

Policy learning within belief systems in the financial crises of 1929 and 2007

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Aprendizaje de políticas dentro de los sistemas de creencias en las crisis financieras de 1929 y 2007

Resumen

El presente artículo compara los sistemas de creencias evidenciados en las crisis financieras de 1929 y 2007, e indaga por el resultado en el aprendizaje de políticas. El texto muestra que los agentes confirmaron sus sistemas de creencias con los resultados favorables de sus políticas en el corto plazo. Esto los motivó a reproducir estas políticas, para enfrentar la incertidumbre en el largo plazo. Sin embargo, estas alternativas representaron decisiones infructuosas cuando las circunstancias cambiaron. Después del impacto de las crisis, los académicos y diseñadores de políticas se abstienen de modificar sus sistemas de creencias. Por lo tanto, los diseñadores de políticas enfrentan el riesgo de asumir una visión cortoplacista sin modificaciones episódicas, que evitan el análisis contextual del fenómeno económico, para prevenir otras crisis económicas similares.

Palabras claves: Aprendizaje de políticas, sistemas de creencias, crisis financieras, la gran depresión, intervención gubernamental, libre mercado, incertidumbre, contenidos programáticos.

Abstract

This paper compares the belief systems in the financial crises of 1929 and 2007, and asks for the outcome of policy learning. It shows that agents confirmed their belief systems through the early good outcomes of their policies in the short cut. It encouraged them to reproduce those policies, in order to face uncertainty in the unforeseeable future. However, those choices represented unsuccessful decisions, when circumstances changed in the long-term. After the impact of the crises, scholars and policy makers refuse to modify their belief systems. Therefore, policy makers face the risk to assume a short horizon view without episodic modifications, which avoid the contextual analysis of economic phenomena, in order to prevent similar economic crunches.

Keywords: Policy learning, belief systems, financial crises, the Great Depression, government intervention, free-market, uncertainty, programmatic components.

Introduction

It is expected that deep economic dislocations lead to significant restructuring on core beliefs through the policy learning process. This is represented by the change in the arguments to build a particular belief system, and which lead the discussion against other ones. Policy learning breaks the one-side position. Indeed, the old belief system takes external ideas to develop a new core belief. The further government programs move away from the old policy package to a new one. Policy makers foster a rational process in order to choose the best programmatic component. It evidences their priorities and core beliefs.

Taking into account that expectation, this article looks at the deep economic dislocations in 1929 and 2007. It shows that the aim of policy makers was threatened by overconfidence on a particular belief system, supported by the early outcomes in the short run. It avoided pertinent adjustments of programmatic components, when a set of events in the long run did not fit into the certainty of agents' belief system.

Economics developed more sophisticated mechanisms to tackle the economic structure. However, they were not implemented at time by policymakers. There was not change into beliefs to explain those financial crises. Therefore, the present paper concludes there was not sufficient policy learning. The discussion between the two opposite core belief systems remains without modification. A significant restructuring on core beliefs in political economy has not been acquired.

The paper is oriented through a method of comparative analysis. It follows a descriptive method of policy suggestions and programmatic components in the 1929 and 2007 financial crises. It looks for the institutional change on belief systems. It is expected that policy makers take into account the historical performance of institutions, before to launch further policies. It is not possible to prescribe change in institutions, but to analyze its historical performance in a particular period of time. It allows researchers and policy makers to implement a new policy package, in order to start an incremental change through innovation in institutional environment (North, 1990). Therefore, the paper looks at descriptive analyses and critical reviews of financial crises from economists and researchers, which belong to one out of two opposite belief systems: on the one hand, free-market, and on the other hand, government intervention.

The current article looks at the analysis of economic public policies in the financial crises of 1929 and 2007. These phenomena are read from the point of view of two different trends within the core belief

systems in the foundations of political economy. The comparison of public policy core beliefs and programmatic components looks for a pattern between them. The analysis of belief systems explains the objectives of decisions made by agents, in order to manage particular events. Further, it points out the features of the political and economic practices and ideas, before and during the both crises. finally, it points out the analysis of economic crises from the lens of different belief systems. The awareness of these issues helps to prevent similar economic dislocations in the unforeseeable future.

The argument of the article is developed through four main sections. The first one introduces the formation process of belief systems. Actors face uncertainty, according to their experience on critical events, and following the principles of theoretical frameworks (Worsham, 1997; Bacharach, 1986). The second section provides the arguments in a controversy between belief systems in political economy for and against government intervention in markets. The third and fourth parts analyze two different lenses of the same episodes in the Great Depression and the crisis of 2007. The first interpretation (Kindleberger, 1978; Akerlof and Shiller, 2009) blames the lack of regulation such as the main cause of the economic dislocations during those periods. The second analysis (Rothbard, 2000; Friedman, 2009; Wallison, 2009), points out the excessive interference of government on the behavior of the markets, like the distortion of the normal business cycle which led to the both crises. finally, the paper associates the belief systems of each period and the different schools, in order to answer to what extent do agents before the financial crises of 1929 and 2007 share their belief systems? Did belief systems in 2007 follow policy learning from the 1929 financial crisis?

Belief systems formation

Economic and political actors respond to daily problems, according to their experience and knowledge about the economic and political world. Every time agents tend to make decisions, which respond to their interests. By doing so, the criteria to evaluate alternatives come from their beliefs on the best option. This intellectual process differentiates the agents' positions in relation to particular economic policies. In this way, individual beliefs become concrete programs.

The economic public policies embody some ideal ways, which led to a mix of political and social goals and material interests. The way to state priorities and to harmonize needs and solutions follows a substructure in the mind of the actors (Worsham, 1997). By doing so,

John Maynard Keynes (1973) asserts that scholars and policy makers are deeply influenced by ideas, even when they are not aware of it.

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else... Soon or late, it is ideas, not vested interests, which are dangerous for good or evil. (Ídem, 383)

Policy makers make mistakes not necessarily because they have evil interest. Rather, they choose the best option among a wide range of policies, according to their ideas about how to build the best possible world. In the same way, Socrates stated in the V century before Christ that a man always pursues good intentions, but he makes mistakes because of his ignorance. Not academic ignorance, but the moral one. The man moves toward the wrong orientation, because of he does not understand that the good one is toward the other side. For instance, a robber believes that the practice to steal is good, because in this way he would get more money. Is it good to steal? In this case, the answer is yes from the point of view of the robber, because he does not understand that the good choice is to leave the money in the hands of its owner. He did not develop the skills to understand the argument. Even the robber could learn to repeat, using his own words: "It is bad to steal". However, in the practice he believes that it is good. Therefore, he is ignorant in the moral way. In the supra-world of the several ideas of good, the man chooses the option, which he thinks that represent the best one. However, he ignored to what extent he ignored which one is the best solution. That is why the Oracles of Delphos said that Socrates was the most wisdom man in The Ancient Athens, because at least he knew that he ignored. That is to say, the men, such as the policy makers, are exposed to be wrong, because they tend to failure within uncertainty.

According to his particular belief system, every agent makes decisions about the unforeseeable future. Different proposals emerge in order to face a wide range of issues within uncertainty (Bacharach, 1986). Actors face uncertainty through their core beliefs. Belief systems includes several dimensions, introduced by Michael Bacharach, like the speech of authorities, actors expectations about the likely behavior of economic and political variables, the economy theories, and individual beliefs about the interests of other agents.

There is a close relation between the beliefs of agents and the development of the economic knowledge. Michael Bacharach (1986)

points out that a weak theory about economic variables indicates a deficient knowledge to tackle with economic issues. No theory could answer to all the possibilities of reality; however frequently some doctrines are followed by agents like a common-sense economics. In these cases, policy makers follow a model like the only solution to every economic problem, independent of the context, the origin of the task and the actors. The analysis should go toward another orientation. The pertinent cure from economics should depend on the features of the pathology inside the society. However, belief systems in economics represent a fortress embattled by rigid walls difficult to break, or at least to modify.

Belief systems are enrooted in the making decision process of policy makers, by an unconsciously way. David Marsh and Paul Furlong (2002) explain that scholars' orientation is shaped by their ontological and epistemological positions, such as a skin rather than a sweater. Broadly speaking, first they state that the ontological position reflects the researcher point of view about if nature being exists necessarily with or without the knowledge about it. "The key question is whether there is a 'real' world 'out there' that is independent of our knowledge of it" (ídem, 18). There are two ontological positions: On the one hand, foundationalists assert that reality is in fact independent of knowledge. On the other hand, anti-foundationalists assume that reality is a social construction, related to the actors involved on it and to the interpretation of social researchers. Second, epistemology position refers to the researcher's view about: "what we can know about the world and how we can know it" (ídem, 19). It defines how the researcher approaches to know the phenomenon. There are two epistemological positions: On the one side, foundationalists state that researchers are objective. On the other hand, anti-foundationalists believe that objectivity is impossible, because scholars are influenced by social constructions of reality. Overall, the opposite ontological and epistemological position determines the approach of scholars to every object. For instance, it determines the assumptions about to what extend actors are able to know the forces which drive the economic phenomenon. Despite the ontological and epistemological 'skin', in political economy is expected that policy makers modify the beliefs within their programmatic components from policy learning.

The structure of belief systems has two elements: policy core beliefs and programmatic components (Worsham, 1997). On the one hand, policy core beliefs belong to the larger environment. Policy core beliefs supports the general understanding of agents, it represents fundamental

policy positions. On the other, programmatic components is related to particular policies about current issues. Programmatic components respond to transitory needs and could change when a specific project has finished. Therefore, policy core beliefs and programmatic components are interrelated. Policy core beliefs have some fundamental normative precepts and ideas with a substantial empirical aspect. In this way, the empirical evidence of belief systems is represented by the actual public economic programs, like regulations or distributive policy.

Unlike natural sciences like biology or chemistry, in economics and politics is not possible to test hypothesis in the laboratory. Instead, agents learn by facing directly to the social phenomena. By doing so, Michael Bacharach (1986) points out two kinds of learning. First, agents learn by reasoning. In this case, agents implement a logic process to link new beliefs into the rules of their knowledge. Second, agents learn by experience. Agents alter their belief systems through the observation of critical events. Therefore, policy learning occurs as the result of the consciousness of the gap between policy core beliefs and economic phenomena. The bottom of line after this crisis is a more accurately answer to a wide range of problems. Therefore, policy core beliefs could change through periods of crises. Agents revise their core beliefs during economic dislocation, in order to confirm it or change it.

Agents differ in their belief systems, because they take into account different priorities. For instance, they evaluate different aspects and alternatives to make decisions in the short or the long term. They have different measures about the limits of their knowledge, their expectations and the confidence on available information. Therefore, agents have relative differences in the way to approach to several economic solutions. In the case of policy makers, their experience provides policy learning in order to adjust their belief systems to new solutions. For instance, there was policy learning after the economic dislocation in 1929. In this way, it is expected that agents avoid similar economic crises in the future.

Belief systems in political economy

The wide range of theoretical trends in economics describes how economic schools follow several lines of arguments, which share and disagree in specific economic features or in big contradictory assumptions about the economic phenomenon. It leads to multiple answers to the questions related to the ontological and epistemological positions, which in some trends are combined among them in complex political models to manage the economic reality. They include a body of several

choices from a dictatorial regime to the anarchist one. The historical discussion helps to understand how belief systems influence policy makers in order to react to the financial crises. In the same way, it analyzes how belief systems modify the perception of scholars to understand the same economic crisis. On the one hand, the lack of controls on markets, on the other hand the useless interference of government.

The liberalization of markets has its roots in the classical economics. The metaphor of the invisible hand was enunciated by Adam Smith in his book *Theory of Moral Sentiments* (1976), where he analyses the world of the ideas of good. This work was the basis for his economic theory, taking advantage of the common subjects of moral philosophy and economics, which share the study of human behavior.

They [the rich] are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its habitants, and thus without intending it, without knowing it, advance the interest of the society. (ídem, 1976:350)

This natural outcome of a nearly same distribution through the individual selfish interest is more explained in *The Wealth of Nations* in 1779. Individuals seek their own security, when they handle the industry in a particular direction. However, they are led by an invisible hand in order to promote an unintended aim in the society, in a more effective way than when individuals have the explicit intention to do it (Smith, 1979). In this way, Adam Smith criticized the mercantilist restriction to exporting crops. However, in *The Wealth of Nations* Adam Smith even accepted some rules to protect national industry. This was criticized by David Ricardo (1937), who stated in a stronger way the efficiency of free-market without any government intervention.

David Ricardo in his book *The Principles of Taxation and Political Economy* (1937) complemented the Smith's assumptions about the benefits of private market and its natural equilibrium. Ricardo states that the restrictions to foreign trade, which seek to protect national economy, would lead to the opposite effect.

The injurious effects of the mercantile system have been fully exposed by Dr. Smith; the whole aim of that system was to raise the price of commodities in the home market by prohibiting foreign competition; but this system was no more injurious to the agricultural classes than to any other part of the community. By forcing capital into channels where it would not otherwise flow, it diminished the whole amount of commodities produced. (ídem, 212)

Overall, the message from the classical school was that government does not have enough knowledge to control the high complexity of variables interaction in markets. Indeed, private actors would adjust themselves, according to their interest in a natural way.

The belief about the natural equilibrium in free-markets without government interference has been embodied by several economics schools. For instance, the Austrian economist Ludwig Von Mises, in his book published before the first World War, *The Theory of Money and Credit*, stated the useless of government rules in markets. “State intervention to assure to the community the necessary quantity of money by regulating its international movements is supererogatory” (Von Mises, 1953:249).

The belief of the *laissez-faire* within the theory of market competition found the both followers and critics. For instance, many scholars remarked that free-market is not enough to ensure the benefits within a capitalist system. They argue that free-markets can performance in an expected way in regular time, even though in some cases there are failures on markets that need the help of external interference.

The market can be mostly right, but occasionally break down.

When the body does not function correctly, we take it to the doctor; when the market breaks down on occasion, we may need the medicine of a lender of last resort. (Kindleberger, 1978:221)

According to this belief, crises follow a pattern of boom and panic of markets. The government intervention should take control of booms, in order to prevent the deeply impact of panics.

Charles Kindleberger (1978) explains the boom phase such as an agents’ euphoria, after the favorable outcome of investments. “Price increase, giving rise to new profit opportunities and attracting still further firms and investors. Positive feedback develops, as new investment led to increases in income that stimulate further investment and further income increases” (idem, 17). For instance, Robert Boyer (2000) asserts that private actors need some rules from the government, in order to prevent economic dislocations. “Forms of competition necessarily imply the imposition by the political process of some constraints or rules to be enforced, merely to prevent collusion which would be detrimental to the rest of the society” (82).

The regulation theory takes some ideas from political scientists and economists from different trends, like John Maynard Keynes and Karl Polanyi, who saw a more effective outcome through the links between private interests and public intervention. Keynes observes the useful

adoption of government measures to promote a multiplier effect in the economy. In this point, Charles Kindleberger (1978) asserts the benefits of government interference to help the economy's performance. "Intervention is an art, not a science. General rules that the state should always intervene or that it should never intervene are both wrong" (ídem, 5). It is expected that this complement takes advantage in between the both forces. "Economic theory does not prove that markets are always, and in any circumstances, the most efficient way of allocating resources. In some cases, public intervention improves the outcome for all economic agents" (Boyer, 2000:70). Therefore, the government is able to modify the economic process, when the reality of its performance does not follow the expectations, and it is in the risk of an economic dislocation.

Broadly speaking, the regulation theory recognizes the historical outcome of private competition. However, it asserts that the market needs some government intervention within critical periods. These scholars refuse an absolute free-market, because they do not believe in the efficiency of market mechanisms in every episode of society. Actually, they do not see practical performance of economy without opportune intervention of government. "Reference to the invisible hand was the only alternative remaining to provide a minimal understanding of highly complex and interdependent developments" (ídem, 66). Particularly, according to the regulation theory, the complex features in the market development avoid the equilibrium through natural methods. "The very maturing and sophistication of capitalist economies make belief in the self-equilibrating role of markets and their efficiency less and less realistic" (ídem, 70). finally, the regulation theory states that market competition needs to be complemented through some government intervention in critical cases, in order to achieve most efficient outcomes and to prevent systemic failures.

Overall, there are two strong positions from different belief systems in relation to the interference of government in the behavior of markets. It is expected that actors modify their beliefs after the experience of an economic dislocation, through a policy learning process. In this way, belief systems would be closer to the economic phenomenon. According to Aristotle, the true is the adaptation of thought to the reality. The more adaptation to the economic phenomenon, the more awareness about the economic failures. It allows policy makers to reduce uncertainty, in order to prevent future economic crises, such as the Great Depression.

1929, a source of policy learning

The Great Depression was experienced at the end of 1920s and during the 1930s. Europe tried to recuperate its economy after the first World War, there were a shift in the financial gravity from United Kingdom to the United States, and the strategy to return to the system of gold standard. The decisions of governments in relation to the economy were criticized by scholars afterwards, because it increased the effects of the crisis; whether omission or excessive intervention, like it is presented in the following two belief systems.

Markets ignore when it is enough

Critics of the absolute free-market argue that agents before the Great Depression shared belief systems supported in deregulation and capital flows. The economy experienced a boom without control, which shifted to panic and crash when profits grew slower than before. The flexible policies were supported in the early benefits of lending booms during 1920's. This context describes a belief system, which belongs to liberalization of markets.

Paul Mattick (1981) asserts that the Great Depression proved the erroneous belief of natural equilibrium in free-markets. He states that governments followed the theory of classical economics, and they cannot be blamed of the deepening of the depression. "The various governments of the capitalist nations relied, at first, on the deflationary crisis mechanism to solve the problem and did not interfere in the economic process" (ídem, 126). Policy makers did not know when was the opportune time to intervene, in order to prevent a great depression. They avoided trade barriers and stimulated capital flows, in order to achieve the expectative of the economic doctrine of liberalism, such as the Ricardian assumption. "The great profits which are sometimes made by particular merchants in foreign trade will elevate the general rate of profits in the country" (Ricardo, 1937:77).

The argument against the natural equilibrium of markets asserts that the Great Depression occurred during the upswing of the global business cycle, and it was in a period of expanding world trade. It was supported through elimination of import and export prohibitions after the World War I. It boosted the world manufacturing production between 1924 and 1929 (Eichengreen, 2004). "The real cause of the depression was expansion of production outside of Europe during the first World War, expansion which proved excessive at 1925. In addition, there were the financial complications of reparations and war debts" (Kindleberger, 1978:136). By doing so, the economic expansion led to international debt.

Barry Eichengreen (2004) asserts that before the Great Depression there was a pattern of lending booms. What is more, in 1920's the United States and United Kingdom governments looked for competitive position of their banks, through development loans. The boom was associated with financial innovation. "When lending shifted to New York in the 1920's similarly derived impetus from the growth of the Eurodollar market and the relaxation of capital controls" (idem, 17). Further, the financial practices turned to the growth of liquid bond market. Policy makers followed the beliefs about positive effects of capital flows in welfare. They saw the benefits of capital flows in the short term. However, it did not remain in the long period. Therefore, the crisis was allowed by overconfidence on lack of regulation and asymmetric information in financial markets (Eichengreen, 2002). The higher development of banking systems implied the deep impact of the crisis (Eichengreen, 2004).

The classical prescription to the economy encouraged United Kingdom to the return to the gold standard at pre-war parity in 1925. After the first World War, United Kingdom emulated the proposal from David Ricardo, who argued the benefits of return to gold standard in England after Napoleon Wars. "The issue of paper money ought to be under some check and control; and none seems so proper for that purpose as that of subjecting the issuers of paper money to the obligation of paying their notes either in gold coin or bullion" (Ricardo, 1937:241).

finally, the dislocated economies delayed over ten years to be recuperated from the Great Depression. Agents experienced policy learning about controls on capital and currency instability in a multi-lateral system of free international trade (Eichengreen, 2004). From this point of view, pure mechanisms are insufficient to behave in the expected way at every moment without state intervention (Boyer, 2000). The policy learning gave to the government the knowledge to intervene the markets, in order to move the economic phenomenon toward a safer situation. It was stated that public spending complemented the benefits of private investment on production (Mattick, 1981). "A key normative element of the policy core since the 1930s is the belief that markets are destructive" (Worsham, 1997:13). That policy learning was evidenced in the economic policy package known like The New Deal. For instance, the United States government was involved such as an arbitrator, and it increased the role of regulators in several areas of economy. Charles Kindleberger (1978) asserts that the 1929 depression was so deep, because there was no international lender of last resort. It was expected that political management of economy prevent future dislocations. In

this way, these scholars conclude that the right performance of market is not always natural.

Markets are smarter than governments

Scholars like economists in the Austrian School trend argue excess of government intervention in the Great Depression, rather than the lack of it. This beliefs system asserts that the crisis did not begin in the upswing of the business cycle, but in the downswing of it. Government was impatient and decided to intervene in the economy, rather than wait for the natural equilibrium of markets. “If government wishes to alleviate, rather than aggravate, a depression, its only valid course is *laissez-faire* — to leave the economy alone. Only if there is no interference, direct or threatened, with prices, wage rates, and business liquidation will the necessary adjustment proceed with smooth dispatch” (Rothbard, 2000:155). Therefore, government interference turned the downswing of the business cycle into the Great Depression.

The Austrian School explains that the economy experiences an incremental change in the long run. It implies a cycle of upswings and downswings in the short cut, according to the needs of private actors. The long picture will shows economic growth, even when the short period evidences an economic crisis. Downswings are necessities in order to follow the self-adjustment of markets, after a period of expansion in the economy (ídem, 2000). Sometimes, a specific sector gets into crises such as part of this natural adjustment, when preferences change in supply and demand; for instance, when consumers substitute one product by another. On the one hand, entrepreneurs forecast the markets; on the other hand, markets change following the preferences of actors. Therefore, might be crisis of firms or sectors in between the natural adjustment of markets, but not general crises. Not all the individual firms and all the sectors make the same decisions at the same time. It just happens when government launches an intervention on markets, and it leads the private actors to the make the same decisions, that otherwise they would not make. It disrupts the natural process of the downswing, and it produces a kind of crises such as the Great Depression.

Murray Rothbard (2000) points out the disruption of the business cycle through the program of the president Herbert Hoover in 1920’s and 1930’s, which allowed the shift from a normal recession toward the Great Depression. Hoover decided to increase taxes, public dams, and government regulation of the stock markets.

Whenever government intervenes in the market, it aggravates rather than settles the problems it has set out to solve. This is a general

economic law of government intervention. It is certainly true for the overall Hoover depression policy. Nowhere has this law been so clearly illustrated as in the American farm program since. (ídem, 229)

According to Murray Rothbard (2000), Hoover's plan against depression included intervention on wage rates and prices, expansion of credit, and increasing government spending. Therefore, the policy of protection to manage inflation affected all the economic system. "The bulk of the American population was injured, both as consumers of imports and as victims of inflation and poor foreign credit and later depression" (ídem, 140) Murray Rothbard recognizes that the economic plan of Hoover responded to good intentions in order to implement a modern economic knowledge. However, according to Rothbard, Hoover's knowledge was wrong. For instance, Hoover's policies tried to protect workers, and it gave priority to higher wage rates over profits. However, in the end, it increased the levels of unemployment.

Hoover's tragic failure to cure the depression as a typical example of *laissez-faire* is drastically to misread the historical record. The Hoover rout must be set down as a failure of government planning and not of the free-market. (ídem, 187)

Murray Rothbard (2000) further asserts the misconception of governments in relation to the management of the gold standard. Governments sought to increase their prestige of being on the gold standard through interference. Actually, he states that United Kingdom could not implement a real full gold standard. "The duty of government is to leave the people free to do with the gold as they see fit. It is therefore its corollary duty not to inflate the money supply beyond the gold stock" (ídem, 148). Therefore, a package of inflationary policies, made by the governments through undesirable rules led to a loosing of gold in United Kingdom. "Great Britain insisted on continuing its policy of cheap money and credit expansion—an insistence of the British government rather than its private bankers" (ídem, 153). Therefore, the British government avoided the natural behavior of free-markets.

Inflation induced by governments was followed by the president John Calvin Coolidge in US between 1923 and 1929. His administration made the decision to help United Kingdom and farmers through low discount rates. According to Rothbard (2000), the government of president Coolidge hid information about the expected consequences of his interference.

If the people were allowed to know what had been transacted in their name and what penalties they were subsequently being forced to pay, they would rise up in their wrath. Better to keep the people in ignorance. This, of course, is the familiar attitude of the bureaucrat in power. (ídem, 158).

finally, the Austrian School argues that the Great Depression was a failure of government planning, rather than the consequence of a free-market reckless.

Hoover, from the very start of the depression, set his course unerringly toward the violation of all the *laissez-faire* canons. As a consequence, he left office with the economy at the depths of an unprecedented depression. (ídem, 186)

According to Murray Rothbard, the market would be adjusted by itself, and the normal crisis would be solved in less time. However, Hoover's economic plan aggravated the crisis and recuperation was delayed 10 years until the Second World War. Therefore, from this belief system, *laissez-faire* would be the solution rather than the cause of the problem.

The guilt for the Great Depression must, at long last, be lifted from the shoulders of the free-market economy, and placed where it properly belongs: at the doors of politicians, bureaucrats, and the mass of "enlightened" economists. And in any other depression, past or future, the story will be the same. (ídem, 337)

Overall, in this line, the policy learning was that the faster way to solve an economic dislocation is let the market to follow its natural cycle, rather than rule its adjustment.

Broadly speaking, followers of the invisible hand argue that the wrong implementation of control by policy makers allowed economic practices, which broke the economic equilibrium expected by liberal foundations. Otherwise, the natural performance of the business cycle would be achieved, thanks to the adjustments of private actors without the constriction of external and artificial rules.

Belief systems in 2007

The financial crisis of 2007 emerged from the relation between housing boom and financial credits. How did this link lead to an economic shock in 2007? The big investors invested their money in the profitable hedge funds, managed by brokers. Brokers analyzed the

financial products available in the market. finally, they decided to invest funds in the second market of mortgages. Mortgages companies, like Fannie Mae and Freddy Mac gave credits to borrowers, and sent them to the second market. However, debtors default the payments to banks. It affected the expectations of investments on mortgages in the second market. The profits from hedge funds were lower than the original forecasting. Investors asked for insurance services in order to cover the loose at the same time. Insurance companies were without reserves to respond to the massive demand. Households did not have money to pay mortgages, the big investors did not receive profits, and financial companies suffered illiquidity and debts. It was insolvency along the financial system.

There are two opposite belief systems to explain the chain of decisions among financial agents, which led to the 2007 financial crisis. It is explained on the one hand, by the complex financial system without government controls (Akerlof and Shiller, 2009). On the other, it is appointed the unnecessary interference and regulation on financial markets (Wallison, 2009; Friedman, 2009).

A complex financial market gets crazy without controls

Scholars that support the need of some regulation of markets, in order to ensure its efficiency, blame overconfidence of free-markets like the main cause of the subprime crisis. In this line, the belief systems before the 2007 financial crisis followed the principles of free-market, deregulation, propensity to risk and capital flows. financial markets moved through innovation of financial instruments, which allowed agents to move easily along international market. By doing so, agents expected that economies could grow without obstacles. These assumptions were based on the outcomes of the biggest economies in the turn of century.

The argument to point out deregulation such as the origin of the 2007 crisis is built on the effects of the deregulation euphoria (Weller and Sabatini, 2008). This belief system looks at the chain of policies to ensure flexibility in markets, and a more complex financial system through higher risks. Some of them are the 'Housing Development Act' in 1968, where the government strengthened the mortgage-backed securities to encourage riskier investments in financial system; the 'Emergence Home finance Act' in 1970 which introduced the role of the public mortgage companies Fannie Mae and Freddie Mac, in order to promote the secondary market for mortgages within a more complex financial system, but more profitable for riskier investors; the Riegle-

Neal Act in 1994, which ended interstate banking restrictions; and the ‘Gramm-Leach-Bliley-Act in 1999, which sought financial services modernization, and led to less restrictions to provide mortgages. These laws reveal the belief of policy makers on motivate liberalization of financial markets through deregulation of financial markets.

The belief system of deregulation of markets is appointed in two stages at the beginning of 21st Century. On the one hand, it was the boom of hedge funds among the biggest investors in financial markets, the high risk of brokers to invest the funds, and the lack of control from the government mortgages companies Fannie Mae and Freddie Mac. On the other hand, borrowers started to ask for mortgages, even low-income people, without restrictions to provide credits. At the end, low-income people default the payments, and the biggest investors did not receive the expected profits.

George Akerlof and Robert Shiller (2009) explain that government did not prevent the crisis, when private actors behaved with overconfidence and reckless. The positive outcomes between 2000 and 2005 led agents to follow the same model for a longer period of time. Investor decided to take higher risks. House buyers asked for mortgages estimated to be paid in twenty or thirty years. Citizens asked for more credits, and it increased the assets of banks. The financial market developed more products. The financial system became bigger and more complex. The world economy grew faster in the period from 2001 to 2007 than in the last 30 years, and hedge funds increased from 21 billion in 1999 to 1.223 billion in 2006 (Weller and Sabatini, 2008). “People began to buy housing as if this were their last can ever to buy a house, and speculators began to make investment in housing” (Akerlof and Shiller, 2009:169). It was experienced the emergence of housing boom between 1995 and 2006.

The circumstances within the house market changed in the following years. High expectations built in the short time did not wait the desirable twenty or thirty years. They crashed from one to another day. Housing speculative fever and uncontrollable mortgages transaction precipitated the financial crisis in 2007. Therefore, these scholars point out the lack of regulation of markets that led to a speculative behavior. However, the high expectation was followed by disappointment, panic and lack of confidence. “Without intervention by the government the economy will suffer massive swings in employment, and financial markets will, from time to time, fall into chaos” (idem, 175).

Free-markets increased the pull over the lending booms. It was linked to the belief systems of liberalization of markets, because of

the recent outcome during the short time. Agents wanted to get more profits, based on a flexible financial market. They took advantage from speculation in mortgages and from every more complex financial instrument. According to this line, they followed the policy core beliefs based on their academic knowledge of liberal doctrine and their recent experience.

Andrew Baker (2008) blames the lack of regulation, like the cause of several financial crises in the turn of century.

The overriding belief held by senior treasury officials was that liberalized capital markets were good for the global economy and overall global welfare, with the benefits believed to show up in higher rates of growth, wages, returns to capital and standard of living. (idem, 40)

In addition, Baker remarks the lack of capital control during international transactions, because of the principle of open capital markets. During the globalization era a confidence market is linked to financial liberalization. For instance, Baker argues that policy makers before the Asian crisis in 1990's followed genuine confidence on belief systems related to the liberalization of markets.

Neo-liberal ideas are not promoted by the Treasury simply because of a strategic instrumental political calculation that they are in US interest, but ultimately as a consequences of a basic intellectual faith in the efficiency of free-markets. (idem, 41).

Andrew Baker (2008) explains that economic policies which support free-markets followed the idea of a superior form of economic organization, where rational agents reacts to market distortions according to specific information, like a rise in prices. Without political barriers, it is expected that agents get benefits from liberalization of markets. Baker (2008) states the good intentions of US treasure officials, and their academic skills. According to their academic formation, they reacted through the core beliefs of free-markets. From their orthodox view, the economic policies applied by US at the end of 20th Century and at the beginning of 21st were the most reliable way to ensure the market confidence.

Baker (2008) states that agents, which made decisions based on classical belief systems, learned from the experience through the good outcomes during the recent years. In this way, agents made decisions in order to introduce policies, following normative liberal principles. By doing so, agents expected to ensure economic success. By doing so,

agents built a financial structure supported in complex settings, which took advantage of capital flows. Further, classical belief systems justified the lack of controls from policy makers. Therefore, it allowed financial innovation, asymmetric information, lending booms, speculation and over risk on capital markets. Overall, according to this perception, belief systems before the 2007 crisis tended toward economic policies, which supported deregulation in order to strength liberalization of markets.

A complex regulation system pressures without knowledge

Other scholars understood the crisis of 2007 such as the consequence of government interference on the natural movements of free-markets.

The current financial crisis is not – as many have said – a crisis of capitalism. It is in fact the opposite: a demonstration that well-intentioned government intervention in the private economy can have devastating consequences. (Wallison, 2009:365)

According to Peter Wallison, the 2007 crisis was caused by excessive interference of government, when it increased pressure on banks to reduce lending standards, in order to promote the access of more people to mortgage financing. The aim of the government was to increase home ownership among minority, low-income and other underserved groups.

Peter Wallison (2009) blames to the ‘Community Reinvestment Act’ in 1997 and the affordable-housing mission adopted by the US Congress in 1990, which allowed the pressure on banks to make loans, which otherwise they would not made it. Government intervention helped to inflate the housing bubble, and precipitated the effects on financial sector. “The financial crisis should thus be attributed to public policies - not to any ‘failure of capitalism”” (ídem, 375).

This belief system criticizes the high government intervention in financial markets. It increased after the ‘good intentions’ of Bill Clinton administration, which promoted the purchase of new house for every family. It decreased the restrictions in mortgages companies to give credits to borrowers. It gave new policies to grade prime credits and subprime credits. Prime credits are given to debtors with a good financial history, and which likely would fulfill their installments. Further, these prime credits are provided with low interest rate. On the other side, subprime financial credits are given to low-income people, who have a red financial history, and it is less likely they would pay the installments in the middle term. The new regulation lowered the

requirements to grade as prime credit. Therefore, some old subprime credits, became graded as prime credits. It sent a wrong message to financial agents. It leads to a distortion in the financial landscape, and affected the making decision process of investors and brokers. Hedge funds were used to purchase prime mortgages, some of them old subprime credits transformed in prime credits. However, these new prime credits given to low-income people behaved like old subprime credits. Borrowers default payments, and led to financial contagion along the financial market from the bottom to the top. Overall, according to this belief system, the government intervention altered the information received by investors within the making decision process. The policy to alter the grades of prime credits confused financial agents, and disrupted the natural reaction of free-market. Otherwise, the banks would refuse credits to low-income people, and financial markets would behave in a less critical performance.

Jeffrey Friedman (2009), from the same line, explains the crisis in 2007 like a toxic unintended reaction among regulatory actions, in order to take the control of the financial market. “The legal protection of the three rating firms by S.E.C. regulations issued over the course of seven decades interacted with the Basel rules in unexpected ways” (idem, 162). Therefore, too much regulation was involved in a more complex system, and the ignorance about its consequences led to the systemic failure.

The problem of the regulator and the scholar -and of the citizen of a social democracy - is essentially the same: There is too much information. This is why modern societies seem ‘complex’. And it creates the special kind of ignorance with which modern political actors are plagued: Not the costliness of information but its overabundance. (idem, 169)

Broadly speaking, these scholars believe that there is no omnisapient government able to know how to harmonize the complex relations in the performance of market. Rather, the market tends to be adjusted by itself.

Overall, the 2007 crisis was the consequence of incautious behavior of actors, which followed their belief systems through a complex financial system. However, who was incautious? For some scholars, like George Akerlof and Robert Shiller (2009), private agents in financial markets should behave with more prudence, and the government should increase controls on markets. On the other hand, Jeffrey Friedman (2009) and Peter Wallison (2009) state that government should refuse

to take the control of the free-market through more complex regulation and confusing information, which will send incentives to financial actors in the wrong orientation.

The experiences of 1929 and 2007

The comparison of the both financial crises in 1929 and 2007 describes the most different cases with a key coincidence, which led to similar outcomes. They evolved from a different background because of the difference in the level of complexity between the financial structures in 1929 in relation to the sophisticated feature in 2007. The policymakers in the subprime financial crisis got the policy learning, the economics knowledge and the political experience of 78 years afterward. Even though, the both crises had a significant coincidence: the policy makers experienced overconfidence after the outcome of their policies in the short-term, which encouraged them to implement it for a longer time and taking higher risk. The circumstances of markets changed in the long cut and the policies did not have the early effect, which led to the both financial crunches.

The financial system in 2007 was more complex than the context in 1929. On the one hand, political institutions build specific policies to the features of the evolutionary market. On the other hand, economics gave more efficient tools to understand and modify the economic phenomenon. Policymakers faced the 2007 financial crisis with a set of available institutions, through a more complex system. Just like it was showed above, particularly the mortgage sector experienced a sophisticated market through specific policies to monitor the specialized market. Some of them are the Housing and Urban Development Act in 1968, which lined the mortgage-backed securities; the Emergency Home finance Act in 1970 that established the Federal Home Loan Mortgage Corporation (Freddie Mac) in order to promote the mortgage market; The Riegle-Neal Act in 1994 that updated the interstate laws to the needs of the modern structure of national banks; and the Gramm-Leach-Bliley Act in 1999 about the financial services modernization, which reinforced the role of investment banks, commercial banks and security companies into the market. Those samples of the new mortgage landscape draw a financial system in 2007 with different features to 1929.

Policy learning moved the dynamic of system forward as well. Bob Jessop (Jessop and Sum, 2006) points out to what extent the regulation approach changed the understanding of management within the free-market scenario. "Although the opposition between market and state is

a canonical feature of orthodox economics, it is fundamentally flawed and cannot capture the complexities of advanced capitalism” (idem, 152). Jessop shows the emergence of mechanisms for economic and political coordination rather than the dichotomy in the market – state relationship.

Economics provided a wide field of tools to prevent crises after policy learning. For instance, John Maynard Keynes suggested the magic quadrangle which combines the goals of macroeconomic policy: economic (sustainable) growth, price stability, full employment and balance of trade. Keynes (1973) claimed the control of financial, goods, and labor markets. It would be adjusted by the expansion or contraction, according to the health of the economy. That system represented a policy learning process in 1930’s, after the 1929 financial crisis. It refused the impact of the widespread of free-market in employment for the long-term. Keynes theory was deeply developed in the demand-side by several economists. Particularly, Hyman Minsky went deeply in the financial crisis formation (Kindleberger, 1978). It highlights the prevention of financial crunch. Therefore, there were tools from economics which would allow policymakers to prevent the crisis in 2007. However, the crisis occurred again. Policy makers forgot policy learning by the up-swing of the economy. The short-run outcomes during the booms erased the lesson from Minsky. Further, Keynes and Minsky branch was criticized by Milton Friedman, Joseph Hayek and other economists, focused on supply-side. These were closer to the core beliefs of policy makers.

Therefore policy learning after the financial crises in 1929, through the prevention of the fragility in markets pointed out by Keynes and Minsky, and the debate about it with Chicago School and Austrian School were eclipsed by the regulation issue to manage a capitalist system based on free-market; again. State and market are mutually implicated and structurally coevolving (Jessop and Sum, 2000). The features of economic system combine the both institutions and market players. However, the debate about to what extent is the proportion of state and market features provided to the mixture of them, survives in economics and politics to implement a policy. It is the case of the theoretical approaches pointed out above to explain the causes of the both crises in 1929 and 2007.

Despite the fertile and diverse production of economics, individuals use to call the same theoretical references to answer different economic puzzle. The making decision process among policy makers in those critical moments before the financial crises did not give chance to

alternative economic tools. Rather, policy makers repeated the guidelines of their core belief systems. It is showed along the set of policies launched before the crises, and that led to the economic crunch; such as the mortgage acts between 1970's and 2000's for the liberalization of markets, or the intervention of government to give incentives to mortgage companies and householders by reducing the bank restrictions to loans in 1999.

Overall, there is a paradox within the making decision process. On the one hand, policymakers have a wide range of tools to manage the economy, according to the need of more or less flexibility of markets, thanks to the evolution of economics through policy learning. On the other hand, individuals which embody the role of policymakers use to implement the same set of policies which represent their belief systems, according to their theoretical formation and professional experience. They leave alternative mechanisms offered by economics. This paradox emerges because of the policy makers experience showed them good outcomes of their core policies in the short-term along their performance. It gave them policy learning about their good outcome. Therefore, they gave the same recipe to tackle new economic problems with unexpected features. finally, it led to unforeseeable financial crises.

Every episode in the history of political economy is susceptible to read in the two opposite directions, from the lens of each belief system. Therefore, there is an optical threat: theory is not adapted to the changes of political economy phenomenon. Instead, the reality is adjusted through the lenses of the two core belief systems. Inside the same episode, where some trends look the lack of regulation, other ones see excessive control and government intervention.

The two beliefs were not the same in the financial crises of 1929 and 2007, because of the dynamic of system changed (Worsham, 1997). It was new institutional settings like the new theories in economics. Even though, the political debate did not move away from the regulation issue to explain the economic crunch afterwards. Belief systems are so strong, that the both financial crises in 1929 and 2007 are explained like a mistake of high regulation by mainstream economics or high liberalization of markets by regulation theory. Therefore, the hypothesis of policy learning is not entirely fulfilled in these cases, even after the deep development by economics. Economic and political systems remain vulnerable to economic crises, because policy learning was insufficient, such as it is stated in the both views of the crises described above.

Despite the differences, the both understandings about the crises share a common assumption: before economic crises, agents made

decisions based on genuine beliefs about the more accurately way to tackle economic problems. Therefore, policy makers behaved on the basis of their academic knowledge on a particular belief system.

A common belief before the Great Depression and the 2007 crisis, within the opposite belief systems, is that economic environment would not change in the short cut. On the one hand, the regulation theory asserts that if free-market was unable to ensure the natural equilibrium was due to overconfidence, on the basis of the outcomes in the short term. In this hypothesis, agents believed that they had excessive resources in the long term. These beliefs encouraged them to assume higher risks in the unforeseeable future. On the other hand, free markets theory stated that if the government intervened too soon with wrong policies, was because it believed that otherwise the critical situation would remain in a long time, and the business cycle would not change in the short period.

Overall, economic and political actors evaluate uncertainty in the short term on the basis of conjectural episodes. The economic environment before and during the Great Depression and the 2007 crisis strengthened the belief systems of agents; against or for government interference on markets. The favorable or negative results in the short term led agents to confirm their beliefs on capital flows. In this way, uncertainty of financial markets was assumed by agents with the risk of absence or excessive public intervention. In the both analyses policymakers made decisions according to their belief systems, which gave priority to the short cut, over the longer one.

Broadly speaking, there were several different settings between the economic environment before the Great Depression and before the financial crisis of 2007. Economics development gave sophisticated tools to policymakers to evolve within a more complex system. However, policymakers leave these tools and used the economic mechanisms prescribed by their core beliefs. Therefore, policy learning was not effective in this case, or lessons were forgotten; a man only knows what he remembers. The challenge of policy makers is to modify the ideal view, in order to apply the whole picture of economics, according to the different contexts.

Conclusion

The economic dislocation of 1929 led to contextual reforms. There was a more complex system in 2007 with more elaborated mechanisms to manage the economy. However, these mechanisms are oriented to increase or reduce government intervention in markets. These are the

two general positions of the two belief systems. Whether regulation or free-market, remain like the same old and current discussion. This is a common issue in 1929 and 2007. Overall, policy learning was used by rulers in order to solve the emergency problem, rather than structural transformations to prevent financial crises in the unforeseeable future. Regulation theory and the fragility of market hypothesis, from Keynes and Minsky, are used today. However the aim of their implementation is adapted by policymakers, according to the priorities of their belief systems. It is revealed through the explanation of financial crises in 1929 and 2007 above. Otherwise, the arguments inside the debate between the two opposite belief systems would be different.

The controversy about the causes of the Great Depression of 1929, and the subprime financial crisis in 2007 shows how is possible to understand the same economic episode such as two opposite realities. It warns about the risk to assume belief systems on political economy such as a dogmatic view, which is inappropriate for the volatile economic phenomenon. Nor two economic dislocations with the deeply effects of the Great Depression and the 2007 crisis could changed the assumptions of actors.

It alerts about the real constriction process and the policy learning after the economic crunch. Otherwise, it threatens the economy to be exposed to further financial crises with similar conditions. The society is always exposed to financial crises. However, without policy learning the economy is more vulnerable. Therefore, the deepness of belief systems highlights the making policies process and helps to face the dark uncertainty. It forecasts an unforeseeable future. Even though, it threatens to blind the understanding of economic phenomena if a short horizon view avoids the policy learning.

Before and during the Great Depression and the crisis of 2007 agents did not take into account the borders of the economic assumptions. Agents had overconfidence on their policy core beliefs. They focused on the outcomes of early episodes. finally, policy makers were unsuccessful to forecast alternatives and risks in the long term.

Uncertainty is implicit in the effectiveness of the policymaker decisions. Agents are exposed to live in crises every time, and the crises have always been in the economy (Eichengreen, 2002). Nor economic doctrine is exempt of failures, neither fix in every situation. Even though, the historical comparison about the settings among economic crises helps agents to make less likely that an economic shock with similar features occur again. Policy learning should be reinforced among economic agents to prevent old mistakes. It avoids

that the core belief systems turns into a fixed principle, without an historical perception of every particular context, which is expected in policy makers.

It is understandable the barriers among the economic and political schools. They grow like parallel lines along the history, through the events which involve the social dynamics. Therefore, the theoretical lenses are reinforced by researchers within the foundations of political economy. These institutions are embodied just like a 'skin' (Marsh and Furlong, 2002). Even though, policy makers should not accept the constriction of those theoretical borders. Unlike the scholars, policy makers should develop the skills to analyze the economic and political context, in order to ensure the adaptation of the most pertinent theory to the problem. Even more, policy makers and governments should combine the suggestions from scholars, rather than launch a policy package based on the cold theory, such as a blue print. Otherwise, the policy package will not fit into the reality.

Economics provides a large and wide range of alternatives to use them in policy formation. However, policymakers focus on a short-room of choices. It is because of the lack of time to make decisions, and the bunch of features within every time more complex financial system. These phenomena avoid the historical comparison and the descriptive analyses during the making decision process. It is difficult to launch a theory during a hot topic. Rather, economics analyzes the closer early events. The emergency pushes policymakers to take advantage of closer economic and political tools; and they are the institutions which represent the programmatic components of their belief systems. Therefore, they repeat a prescription.

The economic and political environment during the both financial crises in 1929 and 2007 was different, because economics evolved and provided new mechanisms to policymakers. Even though, the new mechanisms are used by policymakers to promote or refuse government intervention. The descriptive analysis along the crises shows the risk on overconfidence in one of those belief systems. Instead, policy learning should be acquired through the dialogue between scholars and policy makers, in order to exchange ideas within different belief systems. first, it would lead to significant changes in the argument within the discussion. Second, it would allow stronger policies, in order to prevent further economic dislocations. It is not enough the development of economic mechanisms, if policymakers do not link them to their belief systems.

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