ECONOMIC CRISIS, ITS PROSPECTS AND CHALLENGES

Magdalena RĂDULESCU

Abstract

Actual crisis which originated from USA quickly spread throughout the world economy. Although at the beginning it was labeled as exclusively financial one, after its second wave (in 2008) everything became much clear. Finally we all became aware of its overwhelming influence on both financial and real spheres of national economies as well as global economic system.

For the last two years, the world is facing a severe financial crisis and a dramatic economic slowdown. CEE emerging economies are also affected.

In the first part of the paper, are succinctly presented the main causes of the financial crisis over the world and in the second part are presented the contagion of emerging markets and the recent solutions and progress that has been made.

Key words: financial crisis, global imbalances, emerging economies, economic slowdown, economic theory.

JEL Classification: E58, E61, G01, G12, G21, O23.

1. Introduction

Like many times before, world economy happened to be somehow caught in a trap by events that represented first symptoms of global crisis. So, it took for a while that economists recognize crisis’ potential. According to recent reports [UNCTAD, 2008], world economy notes a fall in growth of output since second half of 2007. In 2007 that rate was 3.8%, last year it was 2.5%, and prognosis say that for this year (even for those who are optimistic) more than 1.6% can not be expected. Judging by measures for easing and overcoming of the crisis, it seems to have the following key characteristics: first, the crisis has spread throughout financial, as well as the real sector (slowing down of industrial production, export and GDP), so it is impossible to be overcome without state intervention; second, taking into consideration its actual and potential consequences, the crisis will demand deeper, fundamental, structural changes; third, according to the prognosis and expectations, it will be most troubling for those economies that experienced excessive indebtedness and constantly present budget deficit.

Current crisis is far from „ordinary” crisis of the first type; having in mind the warnings from economists that the modern capitalism (which is built on a foundation of stimulating private spending) has become structurally unstable [Stanford, 2008, 34], it

* Magdalena RĂDULESCU (magdalenaradulescu@yahoo.com), PhD, Associate Professor, University of Pitesti, Faculty of Economics.
seems that this kind of diagnostics implicate that we are dealing with a structural crisis. Will it grow to systemic one, depends strictly on inner options the system has at the disposal “for restructuring itself to restore profitability and growth” [D’Arcy, 2008, 23].

In response to current financial crisis, developed countries started to apply bundle of measures focused on securing the liquidity. Besides, programmes supporting banks as well as other financial institutions have instantly been initiated. These are extremely complicated measures, and every country is free to choose the combination of measures appropriate for conditions it is facing with. Even though they can postpone or prevent the collapse of financial system, those measures give a small hope for achieving long-term, real recovery.

Given that this crisis has shown the limits of existing regulatory and supervision frameworks on national and world level, new rules and institutions (which would be directed to reducing of the systemic risk) are also necessary. This means that, apart from measures meant for resolving insolvency problems of financial institutions, some additional, reform steps should be undertaken. In that sense, one of the most important tasks is re-regulation of financial markets [Stiglitz, 2009, 5-8] which at least partially will contribute to general economic stability. However, it will not be enough if fiscal part “of the story” is further neglected. Besides, nobody for sure can predict what consequences may produce this “concentration of financial capital via completing the integration of commercial and investment banking” [Panitch and Gindin, 2008, 47-49].

2. Implications on economic theory

Every crisis encroaches on relations and structure of current order. The word crisis is implying that the breaking point (possibly a turning point or a major change) is about to appear in the development of certain event. In medicine a crisis is “questioning” the capability of organism to return to the state of normal functioning (with appropriate therapy). Metaphorically speaking, this can be applied to the example of any economy: above all, economic crisis is about good diagnostics of the problem, as well as testing of potential of one economy to “heal” itself, and challenging the experts in that area.

In the context of actual economic crisis the thesis that it simultaneously represents the signal for existence of crisis in economic theory and/or economic science in general has been revitalized. That is why the question of responsibility of economic science for that crisis is also more often mentioned. In that sense different interpretations of responsibility can be distinguished.

Economic history has registered existence of economic crisis a long time ago, although they started to repeat periodically (on somehow recognizable way) during liberal capitalism (since then they have been known as crisis of hyper production). With the exception of Great Depression (dated from 1929 to 1933), the first half of the last century was characterized by “distorted” rhythm of crisis. That led to belief that capitalistic system, thanks to Keynes’ measures of economic policy, finally got rid of any crisis (since that crisis suffered ultimate defeat). At the time Keynes was declared as the „saviour of capitalism”, and the economic science was proud of achieved consensus (personified in the sentence “we are all Keynesians”).

1 They warn that such solution for “bridging” the insolvencies of investment bankers is quite the opposite to the solution offered during the crisis of 1930’s.
In 1973 the energetic crisis, caused by "oil shock" was actually the first meaningful economic crisis after the Second World War. Since then, the Keynesian theory loses its impact, and its position was taken over by monetarist (neo-liberal) conception [Heilbroner and Milberg, 1997, 56]. Great opponents of state intervention (like Friedman) suggest measures of deregulation and re-privatization in the function of revitalizing economies. And actually, the mentioned measures have been successful in solving the stagflation as the most troubling problem of that time. However, exactly due to deregulation, it has been generated financial crisis in USA (in the middle of 2007), which then spread throughout the world.

Innovativeness of neo-liberalism has culminated in creating so-called “shadow banking system” [Gupta, 2008, 37]. Since it has contained a lot of non-transparent, complicated instruments, involving different processes or aspects, it was difficult to be understood, let alone to be dealt with. That’s why it evaded existing regulations with ease. On top of everything, the Federal Reserve did not make any constructive effort to prevent worsening of the situation. Therefore, by not interrupting illegal chain of activities, it was actually acting as an accomplice to the biggest financial crime in new history.

Officially, every country has taken drastic economic measures designed to lift the economy out of recession. As it was expected, they began on side of monetary policy – by pumping cash into the banking sector [Stanford, 2008, 34]. This was quite the opposite from Keynes’ ideas. What did they need? Speaking about the above-mentioned, re-regulation could be helpful – to prevent another similar crisis and to create safe and sound financial system. It would probably (and just temporary) slow down creation of financial “novelties”, which are supposed to be “must have” in global race; from the other side, it would at least postpone if not prevent the next crisis.

Judging by Keynes’ opinion – a fiscal policy could be more appropriate, but not any kind of such a policy. Proposed solutions directed to stimulate new cycle of investments via cutting of taxes were almost useless – most of them went to savings. Great economists of our time completely agree that global crisis demands global solutions – like coordinated fiscal policy; at the same time, they are skeptical about “feasibility” of such a policy since change of the course from neo-liberalism to Keynesian-ism may not be revolutionary – i.e. those better prepared will not miss the opportunity to “use” the moment of crisis for their own purposes, which can be even more profitable for them than under market fundamentalism [Stiglitz, 2008, 68; Krugman, 2009, 21].

From the point of view of economic science, moment for questioning the dominant neoclassic paradigm has come. Besides, actual crisis will probably reaffirm some of the unfairly repressed ideas. Therefore, in the conditions of exponentiation of economic regulations and managing which relies on changing rules of the “game”, we can expect comeback of Keynesian ideas as well as opening of additional “room” for conception of institutionalisms.

What is the key word and common denominator of most of the explanations concerning the crisis? The right answer is: greed. That is why we would like to emphasize that the main point does not refer to complete discredit of well known philosophy that markets are

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2 Precisely, treating financial institutions as the means to an end, and not the end itself, he had not believed in efficiency of such type of measures during heavy crisis.

3 However, it should not be reduced only to modestly strengthen regulations insisting exclusively on transparency without significant, substantial changes which can prevent any future crisis.

4 Exactly the same happened in the USA and Great Britain when such an idea occurred to neo-liberals.

5 For more details about unchangeable and exclusive nature of this paradigm see: Hodgson, 2000.
self-correcting [Krugman, 2009, 15; Stiglitz, 2008, 17]. “Pure” market economy (in Adam Smith’s sense of the word) takes into account ethical considerations and is more inclined to right regulation than to deregulation. And what we nowadays practice is its distorted version, an “anarchic economy” [Lampe, 2008, 54]. In other words, a bundle of contradictions that arose and flourished within that system are more responsible for crisis than neo-liberal ideology itself [Panitch and Gindin, 2008, 12-16].

In confrontation of different theoretical concepts, the best prospects for victory has the one that succeeds to incorporate in its theoretical model the parameters that describe the real economic system (in other words, the one that has the best “communication” with the economic reality).

Why is it, in spite of the fact that the crisis are immanent in every economy, so hard for economic science to predict and eliminate them? Economic dynamic are consisted of two types of changes: a) cyclic (repeatable) and b) evolutionary ones (not repeatable). If the crisis can be characterized only by the cyclic kind of changes, it would be realistic to expect that economic science has learned something from previous experiences, so it can cope with them successfully. Far bigger “bite” is represented by evolutionary changes that make it impossible for economies to go back to the same position in which they were in the time of the previous cycle.

Unfortunately, paradigms and economic theories that successfully prove their superiority, express the tendency towards conservation (i.e. they became somehow robust). On the other hand, real economic life is constantly changing, which broaden the gap between rigid theory and real economic system. Also, since the rules of the game are not questioned, they are not in accordance with economic practice.

In that way we can spot and follow the cycle of paradigm and/or theories shifting. Two biggest economic crises that have shaken the world during the last century were characterized by the following features: from all of the given answers to the challenge of those crises, accepted was the one that represented the best possible solution for that given situation.

Of course, as the time passed by, the “right answer” looses its pragmatism. That is why previously perspective theoretical concept is no longer capable to communicate with newly created changes in real economic system; this is an intro to new crisis.

3. The crisis in Eastern Europe

One by one, the European banks become victims of the shock on the mortgage loan market in the United States of America and a new crash of the American real estate market may worsen the losses of the European financial institutions.

Until recently, the Central and Eastern European emergent economies seemed to be exempted from the major shocks triggered by the global crisis of the credit market. And this

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6 Panitch and Gindin distinguished neo-liberalism as “ideology” (meant to divorce market and state) from neo-liberalism as “materially-driven form of social rule”. Role of ideological component is now undermined; however, as a social rule calling for more regulation, it can be more dangerous.

7 According to the principle of paedomorphosis (which has been known in biology), «evolution may, as it were, retrace its steps, to make a new start from an earlier point» [Hodgson, 2001, p. 345]. This principle can be applicable to different «evolutions», even in economic science.

8 Keeping in mind all of the complexity, dynamic and stochastic nature of economic system it is obvious that market “game” can not count on stable and long term rules.
happened based on the opinion of many analysts according to which the countries in the above-mentioned region held a series of advantages against the current turbulences.

Despite a significant decline of the consumers’ expenses and a rhythm decrease of the economic growth in countries such as the Czech Republic, Poland, Slovakia and Estonia, the economists asserted for a long time that the situation was not due to the financial crisis that had already experienced a rapid development in the Western area of the continent.

One of the main reasons for which the Eastern European economies displayed an increased strength against the crisis lied with, according to the arguments brought forward by the analysts, the existence of powerful regulations of the financial system.

Although they allowed the massive penetration of foreign banks on the local markets, mainly due to the pressure exerted by the European authorities, the countries of the former communist space found a relatively simple solution in order to counterattack the possible risks, by toughening the regulations in the bank sector.

The advantage of a better regulated market than the ones in the Western area unfortunately quickly faded away on account of fundamental mistakes perpetrated by the political authorities in the region, such as the development of high budget and current account deficit. At the same time, the consumers in the region were extremely exposed to the currency credit market, where the interests increased by 50% during the last year.

The growth rhythm of the bank segment in the Central and Eastern Europe will slow down as a result of the indirect effects of the sub-prime crisis. The majority of the Central and Eastern European (CEE) countries have experienced previously a period of growth that exceeded the potential. First of all, the growth must slow down because the rhythm of the last years is not durable and would lead on a medium-term basis to an overheating of the economies.

The second factor lies with the fact the important export markets (especially the European Union) will also slow down their growth rhythm, because the financial crisis and the slowdown of the economic growth of the United States of America will make their effects felt.

The crisis in Eastern Europe may be caused not only by financial contagion of the globalized markets, but also because almost all Eastern European countries have been recording large current account deficits. In some countries there are deficits that are no longer sustainable because they are even double digit percentages. During the last decade, large amounts of capital flew into the emerging financial markets (Eastern Europe in particularly). The exchange rates tended to appreciate, asset prices and commodities bubbled and the wages rose rapidly. All the capital flows improved national fiscal indicators and encouraged intern credit expansion. Because the emerging economies could not be entirely structured, the weaknesses and the deficits exacerbated. Because of the great profit potential in these markets, the European banks overbought local banks and provided great liquidity. On the other hand, when the optimistic investors’ sentiment got worse, the flows reversed or even suddenly stopped, and the asset prices gave back their gains, forcing hard landing adjustments on the economy and on local financial markets.

The exposure of the western European banking sector to Eastern Europe seems to be a serious concern. European Banks could refuse to roll over credit lines that come due or to extend further credit to their subsidiaries, but this would only increase their own losses, because of the hard landing adjustment in Eastern European economies.

The main risks for banks could be:

- Risk of default rates – will bring credit higher costs for the banks with refinancing
• Risk of exchange rates – a large amount of credits has been paid in foreign currency (EUR, USD and CHF). Because of the eastern countries deficits and macroeconomic imbalances, the volatility of exchange rates could make paying the debts more difficult.

• More than half of the banking system in Eastern Europe is owned by West European banks and they have already their own problems and commitment at the moment.

Taking in consideration the vulnerabilities to the current financial crisis, eastern countries where financial institutions and non-financial companies borrowed a lot offshore short and invested long, will be under pressure to refinance. This could affect dramatically the domestic growth and the account deficits may be getting bigger and bigger. A possible solution could be the government funding injections through complex fiscal stimulus programs, stimulating constructions and investments in infrastructure, in order to boost internal absorption of funds in the region.

There has been made progress regarding rescues plans for the emerging European economies. In this global crisis, is essential to support each other with all the possible measures that they have. A recent agreement (gentleman agreement) has been signed between Romania and the main nine European banks that have important claims on Romanian banking system (Wien, March 2009).

According to the Bank for International Settlements, the claims for BIS Reporting Banks on Central, Eastern and South-Eastern Europe – as % of GDP of the recipient country – september 2007.

Table 1: Claims for BIS Reporting Banks on Central, Eastern and South-Eastern Europe

<table>
<thead>
<tr>
<th></th>
<th>AT</th>
<th>DE</th>
<th>IT</th>
<th>FR</th>
<th>NL</th>
<th>SE</th>
<th>BE</th>
<th>UK</th>
<th>EU</th>
<th>US</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEE</td>
<td>8.8</td>
<td>6.8</td>
<td>6.5</td>
<td>4.6</td>
<td>2.6</td>
<td>2.9</td>
<td>3.7</td>
<td>1.7</td>
<td>44.5</td>
<td>2.2</td>
<td>0.7</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>12.3</td>
<td>4.0</td>
<td>17.6</td>
<td>5.2</td>
<td>1.4</td>
<td>0.0</td>
<td>0.5</td>
<td>0.3</td>
<td>70.6</td>
<td>1.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>28.7</td>
<td>5.3</td>
<td>9.6</td>
<td>17.5</td>
<td>3.4</td>
<td>0.0</td>
<td>24.6</td>
<td>..</td>
<td>93.7</td>
<td>3.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>24.3</td>
<td>23.1</td>
<td>18.4</td>
<td>4.9</td>
<td>3.6</td>
<td>0.2</td>
<td>11.8</td>
<td>..</td>
<td>93.7</td>
<td>2.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Poland</td>
<td>3.5</td>
<td>9.8</td>
<td>12.5</td>
<td>3.3</td>
<td>5.7</td>
<td>1.2</td>
<td>4.5</td>
<td>0.4</td>
<td>51.3</td>
<td>2.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Romania</td>
<td>27.6</td>
<td>14.1</td>
<td>6.8</td>
<td>11.6</td>
<td>4.7</td>
<td>0.1</td>
<td>0.6</td>
<td>0.1</td>
<td>80.1</td>
<td>1.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>40.8</td>
<td>5.4</td>
<td>26.9</td>
<td>2.2</td>
<td>6.1</td>
<td>0.1</td>
<td>9.9</td>
<td>..</td>
<td>93.7</td>
<td>2.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Slovenia</td>
<td>28.0</td>
<td>14.2</td>
<td>13.8</td>
<td>5.7</td>
<td>1.6</td>
<td>0.0</td>
<td>6.2</td>
<td>0.5</td>
<td>73.7</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Ukraine</td>
<td>8.2</td>
<td>2.9</td>
<td>1.5</td>
<td>6.4</td>
<td>2.1</td>
<td>1.2</td>
<td>0.4</td>
<td>0.5</td>
<td>28.7</td>
<td>0.9</td>
<td>0.6</td>
</tr>
<tr>
<td>Russia</td>
<td>1.6</td>
<td>4.0</td>
<td>1.6</td>
<td>2.4</td>
<td>1.6</td>
<td>0.4</td>
<td>0.5</td>
<td>..</td>
<td>15.1</td>
<td>1.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Turkey</td>
<td>0.4</td>
<td>3.0</td>
<td>..</td>
<td>2.4</td>
<td>1.3</td>
<td>0.1</td>
<td>2.3</td>
<td>..</td>
<td>18.8</td>
<td>2.9</td>
<td>0.5</td>
</tr>
</tbody>
</table>


The regional exposure on the residential mortgage markets can be seen below:

Table 2: Overview of EU residential mortgage markets

<table>
<thead>
<tr>
<th></th>
<th>Value of Mortgage Debt, million</th>
<th>Growth in Mortgage Debt</th>
<th>Residential Debt to GDP Ratio</th>
<th>Per Capita Mortgage Debt, thousand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>2,868</td>
<td>64.4%</td>
<td>9.9%</td>
<td>0.37</td>
</tr>
</tbody>
</table>
4. Conclusions

Concerning short-term policy responses, it seems that economists almost exhausted ideas they have at the disposal. Also, they explained and described in details rise, developing and culmination of the crisis. Yes, they noticed one by one almost every symptom which emerged in the meantime. They realized that we have many sick “persons” (number of which has been increasing), suffering from common as well as diverse “pains” at the same time. Surely, they were aware of the possibility that “illness” was becoming epidemic by nature and huge by its dimension.

What they did not do? They certainly cured the above-mentioned symptoms in the order of appearance, being no capable either to determine what really was wrong or how to make right diagnosis and prescribe the remedy. Although pointing at many imperfections of capitalist system in general, their critiques were not that constructive. Precisely, they offered *neither vision of alternative system nor strategy* how that more egalitarian (yet imaginary) system can be established.

References


