ECONOMIC CRISIS – LESSONS ABOUT THE PRESENT

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Abstract. *This article aims to analyze the resemblances and the differences between the crisis that took place between the years 1929-1933 and the crisis that started in 2008. Although both crises started off from a different series of events, the result was the same: The worldwide economic activity downturned dramatically. In the working paper, the events that led to the two economic crises will be analyzed, starting from the speculative bubbles that were created and the severe interventionism of the states in order to prevent the asset prices from falling. Also, the article aims to analyze the different variables that led to a solution to end the crisis, and also the lessons that both the states, and the private companies should learn in order to prevent such situations in the future.*

Keywords: *economic crisis, financial analysis, interventionism of the state.*

The 20th century was one of the most difficult moments of the human society, being torn apart by two world wars that caused unimaginable human and material casualties. The year 1929, seemed to be a year in which things were coming back on the normal track, at least until the moment that panic intervened on the financial markets. This situation forced people to sell their financial assets, without success due to a much higher supply, thing that caused a massive price downfall. The black Tuesday, as it was called by economists, is an event which everybody has at least heard about, but what are the actual circumstances that led to it?

There is a large number of opinions referring to what caused the crisis, but to truly narrow it down to a clear set of factors is troublesome. Historians, politicians and economists have expressed different opinions regarding this subject, but nobody could really offer a series of clear arguments. One thing tough is certain, the above-mentioned crisis was caused by a mix of political, historical, social and economic events. From a historical point of view, the First World War was clearly a major factor. After years of misfortune, people started believing again, and belief is a dangerous tool, especially if it gets out of control. Nobody expected the

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war to last for 4 years, 4 years in which the industries suffered massive modifications, productivity rates suffered as well. In order to finance the war, a large number of countries spent their gold reserves, borrowed money, and when they saw that it is not enough, they ended up going for the last resort method and the most costly of them all, printing currency, thus creating huge inflation rates.

At the time, money was pegged to gold, so while the gold reserves kept going lower and lower, and the amount of currency got bigger and bigger, the inflation never saw a halt in its increase. After the war, the countries found themselves obliged to induce deflation, by contracting their money supply. Also, the geopolitical argument must be taken into consideration, through dissolution of some empires, and thus by creating smaller states, it created instability. A good example of this is the Versailles treaty, through which Germany and her allies were obliged to pay some debts that were practically unpayable if you take into account the difficulties at that time.

As Europe was being torn apart by war and, as Keynes quotes "The consequences of peace", in the USA things were going completely different, USA being the real winner from this war. The US economy was experiencing a boom, due to the fact that Europe was importing more and more goods from there, as mentioned above, European industries suffered greatly, so they were obliged to import. The US gold reserves went up, and at that time, the US was the world`s largest creditor. Thanks to the money granted by the US, Europe started to get back on track, and the trust in the economy was reestablished.

The US became a financial pillar that the entire world needed, and at that moment more and more American citizens wanted to take part at that…but how could this be done easily? Well, the answer was straight forward, stock markets. American citizens had the opportunity to (exaggeration) buy with just 10c, stocks that were worth 1 USD. As the prices went up, everybody was winning, at least until the bubble that was created became very clear. Investors got in the position that they were no longer investing in private companies, and their merits, but would rather keep betting on the continuous rise in market prices. In an attempt to temper this bubble, the FED was created, which started to raise the interest rates higher and higher. On the October 24th 1929, the Dow Jones industrial index was revealing a 20% decrease, larger that the market has ever seen before. This caused panic, and the prices were automatically pushed down. As the capital was absorbed back from Europe, in order to cover the US financial problems, things got from bad to worse, generating a series of banking bankruptcies, both in the US and in Europe. The only countries that weren`t affected by this were the ones in the Soviet Union, that declared an autarchic regime, sustained only by their own resources. The solution to these problems was Keynes, and his well-known interventionism. As the crisis started to take roots, consumer spending and investment dropped, and of course, the industry had to suffer. The British economist, John Maynard Keynes supported the idea in which the markets, left free, cannot come to equilibrium by themselves, automatically providing full employment. The assertion on which Keynes operated, is that of the aggregated demand measured as the sum of spending by businesses, households, and the government, the aggregated demand being the main driving force of the economy. Economists with a Keynesian thinking, justify government intervention through public policies that encourage price stability and full employment, or at least as close to full employment as possible. Keynes tried, and succeed to push the idea that changes in aggregate demand can create gaps between the potential and the actual output gap, and stressed on the fat that monetary and especially fiscal policies could be used to reduce such gaps.

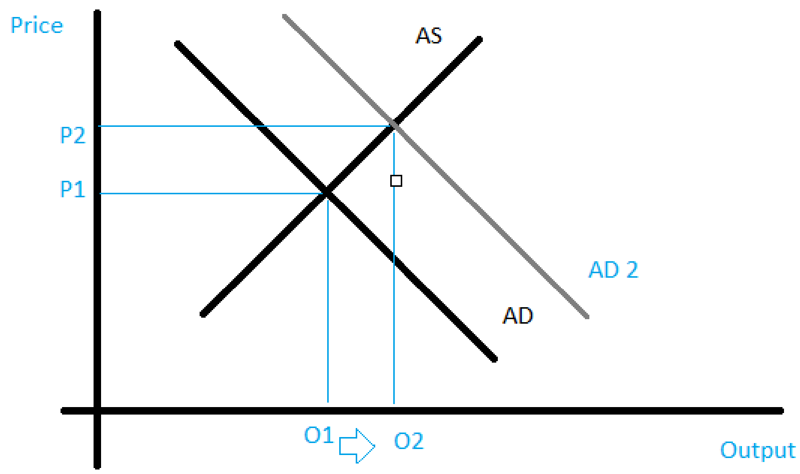

Figure 1. Keynes model.

In Fig. 1 we can observe the way that the boost in aggregated demand works. The government has the ability to practice different policies that could increase the aggregated demand, such as lowering taxes, reducing interest rate etc. Through these policies that would encourage a shift in aggregated demand, the economy would start to produce more. At the same time, an increase in prices is being noticed. Keynes argued that the governments are forced to face a trade-off between inflation and employment. If you want the economy to have a better employment rate, than a higher inflation needs to be tolerated. Also, for the first time, Keynes argued that the inflation expectations were actually very important. By expecting and encouraging expectations of high inflation, the inflation actually ends up being higher than normal. For example companies deal negotiations that actually take into account the inflation rates. If companies actually expect high inflation rates, the prices set between the two companies will be higher, thus pulling the inflation upwards. This is how Keynes underlines future inflation rates may be impacted.

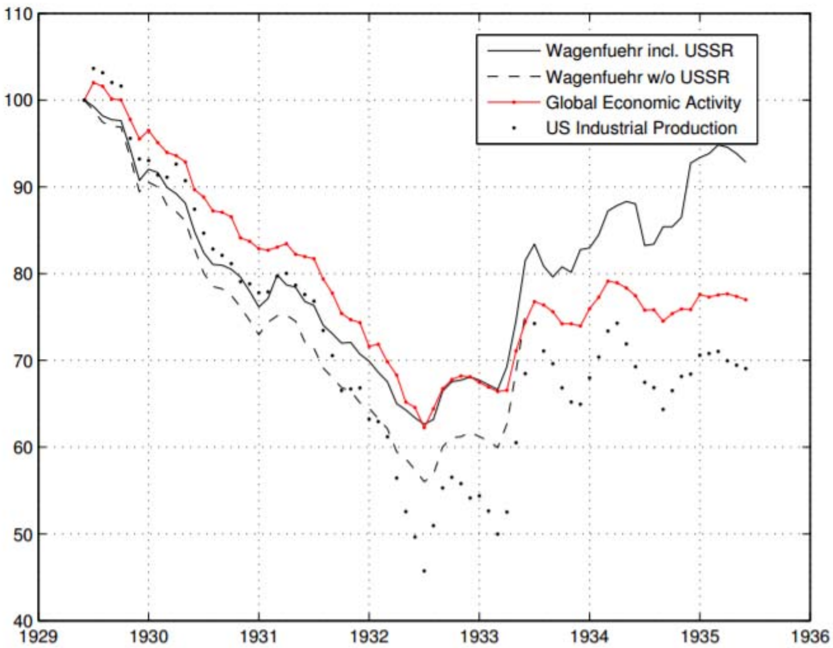

Figure 2. World Index of Economic Activity vs.
World Industrial Production by Wagenführ (June 1929 = 100).

As Fig. 2 shows, the world index of Economic activity had its peak of decrease in middle 1932. By then, nearly 13 million American citizens were unemployed due to the collapse of the industry, and half of the banks went bankrupt. Also, a point needs to be made that the number of unemployed people in each year, only presents the people that were working with a labor book, if we take into account the workers that were working by the day, the numbers go up much higher.

Year	Population	Labor Force	Unemployed	Percentage of Labor Force
1929	88,010,000	49,440,000	1,550,000	3.14
1930	89,550,000	50,080,000	4,340,000	8.67
1931	90,710,000	50,680,000	8,020,000	15.82
1932	91,810,000	51,250,000	12,060,000	23.53
1933	92,950,000	51,840,000	12,830,000	24.75
1934	94,190,000	52,490,000	11,340,000	21.60
1935	95,460,000	53,140,000	10,610,000	19.97
1936	96,700,000	53,740,000	9,030,000	16.81
1937	97,870,000	54,320,000	7,700,000	14.18
1938	99,120,000	54,950,000	10,390,000	18.91
1939	100,360,000	55,600,000	9,480,000	17.05
1940	101,560,000	56,180,000	8,120,000	14.45
1941	102,700,000	57,530,000	5,560,000	9.66

US Unemployment rate during the great depression

As we can observe on the table above, the unemployment rate actually started to look better with the need of mass production brought by the Second World War.

USA NATIONAL UNEMPLOYMENT RATES | 2008-2016

Year	Average Unemployment Rate
2016	4.87
2015	5.28
2014	6.18
2013	7.35
2012	8.08
2011	8.95
2010	9.64
2009	9.26
2008	5.81

Looking at times closer to our existence, we can observe, that the unemployment rate did not drop nearly as much as it did during the great depression, yet these rates still posed major threats to the US economy. Moving our focus to the crisis that we all experienced, we notice the fact that although the events that took place back then, look nothing alike the ones in the present, society`s behavior was pretty much the same. Of course, no war took place for quite a few years; basically people were offered the chance to win a lot of money, or to achieve dreams that were otherwise untouchable for some. Take for example the housing policy that was practiced, in the US it became easier and easier to buy a house, which is not a bad thing, but the way that they were able to do this is a completely different story. The money and the dreams that were described above came from lack of consistent regulations, technology evolution and of course, a much richer access to information. Of course, technology`s evolution together with access to information, looking at them abstractly are positive things, but in the situation that the capital is left almost entirely free, the danger gets bigger.

Looking at the circumstances that caused the crisis, we see that the times have changed, but one thing remained the same: People. People have the same dreams, and still have the same expectation to "win fast, and win big".

They were not only given the opportunity to do certain things, but have actually been encouraged to have a behavior that does not take into account risks. The problems were many, starting from a bad remuneration system to the audit company's corruption. The executive`s remuneration system was one based on the immediate result. In other words, the more profit you were realizing until a certain time, eg: the closing of the financial year 2xxx, the more the bonuses became more substantial. This provided an incentive for managers to exert higher pressure on people in order to obtain bigger profits, and also to take advantage of different gaps in accounting standards, just like the early recognition of revenue. More so, the bonuses were calculated as a percentage of different financial indicators, so the managers did not have any limits towards the amount they could receive after the year end. Also, some executives were paid directly through shares, so it was in their best interest to bring the share prices high and again, to report higher revenues. Also, the incentive for the audit firms need to be analyzed and by doing so we observe a vicious circle that at the time, was visible when things were too late. If we take a look at the famous case, Enron, an audit company was hired by the CEO to realize audit and consultancy services. It was in their best interest to please the CEO, in order to obtain further revenues from consultancy services. In other words, the audit company closed its eyes on certain things, and in short time, disaster happened. In order to correct behavior like the one presented above, through the Serban Oxley Act, measures have been taken in order to limit the possibility of audit firms to also perform consultancy services and audit, for the same client. Even so, the CEO still maintains a high level of control over the committees, so some sort of danger still exists.

If we are looking at the crisis at an aggregated level, it is pretty easy to observe that the overall effects on the economy were the same. During the crises, the economies have experienced lower production, higher unemployment rates and the freezing of the loan grants. A difference would be the fact that the financial system wasn`t as developed during the great depression, the economy had once again come to a stop. People started losing money, losing dreams, losing houses and so on. Shortly banks and creditors were in the situation that they had to take back the houses offered through mortgage loans, but no longer had the possibility to resell them, due to the lack of liquidity that the economic system was experiencing.

The solution back in the interwar period was Keynes. But how did the world solve the economic problems during the 2009 crisis? Keynes did his job, once more. The effort to end the crisis was centered on a series of fiscal policies that would encourage the spending. For the US, the fiscal and monetary policies decision makers tried to save the auto and housing industries, as they were the main reasons for which the crisis started in the first time. Also, it`s worth mentioning the grants made by the IMF to various countries which were in need. They`re deficits went up, but with the money received, the countries governments were able to increase government spending and also to relax fiscal policies in order to give a fresh start to the consumer spending and the economy. With an increase in the consumption rate, the industry started to produce yet again. The real question behind this crisis is did it actually end? Judging by the fact that the FED resorted to the quantitative easing measure, it is worth raising the question whether the financial crisis ended, or was merely hidden behind artificial money. Quantitative easing relates to the massive expansion of the open market operations of a central bank, thus making it easier for businesses and households to borrow money. But as we all know, printing money has it`s downsides; Inflation and currency rate depreciation, the later having actually helped the economy as it is a positive thing having a depreciated currency, being able to export more.

As I was mentioning earlier, from one crisis to another, many things have changed looking at the economic variables. The financial system got a lot more developed, the services sector has seen a large increase, technology and information access have evolved but one thing remained the same, people.

By offering the chance of winning big and in short periods of time, a behavior that encourages risk taking is a natural follow up. This is what both the public and private sector need to understand. Having large inflows of money for short and medium periods of time, followed by a massive outflow on the long term, actually causes more harm than good. Since then, things have changed for the better. Companies started to listen more and more to their risk departments and are actually more and more interest in the "cost of winning". As long as the public and the private sectors are cautious with regards to risk taking, the chances of another crisis should be diminished. The only question is: For how long will the cautious behavior last? It is the human nature to want more, so the long term solution, would be regulations harsh enough to stop companies from excessive risk taking, but soft enough to allow them to do business as they should.

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