How can we anticipate crises?

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HOW CAN WE ANTICIPATE CRISES?[1]

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Abstract:
Every crisis should teach us a valuable lesson. However, it seems that we learn almost nothing since they still occur from time to time strongly affecting economies all over the world. The basic question from where we started our research and to which we tried to answer as clearly as possible is the following: Can we (and how can we) anticipate future crises before they begin to make their presence felt on the global economic scene? The answer is both simple and handy, as the most consistent and relevant explanations in this regard come from the Austrian School of economics. We refer, in particular, to the theory of business cycle. Analyzing this problem, we discovered multiple causes, or better said clues that might help us anticipate and recognize the onset time of economic recessions. We will focus on two of them, considered to be the most important ones. The first clue is closely linked to an expansionary monetary policy that led to a deterioration of credit and to inflation. The second sign that we will be argued in this paper, a sign in close connection with the first clue, is due to the application of protectionist measures or, in other words, the second cause was actually the state's interventionism.

Keywords: Austrian School, business cycle, crisis, expansion, interventionism

JEL Classification: B 13, B 25, B 53, E 32, E 40, E 51, G 21

INTRODUCTION

We all have been affected over time by the economic crises that caught us in the middle. And, most of the times, we were unable to find a clear and relevant response to give us the necessary clarifications. Therefore, we tried to give a clear answer to the question that is on everyone's lips: Why do these economic crises occur?

The purpose of this paper is to highlight, from the perspective of an „austrian" mind, the main causes that can be blamed for triggering the recessions in general and the current global imbalance in particular and then to analyze the two main actors: *monetary expansion* though the *state's interventionism.*

The main figures that represent the Austrian School of economics are able to see pass the appearances and consider as the main cause of the present situation, hyper-reglementation and believe that the imbalances are in fact normal and *predictable expectations from a market that is suffocated by the burden of interventionism.*

On this basis, economists representing the Austrian School have succeeded in reviving the most significant elements that have the guilt for the wrong policies, such as: the fractional-reserve problem, the role and effectiveness of national banks, the utility of hyper-regulation and last but not least, the role of risk management institutions.

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CAUSES, CAUSES AND AGAIN CAUSES...

Although some might say that the current crisis came without any warning, what could we have expected, given the chaos on the global economic scene, a chaos which has been taking place for several years? The present situation does not represent a market failure, but a normal and predictable effect from an economic point of view, of government intervention in economy.

This situation that we have been dealing with for more than three years now, was thus, by no means, the fault of the capitalist system, as some might rush to support. But we might say that it was an error made by the government, an error manifested by an unjustified intervention in an ensemble as complex as the economy. We are talking about a vicious government policy materialized in a flawed monetary policy.

The safety inspired to people by banks, as well as their faith in government when it comes to handling as efficiently as possible micro and macroeconomics, have been compromised during the past years.

From the microeconomic point of view, emerges the idea that regulations used so far proved incapable of solving the problems, even more, they are responsible for the unhealthy way in which banks operate today. From the macroeconomic perspective, we are dealing with the hypothesis which claims that the starting point of the crisis is closely linked to the recent global economic imbalances, the reference here being made to the interest rate's fluctuations, to the surplus of money from circulation, as well as to the interventions that aim to stimulate mortgage loans.

In order to understand much better the events that are happening around us, it is absolutely necessary to return to Ludwig von Mises and Friedrich Auguste von Hayek! What we have been dealing with, and unfortunately still have to face, is not a consequence of the lack of demand, in other words a lack of consumption or investment, as John Maynard Keynes used to claim. As a result, the state's interventionism prescribed by Keynes and practiced in an abusive way is not righteous at all. On the contrary, these suffocating actions have only extended and deepened what they have already started: the crisis. A first cause for the present crisis is being outlined, a cause that can rightly be regarded as a triggering one. We are talking about the already known ***state interventionism*** **(1)**, an interventionism indicated by the ***faulty monetary policies*** **(2)**. As a basic factor of the crisis is the inflationary policy from the early 2000s, namely the "monetary relaxation" policy applied by Alan Greenspan. From this point springs the nature of all troubles.

We have to bring in light the ***fractional reserve system*** **(3)** as well, as a major cause which requires our attention. This system was accepted, legalized and permanently supported by the government, rather than a healthy and clean system as the one based on the 100% reserve. Within this system it is created the possibility of multiplying, therefore credit expansion, because of the confusion between real savings (refraining from present consumption) and fictional savings (which is based on money substitutes). Unfortunately, today if one mentions the abolition of fractional reserve system and proposes the return to the one based on the 100% reserve, the risk of being seen with bad eyes or considered an eccentric occurs. This brings us to another important cause which underlines the foundation of the current crisis, namely ***the artificial expansion of credit*** **(4)**. This expansion has lead to a drastic decrease in the value of interest rates, which gave the impression of feasibility to some investments that were not at all possible because in reality they were not supported by the people's savings needed for completion. Entrepreneurs were thrown against the wall. Hardly had they realized how things really work and that they cannot finish what they have already started. In their desperate attempt to save something, they continued to resort to banks, demanding for more and more credit. A loan that was much more expensive.

We should definitely mention as a cause of the current crisis ***the mortgage "boom"*** **(5)**. The crisis basically erupted when the U.S. real estate bubble exploded in 2007. Gathered all together, the lax standards for approving the loans, the original advantageous terms and the long term expectations of growth in house prices, represented the needle that broke the bubble. If in 1994, 64% of the American population owned a home, in 2004 this value reached a record share of 69,2%. House prices recorded a noteworthy increase, especially between the years 1997-2006, more accurate an increase of 124%. Compared with the average annual household income, the average price of houses has increased from approximately 3 times to 4,6 times the average annual income in 2006. Mortgage loans with high risk (the subprime loans) increased from 5% in 1994 to 20% of all mortgage loans in 2006. The use of the new type of loans called NINJA (No Income No Job No Assets) has created real problems. As a result of the real estate bubble burst, everyone who invested in the real estate sector suffered tremendously. The signs of panic determined the financial institutions to admit the subprime mortgage losses and made every possible effort to follow a series of recovery measures. But it was already too late…

Finally, it should be noted as a cause that stood as foundation for the current recession ***the moral hazard*** **(6)** as well. Counting on the government as a last resort, the bankers have displayed an inappropriate behavior involving a multitude of risks. Who would worry about the good and correct economic functioning when it is known that the encountered problems, the possible losses can be easily passed to the state? The state, through central banks that are specialized in the issue of currency, became known as the lender of last resort. He is able to clean the mess as it costs almost nothing to produce the money needed to cover those loses. This is essentially what the moral hazard represents.

However, we must remember a very important aspect, namely that the sin for what has happened, is still happening and most likely will happen in the future, undoubtedly falls on the shoulders of the **STATE**.

EXPANSION AND INTERVENTIONISM – DREADED ENEMIES

The main reason for the triggering of economic crisis is, without any doubt, *the monetary expansion*. The current crisis was no exception.

First Mises and a little bit later, with relevant improvements and contributions, Hayek have succeeded in presenting as clearly as possible the mechanism through which monetary expansion, accompanied by loans that exceed the rate of voluntary saving, could lead to a misallocation of resources, particularly affecting the capital structure. They are the ones who laid the foundation of the business cycle theory, a complex and logical theory that once understood can be a real treatment for the economies that apply it.

The business cycle theory is one of the strongest Austrian contributions to economics. The traditional Austrian point of view regarding the economic cycles begins with Mises (1912) and Hayek (1935) and changes very little over the years.

While explaining the business cycle, Mises starts with the distinction between the *commodity credits* which are transfers of savings from the hands of the people who initially chose to save to the hands of entrepreneurs who intend to use these funds in the process of production and the *circulation credits* which are granted by banks and are, as Mises use to say: "*Circulation credit is granted out of funds especially created for this purpose by the banks. It increases the amount of money substitutes, of things which are taken and spent by the public in the same way in which they deal with money proper. It increases the buying power of the debtors. The debtors enter the market of factors of production with an additional demand, which would not have existed except for the creation of such banknotes and deposits. It is the main tool of policies aiming at cheap or easy money"* (Mises, 1933).

In the terms of the current economy we are talking about the distinction between time and demand deposits. For years banks have been operating with the fractional reserve system, an unhealthy system that does not help us realize the major differences that exist between these two types of deposits. Whereas for the demand deposits the ownership remains permanently in the hands of the depositor, the bank being only engaged into keeping the deposit, protecting and returning it at any time the depositor might ask for it (Huerta de Soto, 2010a), in the case of time deposits, the ownership is temporarily transferred to the bank, the bank having the right to use that deposit for its own benefit throughout the contract, returning on the due date the exact amount plus the accrued interest. This is how a healthy banking system should work. We are talking about the 100% reserve system to which urges the Austrian School and which has long been forgotten. Unfortunately, at the urge and with the state's support, the banks, hungry for substantial profit, began to grant loans based on demand deposits, practically they began to create money out of nothing. This additional amount of currency in circulation, this monetary expansion does not only lead to inflation, but also manages to draw down the credit along with the interest rate. How is this thing possible? We will take as an example in our analysis the current economic recession.

The crisis we are currently facing much too long already has as a starting point the monetary expansion during the mandate of Alan Greenspan at the FED. The constant fear regarding the onset of a possible deflation, due to the "dot.com" burst from 2000 and the events that took place on September 11, 2001 determined the Federal Reserve to resort to a series of measurements in order to revitalize the credit by lowering the normal level of interest rate. It started from an average of 6.5% in November 2000 and it got to the incredibly small value of only 1% in July 2003, a value at which it remained for almost a year, precisely until June 2004. The result brought, as expected, a series of new liquidity injections in economy, leading to a situation where *"there are more headlines than money"* according to the explanations given by Jörg Guido Hülsmann (Hülsmann, 2000). From the demand deposits banks have borrowed most part of the amount which, having reached another bank, represented the basis for a new loan. When we say most part of the amount, we refer to a value situated around 90%, the remaining of 10% representing the liquidity kept by banks for possible withdrawals. This is the fractional reserve system, a system that boosts on short term the economy by giving a promising momentum, but has disastrous long-term effects as it inevitably leads to the triggering of economic recessions.

These far too low interest rates represent the main instrument by which this expansion was operated, an expansion which was felt in the strongest way in the real estate sector. The manner in which loans were granted, "just by identity card", to use the Romanian version, without a prior verification of their solvency or some potential guarantees led to an avalanche of loans that had a high degree of risk, the so-called "subprime" loans.

In 2004, when the FED had already begun to realize the harm that has been done until then, it was already too late. We refer mainly to the inflationary policy on which it relied until then, a policy of cheap money that was reached by reducing the normal value of interest rate. It all resorted from that moment on at a gradual increase of this value, hoping to avoid a new round of expansion. What actually happened was a reduction in the number of credits directed towards the real estate sector, which has determined a collapse of the real estate price. A large number of mortgage debts was accumulated, debts that were increasingly more difficult to refund and put pressure on bank's liquidity, causing the failure of the lending action. The uncertainty determined banks to no longer lend to each other on the interbank market, all these marking the road towards a blockage of lending and cash flow. The scenario needed for triggering the crisis was ready to be implemented.

The first clue to a possible trigger of the current crisis could be seized since February 2007 when, in the U.S. the number of debts to the reimbursement of loans given on the "subprime" segment expanded. That was the moment when the actual bankruptcy of certain banks began, as they simply couldn't handle the situation anymore. August 2007 can also be considered a trail that led to the outbreak of the current recession. In fact, if we analyze the situation, August 2007 can be considered the triggering point of today's crisis. Stock markets collapsed at that point and the central banks did not stand aside and did not leave the market to self regulate as they should, but chose to interfere in order to support liquidity.

The expansion we have experienced during the last couple of years, this artificial boom exploded in 2007 and this explosion brought into light a crisis that has been smoldering lying in secrecy. The triggering point of the current crisis depended very much, as we have already seen, on the degree of government intervention in economy. The more the state was involved and tried to help through the imposed measures, the later the effects could be envisioned, gaining a more pernicious aspect. The adopted measures and the massive intervention in the economic mechanism have only postponed the triggering moment of the current recession, a delay of the inevitable.

One important thing should be well understood: when we have **interventionism** and **expansion**, we cannot escape from any recession.

THE AUSTRIAN THERAPEUTIC

We have to admit that the problem we face is a very serious one. These recessions affect us very much and they have to stop. How can we treat this disease that attacks the economy? In order to free ourselves from such situations to which we do not seem to be able to find solutions, we definitely need to implement radical measures.

In our attempt to find a possible treatment for the current situation, we will choose the path suggested by Jesus Huerta de Soto. This path involves creating a free financial-monetary system through the introduction of three major steps:

1. The return to **the 100% reserve system**, a system that has long been buried by the greedily banks. It is required an immediate withdrawal from the fractional reserve system and imposing the rule of keeping a 100% reserve at all times for the demand deposits, complying the traditional principles of law. It will also be taken into account the payment of certain custody fees. De Soto strongly believes that *"nobody, not even a banker, should enjoy the privilege of lending something that has been entrusted to him as a demand deposit"* (Huerta de Soto, 2010a).
2. **Stopping state intervention** in economy, **the abolition of central banks** and **establishing a system of free enterprise banking**. The monopoly exercised by central banks for a while now, along with the idea that these central banks dictate the monetary policy gives the impression of a return to the socialist system, the one with planned economies, against whom we fought for years. In addition, banks will become increasingly dangerous and will continue their destructive policy as long as they realize that the state, with the help of the money machine that is the central bank, comes to their rescue regardless of the situation and provides the coveted liquidity.
3. **The complete freedom of choosing the currency**, based on a standard metal (gold) that will replace all previously issued fiduciary media. De Soto supports, therefore, the privatization of the existing money and pleads for adopting a monetary system that cannot be manipulated by people, such as, for example, the former gold standard.

This radical reform will undoubtedly mark the death of the socialism that is apparently still haunting us. We believe this because our proposed therapy will entail a series of liberating principles that will give full rein to private property and will release the financial-banking system from the burden of central planning, the extreme interventionism and the monopoly exercised by the state.

CONCLUSIONS

We all are, or at least we should be, aware of the tragedy that arises from this string of events that affects the economy. But more tragic is the lack of accurate information about the triggering of economic recessions. A better understanding of the causes that triggered this atmosphere of confusion and uncertainty could be a real liberating solution.

The current crisis is clearly not a market failure as many economists rush to believe, but it is an error caused by the government's intervention through central banks. In this regard, we consider to be quite relevant Jesus Huerta de Soto's statement who claims that:

"Of course the spontaneous order of the unhampered market is not *responsible for the current situation. And one of the most typical consequences of every past crisis and of course of this current one, is how many people are blaming the market and firmly believing that the recession is a market failure that requires more government intervention. The market is a process that spontaneously reacts in the way we have seen against the monetary aggression of the bubble years, which consisted of a huge credit expansion that was not only allowed but even orchestrated and directed by Central Banks, which are the institutions truly responsible for all the economic sufferings from the crisis and recession that are affecting the world"*(Huerta de Soto, 2010b).

According to the Austrian economists, as the fundament for the initial phase of the cycle stands an increase in the volume of credit in economy. This generally occurs through an increase of prices and a decrease of interest rate below that level which would prevail in the absence of currency fluctuation (Rothbard, 2008). This extension of loans may be caused both by central bank intervention and by the fractional reserve system (Huerta de Soto, 2010a).

Broadly, the business cycle can be explained as follows (Rothbard, 1980): in a harmonious market economy appears an expansion of loans and money, encouraged and promoted by the government and its central bank. As the banks increase their money supply (currency or deposits) granting loans to companies, they push the interest rate below the "natural" rate of time preference, meaning under the rate of the free market that reflect the public willing proportions between consumption and investment.

The first visible effect is therefore a relative increase in the prices of all the materials required in production (the concept of relative increase in prices refers to the prices of production goods in terms of consumption goods). As the prices of production goods will grow increasingly more, the profitability of investments will tend to decrease. If credit expansion does not accelerate, the increase in the prices of production goods will catch up the consumption prices, causing a drastic decrease in profitability. The crisis is triggered when, at the existing prices, producers cannot sell their goods (Mises, 1978). This explanation can be applied to the current situation as well.

Therefore, the main causes of economic crises that are responsible for economic crises are ***artificial credit expansion*** and ***state's interventionism***. The current crisis has followed the same "pattern".

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