Theoretical and Applied Economics
Volume XIX (2012), No. 2(567), pp. 59-68

Crisis: a Return to Rationality

Liviu Cătălin MORARU
Bucharest Academy of Economi Studies
Liviu.Moraru@economie.ase.ro
Iulian TĂNASE
Bucharest Academy of Economi Studies
itanase@terralibertas.comti

Abstract. *This paper analyses the causes of economic crisis trying to reconcile the theory of "animal spirits" with the money supply expansion. It also aims to show the limits of the two opposing theories: both of the Keynesian and the Austrian ones, and to investigate the economic crisis in Greece, focusing on the causes that triggered it. This paper also shows the effects of population, bankers and of government officials greed on economic activity in general, and the crisis in particular.*

Keywords: depression; Keynesianism; Austrian theory; the Greek crisis.

JEL Codes: B13, D03, E12.
REL Codes: 18D, 7A, 16A, 17A.

Introduction

There have been numerous economic crises in the history of mankind which were often accompanied by speculative bubbles (the tulip bubble in 1637, the stock market bubble in 1929, the dot.com bubble from the beginning of the 2000's or, more recently, the real estate bubble in 2008). There are numerous studies regarding the nature of the causes of the economic crises, but they are strongly disputed by the economists that have different doctrines. Thus, on one side there is the Keynesian doctrine, which states that one of the major causes of the economic crises and probably the most important is the human behaviour. The human behaviour operates more on the basis of spontaneous decisions generated by an exacerbated optimism (*animal spirits*), and not based on the expectations generated by rigorous mathematics (Keynes, 1936, Akerlof, Shiller, 2009).

On the other side, from antagonistic positions, the monetarists and the Austrian School economists claim that the blame should be put on the variation (the contraction – in the monetarist doctrine, or the expansion – from an Austrian perspective) of the money supply (Mises, 1978, Friedman, Schwartz, 1982, de Soto, 1998). "Credit expansion leads inevitably to a crisis.... It is the necessary and inevitable result of such policies" (Mises, 1978).

Although these explanations of the crisis are well founded and the followers of each side still strongly support them, there are some aspects of the causes of the crises that these theories fail to fully explain. Thus, Keynesian theory does not explain why crises occur only at certain times and are not continuous, because the individual animal spirit is permanent and therefore they should always behave emotionally. In its turn, the Austrian theory cannot prove how in some periods in which the money supply has increased that economy has not experienced an economic crisis.

The best example is the crisis triggered by the tulip bubble in Holland in the XVIIth century, when coins made of precious metals were still in circulation, having an intrinsic value determined by the market (thus eliminating any weakness of fiduciary money) and, moreover, people could coin their own money (free coinage) (French, 1992). In other words, they could go to a mint with gold or silver bars which were then molten and transformed into coins, usually in exchange for a small fee to cover the costs of this service. Thus, the state did not have a monopoly over the money supply and could not influence its size, but, however, the money supply has increased even under the existence of private money made of precious metals.

We will try to overcome differences of opinion between the two doctrines and to demonstrate that the causes of economic crises lay in the synergy between lax credit conditions and animal spirits-like behaviour of people.

1. The causes of economic crises

To demonstrate that the economic crises cannot by fully explained only through the growth of the money supply, we will further on analyse the example of the Dutch tulip bubble in 1637. Beginning with 1634, the price of tulip bulbs has started to rise dramatically, until the point when a bulb was worth more than its own weight in gold. It is said that for a tulip bulb people would offer even five acres of land (Mackay, 1841). The speculative trend was growing and, due to the fact that more and more individuals wanted to buy tulip bulbs, transactions with non-existing bulbs or bulbs ready to be harvested in one year's time have emerged. This speculative bubble had its burst in February 1637 and the financial losses were enormous.

Some studies (Hoppe, 1995) suggest that the Bank of Amsterdam was responsible for the growth of the money supply at that time, but this is contradicted by numerous economists. Adam Smith and David Hume, for example, claim that the Bank of Amsterdam had a very good reputation and that it even had a 100% cash reserve ratio. The proof that this bank was functioning flawlessly is the panic produced by the French threat in 1672, when massive cash withdrawals occurred at the same time and most banks were forced to suspend their payments – e.g. the banks in Rotterdam and Middleburg. The Bank of Amsterdam was the exception and could return all the deposits because it kept a 100% reserve rate (de Soto, 1998).

It is true that the money supply has increased after 1600 due to the imports from America and free coinage, a fact which, according to the Austrian theory, leads to the emergence of crises, but the increase in money supply continued even after the tulip crisis (French, 1992). The conclusion would be that the money growth alone from that period cannot justify the crisis from 1637, because the money supply has continued to increase even after 1637, when the tulip bubble ended, yet this fact has not triggered any other crises or speculative bubbles.

The second element that contributed to the initiation and intensification of the crisis is the emotional reaction (animal spirits) of individuals. Because people had more money, they began to purchase tulip bulbs, thus increasing their price. Noting that the price was increasing and they could gain a lot of money without much effort, people began to buy more bulbs and so they boosted the price of tulip bulbs. Because this increase in price was not based on the intrinsic properties of the bulbs, but on the propensity to speculation of individuals, it is easy to guess that at some point the end of the speculative bubble would have come. Recent researches have demonstrated the large role that emotions play in the process of buying, seemingly irrational. By analysing the facial expressions of the buyers, the researchers identified mental processes underlying common decisions and concluded that the buyers are driven by emotions rather than by rational thinking (Chiru, 2010).

After the appearance of fiduciary money and fractional reserves, the credit expansion became easier, thus creating the premises for economic crises. Given this background, it is normal to observe a multiplication of economic crises in the conditions in which people could get consumer credit very easy and then use them for speculation. It should be noted that only consumer credit (or circulation credit in the Austrian terminology, "created from nothing") leads to an increase of demand and, therefore, of prices. Production credits (or commodity credit, based on savings – in Austrian terminology) do not lead to price increases (Mises, 1978).

The question which may arise is the following: If people's propensity to speculate is known, why do bankers grant credits so easily? The answer is obvious: the bankers themselves are also people and they receive the same pleasure when they gain from speculation. But, in their case, the greed can be explained easier. On one hand, bank managers receive consistent bonuses for being compliant with some financial performance indicators, especially related to the volume of loans granted, so they are encouraged to relax credit conditions to give more credit. On the other hand, in the banking system occurs something that economists call moral hazard. This happens because bankers know that it is considered best practice for the Central Bank to intervene when a bank is found in a difficult situation because, as their theory states, the whole banking system is based on trust and the risk that people lose their confidence in the banking system and therefore withdraw all their money cannot be accepted. In this current situation, based on fractional system, banks cannot deal with massive withdrawals, because they don't have all the money in the depositors' accounts, and a massive wave of withdrawals would determine the collapse of the entire banking system. Thus, if something goes wrong, losses will not be covered by individual banks, but by the Central Bank and, finally, by the population that will pay for them in one way or another. Of course that, if all goes well, profits will be acquired by banks which are in this way stimulated to grant even more credits.

Sometimes, and this is even worse, even the state is economically irrational, proposing populist measures or even borrowing money to pay for them. We can mention here the case of USA, in which the governments that have imposed a series of measures to the banks with the purpose to help low-income people to purchase housing. These measures led to the violation of prudential regulation and to the bankruptcy of two major financial institutions, Fannie Mae and Freddie Mac, a fact which exacerbated the crisis in the US (White, 2008). Another famous case, presented below, is the case of Greece, in which the government had borrowed money from international markets to support the huge inefficient bureaucratic apparatus (about half of all employees are in the public sector). Moreover, they were paid even 14 salaries per year and had many financial facilities.

2. Greece, Euro and moral hazard: recompensing lies with taxpayers' money

Through the errors, omissions and frauds committed during the last years, Greece is threatening to jeopardise the monetary stability of the European Union, and the distance between the fundamental principle of the Economic and Monetary Union – abandoning the national instruments of monetary policy by creating a common currency, but with the member states still keeping a relatively high degree of independence regarding their fiscal policy – and the recent evolutions in the Euro zone is becoming larger. Until recently, 11 of the 17 member states of the Euro zone have approved the decision of extending the attributions of the European Financial Stability Facility, its new attributions covering also the acquisition of bonds on the secondary markets, the recapitalisation of banks found in difficult situations and granting credit lines to countries with difficulties in financing their external debt (the PIIGS group of countries – Portugal, Ireland, Italy, Greece and Spain). Thus, the countries that have systematically violated the conditions imposed by the Stability and Growth Pact are recompensed with the necessary stimulants to continue the financial chaos in which they find themselves at the moment.

The conditions pushed by the Maastricht Treaty upon the states that wish to be part of the Euro zone – limitations upon the budget deficit, public debt, inflation rate and interest rate – had an official role to impose a prudent fiscal policy to those states. In time, the limitations were violated, more and more often. Greece, Italy and Belgium have public debts that exceed their GDP with more than the limit of 60%. Ireland, a country with a fiscal policy conservative enough so as to ensure a sustained economic growth, with annual rates of more than 8% for two decades, had to transfer to its taxpayers the debts of the banking sector, the public debt having increased from 28% to more than 120% in the last four years. Also, Germany and France have violated since 2003 the stipulation regarding the 3% limit on the budget deficit. Not surprisingly, the country that succeeded in not respecting in any year the limits regarding the budget deficit and the public debt is Greece, a country which, in present, jeopardises the stability of the European monetary unification project. The cumulated public debt of the 17 member states of the Economic and Monetary Union (Eurozone) exceeds in present 85% of the cumulated GDP of these countries, and 14 of the 27 member states of the European Union have public debts that surpass the 60% of the GDP limit.

Repeated violation of the rules, imposing new rules – which, very likely, will be disregarded as well (and, afterwards, re-modified) – maintain and amplify the problem of the moral hazard created generally by public spending and, in special, by errors in the economic policy. The Greek government lied repeatedly to the European Commission about budget deficits, and the availability of the Greeks to pay taxes is reducing dramatically. The endemic corruption in Greece does not surprise anyone anymore. Given these circumstances, which are the guarantees that Greece can offer to prove its real desire and capacity to pay its debts? With a public debt that tends to 150% of GDP, the Greek government is, de facto, in a bankruptcy situation, succeeding to keep itself afloat almost exclusively based on financial infusions of European Banks and International Monetary Fund.

3. How did Greece end up on the brink?

Greece, a country characterised by a suffocating and inefficient bureaucracy, with a political class immune to corruption accusations (according to art. 62 from the Greek constitution, government members cannot be prosecuted without the parliament's approval), supported financially by the generous funds offered by the European Union (the total community structural assistance allocated to Greece for the period 1994-2013 exceeds 68.6 billion Euro), can be considered a major setback for the Euro project. During the last 60 years, the Greek political power has been disputed by two families, Papandreou, leading the country in the 40's, 60's, 80's, 90's and the first half of the 2000's, and Karamanlis, which dominated the Greek politics in the 50's, 70's, and in the years preceding the current crisis, 2004-2009 (Lynn, 2010). Far from the democratic ideal pictured by the Greek scholars of the Antiquity, the Greece of the 2000's is an oligarchic system in which the political power is concentrated in the hands of an elite characterised by a lack of any solid principles of governing responsibly.

Even if two of the conditions – nominal convergence criteria – regarding EU accession require that the public debt and budget deficit does not exceed 60%, respectively 30%, Greece has failed in every year, starting with 1991, to respect these limits. The lowest value of the budget deficit, 3.10%, was attained in 1999 and the closest value to the public debt target was attained in 1998, of "only" 97%. The cosmetic adjustment of official statistics – for example, by not including a part of the defence spending (despite the issues that it's dealing with, Greece keeps on spending nearly 3% of GDP for defence, a percentage higher than in any other European states) or the debts of public hospitals – raised serious question marks in the other states of the Euro zone about the credibility of the Greek government.

The major causes of the debt crisis that Greece is dealing with in present are represented by large and continually growing governmental deficits that this country has registered ever since the moment of the accession to the Euro and, specially, by the Keynesist type of answer that the Greek government has adopted at the start of the economic crisis. At the end of 2009, the Greek government announced that the budget deficit exceeded the target agreed by 9 percentage points, from 3.7% to 12.7%. The main cause of the worsening of Greece's situation consists in a mix of counterproductive public policies, backed by a legislation hostile to business, which have contributed to the creation of a fatal combination for the economy. With a public sector that represents 40% of GDP, taxes upon the workforce exceeding 44% of the total wage expenses incurred by employers and, therefore, a flourishing labour market, a progressive tax system for individual income, with rates between 0% (for income lower than 12.000 Euro) and 45% (for income that exceeds 100.000 Euro), a standard VAT of 23% and a profit tax of 23%, Greece can hardly be considered an attractive business environment. The competitive advantages that Greek businesses have in certain fields – tourism, some agricultural and food products, unconventional energy production and others – do not manage to counterbalance the errors of political economy of the Greek government.

Still, Greece cannot be blamed alone for the present situation. Although all the signs indicated the impossibility of the Greek government to pay the debts, there was a series of banks (together with the European Central Bank – its independence from political pressure being annihilated by its president Jean-Claude Trichet – there could be mentioned Deutsche Bank, Commerz bank, Dexia, Société Générale, BNP Paribas) that continued to buy Greek bonds, postponing the inevitable. Not surprisingly, those banks count on the support offered by the states from which they belong, should Greece default. And the one who will pay the bill in the end is, obviously, the taxpayer.

Conclusions

The crisis arises from a synergy of loans easily granted and emotional behaviour of individuals mainly based on their greed. These elements have generated speculative bubbles which, after an excessive increase, have burst, triggering the start of the crisis.

The crisis acts as a warning signal, indicating that something is not working well in that economy and the old economic behaviour needs to be modified. First of all, the money supply should be carefully managed in order to limit speculative credits and to encourage productive investment. Secondly, people should be made aware of risks to which they expose when they take excessive debt. Also, individuals should consider economic returns before investing in different assets, because when they borrow excessively relying upon a continuous price increase, they need to be warned that this approach will turn out to be unrealistic every time (no price can increase indefinitely with annual rates exceeding 100%). Bankers should reflect more on the effects that their decisions have on the economy and act more responsibly when they decide upon the conditions of granting credits.

In turn, even state officials should abandon populist behaviour and also consider the long-term effects of their decisions when they propose various legislative measures. Considering the evolutions from the Euro zone, the politicians' appetite for exaggerated public spending seems impossible to control. Although the Stability and Growth Pact had established clear boundaries regarding the budget deficit (3% of GDP) and public debt (60% of PIB), countries like Greece, Italy, Spain or France have systematically exceeded those limits (Besides, Greece is the country that had never fulfilled any of these conditions, starting with 1991). Populist measures of some politicians can surely find methods of financing, skilfully eschewing the rules of the game. And when the rules cannot be eschewed, they will be simply suspended: the European Council had suspended the Stability and Growth Pact each time when the unfulfilment of the criteria should have been sanctioned – first of all in 2003, when France and Germany exceeded the limit regarding the budget deficit and, more recently, during the current crisis, when many of the states in the Euro zone have exceeded the two thresholds regarding budgetary stability.

The shortest and safest way towards the economic crisis can be, thus, illustrated by the words of Aristotel Onassis: “To be successful, keep looking tanned, live in an elegant building (even if you’re in the cellar), be seen in smart restaurants (even if you nurse one drink) and if you borrow, borrow big” (Manolopoulos, 2011).

References

Akerlof, G.A., Shiller, R.J. (2009). *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, ISBN: 978-1-4008-3012-1, Princeton University Press

Chiru, C. (2010). *Tragedia societăţii de consum*, vol. *Criza e în noi*, coord. Costea, C., Popescu, C., Taşnadi, A., ISBN: 978-606-505-383-0, Editura ASE, Bucureşti

French, D.E. (1992). *Early Speculative Bubbles and Increases in the Supply of Money*, First edition, Ludwig von Mises Institute, www.mises.org

Friedman, M., Schwartz, Anna J. (1982). *Monetary Trends in the United States and United Kingdom: Their Relation to Income, Prices and Interest Rates, 1867-1975*, University of Chicago Press, Chicago

Hoppe, H.H., „The Political Economy of Monarchy and Democracy, and the Idea of a Natural Order”, *Journal of Libertarian Studies,* 11:2, 1995, pp. 94-121, Center for Libertarian Studies

Keynes, J.M. (1936). *The General Theory of Employment, Interest and Money*, Macmillan, London

Lynn, M. (2000). *Bust: Greece, the Euro, and the Sovereign Debt Crisis*, Hoboken: Bloomberg Press

Mackay, Ch., „Memoirs of Extraordinary Popular Delusions and the Madness of Crowds”, London, 1841 http://www.econlib.org/library/mackay/macExContents.html

Manolopoulos, J. (2011). *Greece's 'Odious' Debt: The Looting of the Hellenic Republic by the Euro, the Political Elite and the Investment Community*, London: Anthem Press

von Mises, L., „The Trade Cycle and Credit Expansion: The Economic Consequences of Cheap Money”, Institutul Ludwig von Mises România, mises.ro,1978

von Mises, L., „The Causes of the Economic Crisis: An Address”, Ludwig von Mises Institute, www.mises.org, 1931

de Soto, J.H., „Moneda, creditul bancar şi ciclurile economice”, Institutul Ludwig von Mises România, mises.ro, 1998

Sunstein, C., Thaler, R., “Human Frailty Caused This Crisis”, *Financial Times*, Nov. 12, 2008

White, L.H., “How Did We Get into This Financial Mess?”, *Cato Institute Briefing Paper* no. 110, Nov. 18, 2008