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Book review

KEYNES, MINSKY AND FINANCIAL CRISES IN EMERGING MARKETS

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In this book, Ognjen Radonjić and Srdjan Kokotović analyze a problem of the growing international economic and financial instability from the perspective of Post-Keynesian economic thought. In line with the Post-Keynesians, authors insist on the fact that assumptions of the theoretical model predetermine its implications. Since, authors advocate, assumptions of the efficient markets' model are not realistic, this implies that its implications are not valid, which is a fact repeatedly reiterated in real life last three decades. Again, in real life, this fatal flaw of the theory of efficient markets has still been predominately ignored by economic literature and policymaking circles. On the other hand, Radonjić and Kokotović refuse to follow this ideology. They use theoretical insights of two seminal heterodox economists, John Maynard Keynes and Hyman Minsky as their main research tool in rejecting efficient markets' mantra and explaining the causes of financial crises in emerging markets. I firmly believe that this study presents an undisputable scientific contribution to the current and future analyses of the utmost important issue of the stability of the world financial system.

In *Introduction*, the authors acquaint readers with the issues and objectives of the book. They start by asking the question of why boom-bust episodes occur regularly in both developed countries and emerging markets and why financial crises in last three decades last longer and become more severe. In order to answer these questions, authors emphasize, we need, in the first place, to have a realistic theory. The second step is to prescribe, on the basis of relevant theoretical

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insights, economic measures aiming at preventing and ameliorating the negative effects of eventual financial breakdown.

Broadly speaking, there are two relevant theoretical strands pertaining to rationality and stability of financial markets. The first theoretical strand is mainstream financial economics, or as John Kenneth Galbraith named it "the conventional wisdom". At the moment, mainstream financial theory is predominant; not only in academic, but also in political circles as well – a place where crucial economic decisions are made.

Detailed analysis of the modern mainstream theory of efficient financial markets and its theoretical and policy implications are given in the first chapter *Exegesis of the Conventional Wisdom: Efficient Markets, Rational Expectations and Exogenously Generated Financial Crises.* According to the authors, theory of efficient financial markets is firmly grounded on grossly unrealistic assumptions that future will resemble past and that rational decision-makers are capable, on average, of forming correct expectations. Equally important, humans, like automata, are assumed to have formed homogenous expectations and made decisions independently of decisions made by other market participants. As the proponents of omnipotent free markets see it, the future path of the economic system is predetermined and is not dependent on the past or future choices of economic agents.The direct implication of the efficient market hypothesis is that free decentralized markets, if let alone, inherently, i.e. endogenously generate equilibrium. In this view, ups and downs (boom-bust episodes) are the consequence of an exogenous shock (external to market processes) – most frequently inappropriate and clumsy public policy interventions. In the open-economy model, financial crises can emerge due to a number of factors: inconsistency between the internal and external objectives of monetary authorities; a lack of credibility of the central bank's and the government's commitment to fully defend the foreign exchange rate; massive withdrawals from the host country due to irrational behavior on the part of lenders; corruption and cronyism, etc. A superior recipe for avoiding financial crises is to implement and conduct consistently prescribed market-led policies. On the other hand, unless these rules are obeyed and consequently crisis erupts, the only way to regain the confidence of investors, domestic and foreign, is to implement measures of economic austerity. Since the outcome of theory is determined by the reality of its assumptions, Radonjić and Kokotović conclude that invalid assumptions of „the conventional wisdom" lead to invalid theory and

therefore policy implications which are not up to the task of solving a vast array of problems and growing difficulties in the normal functioning of the global economy.

The second theoretical approach is the one developed by seminal English economist John Maynard Keynes and his Post-Keynesian American follower, Professor Hyman Minsky. Their theory of speculative and inherently unstable financial markets is presented in the second chapter *Keynes' U-turn: Endogenous Expectations, Speculative Financial Markets and Instability of Investment Demand* and third chapter *Hyman Minsky: Endogenous Instability, Debt and Fragile Finance.* Both of them reject economics as a science of abstract and general theoretical principles for all ages, applicable to all occasions independently of the social context. Keynes and Minsky's theory of speculative, as opposed to the theory of perfect self-regulating markets is rooted in realistic assumptions. Realistic assumptions are in the heart of their theoretical explanation of why financial booms and busts are the normal state of advanced capitalistic economies, i.e. why financial crises are endogenous and not exogenous to modern capitalist economies. The kernel of their theory of speculative and unstable financial markets consists of uncertain future, humans as a complex economic, sociological and psychological beings, exaggerated expectations, disappointments and accumulated debts to the extent that they cannot be met by the profits actually materialized in reality. Furthermore, due to the fact that expectations are self-fulfilling even the solid banks and companies are liable to bankruptcy in case tornado of disappointment blows through the market.

The theoretical implication of Keynes-Minsky theory of speculative and unstable finance is that if markets are let alone they will not strive to stability, on the contrary, to instability. Cure lies in timely changes in financial market's regulation as well as in its strict and continuous supervision. Markets are prone to explosive and abrupt ups and downs and the job of regulators is to tame markets and therefore make them predictable as much as possible. Therefore, in the case of increasing financial tension, markets should not be let alone. Timely and decisive fiscal (Big Government) and monetary (Big Bank) intervention is needed. However, Minsky was aware of the fact that government intervention leads to moral hazard, but, as the case of current global financial crisis unambiguously shows, socialization of costs is a precondition for avoiding the Great Depression-like debt-deflation scenario. In a word, the task of financial regulators is financial crisis prevention

and provided they fail, the only possibility left is massive government intervention aiming at escaping vicious circle of devastating debt-deflation episode.

Further on, Radonjić and Kokotović draw on the insights of contemporary Post-Keynesian economic thought in order to expand Minsky's theoretical framework to a developing open-economy case, in which most debt is foreign short-term debt set on a roll-over basis and denominated in hard currency. According to this view, displacement or the key event that triggers massive capital movements towards developing countries is a Minskyan liquidity expansion in rich countries. In other words, movements of capital towards developing countries are exogenous, i.e. the actions of developing countries do not influence movements of international capital. They are rather a result of liquidity changes in the developed world. On the other hand, a liquidity expansion in the developed world and the accompanying capital flows into the shallow financial markets of developing countries produce positive effects only in the short run. In the medium run, unless the external borrowing of local market participants is adequately constrained and controlled, a disastrous debt-deflation episode may take place.

In the fourth chapter, *The Falling Angels: Mexico and the Asian Tigers*, the authors conduct comprehensive Minskyan analysis of the Mexican (1994) and Asian crisis (1997). Here Radonjić and Kokotović conclude that in both cases, massive movements of capital towards these markets were exogenously generated and that a robust period in the host countries led to over-leveraged units, which could not fulfil overly optimistic profit expectations. In the end, the simultaneous effect of endogenous and exogenous shocks within an already fragile environment have pushed those systems into financial instability. Not less important, the authors notice, in contrast to the Keynes-Minsky approach, in both cases international financial institutions transferred the onus of austerity-led adjustments to the crisis-hit countries with devastating consequences.

In the fifth section, *Financial Tumbling in Eastern Europe: From the Ashes of Socialism to the Dust of Capitalism*, the authors conduct a rigorous factual analysis of the cross-country pre-crisis and post-crisis developments in fundamental economic indicators in 13 Eastern European countries plus Turkey in order to prove that the current crisis conforms to the Minskyan liquidity model of crisis generation. The authors show that by deployment of Asian current account surpluses, conducting an overly expansive monetary policy and massive securitization of illiquid assets, the U.S. economy, set in motion a global liquidity cycle

at the beginning of the 2000s. In line with a Minskyan liquidity model, liquidity expansion in the most developed economy in the world led, in no time, to massive capital flows towards developing countries. As Keynes and Minsky would expect, simultaneously with dynamic economic growth and progressiveness in enforcing internationally desired market-led policies, developing Eastern European economies built up massive vulnerabilities to sudden capital reversion. Unfortunately, seemingly unexpectedly, the U.S. financial markets contracted sharply in 2007 and the crisis instantaneously spilt over to a large number of developed and developing countries. However, in this case, massive fallout was avoided thanks to the expansion-oriented policy co-ordinated actions of the governments of developed nations and international financial institutions. It seems that we have gained some very useful lessons learned here from the mistakes made in the past (e.g. Mexico and the Asian tigers). This is why negative effects of the Eastern European financial breakdown in 2009 have been mild up to now.

In the sixth section, *Cross-Country Analysis of Individual Vulnerabilities to the Sudden Liquidity Contraction*, the authors detect the macroeconomic and financial factors that determined the strength of the impact of financial crisis on the local economy. According to the authors, macroeconomic indicators, such as the degree of openness of the economy, the degree of credit euroisation, exchange rate policy and the level of budget deficit in the period before the crisis did not significantly matter. Financial indicators were crucial in conjunction with a selected model of economic development. Countries that accumulated excessive debts and at the same time grounded their development on excessive consumption and development of non-tradable sectors experienced more dramatic economic contraction and vice versa. Countries that have successfully limited the level of indebtedness of households and non-financial sector and invested heavily in tradable sectors have relatively painlessly overcame abrupt and sharp decline in the inflow of foreign capital.

Finally, in the seventh section *Financial Turmoil Now and Then: Empirical Comparison of the Eastern European and Previous Financial Crises*, the authors compare the pre-crisis and post-crisis developments in fundamental economic indicators, the accumulation of vulnerabilities and the impact of the current crisis with the previous cases (Mexico in 1994, Indonesia, Thailand, Philippines, Malaysia and South Korea in 1997, Russia in 1998, Brazil in 1999, Ecuador in 1999, Turkey in 2000, Argentina in 2001-2002 and Uruguay in 2002). The authors find

that developing countries in Eastern Europe, though much more vulnerable by previous standards, have experienced a milder crisis compared to other developing countries which have had suffered from a sudden termination of capital inflows in the past. The reason lies in a large-scale and unprecedented financial assistance to Eastern Europe provided by the developed world and international financial institutions.

The authors summarize in *Conclusion* their thoughts and expose recommendations for policymakers in open economies regarding the issue of financial crisis prevention, and, in the case of crisis eruption, minimization of its hazardous effects. The main conclusion is that the objective of macroeconomic policy should be directing capital towards export-oriented productive sectors and strict control and the constrain of: borrowing of domestic economic participants; raising debts denominated in foreign currencies; and debt maturity (the pursuit of long-term borrowing).

To conclude, the manuscript *Keynes, Minsky and Financial Crises in Emerging Markets* by Ognjen Radonjić and Srdjan Kokotović is a book which doubtlessly increases our ability to understand such a complex phenomenon as financial crisis in developing economies has been. As Professor Marc Lavoie rightly claims in his Foreword to this book „Radonjić and Kokotović provide their readers with a unique contribution, by explaining (sometimes in painstaking details) the evolution of the European emerging countries before and after the global financial crisis in light of this Minskyan framework that they have developed." It is therefore with huge pleasure that I recommend it for reading, not only to Academia and policymakers, but to all economic laymen interested in their future welfare as well.

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Minsky was not the faithful interpreter of The General Theory that he supposed himself to be: he applied Keynes's economics to a system with upward instability, intrinsically prone to overindebtedness and overinvestment. From this perspective, Minsky had the indisputable merit of questioning the myth of growth, which in his view (instead of converging to a uniform and constant rate) endogenously evolves into financial fragility, financial crises, debt deflations, and deep depressions.Â Rigid adherence to anti-inflationary policies will only deepen the crises in emerging markets. As the IMF continues to insist on fiscal austerity and many governments instinctively resist capital controls, a wider recession looms. Open Access Subscription Access. The Psychology of Financial Markets: Keynes, Minsky and Emotional Finance. S. Dow. https://doi.org/10.32609/0042-8736-2010-1-99-113.Â One can see this emerging again in Keyness analysis of financial behaviour, and again in Minskys financial instability hypothesis. The methodological features of their economic analysis are explored which allow this crucial psychological input to be present, focusing in particular on the role and meaning of rationality. Keywords.Â 9. Chick V. Could the Crisis at Northern Rock have been Predicted? An Evolutionary Approach // Contributions to Political Economy. 2008. Vol. 27, No 1. P. 115-124. Chapter 5 Behavioral Finance in the Financial Crisis: Market Efficiency, Minsky, and Keynes. (pp. 99-135). Hersh Shefrin and Meir Statman. The financial crisis that peaked in 2008 is still roiling us in the Great Recession, in which the economy is barely growing and the unemployment rate is frighteningly high. What inflicted this crisis? And what, if anything, can we do to prevent the next one?Â One of the most important functions of financial markets is indeed to provide Êºa means of price discovery of assets.Êº This is an essential step in the process of capital allocation, risk-sharing, and the provision of liquidity. But price discoveryâ€"the determination of an assetÊ¹s valueâ€"requires skill, talent, and information, which are all in scarce supply.