

# A Brief Note On Speculation And Financial Crisis: The 2008 Crisis Through Galbraith's Lens

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## Abstract

**Background:** The 2008 financial crisis unveiled critical vulnerabilities within the global financial system, challenging conventional economic theories' ability to forecast and mitigate such disasters.

**Materials and Methods:** This paper delves into the crisis through the analytical lens of John Kenneth Galbraith, whose work on speculation and financial euphoria provides a profound understanding of the cyclicity and inevitability of financial crises. Galbraith's insights into the psychological and structural dynamics of speculation illuminate the processes leading to the 2008 crisis, emphasizing the speculative boom in the US housing market, the proliferation of complex financial derivatives, and the systemic disregard for risk.

**Results:** By juxtaposing Galbraith's theories with the events leading up to and following the crisis, this study not only reaffirms the prescience of his analysis but also underscores the critical need for regulatory frameworks that acknowledge and address the speculative tendencies inherent in financial markets. Through a meticulous examination of the "newness," expansion, and eventual collapse of speculative bubbles, as outlined by Galbraith, this paper argues that the 2008 crisis was not an anomaly but a predictable outcome of speculative excesses.

**Conclusion:** This research contributes to the broader discourse on financial crises by highlighting the enduring relevance of Galbraith's work in understanding and preventing future financial downturns, advocating for a more cautious and historically informed approach to financial regulation and economic policy-making.

**Key Word:** Financial crisis; Galbraith; Speculation; Subprime crisis.

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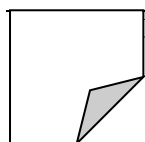
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## I. Introduction

The outbreak of the 2008 international financial crisis highlighted the difficulties that conventional economic theory faces in explaining how crises are gestated and can take disastrous proportions. Part of the economic heterodoxy was already positioning itself as a viable alternative to conventional interpretations, whether because it recognized crises as central elements in capitalist dynamics, or because, in that specific context, it was already suggesting that a similar event was likely in the face of the institutional changes the global financial system had undergone (Keen, 2006; Kregel, 2008).

In this context, alternative approaches gained strength, such as those of Minsky (1977a and 1977b) and Veblen (1904). Minsky explores how the pursuit of profits in the financial sector leads to an increase in leverage and financial fragility, making the system prone to crises. The financial instability hypothesis, which states that "financial stability is destabilizing," is central to his work, indicating how periods of economic stability encourage risk-taking behaviors, increasing the likelihood of financial crises. Veblen, on the other hand, argues that financial profit is the main motivator for companies, directing them not necessarily towards seeking greater productivity or efficiency, but to what can be described as "productive speculation." In this context, the business objective aligns more with opportunities for financial gains derived from disturbances in the economic system. This focus on financial transactions leads to a disconnection between the interests of the community and those of business decision-makers, who see in economic disturbances frequent opportunities for profit. This mindset, based on speculation and the maximization of personal gain, potentiates economic crises, arising from the discrepancies between the initial, optimistic capitalization and the often-stagnant economic reality. The common practice of seeking credit to expand productive capacity and gain competitive advantages ends up placing the company and the economy on a constant brink of crisis, due to the substantial debt that compromises the company's capital as a guarantee for new loans (MARTINS and DRACH, 2020).

Therefore, the crucial role of speculation in the genesis of economic crises is observed. The work of John Kenneth Galbraith (1994), although less explored by the literature compared to Veblen and Minsky, provides valuable insights and nuances for understanding speculative crises, especially that of 2008. Galbraith, in his famous 1994 work, "A Short History of Financial Euphoria," emphasizes the cyclical nature of speculative



optimism and how it, fueled by financial innovation and collective forgetfulness of past failures, leads to bubbles that inevitably burst. His work offers a penetrating analysis of the cycles of financial speculation that have marked the history of capitalism since the tulip mania in 1630s Holland. This mania, which saw the price of a simple flower reach astronomical values, serves as a starting point for Galbraith to explore the cyclic and invariable nature of euphoria and panic in financial markets.

This study delves into Galbraith's reflections to analyze the 2008 crisis, seeking to interpret it through his lens. It aims to demonstrate how several issues raised by Galbraith, "coincidentally," align with the catastrophic events of the early 21st century. By exploring Galbraith's thought, the work emphasizes the predictability of financial crises resulting from unrestrained speculation, the failure to adequately regulate financial markets, and the mass psychology that prefers to ignore imminent danger signs in favor of unfounded optimism. Thus, this work not only recognizes the relevance of Galbraith's ideas for understanding the 2008 crisis but also highlights the importance of his approach in predicting and possibly preventing future financial crises.

The work is structured to offer an in-depth and contextualized analysis of the 2008 crisis, using the prism of Galbraith's observations. After this brief introduction, the text unfolds into four more sections. The second section is dedicated to exploring Galbraith's observations on the common elements that characterize episodes of speculation and lead to profound financial crises. In turn, the third section presents the central elements that triggered the 2008 crisis, drawing parallels with Galbraith's findings. The fourth section seeks to dissect the step-by-step process of the crisis, logically linking them to Galbraith's ideas. Finally, it is argued that many of Galbraith's warnings about the underlying causes of financial crises found a clear manifestation in the events that triggered the global economic collapse at the beginning of the 21st century.

## **II. Galbraith And The Episodes Of Speculation**

According to Galbraith (1994), the most obvious characteristics of a speculation episode are so clear that they are understandable by all. Any artifact or discovery that presents itself as new and desirable – tulips in the Netherlands, gold in Louisiana, real estate properties in Florida – captures the attention of speculators, leading to an increase in the prices of these objects. The values of these assets, acquired today, will be higher tomorrow, thus attracting more buyers motivated by this expectation of appreciation. These buyers, in turn, make purchases, and prices continue to rise. In this way, speculation feeds on itself and generates its own momentum.

Once recognized, this process becomes evident, and the participants' perception occurs in two forms. On one hand, there are those who are convinced that a particular circumstance of the new price increase is under control, expecting the market to continue on its upward trajectory. On the other hand, there are those who, more superficially astute and generally in smaller numbers, perceive or believe to perceive the favorable climate for speculation at that moment. They prepare to surf on the wave's crest, convinced that their unique talent will enable them to withdraw before speculation completes its cycle, planning to obtain the maximum yield while the opportunity persists, withdrawing before the imminent fall.

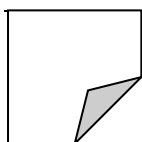
The inevitable fall. The inevitability of this depreciation stems from the gradual disconnection between speculation and the fundamental values of assets, driven more by future appreciation expectations than by real economic bases. This disconnection culminates in a speculative bubble destined to burst when the inflated prices can no longer be justified by real fundamentals, leading to abrupt market corrections and often significant losses, especially for those who entered at the peak of speculation.

Less evident, however, is the collective psychology and propensity to speculate that, once understood, offer a chance to escape the most devastating consequences of these cycles. Despite this, the majority are captured by the force of mass mentality and euphoria, making caution and timely withdrawal exceptions to the rule. This dynamic is reinforced both by personal interest, fueled by excessive optimism, and by the pressure of a dominant financial opinion that endorses this view.

However, only a few observers recognize the perpetuation of error and the illusory credibility attributed to speculative euphoria. Engaging in speculation often results in enrichment, deserved or not, a situation many erroneously attribute to supposed financial acuity or superior intuition.

In each of these historical episodes of speculation, the unifying belief is the appearance of something innovative in the world. From the introduction of tulips to Western Europe in the 17th century to the fascination with joint-stock companies, there is a consistent pattern: enthusiasm for the new and potentially lucrative. Whether an individual or an entity, those who first identify and act on these opportunities see themselves as significantly ahead of others. This advancement is perceived as an acknowledgment of acumen, stimulating the ego as it is expected to also enhance personal fortune. Initially, such perception appears to be validated by success.

In the realm of new financial instruments, however, there is an inescapable and subtly complex truth: genuine innovations are rare. What is often celebrated as novelty is, in fact, just a slightly modified variation of pre-existing strategies, whose newness is more due to collective amnesia than any real advancement. The financial sector has a history of repeatedly hailing the "discovery" of the wheel, though sometimes this new wheel is more



prone to imbalances. This tendency to reinterpret old ideas as innovations reveals that often, the supposed financial novelties are supported by some type of concrete value, however tenuous that connection may be.

Therefore, the cycle of enthusiasm for "new" financial opportunities reveals a collective disposition to embrace the familiar as if it were a revolutionary innovation, fueled both by the hope for profit and by the market's short memory of its past practices.

Thus, Galbraith highlights the cyclical nature of speculation, driven by the constant search for novelty and the optimistic belief that "this time is different," even when the foundations are the same as in previous episodes. The mention of mass psychology and the difficulty of distancing oneself from the prevailing mentality underscores the influence of social pressure and irrational optimism in financial markets. This suggests that, despite the availability of historical knowledge and analytical insights, many investors still fall into the same traps as their predecessors, often with disastrous consequences.

The point about financial innovation being largely a repackaging of old concepts, with a new guise to attract investment, is particularly revealing. It suggests caution against irrational exuberance regarding new financial products, many of which may carry significant risks poorly understood due to perceived novelty and complexity.

Galbraith's conception offers a critical and detailed view of the dynamics of financial speculation, emphasizing the importance of historical and psychological understanding in navigating financial markets. It serves as a valuable reminder of the need for caution, discernment, and a deep appreciation of history to avoid the excesses of the past.

### **III. The Events Leading To The 2008 Crisis**

Between 1997 and 2006, the United States experienced a significant increase in real estate prices, with values in some cases tripling, fueled by a boom in the mortgage credit sector and exceptionally low-interest rates. During this period, the mortgage market saw the movement of trillions of dollars annually, a growth driven by the market expansion, including the incorporation of subprime borrowers, as well as by a significant increase in the securitization of these loans, as pointed out by Borçā and Torres (2008).

According to Borçā and Torres (2008), subprime loans, which were aimed at borrowers without proven financial capacity to meet payments, represented a notable increase in access to real estate financing. This development was largely enabled by the securitization process, in which granted loans were grouped and sold in the capital market, thus transferring the risk from the originating banks to institutional investors around the world. Subprime loans were characterized by a hybrid payment regime, with fixed and low-interest rates during the first two or three years, followed by a prolonged period with adjustable and higher rates. Such a configuration, combined with the possibility of refinancing facilitated by declining interest rates and the constant increase in real estate values, encouraged the expansion of financial operations and facilitated the inclusion of subprime borrowers in the market.

However, this model depended on the continuous appreciation of the real estate market. As conditions changed, many families found themselves unable to refinance their mortgages under favorable conditions, leading to an increase in defaults and triggering the financial crisis. This scenario was exacerbated by a monetary policy of raising interest rates and by the "spontaneous optimism" that permeated risk assessment, both by banks and by borrowers and investors in credit derivatives (BRESSER-PEREIRA et al. 2009).

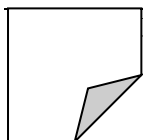
The combination of aggressive expansion of mortgage credit, innovations in securitization, and dependence on real estate valuation created a scenario conducive to the financial crisis, revealing the fragility of a system based on unsustainable growth and optimistic risk assessments.

In summary, the freedom granted to banks to enter the capital market, especially through debt securitization, narrowed the connections between credit and capital markets, making the economy more susceptible to crises. This interconnection facilitated the transmission of shocks from one market to another, contributing to the rapid evolution of a sectoral crisis into a systemic crisis, with broad macroeconomic effects.

Thus, the combination of financial deregulation, questionable monetary policies, and imprudent optimism in the credit market created fertile ground for the 2008 crisis. Indeed, the American monetary policy that, between the second quarter of 2004 and the second quarter of 2007, raised the interest rate from 1.00% to 5.25% per year, coupled with "spontaneous optimism," which led to serious errors in risk assessment by banks, debtors, and credit derivative buyers, sowed the seeds for the severe crisis of 2008, with widespread macroeconomic effects.

### **IV. Innovation – Expansion – Ignored Risks – Recession: Step By Step Of The Anticipated Disaster**

The central proposition of this work is to align the 2008 financial crisis with the theories of Galbraith, offering a deep analysis of the mechanisms that led to the economic collapse. To address this, the following structure proposes to understand the "step by step" of the crisis not merely as a series of isolated events, but as



the outcome of a systemic and interconnected process that reflects Galbraith's warnings about the dangers of speculation and financial bubbles.

Firstly, the identification of a new investment opportunity occurs; innovation in the financial sector, with the development of derivative products and the securitization of subprime mortgages, created an apparent new investment opportunity, attracting a significant volume of capital to the U.S. real estate market. This financial innovation was the initial step in the formation of a speculative cycle, especially when it was perceived as safe and profitable investment opportunities.

Consequently, a rapid increase in prices occurred. The speculation dynamic, fueled by expectations of continuous increases in real estate market prices, illustrated an exaggerated confidence in the perpetual appreciation of assets, highlighting an initial disconnect between real estate prices and their intrinsic value. The ease of access to credit and the adoption of high-risk lending practices fueled a speculative spiral, where the expectation of future profits (mass psychology) supported a continuous increase in real estate prices, demonstrating how speculation can become a self-sustaining engine of unsustainable growth.

This crucial point reflects the phase where speculation drifts so far from economic reality that the risks associated with investments become secondary or completely ignored, culminating in an inevitable real estate bubble burst. Finally, the confidence crisis triggered by the increase in subprime mortgage defaults illustrates the moment of rupture, where the reality of the real estate market and the solidity of derivative financial assets became questionable, leading to a systemic collapse.

This structure, by aligning with the ideas of Galbraith, not only provides a comprehensive understanding of the 2008 financial crisis but also highlights the continued relevance of Galbraith's theories in analyzing the vulnerabilities of the modern financial system.

## **V. Conclusion – Was 2008 Different?**

In broad terms, Galbraith describes how, in moments of speculative euphoria, a collective belief in the endless rise of prices leads to an accumulation of debt, often anchored in promises of tangible value or the reputation of financiers deemed to be geniuses. This phase is characterized by a widespread denial of risks, where critics are quickly marginalized as bearers of unfounded pessimism. However, the transition to panic occurs as abruptly as the fall in prices, triggering a desperate scramble to liquidate positions before values collapse entirely. At this point, the genius previously attributed to the leaders of the financial market quickly evaporates, leaving in the air the question of who will be held responsible for the disaster.

Galbraith argues that this pattern of rise and fall is not an isolated incident but an intrinsic characteristic of speculative markets, recurring throughout history in events like the New York stock market crash of 1987 and the Mexican crisis of 1994. Galbraith's work reveals a perpetual cycle of irrational optimism followed by brutal reality, challenging the perception that next time will be different. The question posed is: was 2008 different?

In 2008, the events that unfolded follow the pattern described by Galbraith almost meticulously. That year's financial crisis, triggered by the collapse of the United States real estate market, vividly exemplifies the cycle of euphoria and panic that Galbraith identifies as recurrent in speculative markets.

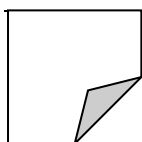
Before the crisis of 2008, there was a strong collective belief in the continuous rise of real estate market prices. This belief was anchored not only in the apparent solidity of the housing market but also in the financial innovation represented by derivative products and the securitization of mortgages, which were promoted by financiers considered innovative and genius. The availability of easy credit and high-risk lending practices contributed to a substantial accumulation of debt.

During this period of euphoria, warnings about a potential real estate bubble and the risks associated with excessive leverage and complex financial products were largely ignored or dismissed as unfounded pessimism. The prevailing mentality was that the real estate market was a safe bet and that prices would continue to rise.

Reality began to impose itself when the default rates on subprime mortgages started to increase, revealing the fragility of the highly leveraged and interconnected financial system. The fall in real estate prices triggered a liquidity crisis, leading to a desperate rush by investors to liquidate positions in assets that were rapidly losing value. Financial institutions once seen as pillars of genius and innovation faced bankruptcies and government bailouts.

The 2008 crisis reinforces Galbraith's theory that cycles of speculation and panic are intrinsic to speculative markets. The widespread belief that "this time is different" was once again disproven by reality. The subsequent global recession, known as the Great Recession, was a grim reminder that the consequences of speculative cycles can be profound and far-reaching.

Therefore, in 2008, it was not different. The financial crisis followed the pattern described by Galbraith, highlighting the historical repetitiveness of speculative euphoria followed by panic and collapse. This repetition reinforces the importance of learning from past lessons and recognizing the need for more effective regulation and supervision of financial markets to mitigate the possibility of future crises.



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