

Crisis and Dialectics of some Fundamental Economic Relations

■

Ion Pohoată

„Alexandru Ioan Cuza” University, Iași
pion@uaic.ro

Andreea-Oana Iacobuță

„Alexandru Ioan Cuza” University, Iași
andreea_iacobuta@yahoo.com

***Abstract.** The phenomenology of crisis is one of the most complex tasks that economics undertook and undertakes to discern. Crisis is not a new phenomenon. As a cycle sequence, either long or short, it entered the “normality” of the economic dynamics. The big ones, like the one in '29-'33 and the current one, escape this register. Their width, development and consequences make them special phenomena. In explaining them, thousands of pages were consumed. The fact they reoccur raises tormenting questions. The attempts to answer these questions followed either a technical line of one supported by the “human nature”. As we use the first variant, we shall try to tackle this topical issue called crisis from the perspective of the correlations existing between economic variables. If when operating normally economy may be in extremis associated to a Newtonian mechanics, crisis changes things.*

Keywords: crisis; Keynes; market; state; USA; the American paradox; demand; supply; economic policy.

■

JEL Codes: E12, E44, E60, N10.

REL Codes: 1F, 8A.

1. Economic dynamics according to the orthodox theory

Even if a picture of economics as a giant pendulum oscillating between demand and supply is, under the keen eye of the critics, given bad press and accused of simplicity and narrow economicism, in crisis times it pops up and obstinately troubles the deep waters. At least in the necessary endeavor of feeling for solutions and ways to get out of the mess, serious analysis cannot avoid the fundamental correlation of any functional economy, like the correlation between demand and supply.

The “mystery” of effective demand as inferred by the classical Malthus and later fructified by Keynes as well as that of the supply, in the beginning theorized – in so far as a manufacturer with a bias for tuition could – by J. B. Say and used centuries later by Laffer, Gilder, Ture or Winniski to support the doctrine of the supply in the 80’s, reactivates and manifestly emerges in times of economic crisis. Demand and supply do not plenary take hold of the economic game. There is distribution and maybe redistribution going in-between them. Only that, to enable redistribution, the economic thinking and practice should first be productive. That means that it is important to produce because “In the supply, the demand is implicit” as G. Gilder said (1981 apud Baslé, 1988, p. 346) catching the essence of Say’s “*Law of markets*”. He found that it was logical to happen that way in the 80’s, when the world economy faced the threat of zero growth. By investing and producing, we pay wages and wages mean potential demand. We need first of all the lake, frogs will sooner or later

come, anyway. That was a logic that worked, yielded results and launched the economy of the initiators and of others who resonated to their ideas on an ascending track. Yet, in the same space, in other times, a different logic also worked – that based on the initial impulse of demand. The specific character of the 29’-33’s crisis claims it: the excess of production should have been reabsorbed by an excess of demand. And it should have happened as the fundamental target seemed not to have been the demand or the supply, but jobs. It is the reason for which Keynes felt entitled to think that in order to “... *justify a certain employment volume, there should be a volume of current investments large enough to absorb the excess of total production over the amount that the collectivity wishes to consume at the given level of employment. Because if this volume of investments does not exist, the receipts of the entrepreneurs will be lower than those necessary to determine them to provide that level of employment. Hence, it results that at a given rise of what we call collectivity’s bias for consumption, the equilibrium of employment, that is the level at which the entrepreneurs do not have any reason to rise or to cut employment, will depend on the volume of current investments. In its turn, the volume of current investments will depend on what we call the drive to invest and the drive to invest depends...on the relation between the curve of the marginal efficiency of capital and the rates of interest as levied upon loans with different deadlines and risks*” (Keynes, 1970, p. 64).

We shall not comment this ample quote from Keynes, essence of his general theory on employment. We shall let his logic reveal

itself by comparing his theory to the one of the theoreticians of supply. Yet we shall retain the key words, as landmarks of his theory bone structure: volume of employment, volume of and drive for investments, excess of production, entrepreneurs' receipts, level of and bias for consumption, equilibrium of employment, efficiency of capital (profit rate), interest rate, deadlines and risks.

We carry it a little bit further providing you with another quote that synthesized another doctrine as aforesaid that of the supply, as Norman Ture put it: *“By definition, global demand is the sum of acquisitions of any kind performed by all entities (administration, enterprises, households etc.). By definition, these expenses should correspond to the level of global income that, in its turn, should always be equal to the value of global production. And production varies only at the extent to which the employed resources vary or the intensity or efficiency of their use varies. To exert a first-rank effect on the income, the action of the state should consequently alter directly the quantity or the efficiency of the resources used in production. But the action of the state itself cannot change the global quantity of the productive resources available in economy and neither their productivity. Variations of the quality of productive resources allotted to production occur only if the real compensation for their use, that is the real price per product unit, is varied”* (Ture apud Raboy, 1984, pp. 15-16). Based on the same method, we extract from this quote the keywords: global demand, global income, employed resources, efficiency of

resources used, real price of resources used, and action of the state.

The two quotes are illustrative; they show the hard core of the two doctrines that embossed, by their force, the economic and social landscape of the 20th century. Called to solve crisis problems, they got different colors depending on their different targets: the Keynesian therapy had to fight against unemployment; the supply doctrine therapy had to fight against inflation.

Apart from the differentiating note, there is a common space that links them. It is here that we find the main relations between the high variables of an economic mechanism. In a relation of circular and dialectic causality, this means that:

- All productions must be met by consumption. The synthesis of this relation is illustrated by the supply-demand ratio. Consumption, which is objectively continuous, needs production, also continuous. The quantitative, structural-qualitative or temporal lack of correlation between the two acts can be synonymous with crisis. The temporal overlap excludes the pre-eminence of any of the two components of the above-mentioned ratio. Despite all these, a Norman Ture finds arguments to show that global demand is nothing but a production reflex, one mediated by prices. Thus, it seems logical for him to be in favor of *“first production, then supply”*.

- We can get from production to consumption with the help of distribution and redistribution. This involves an immense amount of sale-purchase activities. Sale-purchase is in direct relationship with the level of income and, consequently, with the

level of employment. The supply-demand ratio and the balanced price obtained as a measure of the tension of this ratio are directly related to the occupational structure. Economic balance without social balance cannot work.

- The occupation volume depends on the production volume and structure and on the possibility that it be demanded and sold with maximum profit.

- The idea of profit compels us to notice the fact that only a part of the production outcome is used for consumption, whereas the other part is employed for development.

- The road towards development also passes through saving and investments; through an investment volume that is *“large enough to absorb the surplus of total production over the quantity that the collectivity wishes to consume at the given level of employment”* (Keynes, *Ibidem*).

- The stimulation of investments is essential for economic dynamics. It is under the incidence of the expected profit rate and of the interest rate.

- The expected profit rate depends on the state of the economy and on the investment perspectives. Here we may include: capital quantity and quality, social and professional structure of the population and its dynamism, political and social atmosphere, quality of the know-how, *“situation of crediting”* (confidence in the institutions that grant loans), speculative instinct, confidence in general.

- For Keynes, the interest rate is “a reward for giving up liquidity for a certain time period; an essential tool of monetary policy, for Laffer, Ture, etc. In both cases, the interest rate must be below the profit rate

in order to be able to stimulate investments. The idea of “expensive money”, proposed by monetary specialists, present in the structure of the doctrine of supply, makes sense as long as, while fighting inflation, one does not affect the lack of equality that maintains economic dynamics per se: interest rate < profit rate. This objective can be achieved via a credit policy or by increasing (via emission) the quantity of cash.

- The investments-production-employment relation is governed by the multiplication and acceleration effect.

- When current investments entirely absorb a part of what remained apart from the part that the collectivity used for consumption, global demand equals global supply. For traditionalists and partly for neoclassics, the equality of this ratio coincided with the full employment of the workforce. For Keynes and the supporters of supply, this is purely random. For this to be true, all the savings (S) must be automatically transformed into investments (I). Or, between S and I there might occur various circumstances that might question the automatism of equality. Thus, the insufficiency of global demand (C+I) can stop the employment process before reaching the level of complete usage and before unemployment can coexist with abundance.

- For Keynes, consumption depends on income and on the psychological factors that define behavior in relation to consumption; the supporters of supply (under the influence of the philosophy of M. Friedman) consider that consumption depends on permanent income.

- The path from income to consumption is scattered with influences of: the price

level, the valorization rate of the value of the capital, the interest rate, the purchase power of money, tax policy, etc.

- Keynes considers that the volume and efficiency of the utilization of resources can be influenced by the intervention of the state; this can only happen with the help of market prices, according to the supporters of the supply theory.

- Among the components of the economic mechanism, the treasury, the currency and the budget guide us towards the normative. They can give shape to and establish trajectories. According to Keynes, currency plays an active role, and the critique of the “Say Law” is also directed towards the alleged neutrality of money in a game where all products will eventually find a destination. A supporter of state intervention, he transforms the increase of taxes and public expenses into a strong point of the anti-crisis policy. Just as the gold standard is considered a barbarian relic, budgetary equilibrium is a dogma of economic classicism; it is the very deficit that can turn into a source of financing. Liberals such as Laffer, Gilder and Ture see the increase of taxes as an assault upon supply and implicitly, upon profit. Less tax regulation does not automatically mean inflation as long as the emission of currency is kept under control and the price of the loan (the interest rate) can be accessible only for efficient entities. The way he sees it, taxes, as well as public expenses are harmful to production. Even if they generate jobs, behind them there is the weakest guarantor of efficiency – the state; private entities will always find initiatives with better results for using such resources.

2. Economic mechanics in times of crisis

If when operating normally economy may be in extremis associated to a Newtonian mechanics, crisis changes things.

The conclusions drawn based on the two types of representative economic policy illustrate that economy, in general, has a “neutral” component, a part called *mechanism* or *system*, which, apart from all normative acts, has its own laws. The breaking of a relation inside this mechanism leads either to delays or to interruptions. This mechanism is “oiled” by the competitive market. Its mechanism is not perfect. Occasionally there appear “diseases”. In order to “heal” or “relieve” them, certain normative acts may be necessary. Among them, inflation and unemployment proved to be, in the last century, the unwanted but feared and permanent companions of economic evolution. Their stopping involved a series of special policies, based either on the stimulation of demand or on the encouragement of supply. Anyhow, only one of these diseases has not been and is not associated to crisis; not even in correlation, under the form of stagflation, have they questioned the operation of the mechanism in its intimate structures.

A crisis like the one in '29-'33 or 2007-2009 changes things. Most correlations break; other suffer, and the system, as a whole, “breaks”. The analysts of the current crisis have not established a certain diagnosis; they have not defined the greatest evil so that they subsequently find solutions to it. Nevertheless, the same analyses outline serious changes in the normal operation of

economy (Easterly et al., 2000). Some are related to the intimate nature of a mechanism that received a blow in its very engines; others concern the relation between globalization and existent economic nationalist policies; other important changes are the ones generated by the position and rank of the USA in the global economy, etc.

The comparative analysis of the two significant doctrinarian systems that led either to overcoming of the '29-'33 crisis, to "*thirty years of glory*", of constant economic growth or to the generation of the largest world economy threatened by zero growth leads to the conclusion that the state of balance can be seen as a fundamental equation between savings and investments ($S=I$). Fundamentally, the current crisis is synonymous to severe imbalances at this level; and one of these imbalances was generated by and on the territory of credit money.

The equation in itself reminds us that the dynamics of an economy is formed by transforming the saved income into investments. As a standard, S belongs to the nominal economy and I to the real one; S represents a surplus above consumption, which can bring additional income and new jobs if it is transformed into I. Even from this standard perspective, the $S=I$ equality is not achieved without difficulties. The characters that animate S are not always the same characters that make investments. Individuals, families without entrepreneurial predilections do not make direct investments; they choose a devious trajectory, they deposit the money at commercial banks, insurance companies, etc. Only some of them build houses, purchase equipment for

modernization works, etc. Investments can also be thoroughly planned, whereas savings can only be approximated; those resulting from the accounting decrease of expenses from proceeds, ex pot, can be or not equal with the ones estimated ex ante, meant to be transformed into investments. The time factor has a role, too. Although the standard hypothesis argues that the two values always mirror one another and adjust simultaneously, this automatism is nothing but a supposition. Moreover, the two variables have a different dynamics although they are under the incidence of the same group of factors: exchange rate, prices, interest rate, level of economic activity, etc. Their circuit relationship complicates things even more. Thus, an increase of the predilection towards saving can create a potential investment opportunity but, as a part of the same whole, it reduces the part meant for consumption. The reduction of the consumption demand may be a means for reducing the current account deficit, which implies at the same time a reduction of markets for companies and, consequently, a reduction of their activity. The reduction of the activity leads to the diminution of the profit share and therefore to the reduction of savings. Budgetary proceeds, as well as public expenses, social assistance, etc., also suffer from the reduction of the activity of corporations.

A balanced economic policy can keep under control and compensate the contradictory effects of these relations. In times of crisis it seems that this is no longer possible; the meaning, as well as the nature of the fundamental correlation ($S=I$) that generates everything else are distorted.

Actually, what happens in times of crisis is a consequence of the misrepresentation of these relations during the economic boom. During the period right before the crisis, S is artificially “inflated”. Easy and cheap credits are attractive. The mass of passive depositors becomes the mass of active investors. The possibility of living without saving transforms into the possibility of gaining, via speculation, by means of massive, mass loans. This would not be a problem if S turned into I on the territory of real economy. Or it is the overwhelming proportion of investments in the territory of nominal economy that produces “*poisonous mushrooms*”. Even when one invests in something concrete and palpable, the speculative aspect, related to nominal economy, plays a role too. Buying five houses when you only need one illustrates this type of reality. The explosion is accelerated by the embezzlement and misrepresentation of I. Via a dangerous process of automation, investment becomes a meeting area for demand and supply, representing millions of sales-purchase activities that belong to the nominal economy. You borrow (or save) in the nominal economy in order to invest in the same perimeter. You save in the nominal economy and you “look at the money” because in a world which dilutes all values, you no longer have the courage of transforming it in a real asset (see Phelps, 2009). You offer guarantees in order for someone from the same playfield to take over, share the risks, repackage “*the product*” and end up with *mortgage backed securities* (MBS). Allegedly meant to transform mortgage loans in bonds that can

be transacted and with the intent of taking the risk out of the banking system, *special investment vehicles* (SIV) have been invented, virtual banks that issue bonds in a relaxed legislative environment under the protection of governmental or quasi-governmental agencies such as Fannie Mae and Freddie Mac. By developing the risk appetite to such an extent that subprime credits became something “natural”, by engaging the cascade mechanism of allotting MBSs in reimbursement and risk installments, the environment has eventually created the last “babies” – *collateralized debt obligations* (CDO), with extremely alluring profitability and supported by MBSs with a high degree of risk. Everything happened on the territory of nominal economy. The connection with the world of real assets and services remained only contingent. S defined itself in relation to I in an autonomous territory, that of the world of money. On this territory collateralized debt obligations turned out to be bubbles, jobs were created without support and credit money, under its most extravagant and sophisticate forms, became a standard for measuring illusions.

The process whose final result is the so-called “*synthetic products*” has increasingly become widespread and fast-moving. Economic globalization did not miss the opportunity of such phenomenon. No “*serious*” financial institution closed down because of the two-digit profit rates. The bubbles multiplied and entered their financial statements. High return rates defeated the “*autochthonous prejudice*” of speculative capital. After World War Two, the S=I ratio was generally limited to national economies. Nowadays, even this ratio became a

commodity. The borders of national economies are, *de jure*, recognized. It is at this very level that the line is drawn and the balance of payments, the trade balance, the budget, the capital account, etc. are analyzed. *De facto*, all these tolls opened up to the world. Therefore, the budget balance may be different from the current account balance and the budget and current account deficits no longer make up a causality relation. And, by virtue of the same full openness to the world, the opposition between the nominal and the real levels acquires special meaning. Historically speaking, money was invented to measure values, which is a function that may be achieved ideally, as its actual presence next to the assets whose value it expresses is not necessary. It only needs to exist in society. Given these new circumstances, those of a globalized economy, one may ask: “*what society*”? And the answer would be the “*open society*”, and this time not in a Popperian sense, but in a world economy sense. “*The world assets*” are expressed by the “*world money*”. And this, without achieving a strict parallelism between the mirror and the reflected object. Giving up the “*autochthonous prejudice*”, accused of mercantilism, makes it possible for the “*world money*” to be concentrated in certain locations, while others are “*emptied*”, and this does not necessarily reflect a symmetrical distribution of assets. The very existence of such locations with the highest concentration of money triggered the development and multiplication of an unreal world, one of money earned through the money and for the money.

Although national borders matter (and it is well known that the same asset may have

different prices in different countries), a *Pareto optimum of the world* conceived in such circumstances would have something to say. This would enable us to understand why it is so important to control the locations with the highest concentrations of money; why and how it is that the international institutions having these competences manage to get to know a national economy better than the ones inside it, although they are outsiders; how and where decisions are made and what are their outcome; how true and, at the same time, how sadistic statements such as “*The world’s checkbook should also have a zero balance*” or “*Exports should naturally equal imports worldwide, therefore the consolidated current account balance is always zero*” (Greenspan, 2008, p. 352 and 354, respectively) are, as long as the world’s global demand sorely meets the world’s global supply, crushing some and raising others.

National economies have never remained within their own borders and ignored what was beyond them. It was neither possible, nor advisable. World economy has always been a network of relations, or, more specifically, a system made up of millions of contracts. This wide network also includes contractual relations between individuals, households, companies, public entities, etc. Given this texture and from the viewpoint of the same Pareto optimum, it is hard to conceive that one is hardly managing while another is thriving. Evil spreads just like good does, asymmetrically and unevenly, but without omitting anyone. The only difference is the seriousness of its outcome. If a small company or a household goes bankrupt, evil

may be “*localized*”; when the source of evil is a big corporation or a big economy, the shock is generalized; no one escapes it. Relying on a simplistic logical thinking, one may draw the conclusion that, the more “*primitive*” an economy, the less involved in the international texture of sale-purchase input-output contracts, the less it is exposed to the crisis shock. Reality, however, does not support such an assumption. The crisis forgot no one, not even the least developed ones; on the contrary.

Within this game that stopped, freezing or shattering fundamental relations, upsetting judgments and turning standard theory into a joke, the main role is played by the world’s first economy. At times of deep crisis, and this happens for the second time, America proves to be both the country with the most attractive assets in the world and the bubble producing “*bottle*”. It is therefore only normal that a country that scrupulously affords (“*I would place the USA’s current account at the end of the list*”, says A. Greenspan, *Ibidem*, p. 351) endless indebtedness, without worrying that its currency may fall, a country that filled the world with Eurodollars and Asia dollars without being concerned that its commercial deficits mean as many advantages for China, Japan, Germany, France, England, Saudi Arabia, etc., a country whose national currency still holds a significant power on the international cash market even when its large corporations or its economy as a whole

is shattered to the very grounds, and finally, a country that sends its currency even in the foreign currency reserves of its own creditors, should raise questions about its role and place in spreading good and evil in the world. The crisis will pass and nobody will be able to change its status. This is rather unlikely, since the big international financial institutions are nothing but appendices to the American economic politics. One thing is achievable, that *bancor*, a composite currency that Keynes was dreaming about stimulated by Bretton Woods, which may be imposed by a combined international effort. Otherwise, the “*American paradox*” will continue to produce its effects. Although it is responsible for two big recessions, America, due to its extremely high return rates, will continue to attract a huge demand for its assets; it will remain the “*basket*” where everybody hurries to place their “*eggs*”, which, at the end of another century, will noisily break and drown the world again in a universal “*omelet*”; and it will continue to defied us, attracting us through optimistic opportunities and expectations, even in its darkest hour. And above all, the international financial institutions will help those hit by the crisis by offering American dollars (Roubini&Setzer, 2004). The result is a null game, which is both defying and ruthless, and at the same time extremely attractive: USA deficit = surplus of its business partners = the savings of these countries expressed in dollars.

References

- Easterly, W., Islam, R., Stiglitz, J., “Explaining Growth Volatility”, *Annual World Bank Conference on Development Economics*, January 2000, <http://siteresources.worldbank.org/>
- Friedman, M. (1960). *Inflation et systèmes monétaires*, Calman-Lévy, Paris
- Gilder, G. (1981). *Richess et pauvreté*, Albin Michel, Paris, apud Baslé, M. (1988). *Histoire des pensées économiques. Les contemporaines* (Tome II), Sirey, Paris
- Greenspan, A. (2008). *Era turbulentelor: aventuri într-o lume nouă*, Publica, București
- Keynes, J.M. (1970). *Teoria generală a folosirii mâinii de lucru, dobânzii și banilor*, Editura Științifică, București
- Phelps, E., interviu „SUA își pierd dinamismul”, de Adelina Vlad, *Adevărul* nr. 5809/21.03.2009, p. 21
- Puşcaş, V., „Noile crize și soluții ale capitalismului”, în *Foreign Policy*, martie-aprilie 2009, pp. 67-68
- Roubini, N., Setser, B., „Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies”, Peterson Institute, 2004, <http://bookstore.petersoninstitute.org/book-store/378.html>
- Ture, N., „La théorie de l’ économie de l’ offre et politique gouvernementale”, apud David Raboy (ed.), *L’ économie de l’ offre*, Economica, Paris, 1984