Theoretical and Applied Economics
Volume XIX (2012), No. 4(569), pp. 167-176

Challenges of the Economic Science During the Crisis

Ioana MOLDOVAN
Bucharest Academy of Economic Studies
ioana.moldovan@economie.ase.ro
Raluca Andreea POPA
Bucharest Academy of Economic Studies
raluca.popa@economie.ase.ro

Abstract. *Turmoil that affected the financial markets and the global economy since 2008 have generated a series of debates in terms of the economic theory's ability to find answers to the new problems. Among others, the crisis has triggered, at the ideological level, a lively debate about the markets` self regulating ability postulated by economic theory and state interventionism opportunity, and even put into question the soundness of the capitalist system. This paper examines some of the challenges that the economic science has experienced during the global crisis.*

Keywords: financial and economic crisis; economics; paradigm; market fundamentalism; interventionism.

JEL Codes: B12, G01, H50.
REL Code: 2B.

Introduction

The financial and economic crisis of 2007-2008 is the first global crisis that took place after the Great Depression of the '29 -'33. Joseph Stiglitz calls the events that took place in the world economy "the Great Recession of 2008" (Stiglitz, 2010). The comparability of the recent crisis with the Great Depression is acceptable by the fact that this is, like the crisis in '29-'33, an exceptional event that marks the economic history of the world. Apart from this term of comparison, there are few characteristics common to the two crises, and it can be said that the the Great Recession is not nearly as severe as the Great Depression. Table 1 shows the comparative phenomena that affected the US economy during the two crises.

Table 1

The Great Depression of '29-'33 and the financial and economic crisis of 2007-2009

	The great economic depression of '29 –'33		The crisis of 2007 -2009	
Number of bankruptcies	9096 (50%)	January 1930 – March 1933	57 (0. 6%)	December 2007 – March 2009
Unemployment rate	24.9%	1933	10.2%	2009
Economic growth rate	-26.5%	1929 – 1933	-3.3%	2008 - 2009
Dow Jones stock index evolution	-89.2%	September 1929 – July 1932	-53.9%	October 2007 – March 2009
Inflation	-25%	1929 – 1933	+0.5%	2008 - 2009
Increase of money supply	17%	1933	125%	September 2008 – May 2009
Fiscal Policy	increase of taxes, reduction of public expenditure by 1.5% of GDP	1933	Increase of public expenditure by 2.5% of GDP	2009 - 2010

Source: Jeong and Kim, 2010.

Although the recent financial turmoil has not been as serious as the Great Depression either at the US economy level, or at the global level, it has had a major impact on the real economy. The rapidity with which the crisis spread from one country to another was facilitated by the financial and commercial connections between the countries of the world. This aspect was less observed during the Great Depression of 1929-1933, given that the economic and financial globalization advanced especially in the second half of last century.

The global financial crisis of 2007-2008, which, according to many economists, will have repercussions in the global economy for a long time is probably the most complex crisis of all time, not necessarily in terms of its effects, but in terms of the causes that generated it.

The complexity of the causes is the fact that the turbulence was caused by two categories of factors that completed each other:

- factors that were the causes of the financial crises in the past, such as speculative bubbles emergence, expansion of credit, excessive debt or inadequate regulation and supervision;
- new elements and developments such as the emergence of complex financial products, characterized by a high degree of opacity, excessive exposure to the risk of most players in the financial market, unprecedented growth of the interdependence between financial markets and institutions at national and international levels, or the widespread use of risky debt-investment schemes.

An important feature of the crisis that erupted in 2007 is the fact that, unlike the other crises of the late twentieth century, this had as origin the center of the global economy and financial system. The crisis had as a starting point the turmoil in the credit sector sub-guaranteed by the United States and then spread to the US financial system, along with the contamination of other financial markets worldwide. Soon, problems began to make their presence felt in the real economy, the generated social costs being significant.

The crisis revealed a number of weaknesses in regulation and financial architecture, particularly in the direction of management of systemically important financial institutions, correctly assessing the vulnerabilities and risks facing the global financial system, but also the soundness of financial institutions. The extension of the crisis at the global level reminded that the integration of the financial markets, although it brings many benefits, imposes significant risks, with major consequences in the real economy.

1. Changing of paradigm

At the ideological level, the crisis triggered an intense debate on the ultra-liberal theory concerning “the invisible hand” of Adam Smith, and the state interventionism opportunity suggested by John Maynard Keynes to overcome a recession. Thus the crisis generated a change of paradigm, demonstrating that the capitalist system is unable to self-regulate, being susceptible to crises. Therefore, the state must intervene and establish regulations to support the financial and economic stability.

Although history has shown that capitalism is subjected to the alternation of growth periods with decline periods and outlined the features and manifestations of the speculative bubbles at the beginning of the XXI century, precisely when a speculative bubble of huge size began to recover in the US real estate market, great economists strongly believed that the capitalist system exceeded its condition, and that the problem of the economic cycle was solved.

Robert Lucas, the Nobel Prize winner for Economics in 1995, declared in 2003 that “the central issue to prevent the recession was resolved from all practical points of view”. He did not argue that the economic cycle had been removed, but that it was “tamed” and that the problems induced by the appearance of the economic depressions can be easily solved (Krugman, 2009). Lucas was not the only person in the world economic scene who believed in this hypothesis. In 2004, Ben Bernanke, who would later become the US Federal Reserve chairman, said that macroeconomic policies can easily solve the problem of the economic cycle so that this was no longer a significant difficulty.

The crisis that erupted in the US market in 2007 showed the world that those who believed that the economic policies are almost infallible were in great error. We can not doubt that the economists who thought at some point in this thesis would not have impressive knowledge and experience concerning the capitalist system. However, given that the economies of the world seemed flourishing, they fell into the trap of “the black swan”. The theory of “the black swan” belongs to the philosopher Nassim Nicholas Taleb of Lebanese origin, and expresses the fact that the human mind is unable to conceive the possibility of a major bad event as long as no current reality raises questions about future events.

The severity of the crisis caused fundamental changes in the conventional economic theory. Thus, the turbulence in the financial sector has shown that markets are not self-regulating entities, solid and secure as previously thought.

According to George Soros, the markets never reach the equilibrium postulated by economic theory. Reasoning and misconception of the market participants and of the decision makers can significantly influence market prices, so that there can occur easily processes of development type – decline, initially self-generating, and then self-destructing. In essence, the influence on market prices is also transmitted through supply and demand, but the decisions of the market participants are not based only on knowledge, the investor`s feeling also has a special importance.

Basically, according to the classical theory, markets are always in balance, and the financial crises are some unusual anomalies, impossible to explain and highly unlikely. Both the previous crises, and the one in 2008 showed that this paradigm is false, revealing the fact that they are part of the economic reality.

Another aspect that was condemned after the outbreak of the crisis relates to market fundamentalism, “laissez-faire” according to which markets should be left free and government intervention should be minimal. As it actually happened, if the state does not intervene in the economy to regulate and oversee markets properly, the sophistication of the financial instruments combined with excessive liquidity of money market determine excessive risk exposure, the artificial increase of the prices of some assets and the emergence of speculative bubbles that once “broken” cause imbalances in the entire financial system, with severe implications on the real economy.

Thus the crisis showed that the capitalist system is unable to regulate itself, but rather is prone to speculative bubbles followed by severe collapse. Moreover, behavioral economics revealed that people are irrational being, prone to fits of exuberance and euphoria. The crisis generated a change of paradigm, being removed the old conception concerning the ability of markets to self-regulate. Consequently, it emerged the idea that regulation and supervision of financial markets are particularly important and contribute to the stability of the global financial system.

2. The problem of deficits

The severity of the crisis induced strong feelings of panic in the financial markets and to reduce the negative effects on the real economy, governments of many countries resorted to massive intervention and without precedent, in order to support markets. Following interventions to reduce the impact of the crisis, budget deficits in many countries increased considerably. Basically, the global financial crisis was converted in 2010 - 2011, in a sovereign debt crisis in various economies, especially those in the euro area, affecting their capacity to recover.

In Europe, economies such as Greece, Ireland, Spain, Portugal and Italy have accumulated more debts than they can pay and the Euro area countries have been forced to grant aid to avoid collapse. There is concern that the Euro area might fall apart because of budget problems facing many European countries.

European economies are not the only ones that have accumulated major budget deficits. In the US public debt has increased by over 60% since the beginning of the financial crisis, and according to some estimates it will continue to grow. In this context, the rating agency Standard & Poor's downgraded US rating from AAA, the safest, to AA in August 2011.

Japan is also facing similar problems and the same agency reduced at the beginning of 2011 the rating for the Japanese long-term debit titles for the first time since 2002. Generally speaking, bonds or certificates issued by the State Treasury are considered the safest investments and are rated by the rating agencies as having the lowest risk, but given that many countries have accumulated unsustainable debts, these titles have become less safe.

To reduce government spending, many states have implemented various budgetary austerity measures, reducing the number of jobs in the public sector, wages and social assistance payments. Nevertheless, together with similar trends in the private sector, they have slowed down economic recovery.

High budget deficits recorded by the developed countries are part of global imbalances. They are due to the fact that some developed countries, particularly the United States consume more than they produce, and some emerging countries, particularly China, produce more than they consume, making significant savings, which they target to the developed countries, thus financing their deficits. The fact that poor countries finance the developed ones ones is bizarre, and the magnitude of global imbalances seems unsustainable (Stiglitz, 2010).

We believe that unsustainable debt is and high public spending represent and will continue to represent for a long time, the most pressing issues that will face a number of developed countries, especially the US and Euro area countries, and some emerging states, such as Romania.

The accumulation of unsustainable debt for long periods of time significantly reduces the confidence of foreign investors, and thus can cause currency and financial crises. However, their financing by issuing currency creates inflationary pressures. Therefore, it is required the application of fiscal consolidation programs on the medium and long term in order to rebalance the state budget. It is necessary, however, that fiscal policies to be combined with appropriate monetary, social and structural policies, so that economic and social costs of such measures to be reduced.

High current account deficits may contribute to endangering financial stability so that the economic development should be the domestic savings. However, the economic policies should promote sustainable and equitable economic growth, which ensures higher living standards for all walks of life and reduces the gap between them.

3. The problem of interventionism

State interventionism has been the subject of theoretical dispute for decades, and these disputes were re-lit together with the interventions made by the governments of the countries affected by the recent crisis.

Supported by Keynes, the intervention of the authorities in economy was highly criticized by the economists belonging to the Austrian School. According to this economic thinking, loose monetary policies, regulations and state intervention in the economy disrupt the smooth running of the free market. One of the leading figures of this school of thought, Joseph Schumpeter, developed the theory of “creative destruction” according to which the periods of crisis and recession represent tests that only great economic agents can face and they will create a new economic order (Schumpteter, 2006). If Keynes considered capitalism a system which becomes unbalanced occasionally, but can be stabilized by the intervention from the state, for Schumpeter instability was the result of innovation that represents basically the essence of capitalism.

According to this theory, the state should not intervene in the economy even if it is in crisis, but it must leave shaky banks and other companies to collapse so that eventually only strong economic agents survive. State intervention to rescue financial institutions and companies in bankruptcy represents, in the ideology of the Austrian School, a socialization of the private loss, which will lead to increased budget deficits and implicitly to public debt. This will compromise the long-term economic growth, and the state could enter into payment incapacity, the solution to this situation being printing money, with negative effects on price stability.

The Austrian School argues that excessive regulation of markets is the cause of the economic crisis, and after a crisis the tendency of strict regulation does nothing but worsen the situation. The explanation of this view is that actions such as deposit guarantee or government interventions to ensure liquidity contribute to increased banks` appetite for risk, although the immediate effect is to provide certainty to those who save.

Some economists believe that the best solution to economic and financial crisis requires a combination of Keynesian ideas with the Austrians’, i.e. the application on the short-term of the Keynesian interventionism and on the long-term the hypothesis called “creative destruction” (Roubini, Mihm, 2010). Thus, in the context of a financial crisis it is required to grant loans if necessary, since their absence would worsen the problems of the financial system and would push the economy into a severe recession.

On the medium and long term, the Austrians seem to be right. The salvation from bankrupt of entities with problems using the public money, the socialization of losses and the accumulation of budget deficits can not be sustained for a long time. Therefore, inefficient companies should be allowed to go bankrupt since otherwise, the phenomenon of moral hazard leads them to take increasingly more risks, and the burden to be supported by taxpayers being bigger and bigger.

From a theoretical point of view, the problem seems simple enough, but when it should be applied into economic practice, things get complicated. First, in terms of interventionism opportunity, it is very difficult to identify the boundary between long and short term. If a particular financial institution was saved three years ago, why would not the same thing happen now, given that the economic turmoil did not end, and amid the financial globalization, the impact of a large bank failure would be as bad as or even more severe than the situation that could have taken place three years ago. Unfortunately the costs of the materialization of the systemic risk induced by the failure of large financial institution are very difficult to estimate. Perhaps because of this government tend to intervene and "save" endangered entities. On the other hand moral hazard intervenes here, and if the state borrows too much money, its debt becomes unsustainable and enters into payment incapacity.

The current crisis of the sovereign debt affecting the Euro area countries, and not only, seems to be the worst crisis of its kind in the world economic history, considering the large number of countries facing it at the same time, with high debt, likely to become unsustainable. Governments' excessive debt has and will continue to have negative repercussions on the real economy, in that they will be forced to undertake austerity programs in order to pay the debts, which will negatively affect economic growth and impede the formation of new workplaces or reduction of unemployment. People will become aware that the state can not save private companies with problems using debt forever or combat recession. Thus, it is very possible that some individuals will come to take measures against interventionism and be aware that this practice provides only a momentary solution of the situation, with more serious repercussions on the future status. This category of population will make an increased demand for a fiscal responsible state, which at an operational level will turn into a high demand for tax – buget policy designed to avoid excessive debt and excessive social benefits (Croitoru, 2011). However, this category of public will require efficient spending of public money so that it will lead to the creation of new jobs. Certainly, however, that such awareness of the state's over-indebtedness problem involves a high level of education. On the other hand, austerity programs will awaken the public dissatisfaction linked to rising unemployment, and it may choose to meet immediate personal interest.

Conclusions

The deregulation of the financial markets, the growth of connections between them at the international level and loose monetary policies occasioned unprecedented artificial expansion of the global financial system in the last decade, causing a rupture between it and the economic reality. The financial markets offered, for a long time, the possibility for rapid and substantial gains, and thus they became a goal in themselves rather than a means of financing. Thus, the financial markets did not have effectively met the financing role of the real economy. After the rupture from the real economy, the unsustainability imposed by the artificial expansion of the financial markets led to a crisis, and the old paradigm of how markets function was removed. Amid interventionism, markets crisis degenerated into another crisis, a crisis of governments. Cascade crises induced the idea that the economic science itself is facing a crisis, underlying financial and economic turmoil. Thus, the paradigm that has governed until recently the economic life must be changed. The new paradigm should be based on social responsibility and ethics in business, so as to promote sustainable and equitable economic growth, providing a decent standard of living for all walks of life. The new economy should remove excesses specific to corporatist capitalism to determine a return to balance and moderation. The manifestations of "the animal spirits" aimed at achieving rapid and consistent profits by any means should be controlled by regulations concerning business ethics and social responsibility. Basically, humanity is facing not only an economic crisis, but a crisis of values and to remove it, the system of values on which society is based must be rethought, acknowledged and assumed.

Acknowledgements

This article was co-financed by CNCSIS, Project no. 1801/2008.

References

Croitoru, L., „Cine câştigă din criza datoriilor suverane”, *Ziarul Financiar*, 10 octombrie 2011, http://www.zf.ro/opinii/opinie-lucian-croitoru-cine-castiga-din-criza-datoriilor-suverane-8850681

Jeong, K.-Y., Kim, E., “The Global Financial Crisis: New Implications and Perspectives for Emerging Economies, *Global Economic Review*, 39, 1, 2010, pp. 1-13

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

Krugman, P. (2009). *Întoarcerea economiei declinului şi criza din 2008*, Editura Publica, Bucureşti

Nassim Taleb, N. (2008). *Lebăda neagră. Impactul foarte puţin probabilului*, Editura Curtea Veche, Bucureşti

Roubini, N., Mihm, St. (2010). *Crisis Economics: A Crash Course in the Future of Finance*, The Penguin Press

Schumpeter, J.A. (2006). *„Capitalism, Socialism and Democracy*, Routledge, London

Soros, G. (2008). *Noua paradigmă a pieţelor financiare. Criza creditelor din 2008 şi implicaţiile ei*, Editura Litera Internaţional, Bucureşti

Stiglitz, J.E., (2010). *În cădere liberă*, Editura Publica, Bucureşti