CORE
Metadata, citation and similar papers at core.ac.uk
Provided by Research Papers in Economics

ECONOMIC THEORY AND CURRENT GLOBAL FINANCIAL CRISIS

Prof. Jenica POPESCU, PhD
University of Craiova
Assoc. Prof. Dorina POANTA, PhD
Financial and Banking University, Bucharest

1. Introduction

Competition is, without doubt, the engine of economic progress. Pursuing their interest according to Adam Smith's vision is certainly the same process as the survival of the fittest according to Darwin's evolutionary theory. However, wherever there is life there is evolution, but the same can be said about economic progress. Economic development is an ephemeral state, limited to relatively short periods of history and geography. Laissez-faire philosophy of your competition may be invoked to explain progress when it happens, but can not explain the lack of progress when it fails to materialize.

Economists tend to regard today's economic boom as the normal condition, but in fact the last hundred years of human history have been quite exceptional when compared with the few hundred thousand years earlier economic stagnation. And even in these years of rapid development, progress was limited until recently, only for small portions of the globe.

The dominant "laissez-faire", the efficient market theory, can't explain the historical model of economic progress, and also can't explain the emergence of financial crisis, the behavior of investment markets, the need for central bank transactions or the presence of inflation. In short, our economic theories do not explain how our economies work. Scientific method requires, first, that theories are constructed to be consistent with the facts.

If our society will progress to an improved macroeconomic management system, prone to a small crisis, we must first understand how our financial system really works. This method requires that adoption of scientific theories; we must deform to fit the facts and not vice versa. Theories such as efficient market hypothesis, which fail to pass this crucial test, would be removed.

2. Viewpoints on central bank action

John Maynard Keynes set out to find a viable alternative to efficient market hypothesis; Hyman Minsky has led us further along the road. Minsky's theory about financial markets oscillated between expansion and contraction, explains the real financial market behavior. Until the best ideas will occur we should adopt financial instability hypothesis as a working hypothesis about how our financial system really works. Then we should use this as a starting point from which to take into account how best to reform our macroeconomic policies.

Once I accepted wisdom Minsky's financial instability hypothesis, it is only a small step towards understanding the credit cycle demand management. In turn, James Maxwell shows us how it is possible to over-govern balancing system resulting in the destructive activity.

For a system as inherently unstable as the financial markets, we

should not seek to achieve perfect stability. A strategy may have more support if it would involve allowing, and sometimes encouraging a larger short-term cycles using drop smaller, more frequent work to rid the system of excesses. Thus, it may be possible to avoid crises forced the kind where we are now. To achieve this policy it would require recognition of the importance of the volume of excessive credit growth and excessive decline in the volume of credit, and a review of our attitudes related to central bank policy and economic cycles. Normally we should not consider any economic contractions as failures of government policies, but to see them as normal part of the development of a healthy economy.

We should strive to achieve some of this improved stability by encouraging greater self-discipline in the financial market participants. It would be useful in a clear message that explains the over-basis limitations on certain macroeconomic variables and others value; meaning the monitoring of credit creation should increase, while the value analysis based on balance sheets and profit by credit training, including others, would be minimized. If the markets should be encouraged to believe that the central bank stops acting before an expansion of credit and to delay action to reverse the shrinkage, then markets can learn to manage their own affairs a little better. A certain creative ambiguity of central bank policy may also be useful; competition today between central banks for a more transparent as it can move in the wrong direction.

3. Debt drives to inflation

There is one fundamental difference between cyclical inflation, caused by waves of growth or contraction of credit in the private sector, and structural inflation caused by the monetization of the public sector.

Inflationary mechanism is simple enough. Private sector acting as follows: when expansion, Credit extends consensus laissez faire market efficient is invoked to allow expansion running extent possible, encouraging maximum accumulation debt to be realized; then once cycle credit glides inversely, there is a immediately call state aid - as usually favoring capitalism at expanding and socialism at contraction.

Support can come either by accepting the debt by state and then printing money to pay off debt or printing money to spend in other economic sectors. All these policies amount to the same payment process of debt capital through a review of the tax sparing (creditors) benefit too confident (the lender, borrowers). Alternatively, the same process can be, and often is, triggered without private sector interference: governments spend to the point where the central bank must agree to print banknotes. The whole process is described in an elegant way by Alan Greenspan himself:

Historically, companies seeking high levels of immediate gratification and also are willing to borrow on future income in order to achieve this have often suffered of inflation and stagnation. The economies such companies tend to have higher budget deficits, financed with money from currency issue.

It is therefore important to recognize that the threat to price stability comes from the accumulation of debts to the point where it becomes inevitable monetization. If debt capital is used with caution in order not to become monetization policies necessary inflation problem will disappear and long-term price stability will be achieved.

Many of the major economic troubles of our times are the fruits of risk, uncertainty and ignorance ... Yet the cure lies outside the operations of individuals, may be even worse in the interest of individuals to this disease. Cure for these things I think is in part deliberately sought control of currency and credit by a central institution...

For this reason, the central bank's primary focus should be to prevent the economy from excessive debt accumulation of capital can not be used. If it can do this, the central bank mandates long-term price stability and financial stability will become one.

Certainly this policy is much easier said than implemented.

4. Consumer price target removal

Taking consumer price inflation targeting by central banks leads to wrong policy moves. In the late 90's and early this decade, inflation in western economies has been weakened by cheap imports from emerging industrialized economies. This inflation spurred central banks to lower interest rates: affordable goods were found with more money available. Demand was stimulated by monetary policy when the supplies of cheap goods already stimulate demand. Now the situation is reversed, since the emerging economies have started to climb higher inflation in goods prices. How goods become more expensive, also makes it cost money loan.

A better policy would be to have higher interest rates while the advanced economies benefited from cheap imports, allowing them to have far lower rates of interest, since experiencing the effects of higher commodity prices.

Conflict between making the target of consumer price and credit management can be resolved by taking dispensaries targeted consumer price in full and include, alongside it, the price of investment. As previously stated, if excess credits are avoided and also monetization, inflation will take care of itself. In practical terms, this move would change the mandate of the central bank from making consumer price inflation target to making the investment price inflation target. In other words, the central bank would move the focus from management of property markets, who is naturally stable, to the inherently unstable goods markets.

For all practical purposes this policy is equivalent to require central banks to stimulate investment price bubbles are formed not once, but before capital and their associated debt becomes so large as to require monetization, that means, before the bubbles to reach a point where they explode to become a systemic risk to the economy. If the central bank can not detect the formation of a bubble as were those that led to the current global financial crisis, we must doubt his ability to detect any economic turbulence deserves policy.

Moreover, artificial credit expansion policy which the central banks allowed the last fifteen years could not end otherwise. Expansive cycle that ended in 2007 began to take shape when the U.S. economy emerged from its last recession in 2001 and the Federal Reserve resumed its vast artificial expansion of credit and investment that opened it in 1992. The credit boom has been accompanied by a parallel increase in voluntary household saving. For many years, the money supply of banknotes and deposits grew at an average rate of over 10% annually (which means that every seven years the total amount of money in circulation worldwide has doubled). Exchange environments that inflation arising from acute trust was placed on the market by the banking system as newly created loans offered at interest rates very low (and even negative in real terms). This state of fact has fueled a speculative boom resulted in a substantial increase in capital goods prices, the real estate and financial instruments that represent them and which are traded on exchanges, where indices rose sharply.

Interestingly, also the situation in the years before the Great Depression of 1929, the shock of monetary growth has not significantly affected consumer prices for goods and services (which are only about third of total assets). Last decade, also 1920's, witnessed a remarkable

increase in productivity due to the widespread introduction of new technologies and significant entrepreneurial innovations which, in the absence of influx of money and credit, would have led to sustained reduction unit price of consumer goods and services. In addition, full integration of Chinese and Indian economies in the globalized market further boosted the real productivity of consumer goods and services. The absence of an important "deflation" of consumer prices in such a period of tremendous growth in productivity, such as that of last year, provides the main proof that the monetary shock seriously disturbed the economic process.

Artificial credit expansion and inflation (trust) in exchange media isn't a rapid transition to stable and sustained economic development and it doesn't open a way to avoid sacrifice and discipline needed for high rates of voluntary savings. In fact, particularly in the United States, voluntary saving in recent years was not only no increase but reached negative rates sometimes. Indeed, the artificial expansion of credit and currency can not be more than a short term solution, in the best case. In fact, today there are no doubts about the quality, always recessive, of long-term effects of monetary shock: newly created loans (of money citizens have not first saved) immediately provide entrepreneurs purchasing a power that they use overly in ambitious investment projects (in recent years, particularly in construction and property improvements). In other words, entrepreneurs act as citizens has increased their saving, when things aren't so way. There is a widespread lack of coordination in the economic system: the financial boom has a detrimental effect on the real economy, and sooner or later reverses the process as an economic recession, which marks the beginning of a necessary and painfully readjustments. This realignment always requires retraining each real productive structure distorted by inflation. Specific events, that trigger the end of each phase of monetary euphoria and the beginning of the recession, are diverse and can differ from one cycle to another. In present circumstances, the most obvious triggers have been are rising price of raw materials, particularly oil, the subprime mortgage crisis in the United States and, ultimately,, the failure of major banks; when the market was clear that the value of their liabilities much exceeded the assets (mortgages offered).

In 2008, many stakeholders have called for higher reductions of rate and new doses of money to enable those who crave them to complete their investment projects without suffering losses. This bubble of oxygen would only postpone the complications, the cost to aggravate them after a while. The crisis occurred because the profits of enterprises related to capital goods (particularly in construction and real estate development) have disappeared due to errors caused by the credit business as cheap and commodity prices began to evolve less bad than the goods capital. At this point begins a painful and inevitable phase of readjustment, which, in addition to lower production and rising unemployment, we are witnessing harmful growth of consumer prices (stagflation).

5. Adoption of tax supervision

Currency emission impulse may come from the private or public sector waste. If the central bank will maintain the price stability and financial stability, by avoiding excessive debt, such loans should provide oversight of public and private. Constant temptation to manipulate monetary policy for political gain requires removal of the policy areas under the control of elected politicians. The same case could be made to fiscal policy, where the temptation for those in office to cut spending to achieve short term political advantage rather than long-

term economic progress is equally strong.

In an ideal world there would be strong controls to prevent expenditure on government budgets leading to budget deficits, except for emergency. These checks were issued by the central bank care financing budget deficit by issuing money, allowing it to focus only on the private sector. In practice, such rigid controls on government spending appear unattainable.

Central banks could probably provide an annual assessment of government fiscal position, and to seek, where necessary, government to should respond with a corrective action. Such a mechanism would be far from perfect, but at least it gives some influence over central bank policies that lead to destabilization of the monetary system. At the same time could also help to coordinate the implementation of fiscal stimulus and monetary policy, when used, and improve government discipline on expenditure.

6. Conclusions

A rigorous economic analysis and balanced interpretation of recent economic and financial events lead to the conclusion that central banks always fail to find the best solutions for each time money, they can not manage a permanent and perfect harmony, the most appropriate monetary policy. This means that the Federal Reserve and, to a lesser extent, the ECB and monetary responsibilities are neglected, and now they are in a difficult situation. Can they leave now to begin the process of recession and, with him, healthy, but painful, readjustment or they trying to escape, exponentially increasing the chances of more severe stagflation, in a not too distant future. Moreover, the resumption of a cheap credit policy at this stage can only hinder the necessary liquidation of unprofitable investments and conversion business. May even lead to the indefinite extension of the recession, as happened in recent years in Japan; although even they have been tested all possible assistance, the Japanese economy has ceased to respond to monetarist stimulus' rely on credit expansion or Keynesian methods. This is to be interpreted in the context of measures of monetary authorities (who have two conflicting responsibilities: to control inflation and to inject all the liquidity that is needed to avoid system collapse).

It was switched to direct injection of public money into banks and even to "guarantee" the total volume of deposits,, reducing interest rates to near 0% in the United States.

By comparison, the European Union economies are in a situation less sensitive (if you overlook the situation in Greece). Expansionist policy of the European Central Bank, although no error was preserved, was slightly less bad than the Federal Reserve. Moreover, the criteria for convergence of the time they required a significant recovery of the main European economies. Only countries at the periphery, like Ireland, Spain, Greece and Portugal, were flooded by a considerable expansion of credit since they started the convergence process.

In these circumstances, the best policy would be liberalizing the economy at all levels (with emphasis on labor market) to allow rapid reallocation of production factors (particularly labor) to profitable sectors. It is also essential to reduce public spending and taxes to increase income of economic agents, heavily indebted, who must return loans soon. Traders in general, and businesses, in particular, not only can improve their financial situation by reducing costs (particularly the wage) and credit return. To this end it is very important to have a very flexible labor market and a much more austere public sector. These factors are crucial to learn as soon as that is the true value of capital

goods and thus make up a healthy and sustained economic recovery.

Regarding Romania, according to Mr. Governor Mugur Isarescu, the massive capital inflows generates, in time, situations of recession. This view is substantiated by research carried out and generates the next question: Why no central bank could predict economic crisis? Moreover, after the crisis occurred, why analysts of NBR did nothing to prepare Romanian economy for recession? The simple answer is that virtually all over the world banking supervisory systems took a holiday. After the outbreak of the crisis, representatives of central banks have tried various explanations for the lack of vision in the short, medium and long time. All these explanations can be summarized by Mr. Greenspan's assertion that "the existence of a bubble can be recognized only when it broke.

Currently the main question related to the economic crisis has changed. It is now: when it will get over this negative phenomenon? If I noticed that the crisis was anticipated by massive capital inflows, then we can logically assume that this theory will apply in the second part, namely that they entered the crisis countries benefiting from massive capital inflows will go beyond the crisis harder than other countries. Even if the theory of practice may differ, however, this variant of a prolonged crisis should not be ignored in the calculation of NBR. If the Romanian authorities denied the crisis, in this moment we conclude that they deceive ourselves that we passed this.

Because reality is not correctly forecast, this will likely affect us in not too distant future. Lack of consistency of Romanian authorities, added to a lack of vision, are only likely to have continued throughout 2010 crisis. Romanian banking system, although it is much better organized than other industries, can’t be extracted from the Romanian economic context. If the Romanian economy will remain in crisis, also the banking system will suffer. Since the adoption of effective measures we can count on a new foundation and replacing painful for a healthy growth.

REFERENCES

Aftalion, F.	*To discipline central banks*, Ziarul Financiar, Bucureşti, 19.01.2010;
Chorafas, D. N.	*Financial Boom and Gloom: the Credit and Banking Crisis of 2007-2009 and Beyond,* Palgrave Macmillan, Basingstoke, 2009;
Cooper, G.	*The origin of Financial Crises: Central banks, credit bubbles and the efficient market fallacy,* Harriman House Ltd, Petersfield, 2008;
Cohan, W.	*The Last Tycoons,* Doubleday, New York, 2007;
Friedman, M..	*The Moral Consequences of Economic Growth,* Knopf, New York, 2005;
European Central Bank	*Monthly Bulletin*, February 2008;
Greenspan, A.	*The Age of Turbulence: Adventures in a New World,* The Penguin Press, New York, 2007;
Isărescu. M.	*Funding external imbalance and macroeconomic adjustments in the financial crisis. The Romanian Case,* Receiving as Romanian corresponding member of the Royal Academy of Doctors, Madrid, 2009
Merrill Lynch	*Investment Strategy*, March 2008
Moss, D.	*When All Else Fails: Government as the ultimate risk,* Harvard University Press, 2002
Soros, G.	*The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means,* PublicAffairs, 2008