

## A Great Deal of Ruin

A Great Deal of Ruin provides an accessible introduction to the enduring problem of financial crises. Illustrated with historical analysis, case studies, and clear economic concepts, this book explains in three parts what financial crises are, how they are caused and what we can learn from them. It begins with a taxonomy of crises and a list of factors that increase the risk for countries experiencing a financial crisis. It then examines five of the most important crises in modern economic history, beginning with Great Depression and ending with the Subprime Crisis in the United States and its evolution into a debt crisis in the Eurozone. The book concludes with a set of lessons that can be learnt from the crises of the past. It will appeal to university students as well as general readers who are curious to learn more about the recent Subprime Crisis and other financial crises.

JAMES GERBER is a Professor of Economics, Emeritus at San Diego State University. He is the author of *International Economics* (2018), a best-selling textbook now in its 7th edition, and numerous works on US-Mexico economic relations, including *Fifty Years of Change on the US-Mexico Border: Growth, Development, and Quality of Life* (with Joan Anderson, 2008) which won the Association of Borderlands Studies Book Award.

# A Great Deal of Ruin

## Financial Crises since 1929

JAMES GERBER  
San Diego State University



CAMBRIDGE  
UNIVERSITY PRESS

Cambridge University Press & Assessment  
978-1-108-73990-0 — A Great Deal of Ruin  
James Gerber  
Frontmatter  
[More Information](#)

---



**CAMBRIDGE**  
UNIVERSITY PRESS

Shaftesbury Road, Cambridge CB2 8EA, United Kingdom  
One Liberty Plaza, 20th Floor, New York, NY 10006, USA  
477 Williamstown Road, Port Melbourne, VIC 3207, Australia  
314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre, New Delhi – 110025, India  
103 Penang Road, #05–06/07, Visioncrest Commercial, Singapore 238467

Cambridge University Press is part of Cambridge University Press & Assessment, a department of the University of Cambridge.

We share the University's mission to contribute to society through the pursuit of education, learning and research at the highest international levels of excellence.

[www.cambridge.org](http://www.cambridge.org)

Information on this title: [www.cambridge.org/9781108739900](http://www.cambridge.org/9781108739900)

DOI: 10.1017/9781108608589

© James Gerber 2019

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press & Assessment.

First published 2019

*A catalogue record for this publication is available from the British Library*

ISBN 978-1-108-49734-3 Hardback

ISBN 978-1-108-73990-0 Paperback

Cambridge University Press & Assessment has no responsibility for the persistence or accuracy of URLs for external or third-party internet websites referred to in this publication and does not guarantee that any content on such websites is, or will remain, accurate or appropriate.

Contents

List of Tables	<i>page</i> x
Preface	xi
I. Introduction	1
I.1 More Frequent, More Expensive, Harder to Avoid	1
I.2 Economics, Finance, and History	5
I.3 Plan of the Book	9
PART I: FINANCIAL CRISES	15
1. Categories and Risk Factors	17
1.1 An Introduction to Financial Crises	17
1.2 Categories of Financial Crises	20
1.3 Seven Risk Factors	22
1.3.1 Asset Bubbles	24
1.3.2 Credit Booms	28
1.3.3 Weak Supervision and Regulation	30
1.3.4 Capital Market Liberalization	31
1.3.5 Overvalued Currencies	33
1.3.6 Large Trade Deficits	35
1.3.7 Excessive Debt Levels	37
1.4 What Do We Really Know?	40
2. Growth, Globalization, and Financial Crises	43
2.1 Modern Economic Growth	43
2.2 Modern Globalization’s First Wave: 1870–1914	46
2.2.1 Open Capital Markets	47
2.2.2 The Gold Standard	48
2.2.3 Financial Crises	49

## vi CONTENTS

2.3	Interwar Instability, 1914–1950	51
2.3.1	Deflation	52
2.3.2	Gold and the Great Depression	53
2.4	Bretton Woods and the Golden Age, 1950–1973	55
2.4.1	The Bretton Woods Exchange Rate System	57
2.4.2	The End of Bretton Woods	58
2.5	The Second Globalization Wave, 1973 to the Present	61
2.5.1	Factors Behind the Increase in Financial Crises	62
2.6	Conclusion	64
PART II: FIVE CASE STUDIES		67
3.	The Great Depression, 1929–1939	69
3.1	Why Study the Great Depression?	69
3.2	Factors Leading Up to the Depression	72
3.3	What Caused the Great Depression?	76
3.4	The Keynesian Idea	79
3.5	The Monetarist Response	81
3.6	Two Complications to the Monetarist Story	83
3.7	Economic Recovery and Relapse	87
3.8	Conclusions	90
4.	The Latin American Debt Crisis, 1982–1989	92
4.1	Conditions Leading Up to the Crisis	92
4.2	The IMF's First Global Crisis	94
4.3	The Credit Boom	97
4.4	Varieties of Crises	99
4.5	The Search for Solutions	103
4.6	The Return of Capital Flows	108
4.7	Lessons	109
4.8	From Latin America to East Asia	114
5.	The Asian Crisis, 1997–1999	118
5.1	Stable Economies and Rapid Growth	118

5.2	Explanations for Rapid Growth	120
5.3	The Onset of the Crisis in Thailand	124
5.4	Contagion and Common Fundamentals	128
5.5	Crisis Resolution	132
5.6	The Fallout	135
6.	The Subprime Crisis in the United States	143
6.1	Vulnerabilities	143
6.2	Chronology	152
6.2.1	Too Big to Fail	154
6.2.2	Maintaining Credit Availability	156
6.3	Financial Reforms	158
6.3.1	Crisis Prevention	159
6.3.2	Crisis Mitigation	161
6.3.3	Prognosis	163
7.	The Financial Crisis in Europe	165
7.1	The Single Currency Project	165
7.2	An Uneven Crisis	169
7.3	Bank Debt Becomes National Debt	171
7.4	The Doom Loop	173
7.5	Emergency Actions	176
7.6	Recessions Prolonged	179
PART III:	LESSONS	183
8.	Markets Do Not Self-Regulate	185
8.1	Overconfidence in the Market	185
8.2	Market Reality	189
8.3	Empirically Speaking	193
9.	Shadow Banks Are Banks	197
9.1	No Bailout?	197
9.2	Shadow Banks	199

## viii CONTENTS

9.3	Securitization	201
9.4	Regulators and Incentives	202
9.5	Shadow Bank Depositors	204
9.6	Bank Panics with Shadow Banks	206
9.7	The Rise of Finance	208
10.	Banks Need More Capital, Less Debt	212
10.1	Other People's Money	212
10.2	Leverage	214
10.3	Limits to Risk Models	217
10.4	Resistance to Increasing Capital	219
10.5	Capital and Risk Reduction	221
11.	Monetary Policy Does Not Always Work	224
11.1	Overconfidence	224
11.2	The Rise of Monetary Policy	225
11.3	New Classical Economics	228
11.4	The Great Moderation	230
11.5	Zero Lower Bound	232
12.	Fiscal Multipliers Are Larger Than Expected	237
12.1	Acts of Nature	237
12.2	The Keynesian Consensus	239
12.3	The Multiplier	241
12.4	Expectations	243
12.5	Keynesians and Anti-Keynesians	245
12.6	Testing Ideas with a Crisis	248
13.	Monetary Integration Requires Fiscal Integration	252
13.1	The Grand Experiment	252
13.2	The United States Is a Monetary and Fiscal Union	253
13.3	The Euro and Optimal Currency Areas	256
13.4	Promoting the Euro	257
13.5	Missing Institutions	261

14. Open Capital Markets Can Be Dangerous	266
14.1 Assume There Are Benefits	266
14.2 Capital Market Liberalization Defined	267
14.3 From Open Capital Markets to a Financial Crisis	270
14.4 Open Capital Markets and Economic Growth	274
14.5 Should Countries Close Their Capital Markets?	277
15. Not All Debt Is Created Equal	279
15.1 Fear of a US Debt Crisis	279
15.2 Households, Businesses, and Governments	282
15.3 Sovereign Debt Crises	284
15.4 A Second Look at the United States	288
15.5 Getting Out of Debt	292
Conclusion	296
Abbreviations and Acronyms	304
Bibliography	306
Index	327



Tables

1.1	Types of financial crises	<i>page</i> 21
1.2	Common risk factors associated with financial crises	24
2.1	Estimated average annual growth of real per capita income	45
5.1	Annual average rates of real GDP growth	120
5.2	Average annual current account balance, percent of GDP	140

## Preface

In the 1970s, problems of economic instability and crisis began to be pushed into the background of the discipline of economics and replaced by a focus on economies in stable equilibria at full employment. This viewpoint has ample theoretical justification, but as an economist with a background in historical studies, I have a natural skepticism toward stories of long run equilibrium, or quick recoveries from a collapse of the macroeconomy. In the first years of my career, I was continually puzzled by the fact that twenty miles from where I worked was another world where the Mexican economy took nearly a decade to emerge from a crisis that cut wages in half and threw millions back into poverty. Plus, there was the problem of Japan in the 1990s. After several decades of spectacular growth on what appeared to be a stable trajectory that would soon surpass the United States in GDP, Japan fell into a lost decade of intractable economic problems. Solid institutions and competent macroeconomic management did not seem to be enough to avoid a prolonged crisis. While Japan was struggling to emerge from its problems, a group of institutionally strong, fast growing, stable models of economic development in East Asia experienced sudden and catastrophic breakdowns and then came the Subprime Crisis that many thought could never happen.

Watching the difficulties of regaining growth in Latin America, Europe and the United States, puzzling over the lost decade in Japan, and studying the collapse in East Asia, confirms my view that market economies have more than a little instability baked in, and that the natural tendency to return to full employment after a recession or a crisis could be obstructed by far more than simple human error or misguided government policies. If history teaches anything, it is that

xii PREFACE

the world is a lot messier and more complex than the one described by economic theories emphasizing equilibrium and full employment.

Economic theory is a powerful tool for understanding the world but it requires institutional and historical context, as well as a sense of the limits to theoretical models, in order to avoid falling into scholasticism. I am fortunate that both my undergraduate and graduate programs were in universities where economic history was valued and taught beyond the bare minimum. And, in the university where I teach, I had the luck to become the “accidental director” of the Latin American Studies program. That good fortune gave me the opportunity to travel in Latin America, especially Mexico, to talk with scholars and friends abroad, and to think about the problems of economic instability from outside the lens of the US economy.

In 2009, colleagues in La Paz, Mexico, invited me to give a paper on the Subprime Crisis as part of a conference on that topic. I want to thank Antonina Ivanova, Alba Eritrea Gamez, and Manuel Ángeles for the opportunity to begin developing some of the ideas in this book. Shortly thereafter, I created a course on the subject of financial crises which enabled me to develop a set of topics for teaching about the Subprime Crisis and other historical episodes. I thank my colleagues for the space to develop this course. I benefited greatly from the several semesters of students who read earlier pieces of this work and provided feedback and discussion. In 2012, Rosio Barajas and Eduardo Mendoza at the Colegio de la Frontera Norte invited me to give a paper on the Eurozone Crisis and lessons from Mexico’s experiences with debt and currency crises. I am thankful to them for their invitation and their spirit of collaboration. My colleague and friend Miguel Montoya at the Tecnológico de Monterrey, Campus Guadalajara, let me try out ideas as an invited lecturer in his Masters in Engineering Management program and the results became the genesis of the present work. The book took further shape when my friend Tom Passananti suggested we collaborate on an historical comparison of the financial sector policies of Mexico and Brazil in the 1890s. Tom later suggested we look at the impact of the Panic of 1907 on the Mexican Revolution.

I am grateful for these opportunities and for the friendship and support of my colleagues. Needless to say, I alone am responsible for the mistakes and errors of the current volume.

Academic colleagues and friends are essential but even more so is the support of my wife, Marion. For her patience, her enthusiasm, and her love, I am forever indebted.