# ECONOMICS OF CRISIS VERSUS CRISIS OF ECONOMICS

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**Abstract**

*My paper aims in bringing on the table the concept of economic irrationality together with the lack of regulation and a pressure groups scenario, all of the three being the perfect recipe for a crisis, as the most recent has just demonstrated. I am trying, on one hand, to bring arguments with regards to the necessity of a complete reinterpretation of Economics and on the other hand, to put a special emphasis on our memory and of the recent history as able to give us the right perspective on how not to act if a crisis and of what to expect if doing so. We have examples in the past, we only need to open our eyes and not think we can reinvent cold water.*

**Key words: crisis, irrationality, financial system, substandard securitization**

**JEL classification: G01 – Financial crises**

## Does The Economic Theory Passes By A Conceptual Crisis?

For each one of us, learning Economics starts from some basic notions and concepts which include, among others, paradigms, specific ways of thinking, approaches set on one direction or another, but also a whole list of alternative theories to the initial ones as some of them proved unjust along the time and suffer changes which afterwards become the new norm, only for these ones themselves to end up in new evaluations. Two theories like these are the rational expectations theory and economic utility theory. What does each of them state?

## Rational Expectations Theory

**Rational expectations theory** claims that economic agents have the capacity to foresee the future to such extent that they can avoid any dissatisfactions in every action they will make. In other words, this theory sees the citizens as very lucid visionaries and as perfect connoisseurs of the consequences of their own actions.

I would give a counter-example to this theory: obesity and food surplus ending up in the garbage can. From this perspective I can state, with a very mild push towards exaggeration, that the native instinct (present in animals) proves to be much more rational than the free will characterizing human kind. A conscienceless animal will never eat more than what his body asks, that is the need, and will ever hunt more animals than his interest would require (survival).

At least for the perspective of this example – to which there can be added tens of years of waste and lack of efficiency proven in loans conditioned by having an identity card or in

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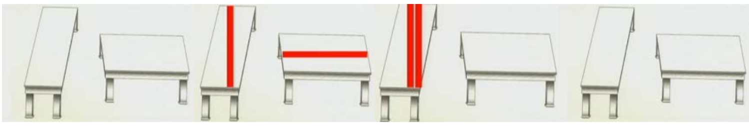
the inner selves conflict of interests and in the self delusion that we make good choices based on personal incentives which deform our perception on reality – I can easily strengthen the claims of economists who say that people not only do not learn from historical mistakes and they act as if they lack memory when it comes to consequences of their past actions but they also suffer from a pathological myopia when it comes to the future.

I would like to take two examples able to explain why do we have, so often, the illusion of a conscious choice.



We have here four images that were shown to a public together with the question: which table is longer? Everybody's tendency was (fig.1) was to say that the left table is longer, proving later on, due to measurements (fig. 2 and fig. 3) that they were wrong and that the tables are identical in length. The slides slipped again to the first image (fig. 4) which made the public suddenly doubt the obvious truth prior proved and to decide again, as if no memory was involved there, that the left table was longer. Why did this happen? Because they fully based on intuition, a feature which very many times cancel our sense of rationality and of correctness.

In my second example a commercial for a magazine subscription is given in three possible choices: 59 dollars/ online magazine, 125 dollars / printed magazine and again 125 dollars for both. Obviously the public chose to buy the third subscription as it appeared to be far more profitable that the other ones. Very few of people chose the first subscription.


The experiment continued with pulling out from the survey the subscription with zero buyers and asking again the public to choose.  The result was an inversed hierarchy compared to the first one, which meand only one thing: the assumingly useless subscription was useless only in the first survey and had the role to draw people's attention to its better alternative. Which it successfully did. But taking into consideration the second survey with only two options, it suddenly becomes important because it helped people finding out what they were really looking for: the online subscription.


The most difficult thing is to recognize that sometimes we too are blinded by our own incentives. Because we don't see how our conflicts of interest work on us.

The illusion of a decision is everywhere but we must keep in mind that "when it comes to the mental world, when we design things like health care and retirement and stock markets, we somehow forget the idea that we are limited. I think that if we understood our cognitive limitations in the same way that we understand our physical limitations … we could design a better world." (Dan Ariely).

**Marginal Utility Theory**

The second theory prior mentioned has a starting point in defining utility as being the satisfaction anticipated by a consumer to be felt due to the consumption of a portion of a good and is in direct relation with the marginal utility, that is the "extent" to which this consumption is justified. The fact that the marginal utility is considered to be a decreasing function is being connected with the fact that the total utility of a good's consumption has a maximal point. Continuing the study of this theory we find out that every consumer, whenever making a rational choice, has to compare the marginal utility with the marginal cost incurred by consumption of a certain good.

A counter-example can be travelling abroad. Although it is not the core activity for mostly anybody and there are obvious budgetary constraints, there is a massive number of people who do not find a maximal level in doing this activity for the rest of their lives, so they do not see a threshold beyond which they will unlike travelling and more than that, to experience negative utilities and therefore, costs.

By correlation with the behavioral economics, maximizing utility can very well describe the way people make choices in an unconsciously manner, an approach which almost eliminates the breaches between economic analysis and the social sciences. It is being claimed that individual actions are in direct relation and even directed rather by socializing than by a conscious, rational resort. Most of the times people act a certain way due to their habits, out of routine and in a way they seized to question anymore, being a result of the society they belong to and not being aware that they could have behave differently under other circumstances. It is an anthropological-social-economical chapter which addresses issues of tastes, norms, ideals, social categories, in short identity as a fundamental motivation for people all over the globe for being who they are, an identity which, very important, has an utility (when in Rome do as the Romans *and you'll be happier*) and an elasticity (because the way people behave depends on the way they define themselves and on the way the society define them).

Moreover, the theory addresses behavioral features such as shame, discrimination, inferiority complex or guilt which the classical economic theory doesn't take into consideration but which influence people's choices and their utilities sometimes more than even their own native needs.

It hasn't yet been decided whether the social norm is internalized by citizens or imposed, even by force, by the exterior, but it remains a certain fact that people's need to respect this norm is included in the utility function because a significant number of clues suggests that the ones who respect it are doing it, in spite of some certain societal constraints, because they believe in it. This fact excludes externalities which appear for instance when a person cheats and makes cheating become contagious ending in an epidemy which in the end makes the whole system collapse and the inherent losses suffered by the citizens counterbalance the initial benefit of the cheating.

Obviously, not the free-riders are the ones that make a society prosper although economic theory claims that each individual is being motivated in his action by his inner and deep selfishness. The thesis that economy can be "immoral" serves only to those who claim not to understand that human society has a strong social side and that the moral values can not be subtracted from the relationships between individuals and economic organizations. (D.Daianu).

What remains important from the behavioral economics is that identities and norms result from social interactions and power-related mechanisms, the latter being able from the oldest time to the farthest future to determine the way things will happen in the world.

**Heterodox Macro Economy**

A new theory that drew my attention and which is worth mentioning here is the one that claims a revitalization of the classical, orthodox theory, incapable of foreseeing the actual economic crisis because it has been thought to have started from the wrong premises (like the general equilibrium). It is the heterodox macro economy, resumed in the below graph.

| Neoclassical Economy | Heterodox Economy |
|---|---|
| The normal state of the economy and of the markets is the equilibrium. | The normal state of the economy and of the markets is the imbalance. |
| The system is perfect, economic crises are determined by external factors | Economic crisis are inherent depending on the nature of the economical system |
| Economic agents are rational and the results of their actions are predictable. | Economic agents are irrational and our future is being subject to a profound unpredictability |
| Money are neutral | Money are not neutral |
| Inflation represents an excess of monetary mass | Inflation is influences by the profit rate, by distribution of income, by public investment. |

The starting point of the heterodox theory is that any economical equilibrium is transitory and it leads to an inevitable imbalance because the expansion leads to an economic boom which determines inflation and, therefore, financial fragility.

I have mentioned only three approaches by which it can be easily observed that economic theories can be considered to be at a conceptual loss, in a redefining context and in the need of a serious analysis. In an era when performance failures prove the necessity for an economic reform, any changing program which wants to be successful has to be well anchored in a sustainable and profound knowledge of the way economic processes work in the existing institutions. Such a knowledge is presumed to be given by the economic theory. Just like institutions and customs don't arise out of nothing, the economic theory is not a natural gift either, but it is the result of imagination, of concepts and thinking directions existing at some point. And ideas have consequences. I believe that the beginning and the ending of any economic demonstration should address undisputed realities for any given era: on one hand that the individuals are dominated by needs, wishes and interests which determine their choices, so as by selfishness which adds irrationality in these choices, and on the other hand that the correct answer to the question "what should be done?" starts and ends with "it depends". Apart from this, a lot of economic theories are set as guidelines of certain analysis but they only have a temporarily and historical-contextual validity and determination.

**2. The Economic Crisis**

Economic crisis are often seen as components of everyday life and as a distinct and necessary part of the business cycles. No matter the approach of the business cycles context, they are there:

Crisis
Depression
Economic boom

Contraction
Expansion (Samuelson)
Peak

Crisis
Depression as a turning point of incomplete recovery (Larousse)
Expansion

Ascending phase
Maximal phase (Francesco Forte)
Descreasing phase
Minimal point

Expansion
Superior inflexion point (crisis) (Franco Poma)
Depression
Inferior inflexion point (anticipating expansion)

No matter the initiator of the theory and regardless of the different names used for every part of the economic cycle, the crisis, as a turning point, is one way or another taken into consideration in each of the upper approaches. In other words, the fact that an economy can sooner or later enter a critical moment is not something new nonetheless a shock. With reference to the USA crisis J. Stiglitz said that “the only surprise that the 2008 crisis brought was that there were so many people surprised”. Economical cycles (with all their phases including the crisis) which marked the last couple of hundreds of years ago are not only the witness for his belief but also what “creatively destroyed” their previous state of fact:

| Year | The field of structural development |
|---|---|
| 1789 | Revolution in the textile/ metallurgical industries |
| 1848-1850 | Inventions in railways/ siderurgy |
| 1890 | Discoveries in automobile’s industry, in electricity and in the chemical industry |
| 1970 | Inventions in electronics, robotics, telematics and biotechnology |

Each historical phase was characterized by a sum of specificity, knowledge, information, power and political thinking which ended up going in the same direction: the ascending phase ment a very important wave of investments, a massive production and a rising level in the national income and in economic efficiency followed by a necessary descending slope when exhaustion effect of recent discoveries start to show and when, from a need of compensation new investments in researched occur (it has been proven, statistically, that the peaks of scientific discoveries are made in the descending phases of long cycles). It’s very important not to enter a cyclical crisis – the new investment profit rate is lower that the anticipated marginal profit rate and the production capacities are unsolvable – but that is a se parate topic. What remains important is that when all signs indicate that an imminent crisis is about to show up it is not appropriate to take in a hurry pro cyclical (which only accentuate it) measures and more than that, measures that will only become contagious for the whole world. Theoretically. In practice, rules are made every day.

**The Financial Crisis From 2008 To 2012**

The financial crisis of the last couple of years started also from an invention, this time a financial one and which lead to a conceptual semantic dissolution of the most important democratic and capitalist principles: private property, free will, free market, competition, decision transparency and it imposed a pattern of corruption, crisis and absurdity of the highest level and this way “knocking-down the fight over these values bigger than any totalitarian regime would ever do” (J.Stiglitz). The paradox which always occur in times of crossroad is the one that sets aside on one hand, the obsession for change, the fact that we all consider that change is an everyday constant and that “being perfect means changing frequently (W.Churchill), that change is not only necessary in life as it is life itself (A.Toffler) and on the other hand, our thinking dominated by the status-quo and by the assumption that what is valid now will last forever.

For a few observers the most recent crisis has been a classical by the book case, not only predictable but also predicted. A deregulated market full of liquidity and low interest rates, a speculative bubble in the real estate market and an exponential rhythm of loaning in substandard conditions – here is a toxic combination. If we also add the commercial and fiscal deficits of the US and the corresponding accumulation of dollar-reserves in China – therefore a strongly global imbalanced environment – it was more than clear that things got out of control. In the attempt of a morphological analysis of the guilt of the ones that took part in this world crisis it is obvious that we should start from the bottom, that is the initiators of real estate loans. Credit companies convinced millions of people to buy real estate exotic titles, a lot of them not knowing what they were getting themselves into. But these companies would have never accomplished their actions unless the help and complicity of the banks and rating agencies. The banks bought the mortgages and reorganized them for reselling them to some naïve investors. US banks and financial institutions have presented their innovative and ingenious investment instruments as a great asset. They have managed to create some instruments that, although shown to the public as able to better manager risks, were so dangerous that they threatened the whole American financial system. Rating agencies, which should have checked these instruments' sharply rise, hurried to give them a vote of confidence, a gesture which encouraged the others – including pension funds in the search of a safe place to out the money they raised from the populations' economies – from the US and abroad to buy them.

To sum it up, American financial markets have failed in accomplishing their essential functions of managing risks, of allocating capital and of encouraging economies and maintaining low transactional costs. Instead of doing all these things they created and multiplied risk, they wrongly allocated the capital and stimulated excessive debt imposing very high transactional costs. In their peak in 2007 it is said that the American financial markets absorbed 41% of the corporative sector's profits (J.Stiglitz). In some cases the apparent lack of skill in correctly appreciating the price and the risk have at starting point a winning bet: they knew that in case any problems should occur, the Federal Reserve and Treasury will caution them – and they were not wrong (take for instance the almost 200 million dollars cautioned for AIG due to derivative instruments (credit default swaps) – some very risky and gambling bets closed with other banks).

Although the financial sector carries the biggest blame of all, the regulators are not very far from this neither as they didn't do their job as they should have – that of insuring that banks will not overreact as they often do. Some institutions from the least regulated part of the financial system (like coverage funds) used this occasion to say that the problems occurred were only due to existing regulations which should be fast eliminated. It's just that this conclusion is just in the vicinity of the real reason why these regulations exist: a collapse in the banking sector could end up in damages to the entire American financial system. It is worth mentioning a reason in the failure of regulations from the last quarter of the century and which has a direct influence with the political special interests, especially of those in the financial sector who ended up with huge profits due to non-regulations (a lot of their economic investments were non-profitable but they were more oriented in their political choices) and with the ideologies – stating that regulation is not at all necessary.

The new world financial architecture has a lot of fundamental weaknesses based on neoliberal politics of liberalization, deregulation and faith in the natural adjustment of the markets, all of which leading to the crisis we all witnessed recently.

The general causes for the recent financial crisis have their starting point in a few pillars.

A. **Insufficient** or even absent **regulation** of commercial banks, of investment funds and of the whole shadow financial system

Regulation agencies were the last defense line against the excessively risky and unscrupulous behavior of banks, but, after years and years of strong lobby and economic pressure, the government not only that drastically cut through the current legislation but also did they forget to adopt new ones, adapted to the latest occurred changes in the financial area. People who didn't understand why regulations were necessary – and who, therefore, considered it as useless – have become regulators. The abrogation of the Glass-Steagall Law in 1999 which separated the commercial banks from the investment ones lead to larger and larger banking sectors– and in the end too big to be left drowning. The exact conscience of the fact that they were too big to be left collapsing was a bigger stimulus for taking even more excessive risks up to the point when the American state ended up having an unprecedented role for an economy – by becoming the owner of the biggest automobile industry in the world, of the biggest insurance company and (should they have received in exchange what they have given the banks) of several of the biggest banks worldwide. A country where socialism is often seen as an anathema nothing less than socialized risk and intervened on the market in a way not ever seen before.

Many of the officials responsible with taking crucial decisions with regards to regulations had already had a clear position on the matter and also known for some time. There is a phenomena in psychology called "commitment augmentation". From the moment when you take a certain position you feel obliged to defend it. Economic science has an opposite perspective: what has been done has been done. Man should always look forward, constantly evaluating if a former position has brought him the desired results and if not, to take it to the next level. Not at all surprising, psychologists are right and economists are wrong on this subject. The champions of deregulation had a personal interest in insuring that their ideas will be the wining ones – even in the face of obvious contrary evidences.

As it is easy to understand, banks are not the biggest fans of transparence. A totally transparent market would be highly competitive and in the case of intense competition commissions and profits would lower significantly. Financial markets have deliberately created complex products in order to reduce their effective transparency without breaking the explicit rules. This complexity allowed banks to impose higher commissions, in this way being able to make a prosperous but unsustainable living out of high transactional costs.

B. **The allowance of the establishment of off-balance sheet entities** for the initializing commercial and investment banks which paid them substantial commissions; these entities were opaque to the common deponent but permitted reports of huge profits without registering in the accounting balance sheets also the corresponding costs and without provisioning for risks the investments made through these financial vehicles.

C. **The shadow banking system** which include hedge (investment) funds, structured investment vehicles, non-banking dealers of real estate loans and all the financial instruments derived and associated to these ones, led by secured mortgage loans and collateralized debt obligations.

The crisis started from substandard credit securitization, but its contagion area was much more bigger as an entire empire of sand was given birth based on these derived instruments. Securitization implied slicing, chopping, packing and re-packing of these real estate loans and forwarding them to others, it actually implied forming a tank of financial actives, especially for those which do not have a secondary liquid market, like mortgages, transferring of these structures actives to a specialized investment vehicle and using them as collateral when issuing new financial actives by the same investment vehicle. All this system could only work as long as the value of actives continued to rise due to the increase in real estate prices. When the speculative bubble broke, all this cards' castle collapsed. It was an ingenious financial scheme very similar, in the end, with a Ponzi scheme. Roubini (2008) explained: "The majority of the members of the shadow banking system borrow on short term, have a higher debt than the banks and also lend to others and invest in illiquid long term instruments. Just like banks, they have to face the credit swap but, unlike them, they are not protected by this risk. The panic started only after the breaking of the speculative real estate bubble and when uncertainty started to link to the once solvable financial institutions. The first step was the collapse of structured investment vehicles, when investors found out about the toxicity of the these investments and were not able to obtain short term financing. The next step meant spreading the panic over the credit dealers".

An empirically unsupported story was the one trying to prove the reduction and the segmentation of the risk through the complex derivative instruments. Each investor could invest in instruments from a certain segment of the risk, in this way the risk splitting globally instead of concentrating. The reality, though, proved that the risk didn't split but it multiplied, and that the securitization and the globally market financing contributed to its contagion and its spreading all over the US up to the level of a global systemic crisis. The crisis very fast became global due to the fact that almost a quarter of the real estate titles issued in the US had already traveled in very distant places abroad from Norway to Bahrain and China. Unintentionally, this fact sort of helped America: should the foreign institutions didn't buy so many of its toxic instruments and of its debts, situation could have been much worse. But the USA first of all exported their deregulation theory and in the end, their recession. This was, of course, only one of the channels through which the American crisis became a global one: the US economy continued to be one of the biggest in the world and its substantial decline couldn't have not influenced the rest of the world. Moreover, global financial markets have become very close interrelated – as a proof of that being that two of the first three beneficiary of saving AIG by the American government were foreign banks.

A. Just like in a Ponzi scheme, **overleverage** played a major role in this crisis. Capital inflows for covering debts became bigger and bigger making the ratio actives/ debt to deteriorate. As investment banks are concerned it is estimated that half of their very big earnings from the lasy four years before the crisis came from overleverage, while as commercial banks were doing well and were satisfactorily capitalized only on the surface because they were hiding outside the balance sheets the financial vehicles which toxically invested with the loaned money.

B. **Financial management people incentives** to take on excessive risks as a perverse effect of awarding financial performance. Such an asymmetrical awarding system (which included huge commissions for securitizing and distribution of derivative packages, success bonuses for bankers whenever taking massive risks ended in a short term substantial profit – for instance in 2006 an executive of Goldman Sachs earned a bonus of fifty million dollars –, no penalties of any kind for when losses appeared, bribing of rating agencies by the investment banks which' derivative products had to be evaluated) made the financial top managers to take (in the name of the companies they represented) huge risks even when they anticipated that a collapse in the market appears as imminent in the near future.

The unprecedented development of credit default swaps made the banks vulnerable just when they thought they were being protected by this instrument. By the middle of the year 2008 only the losses caused by it at the international level amounted five trillion dollars and lead to the spectacular collapse of giants like AIG, Bear Stearns and Lehman Brothers.

Extravagant instruments were meant to extract as much money as possible from the loaners. Securitization implied unlimited commissions, unlimited commissions implied unprecedented profits, and unprecedented profits generated unseen bonuses, all of which consisting in the ultimate illusion for bankers worldwide.

There is one thing important to be mentioned here: the securitization premise was diversification, but a diversification without an uncorrelated system of loans representing the title is not functional (and so there won't be any "failed" evaluations of the rating agencies' models which used to claim that never will a decrease in real estate price will occur, not to mention a simultaneous decline of these prices in different regions of the country.

Derivative financial instruments such as mortgage-backed securities or credit default swaps ended up being very opaque. They were not market traded but, mostly, over the counter in direct negotiations between an investment bank and one or more buyers. In the case of these derivative instruments not even the standard theory stating that the correct price is the one set on the market applies anymore. Their price was established by the seller (the investment bank) and the rating agency based in some abstract and somewhat inoperative mathematical models (because the financial innovations didn't have a history based on which projections could have been made). And the bigger the insurance societies and funds, the bigger the incentive to "innovate" under the umbrella of the certainty that these companied were too big the be let fall.

## Solutions And Conclusions

In economical science you have to run fast in order not to shake, therefore a recovery program well organized has to respect a few basic steps: to be fast, to be efficient, to address issues on a long term basis, to focus on investment, to be equitable, to address short term issues occurred with the crisis, to stimulate the areas where layoffs occurred; among the most efficient stimuli – because they allow money entrance on the market whenever and wherever needed – are the automatic stabilizers, which are expenses automatically rising when the economy contracts.

The latest crisis demonstrated that market failures (moral hazard, the information asymmetry, externalities, adverse selection) can be complex and not very easy to be corrected, whereas the application of mechanical measures can only make things worse. Efficient markets can produce socially unaccepted results. Some people can have an income so low as to be enough only for survival. Moreover, markets themselves do not have any humane component, in every sense of the word. The market players might just as well take advantage of any advantages they might have or of any weaknesses their opponents might show at some point. Whenever possible, private companies may try to restrain competition and also to exploit to the maximum extent the irrational behavior of the consumer and his weaknesses. Cigarette producers, for instance, sold their products about which they already knew were addictive and might have cause grave diseases – although they always denied the existence of any scientific proof of such kind. They knew that smokers will be receptive at their message saying that there is a scientific doubt with regards to diseases provoked by smoking.

Mortgage loans initiators and credit cards companies exploited the fact that a lot of people should be late with their payments at least once. They were attracted in  the system with initial small interest rates and if later on the interest would rise very much due to a delay in payment, it was considered as a compensation for the very small initial rates. Banks encouraged their clients to contract and facilitate overdraft with some substantial commissions, knowing that they won't check whether they used their balance or not.

Whenever markets fail, the state will come and repair things, and knowing that, the government should take all the necessary steps in order to avoid calamities. Any game has its rules and arbitrators and the economic game falls in the same category. One of the crucial role of the state is that it has to write the rules and to bring the arbitrators. The rules are the laws which govern the market economy.

J.M.Keynes said that "in an unstable economy, speculation dominates the economic action"; using the same logic Human P. Minsky states that there is an inherent and a fundamental instability in an economy which heads towards a speculative boom and apart from the ones that see the "shocks", the "irrational exuberance" or the "reckless policies" as the conditions for financial fragility, he considers them to be endogenous to the system. In Minsky's opinion capitalist economy is at best "conditionally coherent". Instead of an economic equilibrium he proposes "calm periods" and claims that "stability is destabilizing" as long as the relative calmness encourage economic players to take on more risks and to start innovating, which would increase incomes with the risk of interfering with the "coherence" and the "calmness". In other words, if an equilibrium state should be at some point reachable this could only trigger some behavioral reactions which would rapidly direct the economy towards imbalance. It is the affirmation under which many critics have characterized the 2008 crisis as a “Minsky moment” and have wondered whether USA have become a “Ponzi nation”.

I will end my paper quoting a Wade’s true and justified assumption, that of which some contemporaneous economists should be reeducated because some of the axiomatic formulations of the standard economic theories should be reanalyzed. The free market doesn’t self regulates – markets left alone end up in failures -, supply and demand do not necessarily meet at the equilibrium point, economic agents’ choices are not always rational, money are not neutral and economic crises are not exogenous.

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