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The Economic Theory and the Global Crisis, between Theoretical Solutions and the Economic Reality*

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Abstract. *This work aims to study the evolution of the global crisis and its impact on various areas worldwide, as well as its impact on certain decisions which have been implemented by the authorized bodies.*

The general framework of this analysis starts with a short review of the relevant economic movements and trends; it continues with presenting the potential solutions aimed to overcome the dark period which is currently crossed by the contemporary economy.

In the same time, the authors aim to highlight the impact of the monetary policies throughput the history on the real economy, until the current period.

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At the beginning of 2009, in an interview for *Associated Press* agency, when Dick Cheney, Vice-President in Bush Administration, was asked why the Administration was not capable to foresee this economic disaster, he had quite a revealing answer: "Nobody, nowhere, was clever enough to realize what was going to happen. I don't believe somebody expected this."[(1)]

During the years which preceded the crisis, one hypothesis circulated and it was about the fact that the *Theory of the Business Cycles* was obsolete, while the economic fluctuations were not any more valid. Some economists went even further and said that the business cycles have disappeared, while us – from the perspective of the New Economy – we were witnessing a continuous economic growth. These prolonged periods of economic growth and expansion had only the role of generating clear anomalies in economy; in the same time, preventing us that, when the "bubble" burst, the blast wave will be powerfully felt and not only locally.

The events which occurred during the last years hit us morally and not only in this way, because the hit was practically felt in the pockets of the people worldwide, irrespective of the country, nationality or place of work. We are witnessing the worst crisis since the Great Depression. And when I make this statement I take into consideration the fact that, out of the eleven periods of recession which followed the Great Depression, only three of them had been longer than one year (Stiglitz, 2005, pp. 673-675).

How could this boom happen? A starting point was that the speculators start buying and selling parts of land, doubling thus their profits in a very short period. The ordinary people have been lured towards Wall Street, attracted towards the new type of industrialized economy, to the extent to which they risked here their life-time savings.

The politicians, instead of having a rejecting attitude and a hard word against these schemes of quick enrichment, they became supporters of this movement. More than this, the new financial instruments have been praised and included in what was called "economic growth". At a certain moment, all these things became a speculative "bubble". And once this bubble burst, the securities market began to shake, cases of enforcement of the guarantees appeared and many companies became insolvent. As a result, the unemployment rose dramatically, while the industrial production collapsed. They say this was really the end of the economic boom, however a utopian boom and with no solid ground.

The above description it is not about what happened few years ago in the United States economy, but it concerns what happened about eighty years ago, before the Great Depression (Galbraith, 1954). Do we watch a repeating history?

This scenario looks similar to the one which some three years ago generated the burst into the global crisis; today the framework is exactly the same, and the conditions are met for the "bubble" bursting, only that there are different nuances now. By nuances it is understood financial engineering, which appeared and developed on Wall Street, toxic assets simple called with three letters, almost like a chemical formula: CMO, CDO, ARS or TOB, false debits and credits, the most known being those called NINJA (No Income No Job or Assets). All these, combined with a defining feature of the modern man – the greed – generated the beginning of a grey age of the world economy. When the panic started and it was felt, the first who went into the bankruptcy were the non-banking lenders, followed by the investment banks, hedge-funds, while the climax was reached by the massive cash withdraws out of the banking system. About the end of the year 2008, the effect extended from the United States up to countries like Japan or Ireland. Nobody could resist to the shock wave and the pandemic has spread (Roubini, 2010, pp. 62-70). One fact which fully sustained the pandemic status was the technological progress, one of the most important pillars of *globalization.* Thus, due to the speed of information during the last decades, the less developed countries are connected with the developed economies, those which influence and set the economic trends for the entire world.

Two years have passed since then, however the situation didn't change to a better status, not even to at least a "normal" one. But what does currently mean "normality", when the practical reality is a much harder nut than any theoretical scenario? Well-known economists like Keynes, Minsky, Friedman or Scumpeter became again very much "in-fashion". In continuing this paper, we will try to exemplify some of these theories with reference to the economic recovery during the crisis time; also, to exemplify how the theories are reflected into the daily reality.

The most famous economist who imposed himself during the Crash which started in 1929 was – without any doubt – John Maynard Keynes, who held in several occasions various positions into the British Cabinet of those ages.(2)

The main factor which made the difference between Keynes and the economists of that age, i.e. classical and neo-classical economists, was the one that Keynes did not believe the economy could recover by itself, irrespective of the premises. The classical economists of the 30-ties thought that the economy could recover by itself, the main premises for this being the fact that the complete occupancy of the labour force is the natural status of the things; and when the salaries became too high, the economy will suffer a necessary contraction, while when the unemployment rises, the salaries will drop. According to this theory, the process is valid in the other sense, too: when the salaries drop, the employers will start making employments and so the economy will reach its natural state of equilibrium.

John Maynard Keynes had a different opinion: the main element determining the level of the labour force occupancy is actually the aggregate demand (AD). If the salaries drop and the employees are fired they will have smaller incomes and consequently will consume less, which will continue to lead to a decrease of the aggregate demand. So, the ordinary consumers will save more and consume less, which will lead again to a drop of the aggregate demand. This dilemma was called by Keynes (1936) "the paradox of saving". All this process will lead to a state of underemployment of the labour force and when the aggregate demand drops below the level of the aggregate offer, the firms will have to reduce the costs in order to sell the stocks, the whole cycle leading to deflation; thus we will have a new decrease of the profits and of the money supply available in economy.

His suggested solution was quite simple: the Governments should replace the entrepreneurs, who were either absent on the market or having no more force to make important investments; in this way, through Government spending, the State will stimulate the demand.

A different opinion had the "father of monetarism", Milton Friedman, who says that the instability in every economy is explained by the fluctuations of the money supply. He translated the beginning of the Great Depression in 1930 like a direct consequence of the decrease in quantity of the bank deposits and savings. This quantity diminished considerably when the bank account holders started to panic and withdraw the capital, determining so the decline of some important financial institutions of that time. The monetarist movement called this phenomenon "The Big Contraction". Thus the aggregate demand was seriously pushed down, diminishing the level of incomes, spending and employment, as an emergent effect. Opposed to the Keynesian doctrine, the monetarists were totally against the State intervention in economy, through the Government spending. As a solution they suggested a reduction of the interest rate in economy. The bankruptcy of the financial "dinosaurs" had to be prevented by all means and the central banks - in this case - had to become the last lenders.

At the beginning of the crisis, after the international capital markets fully felt the shock of the bankruptcy of the Lehman Brothers investment Bank, Washington Administration opted quite for this type of solution. The shock was felt by the main part of the stock exchanges worldwide (for instance, Moscow Stock Exchange suspended its operations for an hour, after the bankruptcy of Lehmann Brother determined in the same day a decrease of the market index in Russia by 11%; the most important market index in Asia decreased in that day by 5%.)[(3)].

The politics of the United States remained still constant: before G-20 Summit in Seoul, the Federal Reserve announced a new infusion of another 600 billion dollars in economy[(4)], opting thus for what the specific literature named monetary relaxation or Quantitative Easing (QE). After this announcement, the dollar quotation on the FOREX market has a modest improvement. The first critics to this announcement came from another big power, China, who said that the monetary politics of the United States, i.e. to infuse with cheap money the emergent economies, could destabilize the international economy, which is still fighting to survive. These capital infusions could have an important effect on the financial markets, in the nominal economy, taking into consideration that the S&P500 index[(5)] entered on a positive territory after this announcement was made, however in the real economy the effect was less noticeable.

Is this the right strategy, considering that the international economy still stagnates, even after two years from that very moment? The economic reality cannot currently reveal significant signs with regard to the opportunity of the options which were made.

In theory, Keynes's followers do not have anything against printing currency, but they say this is not enough to help the real economy. An ideal model, for instance, would be Great Britain, where the Bank of England intended to print an alternative pound, maybe having a different colour, in order to distinguish it from the other type of money on the market and having a validity of only few months; during this period, the alternative type of money should be spent only on services and internal goods. This process should be repeated from time to time, till a relaxation of the banking system in England will be noticed (Skidelsky, 2010).

In reality, this is less probable to happen, as it would mean extreme protectionist politics. Another factor which does not allow putting into practice this model is the high level of logistic required and, of course, the consequent expenses.

Let's see what really happened in England. At the beginning of 2009, Bank of England starts printing the currency in order to redeem the public debt. During the year, more than 200 billion pounds or better said 15% of GDP have been used to redeem the bonds issued by the Government. The monetarists thought that such an infusion of capital would be able to change England economy direction, from recession to an easily observable economic growth.

The predictions were not confirmed by the uncovered money infused in economy. In the first quarter of the current year, England GDP grew by only 0.2%. Something must have been wrong! This was due to the fact that the commercial banks used the money taken from the population, either for creating reserves at the Central Bank, or for purchasing bonds issued by the companies. It means we are in a vicious circle. The capital infusion could be felt just on the capital market in England, at London Stock Exchange, but in the real economy the effect was not the expected one.

The above policies can be however applied only in a country which is not part of Euro zone. In an economic and monetary union disappears the right of seigniorage for each country and so the right of printing currency is transferred to the Central European Bank (BCE). This could be an important disadvantage for certain states who try to implement anti-crisis policies, while on the other hand, in certain countries with a less developed financial market, the solution suggested in England could be fruitful, the money reaching thus the real economy.

By observing from a global perspective the overall economy towards we are slowly moving, we can notice that, besides the positive effects of the globalization process (e.g. the reduction of the transaction costs or the important increase of the standard in living for millions of citizens in emergent economies like Brazil or China), there are obviously minuses generated by the fact that the world economy is set under one single umbrella. The risks have been noticed especially during the last years. It is possible that the globalization opens the ways for crises even more threatening and more frequent. The speed of circulation for the financial capital and hot money, to and from certain markets and economies, amplified the prices volatility and the morbid ability of the financial crises (Roubini, 2010, pp. 498-501). If this mix of social and economic phenomena hadn't had such a huge importance, probably many countries would not have suffered as an effect of the crises born in New World. Also, if such a high grade of trade liberalization hadn't existed, some countries could have been quicker recovered after the serious illness that the economy still has to face.

An example which accounts for what has been said before is the subventions program aimed to support an issue we are all facing: environmental degradation. The changing of the car fleet older then 10-20 year is a measure aimed to support the recovery of the automotive industry, but in the same time it aims to decrease the concentration of carbon dioxide in the breathing air for the inhabitants of those countries which run the type of program called in Romania "Rabla" program. There are currently five countries where the program is being implemented: France, Portugal, Cyprus, Holland and – of course – Romania(6).

If all these countries bought with the issued vouchers cars from their internal production, we would probably witness a positive evolution of the economy of those countries. But most of the times the money is spent on cars produced in a different country that the country supporting the subvention program. In this case, the globalization is a barrier for the economic recovery.

What are the solutions aimed to defend us in front of the financial crises which still exists, irrespective of the historical period? Does the past not succeed to be a good teacher or we do not succeed to be good students?

The Austrian School, represented by Joseph Schumpeter, the most important adversary of J.M. Keynes, resumed in two words the events produced in the economy: *creative destruction.* According to Schumpeter, the capitalism is made up of two cyclical phases: innovation during the prosperity periods, followed by a brutal selection of those who are the players on the market, during the recession periods. As to Schumpeter (2006, pp. 107-109), this forced selection should not be either avoid or minimized, as it is a painful adjustment, however beneficial, after which the survivors will create a new economic order. The Governments interfered into the natural selection of the players on the market, thus making, according to the Austrians, from private losses – collective losses, with impact on the entire society. The giants should not be sustained with the money of the whole nation, because in this way they will never have the consciousness of their mistake.

They are still looking for solutions to prevent the next crises. Is the regulation the solution? The Austrian economists are against the current tendencies; to more strictly regulate the economic financial system, while diminishing the flexibility which preceded the crises is exactly what the big powers want now. According to the Austrian School, the excess of regulation is the basement of this crisis and, by adding new laws, the situation will become even worse. It is as if one tries to treat a disease with harmful medicines. Should this theory be the explanation of the fact that – overall – the Austrian economy performs better than others during such critical times of crises? Last year the GDP of Austria decreased by only 3.9%, which is less compared with other countries from the Euro zone, while for 2010 the forecast is for an economic growth of 2%.

When the crisis started, the Governments' concerns were related to the fact that it could be deflation, an economic phenomenon which powerfully shaked the economy of the United States after 1930. Hoping to move into the opposite direction, towards inflation, they used monetary relaxation and zero interest; however deflation appeared both in the United States and in Euro Zone. Of course, on a short term, the deflationary pressures will continue in most of the advanced economies and even in some emergent economies (Roubini, 2010, pp. 107-109). Here occurs the issue of the unsold stocks, which should be cleared by the companies at reduced prices. In spite of these, according to the economists, there are inflationary expectations regarding the advanced economies starting with the year 2012, as the Governments will continue to decide for currency vs. deficits. In case of the United States, should we further have the dollar depreciation, the prices of the products imported over the Ocean will grow. So, on a short term it is possible to have an insignificant deflation, however on a long term inflation is expected.

It is only the history which can transform a less good decision into a good decision, or vice-versa. Paul Samuelson replied in 2009, during an interview, to the following question: "What would you tell to someone who would like to become a student in economics?" The answer was: "Well, there is probably a change compared with what I would have told to him while I was younger. I would tell him to pay a great deal of respect to the study of the economic history, as this is the raw material where from his future deductions and tests will be generated." (Clarke, 2009)

If we do not succeed to learn from the history, it is most probably that, trying to apply some of the theoretical solutions to the daily reality, we only prepare the ground – even we do not realize this – for future economic crashes, perhaps even more dangerous that the current one.

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Notes

(1) Dick Cheney, interviewed by Deb Riechmann, *Associated Press*, 8 January 2009.
(2) See Heilbroner, R.L., Thurow, L., *Economics explained: Everything you Need to Know about How the Economy Works and where it's Going*, 4th edition, 1998, pp. 38-39.
(3) See www.wallstreet.ro – Shock on the international capital markets.
(4) See www.ziare.com – USA prepare for the relaunch of the monetary policy.
(5) S&P 500 Index – Standard & Poor's 500 Index - An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of US equities and is meant to reflect the risk/return characteristics of the large cap universe.
(6) www.money.ro - Rabla program. What countries pay more money for the old cars – 14.11.2010
(7) Source: Eurostat.

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