ft.com/content/9c158a92-1a3c-11de-9f91-0000779fd2ac.

Janeway, William H. "Doing Capitalism in the Innovation Economy: Reconfiguring the Three-Player Game Between Markets, Speculators and the State." 2nd ed. Cambridge, United Kingdom ; New York, NY: Cambridge University Press, 2018.

Kose, Ayhan, and Stijn Claessens. "Financial Crises Explanations, Types, and Implications." IMF Working Papers 2013, no. 028 (2013): 1. https://doi.org/10.5089/9781475561005.001.

Kuehnlenz, Sophia, Valeria Andreoni, and Imko Meyenburg. "Capitalism and Crises: A Comparative Analysis of Mainstream and Heterodox Perceptions and Related Ethical Considerations." *Business Ethics, the Environment & Responsibility* 32, no. S1 (February 25, 2022). https://doi.org/10.1111/beer.12420.

J. B. DeLong, "Profits of Doom," Wired, 11(4) April (2003).

Kenton, Will. "Financial Crisis: Definition, Causes, and Examples." Investopedia, 2019. https://www.investopedia.com/terms/f/financial-crisis.asp.

Raworth, Kate. 2017. "Doughnut Economics: Seven Ways to Think Like a 21st Century Economist." White River Junction, Vermont, Chelsea Green Publishing.

Reinhart, Carmen M., and Kenneth S. Rogoff. 2009. "The Aftermath of Financial Crises." American Economic Review, 99 (2): 466-72.

The Economist. "Economics A-Z Terms Beginning with a | the Economist," 2019. https://www.economist.com/economics-a-to-z.

Were, Maureen. "Differential Effects of Trade on Economic Growth and Investment: A Cross-Country Empirical Investigation☆." Journal of African Trade 2, no. 1–2 (2015): 71. https://doi.org/10.1016/j.joat.2015.08.002.