**NEW ECONOMY** Section

# COMMON MISTAKES IN COMBATING THE ECONOMIC AND FINANCIAL CRISIS

Cătălin-Emilian HUIDUMAC-PETRESCU[*],
Alexandru Cătălin POPA[**]

***Abstract.*** *It's been more than five years after the beginning of the global financial crisis and its negative effects can still be felt in the present. Almost all countries in the world have been affected by this crisis to some extent. Authorities' responses depended not only on the specific conditions of their economies, but also by the different political and economic vision of the decision makers. This paper proposes a brief analysis of the effectiveness of different types of anti-crisis measures, focusing on common mistakes made by authorities around the world.*

***Keywords:*** *financial crisis, monetary policies, fiscal policies, anti-crisis strategies.*

**JEL codes:** E44, Q54, E43.

## 1. Introduction

Any government is to some extent responsible for the wellbeing of its citizens and must have a proper answer to their economic problems. The crisis first appeared in the US and originated in the subprime loans granted by their commercial banks to households and secured by mortgages. Although in the beginning the government response to the financial crisis seemed a little reluctant, today we can see that it was a far more promptly than the European one. At least on paper, the US seems to have overcome the financial crisis, having more than four years in a row of solid economic growth.

The economic crisis in Europe has one part of its roots in the financial sector and another part in the fiscal policies adopted by many of the Member States prior to 2008. The European Union is basically an economic union of 28 states between which there are significant differences in key areas that relates with the crisis development. Nevertheless some of the

[*] The Bucharest University of Economic Studies, catalinhuidumac@yahoo.com
[**] The Bucharest University of Economic Studies, alexandrup86@gmail.com

Member States that were most affected by the economic crisis turned their hopes to the European institutions. The problem was that those institutions were not prepared to help and were very reluctant to do so. The truth is that this is the biggest crisis that the European Union had to face since its formal creation in 1993 by the Treaty of Maastricht. This can be an explanation for the fact that EU seems to have almost completely failed in anticipating the crisis and didn't do a very good work regarding its management.

This article is structured in five parts. After a brief introduction, chapter 1 is dedicated to a general view of how this financial and economic crisis emerged and developed in both continents, with emphasis on things that seem to have gone wrong in the results of authority's responses to the issues. The third part of the paper treats two of the European countries most affected by the financial crisis, namely Greece and Cyprus. Greece is the best example of everything that went wrong with the anti-crisis strategies. Cyprus is another EU and Euro Area country that was very affected by the financial crisis, but different from Greece in key areas that prove to count very much in the outcomes of the crisis development here. A closer look to these two countries reveals all the major things that work or didn't work in the case of Europe. Conclusions are presented in the fourth part of the paper.

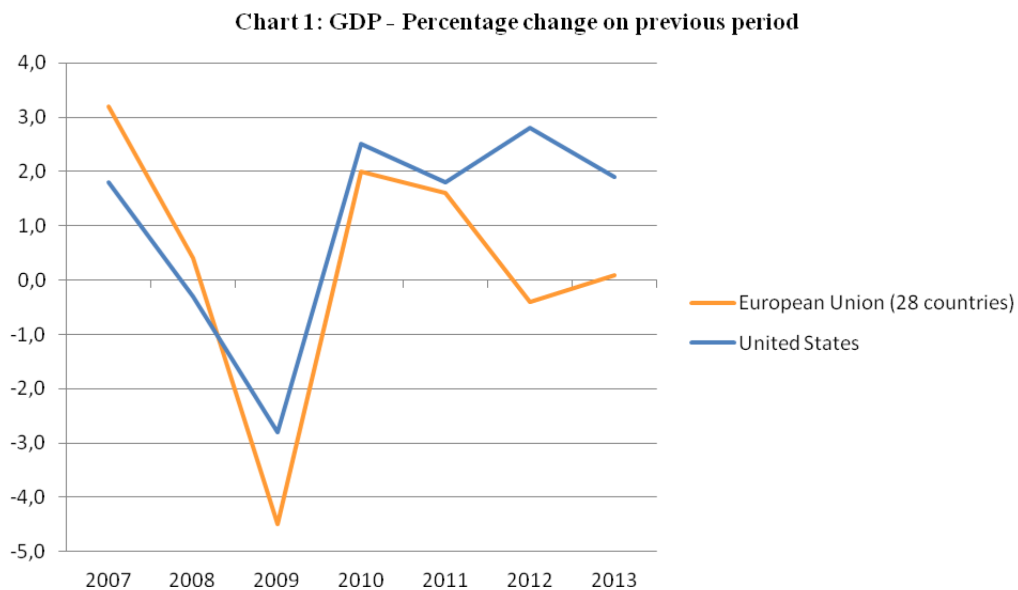
## 2. Handling the crisis: US vs. Europe

The subprime lending is considered by many to be the main culprit for the financial crisis. Prior to the year 2008 this happened all over the world, but especially in the United States. In simple terms, the American financial system seems to have been unable to filter the good lending clients that would pay their debts on time from the undesirable ones. The reasons for this are plenty and they relate to regulation, corporate governance and the way all the parts of the financial system are connected.

Although it the crisis begun in 2007 in the US, the bankruptcy of Lehman Brothers in the fall of 2008 is a major turning point in the development of the economies world over. The US administration at that time responded quickly and expectedly by ensuring additional financial resources in the market in a heroic attempt to compensate for the mistrust

of many in the US financial system and in the economic future of all. The efforts were not light, and the politicians had many problems convincing the taxpayers that some financial entities are simply “too big to fail”. However, now, at almost six years since after the Lehman Brothers bankruptcy, one can easily assert that the US overcome the crisis, having a steady economic growth rate of about 2.5% per year in the last four years and with a government public debt that finally seems to have stabilized at 100% GDP. The costs for this adjustment, however, were pretty high many people have lost their houses, their jobs and their trust in a better future.

In the case of European Union, things developed quite different, as EU still continues to struggle to have economic growth. The graph bellow illustrates this fact.




**Source:** Eurostat.

The interesting thing is that the recipe for addressing the short time problems was basically the same in the two continents. Also, it’s rather hard to say that the European problems were bigger than the US ones. It’s true that in the European Union the crisis overlapped with some serious internal problems related with fiscal policies in some states, but we must not forget that subprime lending was mostly done in the US and the European banks imported the crisis by buying toxic assets only to some

extent. In these authors opinion, the crisis development was worse in Europe than in US due to the fact that the response wasn't firm enough, especially in the beginning. It was pretty hard for the US politicians to convince their voters to spend billions of US dollars from their taxes in order to help some major banks and insurance companies, but it was even harder in the European Union to convince for example the German people to help the Greeks overcome their problems.

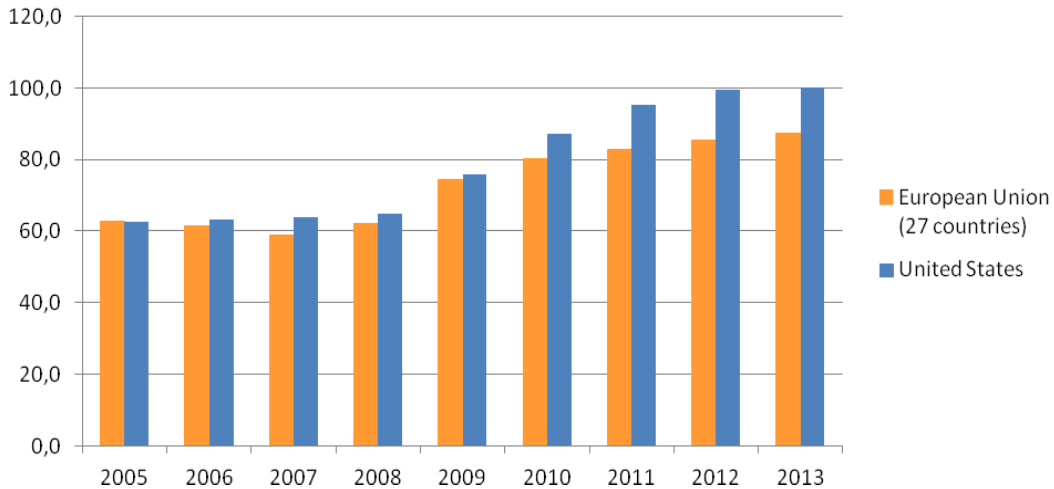
From this point of view, the European model failed not only to prevent the crisis, but also to address its effects and put things back on track. This can be explained by considering the fact that the European Union in its present form of administration (since Maastricht – 1993) has never seen a crisis of such a great magnitude. Things happened slowly not only because the Europeans were not united, but also due to the fact that EU simply didn't had the institutions and mechanisms to quickly intervene. In the absence of those mechanisms, the 27 leaders had to meet and reach to a consensus.

Also, the European Union is an economic union not too much homogeneous. With Croatia joining EU in 2013, there are now 28 Member States. Many are old members and some are new, some countries are a lot more developed than others, some EU members have a common monetary policy and others have their own policy and the list can continue. Any response to an economic crisis must take into account the particularities of the economy in which they are adopted. Even the countries that were in the most need of help were too be reluctant to accept the international aid, feeling they are punished unfairly by having to take some drastic measures to limit their own reckless public spending.

Eventually the European Union agrees to help the countries (especially the Euro Area ones) in need of urgent financing, together and in close cooperation with the International Monetary Fund and the World Bank. This was a good idea considering the fact that EU simply didn't have experts prepared to assess the macroeconomic prospects of countries, lay down concrete solutions and follow their implementation closely. IMF was more experienced in this area.

Solutions were found more or less easy but the biggest common mistake in Europe, as in the US, was the glaring underestimate of the magnitude of the crisis.

**Chart 2: Government consolidated gross debt %GDP**




**Sources:** Eurostat, U.S. Bureau of Public Debt.

Chart 2 above illustrates an additional problems that, mainly for the US. If at the crisis debut, in 2008, the public debt was just little over 60% of GDP in both continents, at the present the same indicator is about 87% in EU and 100% in the United States. This is making the economies to be more vulnerable the next similar event. From this perspective the Europe seems to have spent less money to help its countries financial systems and this can be considered an achievement.

In the following chapter we propose an in depth analysis of two European economies that were mostly affected by the financial crisis: Greece and Cyprus.

## 3. The Greek and Cyprus crisis developments

Greece had lots of economic problems prior to the financial crisis debuted in 2008. This was a fairly small country that joined the Euro Area, in 2002, very soon after its creation. It supposed to be one of the 12 states that founded the EA, but due to some economic issues the accession of Greece in EA postponed a few years. Soon after joining the Euro Area the Greek government started to borrow more and more money, especially form foreign markets, benefitting from their current status of member in the Eurozone. This translated in the fact that when the crisis came, Greece

already had a problem with the government debt and a highly fragile budgetary system.

Greece asked everybody for help and initially the problem was considered an internal issue of the Euro Area. In 2009 the country recognized the unsustainability of its budgetary system, both on the collection part and the spending part, and agree to a plan for correcting this in the near future. In order to do so, they even asked for IMF technical support and expertise. However, on the background of the crisis, things didn't improve too much in this area and Greece keep borrow money at interests higher and higher. Finally, all parts involved decided in the spring of 2010 for a formal rescue of Greece. The total financing amounted to 110 billion Euros, of which the Fund committed 30 billion Euros, the rest of the money coming from ECB and the European Commission. This help was exceptionally for many reasons: it was the largest aid program ever funded by the IMF and it was the first aid program supported by the IMF to a country from Euro Area. It's worth mentioning that a political decision was generally adopted in the EU that Greece shouldn't exit the Euro Area. This program had 3 pillars[1]:

- The first pillar of the program was to drastically shrink the fiscal deficit;
- The second pillar of the program consisted of structural reforms;
- The third pillar of the program was to preserve financial stability.

In a public report published by the IMF in June 2013, the Fund admits that mistakes were made in the case of Greece by underestimating the magnitude of the problems.[2] The outcome of the program was not what the Fund expected. The only thing that was managed by this program was to lower the budgetary deficits of Greece, effectively stopping the reckless spending. Also it can be argued that this program helped to limit the spillovers brought by the Greece financial system. The public debt remained an issue and other macroeconomic indicators didn't improve too much.

The public debt had to be restructured, and after a program of about 200 billion Euros (about 50% debt relief) in the spring of 2012, the Greece public debt finally became more manageable. The cost of this action for Greece and for the entire Euro Zone is that future creditors will be very reluctant to borrow the players involved.

Another European country that was highly affected by the financial crisis was Cyprus. Cyprus is a very different country form Greece in the

[1] IMF Country Report No. 13/156, Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement, June, 2013, p. 11

[2] *Idem*

sense that it's a lot smaller and didn't hat so many problems in the fiscal and budgetary area. However, the Cyprus problems came from their financial system that was several times bigger that their own GDP. Cyprus is considered an offshore center and, prior to the crisis, their commercial banks had lost of liabilities with foreigners in the form of attracted deposits or current accounts. Confronted with this situation, it was virtually impossible for Cypriots banks to place their liquidities in the national economy. Therefore it was only logical to look for external opportunities of investments, including investments in securities in the form of debt obligations issued by other and larger Euro Area countries (considered some of the safest prior to the crisis). One country from the Euro Area that was issuing lots of this type of securities was Greece. Debt restructuring of Greece hit Cyprus pretty hard. This, together with the general feeling of mistrust of foreign investors in the Cypriot banking system (translated in an important withdrawals of liquidities), was what seriously crippled the Cyprus financial system and lead to the closings of important banks. ECB and other European institutions and countries were lot more reluctant to help Cyprus than Greece, probably due to the fact that the spillovers on their banking systems were estimated to be a lot less painful.

There are two things that can emerge from the facts presented above. First, it's clear that a double standard applied. EU and the Euro Zone didn't act as a united fort against the crisis. Secondly, this will affect the future credibility of all the Euro Area together both in government bonds and in banking systems.

## 4. Conclusions

It's clear for everybody that the financial crisis originated in the US but, today, at about 6 years from its debut we can affirm that overall the United States handled the crisis better than the Europeans. Although the US public debt is slightly bigger that the EU 27 (about 100% GDP vs. 87% GDP), no one can deny the steady pace of economic growth. The US public debt has not been restructured and any a few banks which were more specialized in risky investments than in classical financial intermediation failed. If things continue on this path, the US can gradually even lower its public debt. Trust in the US dollar remains to be high in financial and commercial markets.

By contrast, although smaller, the 87% GDP public debt of the European Union countries might be an even bigger problem for the EU simply due to the fact that in the Maastricht Treaty, the level considered to

be optimal and ideally followed by everyone is only 60%. This added to the other issues related with the general public and the investors mistrust in the European model provides an explanation for the fact that EU is still struggling to have sustainable growth.

In EU, apart from the obvious underestimation of the magnitude of the crisis, another striking mistake was the inability to provide a common and united response to the crisis. The newly created European institutions (especially European Stability Mechanism) and the changeover in the area of regulation are meant to address exactly this issue. Only a future similar crisis can show us if these institution will do their job. Of course, we all hope this will not happen again.

## REFERENCES


[1] A. Greenspan, *Turmoil Era. Adventures in a New World*, Public Publishing, Bucharest; 2008.

[2] A. Popa, *The Need of a New Economic Model*, Theoretical and Applied Economics, vol. **XVIII** (2012), Issue **2**(567), pp. 97-106, 2012.

[3] A. Theophanous, *The way out the Cyprus economic crisis*, Notre Europe – Jacques Delors Institute, policy paper 96, 2013.

[4] C. Huidumac and A. Popa, *The European crisis and its consequences*, Proceedings of the International Management Conference, **6,** Issue **1**, pp. 145-153, 2012.

[5] IMF Country Report No. **13**/156, *Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement*; 2013.

[6] J. Stiglitz, *Freefall*, Public Publishing, Bucharest, 2010.

[7] J. Zettelmeyer, C. Trebesch and G. Gulati, *The Greek Debt Restructuring: An Autopsy*, Peterson Institute for International Economics Working Paper No. 2013-13-8;

[8] http://epp.eurostat.ec.europa.eu, 2013.

[9] U. S. Bureau of Public Debt. on GDP (Chart 2).