THE GREATEST FINANCIAL CRISES AND THE ECONOMIC THEORIES

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Abstract

The financial crisis erupted in 2007 caused disruptions on the others markets and then was followed by economic recession. This article present the explanations provided by economic theories about the main consequences of the greatest financial crises on the economy, form XIX century till today. The conclusion of the paper is that the main changes in the economic theory should be about the role of human and a more ethical view of economy.

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Introduction:

Some financial crises have little effect outside of the financial sector, but other crises, like the crisis form 1819-1825, 1873, 1929 and 2008 had recessionary or depressionary effect on the rest of the economy In this paper I tried to present the main theories about the financial crisis and their aftermaths.

The financial crisis that erupted in 2007, continues in 2009 and likely continues longer, is in need for explanation by economic theory. The monetary authorities and financial regulators provide us with a series of explanations and measures but there is a lack of overview. The lack of convincing theory and strategy becomes especially worrying when we see the crisis affecting the real economy. Since the financial crisis turn into economic recession, there is little guidance from economic theory on how to solve it. This crisis provides a test on existing theories and allows us to identify which theories are relevant and which are not.

The main financial crisis and their aftermath over the economy

The greatest financial crisis and their consequences on the economy raised the problem of the viability of economic theories. The search for causes is closely connected to the question of how to avoid a future depression. The even larger question is whether it was largely a failure on the part of free markets or largely a failure on the part of government efforts to regulate interest rates, curtail widespread bank failures, and control the money supply. The answer of this question is a debateble one, those who believe in a large role for the state in the economy believe

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it was mostly a failure of the free markets and those who believe in free markets believe it was mostly a failure of government that compounded the problem.

Current economic theories may be broadly classified into three main points of view. First, there is orthodox classical economics: monetarist, Austrian Economics and neoclassical economic theory, which focus on the macroeconomic effects of money supply, how central banking decisions lead to overinvestment (economic bubble), or the supply of gold which backed many currencies before the Great Depression, including production and consumption.

Second, there are structural theories, most importantly Keynesian, but also including those of institutional economics, that point to under consumption and overinvestment (economic bubble), malfeasance by bankers and industrialists, or incompetence by government officials. The only consensus viewpoint is that there was a large-scale lack of confidence. Unfortunately, once panic and deflation set in, many people believed they could make more money by keeping clear of the markets as prices got lower and lower and a given amount of money bought ever more goods.

Third, there is the Marxist critique of political economy. This emphasizes the tendency of capitalism to create unbalanced accumulations of wealth, leading to over accumulations of capital and a repeating cycle of devaluations through economic crises. Marx saw recession and depression as unavoidable under free-market capitalism as there are no restrictions on accumulations of capital other than the market itself.

The first major financial crisis 1819-1825

The first major financial crisis, started in 1819 in the United States, had occurred after the nation faced a depression in the late 1780s, and another severe economic downturn in the late 1790s following the Panic of 1797. In those earlier crises, however, the primary cause of economic turmoil originated in the broader Atlantic economy. In contrast, the causes of the Panic of 1819 largely originated within the U.S. economy. The resulting crisis caused widespread foreclosures, bank failures, unemployment, and a slump in agriculture and manufacturing.

In the same period, european demand for american foodstuffs was decreased because agriculture in Europe was recovering from the Napoleonic Wars, which had decimated European agriculture. War and revolution in the New World destroyed the supply line of precious metals from Mexico and Peru to Europe. Without the base of the international money supply, europeans needed all the available specie. This caused American bankers and businessmen to start issuing banknotes and expand credit and by the end of 1819, the banks would call these loans . American bankers, who had little experience with corporate charters, promissory notes, bills of exchange, or stocks and bonds, encouraged the speculation boom during the first years of the market revolution. From 1825, because the evolution of european economy, of northen american and latin american countries and it was triggered the British crisis, which become on of the greatest international crisis.

Different economists have offered explanations for the Panic of 1819. Keynesian economist suggest that the Panic of 1819 was the early Republic's first experience with the boom-bust cycles common to all modern economies, but this view could be not complete, this panic seems to be more complex. It was a failure of the banking system following the War of 1812 and combined with the issue of the depression and over speculation, it became the first *failure* of the market economy in America. The Panic of 1819 marked the beginning of a new phase of American economic history, where mature market institutions would continue to move cyclically from boom to bust.

Austrian school economists view the nationwide recession that resulted from the Panic of 1819 as the first failure of expansionary monetary policy. This explanation is based on the Austrian theory of the business cycle. Government borrowed heavily to finance the War of 1812, which caused serious strain on the banks' reserves of specie and led to a suspension of specie payments in 1814. The suspension of the obligation to redeem spurred the establishment of new banks and the expansion of bank note issues. This inflation of money encouraged unsustainable investments to take place. It soon became clear the monetary situation was bad, and the Second Bank of the United States was forced to call a halt to its expansion and launch a painful process of contraction. There was a wave of bankruptcies, bank failures, and bank runs; prices dropped and wide-scale urban unemployment began.

The financial crisis form 1873

The Long Depression started after the financial crisis of 1873 and it was considered, a long time, a worldwide economic crisis though there is some controversy over whether it should be labeled a depression or recession. The Long Depression, labeled The Great Depression (until the Depression of 1930s), was felt most heavily in Europe and the United States, which had been experiencing strong economic growth fueled by the Second Industrial Revolution and by the american civil war. It is often considered that United Kingdom have been the hardest hit and during this period it lost some of its large industrial lead over the economies of Continental Europe

In the United States, the Long Depression began with the Panic of 1873 and the causes of the this depression are debated, mainly because it was not a production depression; it was a price depression. The most immediate cause, and the date that is often used as the start of the Depression, was the collapse of the Vienna Stock Exchange on May 9, 1873. Others have argued the depression was rooted in the 1870 Franco-Prussian War and the Treaty of Frankfurt (1871), that forced French to make large war reparations payments to Germany. The primary cause of the price depression in the United States was the tight monetary policy that the U.S. followed to get back to the gold standard after the Civil War. The U.S. was taking money out of circulation to achieve this goal, therefore, there was less available money to facilitate trade. Because of the monetary policy described above the price of silver started to fall causing considerable losses of asset values, however, by most accounts, after 1879 production was growing, thus further putting downward pressure on prices due to increased industrial productivity, trade and competition.

In America the speculative nature of financing due to both the greenback which was specie issued to pay for the US Civil War and fraud in the building of the Union Pacific Railway up to 1869. Railway overbuilding and weak markets collapsed the bubble in 1873 in USA and in UK.

Because of the Panic of 1873, governments depegged their currencies, to save money. The demonetization of silver by European and North American governments in the early 1870s was certainly a contributing factor. The Coinage Act of 1873 in America was met with great opposition but were Americans who advocated the continuance of government-issued fiat money to avoid deflation and promote exports. The resumption of the US government buying silver was enacted in 1890 with the Sherman Silver Purchase Act.

Some economic historians argue that the Long Depression was actually a deflationary period but not a time of falling production and GDP. The deflation thesis has led to the claim that the Long Depression was not truly a depression at all because production and real GDP grew throughout the period. The confusion comes from the fact that prices were falling (hence, deflation) because of greater industrial productivity and the presence of sound money (gold and silver).

In the modern view, the Long Depression was actually a period of great economic growth, but that many Americans at the time were confused because of falling prices and increasing income inequality, as the living standards of the wealthiest Americans were increasing at an even faster rate.

Monetarists believe that the 1873 depression was caused by shortages of gold that undermined the gold standard, and that the 1848 California Gold Rush. Other analyses have pointed to developmental surges, theorizing that the Second Industrial Revolution was causing large shifts in the economies of many states, imposing transition costs, which may also have played a role in causing the depression.

The Great Depression

The Great Depression, originated in United States was a worldwide economic downturn starting in most places in 1929, after the stock market crashed of October 29 and ending at different times in the 1930s or early 1940s for different countries. It was the largest and most severe economic depression in the 20th century, and is used in the 21st century as an example of how far the world's economy can decline. The depression had devastating effects in virtually every country, international trade plunged by half to two-thirds, as did personal income, tax revenue.

There were multiple causes for the first downturn in 1929, including the structural weaknesses and specific events that turned it into a major depression and the way in which the downturn spread from country to country. The causes of the crisis are considered to be structural factors like massive bank failures and the stock market crash, but other opinions had pointed to the Britain's decision to return to the Gold Standard at pre-World War I parities.

During the Great Depression, Keynes had published his most important work, The General Theory of Employment, Interest, and Money. Keynes argued in his work that lower aggregate expenditures in the economy contributed to a massive decline in income and to employment that was well below the average. In this situation, the economy might have reached a perfect balance, at a cost of high unemployment. The basic basic idea of his theory was simple: to keep people fully employed, governments have to run deficits when the economy is slowing because the private sector will not invest enough to increase production and reverse the recession. Keynesian economists called on governments during times of economic crisis to increase government spending and/or cutting taxes increasing individuals' incomes. As incomes increased, they would spend more. As they spent more, the multiplier effect would take over and expand the effect on the initial spending. Keynesian economists assumed poor people would spend new incomes; however, they saved much of the new money; that is, they paid back debts. Keynesian ideas of the consumption function were upset in the 1950s by Milton Friedman and Franco Modigliani.

Monetarists, including Milton Friedman[1] argue that the Great Depression was caused by monetary contraction, the consequence of poor policymaking by the American Federal Reserve System and continuous crisis in the banking system. In this view, the Federal Reserve, by not acting, allowed the money supply as measured by the M2 to shrink by one-third from 1929 to 1933. Friedman argued that the downward turn in the economy, starting with the stock market crash, would have been just another recession. The problem was that some large, public bank failures, particularly that of the New York Bank of the United States, produced panic and widespread runs on local banks, and that the Federal Reserve sat idly by while banks fell. He claimed that, if the Fed had provided emergency lending to these key banks, or simply bought government bonds on the open market to provide liquidity and increase the quantity of money after the key banks fell, all the rest of the banks would not have fallen after the large ones did, and the money supply would not have fallen as far and as fast as it did. With significantly less money to go around, businessmen could not get new loans and could not even get their old loans renewed, forcing many to stop investing. This interpretation blames the Federal Reserve for inaction, especially the New York branch. One reason why the Federal Reserve did not act to limit the decline of the money supply was regulation. At that time the amount of credit the Federal Reserve could issue was limited by laws which required partial gold backing of that credit. By the late 1920s the Federal Reserve had almost hit the limit of allowable credit that could be backed by the gold in its possession. This credit was in the form of Federal Reserve demand notes. During the bank panics a portion of those demand notes were redeemed for Federal Reserve gold. Since the Federal Reserve had hit its limit on allowable credit, any reduction in gold in its vaults had to be accompanied by a greater reduction in credit.

[1] *A Monetary History of the United States, 1867-1960.* Princeton University Press

Recent work from a neoclassical perspective focuses on the decline in productivity that caused the initial decline in output and a prolonged recovery due to policies that affected the labor market. This work, collected by Kehoe and Prescott[2], decomposes the economic decline into a decline in the labor force, capital stock, and the productivity with which these inputs are used. This study suggests that theories of the Great Depression have to explain an initial severe decline but rapid recovery in productivity, relatively little change in the capital stock, and a prolonged depression in the labor force. This analysis rejects theories that focus on the role of savings and posit a decline in the capital stock.

Another explanation comes from the Austrian School of economics. Theorists of the "Austrian School" who wrote about the Great Depression include Austrian economist Friedrich Hayek and American economist Murray Rothbard[3], who wrote *America's Great Depression* (1963). In their view and like the monetarists, the Federal Reserve, which was created in 1913, shoulders much of the blame; but in opposition to the monetarists, they argue that the key cause of the Depression was the expansion of the money supply in the 1920s that led to an unsustainable credit-driven boom.

One reason for the monetary inflation was to help Great Britain, which, in the 1920s, was struggling with its plans to return to the gold standard at pre-war parity. Returning to the gold standard at this rate meant that the British economy was facing deflationary pressure. According to Rothbard, the lack of price flexibility in Britain meant that unemployment shot up, and the american government was asked to help. The United States was receiving a net inflow of gold, and inflated further in order to help Britain return to the gold standard. Rothbard says American inflation was meant to allow Britain to inflate as well, because under the gold standard, Britain could not inflate on its own. In the Austrian view it was this inflation of the money supply that led to an unsustainable boom in both asset prices (stocks and bonds) and capital goods. By the time the Fed belatedly tightened in 1928, it was far too late and, in the Austrian view, a depression was inevitable.

According to the Austrians, the artificial interference in the economy was a disaster prior to the Depression, and government efforts to prop up the economy after the crash of 1929 only made things worse. According to Rothbard, government intervention delayed the market's adjustment and made the road to complete recovery more difficult. Furthermore, Rothbard criticizes Milton Friedman's assertion that the central bank failed to inflate the supply of money. Rothbard asserts that the Federal Reserve couldn't do his job because the lost of faith in banking system of American population and their preference for cash. The potential for a run on the banks caused local bankers to be more conservative in lending out their reserves, and this, Rothbard argues, was the cause of the Federal Reserve's inability to inflate.

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[2] *Great Depressions of the Twentieth Century.* Federal Reserve Bank of Minneapolis

[3] *America's Great Depression.* Mises Institute. 5th edition

Two economists of the 1920s, Waddill Catchings and William Trufant Foster[4], popularized a theory which states held the economy produced more than it consumed, because the consumers did not have enough income. Thus the unequal distribution of wealth throughout the 1920s caused the Great Depression. According to this view, wages increased at a rate lower than productivity increases. Most of the benefit of the increased productivity went into profits, which went into the stock market bubble rather than into consumer purchases. Say's law no longer operated in this model (an idea picked up by Keynes). As long as corporations had continued to expand their capital facilities, the economy had flourished. Under pressure from administration of that time and from business, the Federal Reserve Board kept the discount rate low, encouraging high (and excessive) investment. By the end of the 1920s, however, capital investments had created more plant space than could be profitably used, and factories were producing more than consumers could purchase. According to this view, the root cause of the Great

Depression was a global overinvestment in heavy industry capacity compared to wages and earnings from independent businesses, such as farms. The solution was the government must pump money into consumers' pockets. That is, it must redistribute purchasing power, maintain the industrial base, but reinflate prices and wages to force as much of the inflationary increase in purchasing power into consumer spending. The economy was overbuilt, and new factories were not needed.

Irving Fisher[5] argued that the predominant factor leading to the Great Depression was overindebtedness and deflation. Fisher tied loose credit to over-indebtedness, which fueled speculation and asset bubbles. He outlined 9 factors interacting with one another under conditions of debt and deflation to create the mechanics of boom to bust: debt liquidation and distress selling, contraction of the money supply as bank loans are paid off, a fall in the level of asset prices, a still greater fall in the net worths of business, precipitating bankruptcies, a fall in profits, a reduction in output, in trade and in employment, pessimism and loss of confidence, hoarding of money, a fall in nominal interest rates and a rise in deflation adjusted interest rates.

Many economists have argued that the worsen of depression was due to the sharp decline in international trade after 1930 helped to, especially for countries significantly dependent on foreign trade. Most historians and economists partly blame the American Smoot-Hawley Tariff Act for worsening the depression by seriously reducing international trade and causing retaliatory tariffs in other countries.

[4] *Foster and Catchings: A Reappraisal*, Journal of Political Economy

[5] *The Debt-Deflation Theory of Great Depresion* , Federal Bank of Saint Louis

The financial crisis of 2008

The prezent financial crisis, started in 2007 has been called the most serious financial crisis since the Great Depression, with its global effects characterized by the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.

The immediate cause of the crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. High default rates on "subprime" and adjustable rate mortgages (ARM), began to increase quickly thereafter. An increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices had encouraged borrowers to assume difficult mortgages in the belief they would be able to quickly refinance at more favorable terms. However, once interest rates began to rise and housing prices started to drop moderately in 2006–2007 in many parts of the U.S., refinancing became more difficult. Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and ARM interest rates reset higher.

From 2007, significant amounts of foreign money flowed into the U.S. from fast-growing economies in Asia and oil-producing countries. This inflow of funds combined with low U.S. interest rates from 2002-2004 contributed to easy credit conditions, which fueled both housing and credit bubbles. Loans of various types were easy to obtain and consumers assumed an unprecedented debt load. As part of the housing and credit booms, the amount of financial agreements called mortgage-backed securities (MBS), which derive their value from mortgage payments and housing prices, greatly increased. Such financial innovation enabled institutions and investors around the world to invest in the U.S. housing market. As housing prices declined, major global financial institutions that had borrowed and invested heavily in subprime MBS reported significant losses. Falling prices also resulted in homes worth less than the mortgage loan, providing a financial incentive to enter foreclosure. The ongoing foreclosure epidemic that began in late 2006 in the U.S. continues to drain wealth from consumers and erodes the financial strength of banking institutions. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Total losses are estimated in the trillions of U.S. dollars globally.

While the housing and credit bubbles built, a series of factors caused the financial system to both expand and become increasingly fragile. Policymakers did not recognize the increasingly important role played by financial institutions such as investment banks and hedge funds. These institutions as well as certain regulated banks had also assumed significant debt burdens while providing the loans described above and did not have a financial cushion sufficient to absorb large loan defaults or MBS losses. These losses impacted the ability of financial institutions to lend, slowing economic activity. During September 2008, the crisis hits its most critical stage. There was the equivalent of a bank run on the money market mutual funds, which frequently invest in commercial paper issued by corporations to fund their operations and payrolls. Withdrawal from money markets were $144.5 billion during one week, versus $7.1 billion the week prior. This interrupted the ability of corporations to rollover (replace) their short-term debt.

The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. Moreover, the de-leveraging of financial institutions, as assets were sold to pay back obligations that could not be refinanced in frozen credit markets, further accelerated the liquidity crisis and caused a decrease in international trade.

It seems to that the economic theory was not enough to describe and to prevent the present crisis. Although the economists have proposed as solutions to strengthen the regulations and enlarge supervision to avoid the futures financial crisis, I don't thing it is the correct solution. In my view it is necessary to rethink the role of the human in the economic theories and to propose a ethical concept of economy could mitigate the cyclical greatest financial crisis. I think that investors will always find the ways to escape form the regulation and it is necessary to requires a general economical ethical cod.

Conclusion

The implicit view behind standard models is that markets and economies are inherently stable and that they only temporarily get off track but this view failed to warn policy makers about the threatening system crisis. As the crisis has unfolded, economists had to abandon their standard models. In this period the common-sense advice is a poor substitute for an underlying model that can provide much-needed guidance for developing policy and regulation.

Although it could be seen as a failure of popular models, I think the real problem is the lack of historical memory, the greatest financial crisis (from 1825, 1873, 1929 and 2008) have had the the same main features along the time despite their particular features. If we try the visualize the economic history we can see the real problem - the human greed. The main problem is not just the economic theory but a continuous human desire to have more than it needs which allows speculations and thieves. The solution in my vision is a more ethical and moral way to conceive the function of economy.

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