Global Economic Crisis and Government Intervention

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Abstract

The new economic context which brings into discussion the state's role in the economy is the result of several factors, all contributing to the emergence and spread of the crisis. What does history have to say about the political and economic after-effects of financial crises? There are clear similarities between the 1929-1935 and 2007-2009 crises in terms of initial conditions and geographical origin. In each one of the cases, the financial pain at the root of the crisis was followed by a deep recession in the real economy, but the most devastating impact of the global crisis was the human suffering. So, the society changed its vision of business legitimacy, calling for structural changes in the system, including increasing government influence in economy. In this sense, structural policies are the best option for long-term recovery after the event of a crisis.

Key words: crisis, interventionism, structural policy
J.E.L. classification: E12, H12, P16

1. Introduction

Philosophically, the very existence of the individual in society becomes a consumer need, as a result of basic needs, which positions him legitimately in this circuit: needs - consumer (spending) - production (profit). In other words, the coexistence of many individuals generates needs, which in turn generates demand for products or services, and so, diverse consumer needs determine the profits to be possible. In fact, profit emerges due to the human need and the state is absolutely necessary to intervene for income redistribution and for providing services to individual, as part of society (Răsăuţeanu, 2016, pp.6).

The philosophical concept developed by Hobbes shows the permanent preservation efforts made by the individual through the accumulation of power over others. The natural state is the war of all against all. Living in such a world tends to be bad, brutal and short. The impulse to accumulate this power comes from its natural weakness: consciousness. This predisposition represents for the representatives of political realism the policy goal in the definitions of Max Weber and Nietzsche: politics being an obvious expression of the struggle for power. Promoters of realism consider that the sum of human faults and qualities are transferred to the State, which, like the individual, is trying to provide security by gaining power over other states.

But if the economy evolves naturally to the concentration of wealth in a few hands, if allowed to run its natural course, the economy could create, and then, deepen the gap between high income of the few and low income of the many? Is the population splitting naturally into strong and weak? According to economist Paul Krugman, what happens in the US from 1980 onwards reveals those few in numbers who were strong and retained or even extended their richness as well as those many in number who were weak and gradually lost even the wealth they'd own before. It seems then that freedom of population turns to natural liberty of those who actually possess - large holders of capital (freedom that reinforces and extends), and to a situation where there is no freedom, first economic and then political and social one, belonging to the many. This demonstrates that the nature of the economy, uncontrolled by state, favors those people who have power.

What is happening now in the world is the clearest evidence that the economy can't adjust itself. The new economic context which brings into discussion the role of the state in the economy is the result of several factors, all contributing to the emergence and spread of the crisis. The overly abundant liquidity and savings created enough resources available for investment, especially in sophisticated financial instruments, hardly understood by investors because of their complexity; thus leading to an inefficient management of resources. In addition, the growing investments in newer and more cost-effective production technologies, alongside the entry on the markets of cheaper products from newly industrialized countries, have caused an overproduction in most of the markets.

The objective of present research is to demonstrate that, in order to avoid the harmful effects caused by the free operation of markets, state intervention is necessary by appropriate regulations, which prevent excesses, abuses and damages, incurred by all individuals.

2. Crisis of 1929-1935 and the measures implemented at government level

There are clear similarities between the 1929-1935 and 2007-2009 crises in terms of initial conditions and geographical origin. They all occurred after a sustained boom, characterized by money supply and credit expansion, rising asset prices and high-running investor confidence and overoptimistic risk-taking, culminating in an overproduction. All were triggered in first instance by events in the US, although the underlying causes and imbalances were more complex and more global, and all extent internationally to deeply affect the global economy (E.U., 2009, p. 6). And in each of the cases, the financial pain at the root of the crisis was followed by a deep recession in the real economy.

The main reason for the economic downturn in the US in 1929 was that the authorities have allowed the development of a prolonged crisis in the US banking and financial system by not adopting sufficient expansionist measures needed to counter the phenomenon of overproduction. In addition, the Federal Reserve's actions were simply contradictory: in 1928 and 1929 set higher interest rates in an attempt to reduce market speculation, affecting demand, which has deepened the economic decline. The crisis in the US financial system has spread to the real economy, contributing to the decline in production and employment and to deflation. US crisis eventually spread globally due to the way the gold exchange standard functions (1926-1931): national monetary systems were pyramidal structures: the American pyramid based on gold, the British pyramid based on the dollar and other European currencies based on the sterling. By the summer of 1931, the European economy experienced lower prices and a lack of demand and unemployment. Because of this, a substantial negative impact on the banking system followed, particularly in Austria and Germany.

The most devastating impact of the Great Depression was unprecedentedly the human suffering. For a short amount time, global productivity and living standards have suddenly collapsed. Up to a quarter of the workforce in industrialized countries was unable to find work in the early 1930s. Across the capitalist countries, crisis has reduced industrial production by 44% and the number of unemployed exceeded 30 million. The crisis has also affected agriculture, commerce, banking, credit and financial. Although economic conditions have started to improve towards the middle of 1930, total recovery has done not only at the end of the decade.

In the US since 1933, under the initiative of President F.D. Roosevelt, a reform program, which was named "New Deal", was put into practice. This program aimed to alleviate the consequences of the economic crisis and strengthen elements of state capitalism, using elements of planning, balancing and coordination of the capitalist economy, and it entrusted the capitalist state with economic functions.

For the new president Roosevelt, this dire situation of the working class which got left without jobs became a top priority for his economic program New Deal. This happened because the working class was able to organize uncontrollable riots which could lead to the downfall of the American economic system.

There are three lines in the New Deal:

I. The reorganization and revival of the fundamental sectors of activity:

• Banks - Banking Act allows tighter control of financial organizations and establishes a clear distinction between banks for deposits for short-term loans and merchant banks for long-term loans, no banks being allowed to have direct participation in enterprises. An insurance system is set up to guarantee the deposits of account holders. In June 1934 it created a system of surveillance of stock exchange transactions that will limit the ability to speculate on credit.

• Industry - NIRA (National Industrial Recovery Act) actually wants to govern cooperation between the State and enterprises to focus the objectives of the fight against the crisis. The program involved a Federal Relief Act, while the Civil Works Administration oversaw vast public investment. Civilian Conservation Corps hired 2.5 million youth to build roads, dams, and plant trees on public land. To stem the disastrous fall in prices and profits which began in 1929, there were proposed codes of fair competition to businesses from the same industry, to harmonize production conditions. These codes of competition lead to a kind of corporate cartelization of American industry, being a relative American tradition abandonment of antitrust vigilance. Adherence to codes has even become a criterion for the civics to combat the crisis, the state reserving the only support of signatories, whose products are actually reported to the public by drawing a blue eagle and the words ‘We do our part’. In consideration of those economic advantages, NIRA has had important social clauses. Democratic Administration proposed employers a framework on which they can join: the prohibition of child working week of 40 hours for offices and 35 hours in industry, and a basic wage of $12 to $15 per week for other areas. In addition, the text called into question individualism in economic and social matters, NIRA guaranteeing workers the freedom to organize and to choose their own representatives, action that enhanced the development of trade unions; in 1937, the strikers will use large-scale occupation of factories.

• Agriculture - AAA (Agricultural Adjustment Act) is the centerpiece of a device that combines two types of actions envisaged by agricultural policy developed by Henry Wallace to return a decent standard of living to the farmers, the main victims of the crisis, thanks to the higher prices of agricultural products. It was intended to reduce debt by implementing a credit system adapted to the possibilities for reimbursement of farmers. For a brief amount of time, the administration superseded neediest borrowers, after which it provides loans with low interest rates (4.5% per year) and long repayment terms. In parallel, it encourages the decrease in production to create a relative shortage of agricultural produce favorable growth rates; allowances are granted for the destruction of existing stocks, then premiums for farmers who undertake to reduce their production. Commodity Credit Corporation becomes the central management body of support for agricultural prices.

- Electricity - Tennessee Valley Act and by Public Utilities Holding Company Act
- Transport - Rail Road Emergency Act and Wheeler Lea Transportation Act.

II. A policy aimed at bringing the United States into a favorable position in the world market:

• Abandoning the gold standard (April 19th 1933) and gradually devaluating the dollar against gold - Gold Reserve Act. It is a voluntary policy of dirigisme money that did not come to respond to speculative movements against the dollar, this targeted the inflation needed to create an economic recovery, reducing debt burdens and promoting the export of American products.

• Reciprocal Trade Agreements Act.

III. Searching for a new social compromise on which the main social forces can agree without an upheaval of capitalism, Roosevelt declaring during the campaign of 1936: 'My administration is the one that saved the system of private profit and free enterprise'. What was sought this time was the imposing of a set of reforms to the most reactionary forces and to the most selfish interests.

Many of the programs, such as Social Security, the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) are ongoing even today.

3. The global crisis of 2007 and the solutions applied at European level

The main source of today’s crisis is the declining vitality of the advanced economies since 1973, and, mainly, since 2000. Economic performance in the U.S., Western Europe, and Japan, constantly decreased with each business cycle in terms of every standard macroeconomic indicator -- GDP, investment, real wage. More so, the business cycle, from 2001 through 2007, was the weakest one of the postwar period, in spite of having the greatest government economic stimulus in the U.S. peacetime history.

Since the end of the 1960s the main cause of this state it is a deep, lasting, decrease of the rate of return on capital investment. The failure rate of profit to recur is all the more remarkable, considering the huge drop-off in the extension of real wage over the period. The most important reason of the decline in the rate of profit has been the persistent tendency of over-capacitating world manufacturing industries. The reason for this is that new industrial power entered the global market (Newly Industrializing Countries), especially, China. These countries produced the same goods that were already being produced by the developed countries, only cheaper. The effect was that in all industries, there was too much supply compared to demand. As a result, it forced down prices decrease profits. Corporations tried to keep their position on the market by investing in new technologies, action which also led to overcapacity. Due to the decreasing rate of return, corporations were getting smaller and smaller outcome from their investments so they had to lower the investments for equipment and employment. Meanwhile, in order to restore profitability, they decreased employees' compensations, at the same scale as governments' reduction on the amount of social expenditures. But the result of all these cutbacks in spending has been a long-term matter of aggregate demand. The decrease in demand has been the immediate root of all economy's long-term weakness.

The Federal Reserve, by keeping interest rates low, determined an easy way to borrow and to encourage investment in financial assets. As asset prices climbed, corporations and households experienced huge increases in their wealth, at least on paper. They were therefore able to borrow on a large scale, increase their investment and consumption (Brenner, 2009, pp.1-2).

Subprime credit crisis erupted in August 2007 and has its origins in a financial system that generated paper assets whose value depends on the price of housing. They were granted loans to applicants with poor credit history, which normally wouldn't have met the criteria needed for a standard mortgage. Unfortunately, the drop-off in property prices recorded in the US has prevented many owners to fulfill their financial commitments and, as a result, there was a significant increase in the number of foreclosures in the subprime mortgage market. Under these circumstances, a number of major companies active in the market were either closed or went bankrupt. For 13 months, the world viewed it as a small financial crisis, one that will only affect G7 countries that faulted some elements of monetary and legislation policies (especially the US and Britain). Then the crisis has had metastasized and became worldwide in September 2008. The defining moment came when the US Treasury has accepted the bankruptcy of Lehman Brothers. It was a shock to the global financial community, which did not expect that any major financial player will be left in the lurch by national governments.

The solutions adopted at European level for getting out of the financial crisis

	Crisis Control	**EU Coordination Frameworks**
Structural policy	• sectoral aid • unemployment compensation	Single Market, Competition Policy, Lisbon Strategy
Financial policy	• liquidity provision • capital injections • credit guarantees • asset relief	EU supervisory Committees, Single Market, Competition Policy
Monetary policy	• conventional and unconventional expansions • interest rate reduction	Single Monetary policy; European System of Central Banks
Fiscal policy	• expansions and automatic stabilizers	Stability and Growth Pact European Investment Bank

Source: E.U., 2009, p. 58

There have been taken "unconventional" measures of financial policy, at the European level, towards increasing the liquidity of banks, dropping in interest rates and granting facilities to financial institutions from central banks and from governments. In this regard, in October 2008 The

European Central Bank (ECB) lowered several times refinancing interest rate (to 1% in July 2009). In 2008, European Commission adopts European Economy Recovery Plan (EERP) (through which Romania has received in March 2009 approval of 5 billion euros of aid for energy projects, broadband Internet and rural development measures). In 2009, Commission adopts decision on increasing competence of supervision of EU financial markets. In May 2009 the ECOFIN Council approved € 50 billion - lending ceiling for euro area Member States in financial difficulty.

4. The effects of the global crisis on political system

Nationwide, newly emerging political parties rise in elections, and street demonstrations and strikes multiplied. Indeed, studies conducted worldwide have shown that after the crisis of ’30 extremism in politics intensified, and, after financial crises, fractionalization and polarization phenomena occurred in parliaments (Mian *et al*, 2012, p. 4 and Bloom *et al*, 2011, p. 12).

A new study conducted in 2015 (Funke *et al*, 2015) in 20 countries with democracy, in the period 1870-2014, it reached some interesting conclusions on the effects of financial crises on the political class. Governance becomes more difficult (majority share is reduced) being accompanied by increasing fragmentation of parliaments and political parties. The resulting policy uncertainty may contribute to the much-debated slow economic recoveries from financial crises.

The great economic crisis requires quick reactions from the political class. These great economic crises require quick reaction from the political class. They cause a state of uncertainty and panic among the population (be they entrepreneurs, pensioners or employees) and require implementation of structural policies. Until the economic crisis in 2007, there was a general consensus on the need for structural reforms in many countries to improve economic performance and to meet the challenges arising from new technologies, aging and globalization process.

An economic crisis can promote structural reform, where institutions or existing regulations are recognized as being at least partly responsible for the deterioration of economic conditions. For example, countries with tighter regulation of the labor market and more generous rules on early retirement age may need urgent reforms of pension systems and labor market. Crises may require urgent reform, if there is sufficient consensus that structural reforms can facilitate the recovery and increased production.

It must be taken into account that the manifestation of the crisis could impede reforms. Individuals and socioeconomic groups are less eager to lose the benefits, unless they are offered compensation. In addition, costly reform packages are more difficult to finance during the crisis. So, while reforms aimed at improving the functioning of the labor market may be necessary, especially during periods where there is high unemployment, economic crises may prevent making these reform measures, given that increases flexibility may be seen as requiring adjustment costs from workers who already suffer from unfavorable economic conditions.

To succeed in reforms, governments must use their political capital to stop the resistance which comes either from the government or from the opposition parties or unions. Political parties usually have political preferences that differ, because of how each of them is trying to appeal to their voters. Thus, conservative governments adopt policies to increase efficiency and to reduce the role of the public sector in the economy, by liberalizing financial markets and the property market through privatization. On the other hand, leftist governments promote equality and redistribution of income, opting to expand social spending. Contrary to political beliefs, there is an argument that explains why some governments have been successful in advancing reforms that were actually in contrast to their belief / political constitution and sometimes even with their electoral program. If voters are not able to check whether a reform is imposed for purely ideological or economic necessity, they would like to believe that reform is driven by economic motivations.

When an economic crisis erupts, political parties may have different views on the respective intensity of the crisis, its causes and possible remedies. In addition, political parties pursue those economic policies that are supported by most voters or undecided voters (or who can change their political choice). The mandate of the government and the time until the next elections may affect the reform process. If approaching elections, the government will limit the application of those measures which bring high costs on short-term and adopt reform policies that are accompanied by higher short-term benefits.

5. Conclusions

The crisis has demonstrated that the market is not efficient in controlling unethical practices driven by greed, mechanisms misunderstanding or by herd behavior. The society changed its vision of business legitimacy, calling for structural changes in the system, including an increase of government influence in business.

Structural policies are the best way for long-term recovery from the economic crisis aftermath. They should include a review of social protection systems with an emphasis on preventing unemployment and promoting employees later exit from the labor market. Here we must remember the policies that aim to support economic growth and competitiveness - which would result in a greater resistance to the crisis.

Regarding another category – stimulating macroeconomic policies of the fiscal field and monetary field - the objectives of stability in the medium term must not be undermined due to the danger of inflation. The expected trend – demand lowering - with its negative side effects on investment and employment - must be reversed through a significant budgetary stimulus package and tax. Theoretical and empirical research indicates that growth can be supported when public expenditure is oriented towards investment. The impact on growth is largely driven by public investment in human capital (through education and health spending), technical progress (research and development spending) and public infrastructure. Some researchers have concluded that lowering the tax burden on labor by shifting it to a wider tax base, such as VAT, could foster employment and economic growth. From the simulation models based on euro area it is estimated that on the long-term the tax shift of 1% of GDP from labor tax to the consumption tax will increase real GDP by about 0.2% and employment by about 0.25%. The effects depend largely on institutional and structural factors such as the indexation of transfer payments and the response of wages.

The whole world affected by the current crisis will tend towards overall progress of society capable of ensuring human emancipation. A new order will be established worldwide: the orientation of the entire economic life and economics science towards the human and his needs.

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