

## Aspects of signaling hazards and of identifying opportunities in crisis situations

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**Abstract.** *This present research attempts to highlight some causes that have led to the current crisis, the role and importance of signals in anticipating events that characterize a situation of crisis, the need for interpreting these signals not only based on the economic theory but also on interdisciplinary methods and theories. The threats that may occur in situations of crisis should be identified properly, as well as opportunities, in order that the measures that are to be taken at macroeconomic level could be imbedded in the economic policies so as to contribute to improving the macroeconomic decisions and to successfully achieve the objectives already set.*

**Keywords:** crisis; risk; opportunity; cognitive dissonance; economic policies.

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## Introduction

The current crisis goes far beyond the economic sphere, although the specific of economic actions (particularly in the financial sector) is considered by many analysts as the main reason that led to the manifestation of the effects that characterize a crisis. The previous, current and future debates try to highlight the causes that led to the crisis, the crisis analysis models and the prevention methods as well as to identify solutions to minimize the negative impact of the effects of the crisis or even to identify a basis for developing new relationships and correlations not only in the economic practice but also in the economic theory. If we consider the Chinese specific symbolism of the word crisis, which consists of two ideograms (the first meaning – *danger*, and the second – *opportunity*), the crisis itself flags the danger but it also flags the need to engineer processes of change.

After the emergence and identification of signals of particular importance would be the way to ground and implement preventive measures, and if this prevention did not exert the expected role, important would become the actions and measures that have to be taken (both at microeconomic and macroeconomic level) to reduce the negative effects that may arise and which may help reducing the possibility of further deepening of the crisis.

## An analysis of the economic history

If we look back to what happened in the past, we are clearly shown the positive developments that have been registered both in economy and in economics for the last 140 years. Two world wars that brought about death could have also meant the crossroads for reestablishing economic relations so as to make possible the extraordinary reconstructions following the cessation of hostilities. The two world wars, which resulted in millions of casualties, were due to the inability of politicians to defuse the accumulated geopolitical tensions, so that these led to the swelling of a “bubble” which, the moment it burst, has poured a lot of misery into the world.

The realm of the recent years is not to be resumed only to “bubbles” which, by bursting, would literally trigger wars. In the economic area specific “balloons” arose, which did not necessarily result in the physical death of individuals involved in various economic activities, and which were more or less related to the swelling of the “balloons”, but led to such serious situations that these can be compared to ones arising from actual wars.

The first balloon filled with tensions of this period can be considered the one registered between 1890 and 1893 in the United States. The tensions were

caused by an increase of 36% of stock exchange indexes between 1890 and 1892, followed by a decrease of 27% thereof until the second half of 1893; this sudden increase – dramatic fall registered by the financial markets accompanied by a decline in nominal wages applied by employers (using lower wholesale prices as an argument), and this state of instability seems to have triggered panic, resulting in a sustained withdrawal of savings deposited in banks (Akerloff, Schiller, 2010, pp. 111-113). Thus, many businesses artificially inflated by the increase of the value of shares began to disappear due to the high costs of credit accession. Unfortunately, in such a tense climate, viable businesses also suffered, and the cumulative effect translated into maintaining a high unemployment for a long enough period so that the overall situation of those years to be marked as economic crisis. The turmoil recorded during this period determined the occurrence of interesting approaches on certain concepts, such as that of “money illusion” that have been used including during electoral battles, but also created opportunities to address these complex economic phenomena, and a noteworthy result of that period was the invention and stabilization of the term of real interest rate by the Professor John Bates Clark from Columbia University (Akerloff, Schiller, 2010, p. 116). Also, after an analysis of what had been happening during the last decade of the nineteenth century and a reflection that was extensive enough so that it shouldn’t be affected by the tragedies that happened then, can be seen as an opportunity also the setting-up of the “bank of banks” in the US, namely the Federal Reserve System, in 1913, which had the opportunity to act operatively in case of similar negative situations.

The third decade of the twentieth century was a period where symptoms registered in the US only three decades ago seem to have been forgotten. The economic features of this decade are similar to those of 1890 and 1892 in terms of growth indices, indicating that this increase lasted longer, and that the reduced experience of the Federal Reserve System in terms of correcting deviations from nonbank economic environment and insufficient caution regarding specific banking activities have contributed to the “overheating” of the economy in a way that the “balloon” swell too much, even if the materials from which this balloon was made of appeared to be quite resistant. During this period, the effects caused by the unexpectedly unnatural momentum (as the illusion of a lower cost of waste or the illusion of the occurrence of brilliant investors out of nowhere) were turned into factors that deepened the long-term effects of the crisis. The burst of the bubble occurred in October 1929 (since then, the dramatic decrease of stock exchange indices are almost universally regarded factors triggering the crisis), and the effects generated by this burst were felt not only in the US but also in many other countries. One of these

effects was an almost general collapse of the monetary system based on the gold standard and the distrust shown to banks became increasingly present. Also, by achieving very high unemployment rates led to an extremely tense situation on the labor market, tensions which generated not only “bubbles” in the economic environment, but also, more dangerously, they generated “balloons” in the ideological space (fascism and communism fueling intensely on these tensions). As in the case of the previous crisis, the Great Depression (as it was regarded in the books of economics) was characterized by a dramatic decrease in consumer price indexes, but the drop registered in the nominal wages was not simultaneous with the decrease in prices, which led to an increase in real wages. The dangers of this crisis developed harshly in the economic environment, but more difficult was to deal with the dangers of the totalitarian regimes, whether they were registered in Germany, or in the USSR Poland, Czechoslovakia, Romania, Hungary or Bulgaria. The opportunities arising subsequent to the Great Depression were unfortunately overshadowed by other dangers generating more negative effects. One of these refers to the consecration of the clear importance of the concept of “money illusion” in the economy, and another one could be related to the increase of research on economic phenomena and to the obtaining of important results of the research (1936, the year of the General theory of employment, interest rate and currency of John Maynard Keynes). It can also be linked to the concept of opportunity, and the importance that must be allotted by a researcher of the economic meta-space, or by a practitioner of the real economic environment to issues not based only on rational behavior, but rather on the behavior that Keynes relates to the animal spirits.

“The explosion of financial markets of sub-prime type in august 2007 can be seen as the detonator that triggered the crisis,” argues Thomas Palley in his “America's flawed paradigm: macroeconomic causes of the Financial Crisis and Great Recession” of 2011. This detonator was linked to a bomb to produce the explosion, and the bomb should have certain characteristics. Suffice it to say that the bomb can be characterized only as a bubble inflated continuously and just waiting for the occurrence of a detonator? Can authors of this bomb be identified? Can such a bomb be defused? Here are a few questions that analysts have tried to answer. According to some authors, the triumph of the neoliberal theory in economics, the triumph recorded in the ninth decade of the last century, on the paradigm that is based on achieving full employment and labor market balance in strict correlation with nominal wage labor productivity growth (Palley, 2011, p. 5) was exactly the skeleton on which such a bomb could have been built. A rational approach to this situation would lead us to believe that those who drew the main features of the neoliberal theory of

Reagan-Thatcher type relied on a strategy of borrowing in order to support the sustained growth of investments in the military without sacrificing those in the civil field, so, through this strategy, the communist bloc was to record a stifling state of investment, which led at one point to a choking of the domestic consumption in communist countries. With the fall of communism it became an achieved goal, a return to sound economic policies that have ensured the restoration of after-war capitalist economies was a reasonable enough goal. But it was not so, as neoliberal economic policies were continued after the fall of communism leading to a decrease in the capacity of negotiation and placement of workers, to a strengthening of the capacity for corporate positioning and to an establishing of financial markets' characteristics according to the interests of business and financial elites, the element of intent in this regard being obvious (Palley, 2011, p. 7). With this sequel, there was a sharp polarization process, both economic and social, and the effects of this polarization may be the sources of social conflict, which, if not defused in time, will not only generate high social costs, but also economic costs which may worsen things or can become prerequisites for the emergence of a new crisis.

### Aspects of the rational expectations' theory

Rational behavior theory assumes that a customer, producer or any other individual related to the economic space acts only in a way to achieve their goals (or at least not to act in a manner directed against their own interests). For a long time, this theory was the source from which solutions were obtained for the increasingly diverse needs of the economic space. Moreover, economics was characterized by a relative stillness in the rational choice theory while other sciences such as sociology, psychology and sociology have tried (and failed) to develop other directions of research (Akerloff, 2009, p. 166). An illustration of the limits of the economic theory based on rationality may be the case of the firm had all the chances of becoming one of the most representative one in the financial services market. It is about Long Term Capital Management (LTCM), a company founded in 1994 by practitioners renowned in their field, but it also had two leading scholars in their field in the composition of the board of directors, and who even received the Nobel Prize in economics (that is, Myron Scholes and Robert Merton, who received the most precious award for a research analyzing modern methods of determination of derivative securities). Rational expectations lead us to the idea that such a company, combining the practical skills so necessary for the financial markets with academic expertise at the highest level, and allowing the use of models that have been recognized by representative scientific bodies, could only have

registered the best outcomes. And yet, it was not the case. In 1998 the losses of the company amounted almost unimaginable levels (about 4.6 billion dollars). Rational expectations would indicate that, in case of such losses, the supervisory and regulatory bodies should investigate what happened and take the necessary actions to prevent the occurrence of similar cases. And yet, it was not the case, although in April 1999 a report was drafted of the Presidential Group on analysis of financial markets, a group that was composed of people having the highest level of decision in their field. Rational expectations should indicate the identification of individuals responsible for allowing such losses to be registered, the negative effects of such an event being even more important than the actual value of the amounts involved. And yet, it was not the case, because there were no penalties at individual level, and the company could disappear as if it never existed, although there was a recovery plan to should have allowed the recovery of at least part of the losses.

Financial innovations have been a very interesting process that led to the intensification of activities multiplying on the financial market, both banking and non-banking sectors, but at the same time created the possibility of disseminating the risk to such an extent that the impression was generated that if a player falls it will not be singular, but it will be followed by many others, leading to behaviors similar to those exhibited in a safe environment, but this so-called security did nothing but convince those actors in financial markets to let their guard down and not take even the most basic precautions. Also, the relatively easy access of investments' funds to loans practically contributed to the shift from a relatively well regulated area (a feature of the banking system) to very little or no regulation (Boheim, 2011, pp. 315-317). The rapid internationalization of the financial markets' actions contributed to limiting the capacity of national authorities to check those types of activities that involved high risks, and this limitation of capacity has led to nothing but a deepening of the uncertainty in these markets. The rational expectations suggested that steps should be taken to reduce the negative impact of some innovative financial products. But it was not the case, or even if there were such measures, they have not proved successful.

The deficiencies of regulatory processes is one of the most important causes that led to the multiplication of the negative effects of the crisis, this being possible due to the dominant paradigm in the field of regulation starting from the assumption that the stability and the efficiency of financial markets can be obtained automatically (Boheim, 2011, p. 323). The role of regulating authorities can be optimized only if the measures they take are effective and efficient, but apparently it was not the case.

The relaxation of competition policies can be an important signal of the depth of the crisis. When granting state aid, if only by guaranteeing loans to certain banks or private or state companies (especially if the selection criterion is based on TBTF – too large to fail), this behavior can become a real threat regarding competition because competition distortion adversely affects the efficiency of resource allocation rather on long term than on short term.

The characteristics of insolvency, as a specific procedure for business reorganization, represents another important signal on the depth of the crisis. The moment when insolvency proceedings are applied correctly and effectively the result is reclamation of the economic space only on those firms that cannot be saved. When the behavior insolvency practitioners is inappropriate (and in times of crisis this can be seen as an opportunity) some viable businesses may be affected, that will generate negative effects, especially in the short term, and if the number of these companies is high enough, on long term as well.

The inappropriate and arbitrary way of ratings' setting for various companies of financial intermediation is another element that can signal that something is wrong and can lead to profound alterations in the financial markets which may lead to serious problems. In terms of rating agencies, an important signal of a potential crisis can be considered also the weight of the consultancy activities they offer on financial economic agents (in the banking and non-banking sector) in the total activities that these agents have. When we refer to consultancy activities we do not only consider consulting activities performed by agents as legal entities, but also those provided by individuals working within those agencies (although rational expectations would suggest here conflicts of interest which should be penalized). The role of rating agencies can be critical at times, as any inadequacy (that is bias) in determining the rating of a financial economic agent, followed by a collapse of the respective agent, will determine negative externalities throughout the financial system, even direct competitors, since a collapse of the financial agent leads to a decrease in the rating of the entire sector (Boheim, 2011, p. 324).

The fact that the perception of rationality in economics may create difficulties in understanding what happens in the economic environment is suggested by Pascal Bruckner in his book *The prosperity's misery*, when referring to *The capitalist Oracle* (p. 23):

In his novel *Money*, published in 1891 and which presents the Stock Exchange rotten world, with heroes, crooks and its stupid, Emile Zola depicts effectively a rich jerk, a fellow called Amadieu, “a fat gentleman whose face was red and shaved” and who “through gross lucky stubbornness” put his entire fortune on mining titles fallen to the lowest level. Discovering real and significant ways makes him earn 15 million of a sudden. “And his stupid

operation that formerly would have put him in prison; it now raises him to the rank of vast financial brains.” He is asked for advice often. But to every question he answered with a grimace and the applicant was forced to interpret his silence. Haloed by that single, solitary stroke of genius, the visionary dreamer chose the attitude of Pitia: grumbling and keeping silent. We wouldn’t want to distort: how many Amadieu are today among managers and other experts whose injunctions often lead to ruining their clients? It is exactly what proves the following experience encountered – according to a rumor that should be taken with caution – by the Wall Street Journal: the same portfolio of shares managed by a very serious office and gambled on during a game of darts played by newspaper editors would have produced at the end of a year about the same performance! What is then the purpose of financial analysts? To rationalize random, to appease customers, to give the whole chaos an appearance of logical mayhem. Economy, the science of uncertainty, should teach students its oracular speech: the art of neither saying “yes” nor “no”, of not stating anything, to drown each sentence in savior fluency. What a confession in this phrase of Alan Greenspan addressed to the reporters: “If you understood what I have just said earlier, it means that I didn’t express myself well!”

### Aspects of the cognitive dissonance theory

Many of the theories from other social sciences do not allow the possibility of being integrated into the economic environment. But elements specific to some theories can complement the economic theory so that results become closer to reality, because there may be situations in which the use of certain specific economic concepts can lead to a distortion of reality (Heyne, 1991, p. 476). At some point economics was labeled as “imperialist” tending to invade other social sciences, but the interaction of sciences is normal when more complete answers have to be identified. The opportunity provided by the current crisis is to increase the use of some elements of already established theories in other sciences (sociology, psychology, law or medicine) to get out of the field of rationality. The economists’ perception regarding the terms of rationality and irrationality is a specific one, an example would be of the great economists, Gary S. Becker, referring to irrational behavior as being a random deviation. Or, some theories of psychology “consider irrational behavior as being predictable, and therefore not entirely random, and the predictability of such behavior entails implications regarding welfare” (Akerloff, 2009, p. 166).

One of the theories of psychology which may provide important elements for the development of economic theory is the theory of Cognitive Dissonance, elaborated by Leon Festinger, and translating these elements into the economy



concerned leading economists such as George Akerloff and William Dickens. They based their assumptions on some statements regarding the ability of people to have preferences not only at the level of things in their surroundings but also at the level of perceptions that they have of the state of the environment, the ability of people to choose one or the other of beliefs and even manipulate this option by selecting the subjective criteria of information resources to provide the best possible support in order to argue that option, and the ability of people to choose those beliefs that persist over time (Akerloff, 2009, p. 167).

If we carefully study the behavior of agents as subjects of the cases presented above, we can realize that most of them are unaware of the risk embedded in the actions they were undertaking, or they considered that what they did was not risky. The presentation of certain experiments (Akerloff, 2009, pp. 168-174) shows that actors rather risky financial markets which were not considered. The economic policy decisions are very important in the crisis management, and some considerations must be taken into account when the decision is grounded. First, the manifestation of a crisis may catch economic policymakers unprepared, including on the awareness of a crisis situation. Second, it is possible that once the crisis is acknowledged, the decision-makers may not necessarily take decisions so as to maximize the likelihood of identifying an appropriate solution but to position them in a way that would allow their own beliefs' reasoning, which can place decision-makers farther away from the grounding of solutions to real problems.

Governmental decisions are translated into economic spaces through some normative decisions. But a lot of normative decisions adopted by the government had a different impact that the representatives of government really wanted (Caramidariu, 2012, p. 362), and the cause of this thing was the fact that a lot of these decisions were elaborated by some individuals that had a real target to protect their own beliefs about what have to be done.

Crisis can figure such a situation that can create the premises to abruptly infirmed some beliefs of representants of new libelalism (in an interesting way named „believers of laissez-faire” by Adam Kessler) by the manifestation processes in real economy and the reactive responses of these representants conduct to a higher distortion of a reality. And that mean that they are in a full cognitive disonance process.

## Conclusions

The appearance and manifestation of crisis generates a lot of consequences and the majority of these consequences are characterised by a lower or a higher level of dangerousness. In the same time, any crisis situation

generates the possibility to identify oportunities, „signs” that must convince us to change something in economic life.

The economic theories based on principles almost exclusive rationale cannot explain in a convincing way what is happened in real economy and sometimes cannot suggest any milestones that can contribute to the fulfill of a target that can identify the most adequate behavior of economic agents.

This crisis created stimulus for economists to reoriented their efforts in order to promote interdisciplinary research and to find incentives to use concepts and theories that are specific to another fields of social sciences.

The human behavior is not dominat by rationality (even if it is rational), but there are many situations that can generate the manifestation of animal spirits and sometime great economist can reffer at them in a plastic way (Alan Greenspan use the concept of *irrational exuberance* and Hyman Minsky the concept of *euphoric anticipations*) but these aspects must be taken in consideration in a most open manner to reality.

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