AICEI PROCEEDINGS

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Crisis Theory: What Do We Know? What Do We Need to Know?

Abstract

Today everyone is speaking about world economic crisis; however inaudibility takes place as soon as conversation drifts to plain reasons explanation of crisis, predictions and, most of all, results of it. Today are diverse ideas about recent economic crisis around the world, and particularly this paper endeavor to analyze as exactly as possible the ways of its development and its main consequences. The study is structured trough the following aspects: (a) what does theory foundations tell us about crisis? (b) What is the implication of “Reiganomics” and what 70s crisismean? (c) What consequences brought “Financial” capitalism? (d) What are the actual crisis development mechanisms? These aspects and elements are sustained by statistical graphs, from which we derive conclusions about implications of the economic crisis on world and European economy. The main findings are that crisis theory is based on two main statements. First of them was intensively developed by XIX century political economy within the limits of labor cost theory, according to which labor product is distributed irregularly between 2 production factors – labor and capital. World division of labor became second basic element in our system because of its important role in scientific and technological progress model, which was formed in the end of XVIII – beginning of XIX centuries and is distributed all over the world today. The fundamental peculiarity of this model is in fact that each another stage of scientific and technological progress is always supported by enhancement of labor division processes, which in its turn required increase of market channels volumes. Crisis of capitalism in 70s of XX century was caused by two reasons. Firstly, surplus capital utilization problem has arisen again by this time in connection with exhaustion of regions for capital export. Secondly, stoppage in market channels increase complicated significantly processes of STP[67] development. Therefore tough crisis was started, and it had not local, but system-wide character. Dollar default was announced by the USA in 1971, oil crisis was started in 1973. The same processes took place in USSR (they are now called as “slack”), and both of them must have looked for way out exactly in frames of capital efficiency increase problem, which must provide the next stage of STP. This problem had not been solved by USSR and this led to well-known results. And finally we found that the main consequence of “financial” capitalism system introduction was the fact that throughout several decades the American economy existed in the conditions of the constant overestimated demand. Over the 30 years of the existence of this system the performance indicators of the financial part of the economy have rise significantly, and the financial bubbles and structural disproportions have reached such a scale that the economy could not bear them anymore. This fact is expressed in many effects, for example in the fact that recently the market crediting rate stopped reacting on the changes in the discount rate. There are serious reasons to believe that the slack in the US economy began some time ago, but it would not be correct to call this slack a recession, as this word is usually used for the definition of cyclic processes in the economy and the contemporary depression has a strong structural character. It is already impossible to stop this crisis – as demand falling, either inflationary, or resource (refusal of emission) will proceed. Thus the scale of structural falling will make at least 25% of present gross national product of the USA (it is already scale of "Great" depression), and it will be followed by depressive falling volume of which can be estimated by Russian experience of the beginning of 90s and the USA beginning of 30s of the last century, which makes 30-40% from gross national product, but already reduced.

Keywords: *market, credit rate, USA, crises theory, economy*

1. Introduction

Today everyone is speaking about world economic crisis; however inaudibility takes place as soon as conversation drifts to plain reasons explanation of crisis, predictions and, most of all, results of it. At the same time, simultaneously with diverse ideas about recent economic crisis around the world, theory about this crisis had been developed by Russian economists O.V.Grigoriev, A.B.Kobyakov in 1997-2001. It is more or less fully stated in “The end of Dollar Empire and Pax Americana”, but this book was published in 2003, it is long enough since, and therefore we found appropriate to analyze as exactly as possible the ways of development of actual economic crisis and its main consequences. The proposed study is structured trough the following aspects: (a) what does theory foundations tell us about crisis? (b) What is the implication of “Reiganomics” and what 70s crisis mean? (c) What consequences brought “Financial” capitalism? (d) What are the actual crisis development mechanisms? These aspects and elements are sustained by statistical graphs, from which we derive conclusions about implications of the economic crisis on world and European economy.

2. Theory foundations

2.1. Labor and capital.

Crisis theory is based on two main statements. First of them was intensively developed by XIX century political economy within the limits of labor cost theory, according to which labor product is distributed irregularly between 2 production factors – labor and capital.

Capital, according to the fundamental principles of capitalism, considers labor product as its private property, and therefore labor owners don’t get for it appropriate remuneration. So, constant accelerated capital increase is immanent, inherent problem of capitalism.

Problem is in particular linked with capital existence not only in monetary, but also in assets form. Asset cost is usually defined by market desire to buy it, and through the chain of buying it will come to final customers or state demand. But both of them represent directly labor side in frames of production relations. So demand increase in terms of capitalism lags inevitably behind capital increase, which can devalue capital (without taking specific actions) in goods form or because of efficiency decrease. It is caused by decrease of demand growth volumes relative to capital increase, which leads to decrease of earnings volume to the unit of new capital. Figure 1 illustrates this thesis (because of proof given in XIX century).

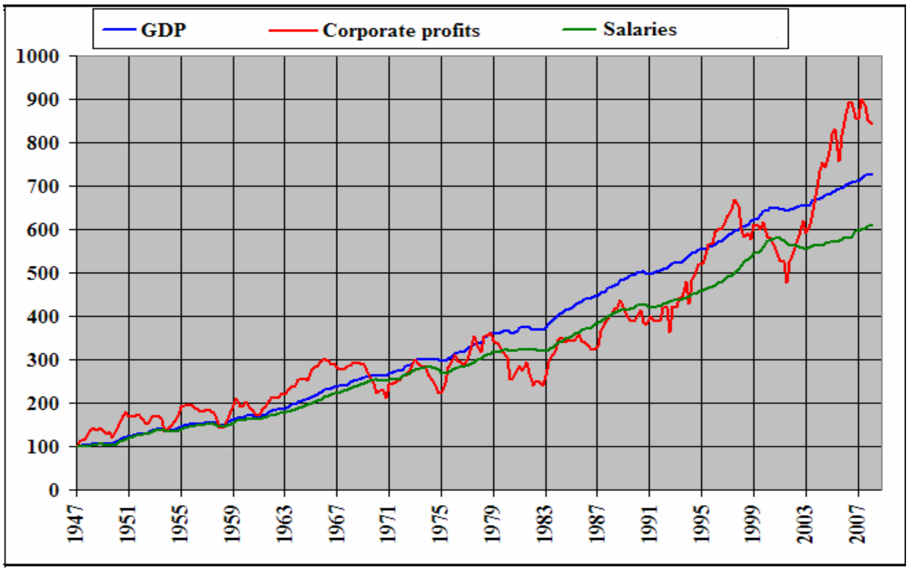

Fig.1. GDP and relative dynamics of Corporate profits and salaries for USA (nominal prices, 1947-2007)

This problem solving was always very important for capital and has been realized by three main methods during all the human history. First method arose in period of classical capitalism, during which crises of overproduction took place regularly. This method worked effectively but as world economyadvanced crises became more and more tough, so it was necessary to find something new.

Capital export to not mastered territories became the second method: respective policy derived name of imperialism in the end of XIX century. This method caused inevitably an intense competition not only for market channels of goods, but also for markets of capital export and was ended by I-st and then II-nd World War. Because of USSR and then socialism formation caused alert for all capitalistic system, it was necessary to create much more consequent policy. Finally capital export was institutionalized under Bretton-Woods agreements, which created as institutes, regulated this process (WTO, IMF and World Bank), as world finance regulation system on the base of American dollar, linked to the gold and controlled respectively by Federal Reserve System.

2.2. World division of labor.

World division of labor became second basic element in our system because of its important role in scientific and technological progress model, which was formed in the end of XVIII – beginning of XIX centuries and is distributed all over the world today. The fundamental peculiarity of this model is in fact that each another stage of scientific and technological progress is always supported by enhancement of labor division processes, which in its turn required increase of market channels volumes. Therefore development of each country on the way of scientific and technological progress in last 250 years required market channels extension, i.e. markets under its control (Gershuny 1993).

Quantity of technologically independent countries constantly reduced in last two centuries in connection with this fact. If in the middle of XIX century it was possible to find 10 really independent countries (with possibility to develop individually full spectrum of technological production), by the beginning of XX century we could talk about only 5 countries (Russian Empire, Germany, Austria-Hungary, France and Great Britain) and in the middle of XX century there were only two really independent countries in all world – the USA and USSR (Boettke 1999).

However political and social models in USSR and the USA were fundamentally different, scientific and technological processes developed there almost in parallel, and this fact confirmed identity of development and STP models. Both of them tried to rely on necessity to pay for the next STP stage by market channels extension, but their technologies of markets were absolutely different. At the same time process substance, STP financing, using load on customers as in the USA or using centralized social funds redistribution as in USSR, was unaffected.

But these two world economic leaders must have met real difficulties with next STP stage financing by the last quarter of XX century in view of rapid development of science and technique.

2. 70s crisis and "Reiganomics".

Crisis of capitalism in 70s of XX century was caused, in the context of above mentioned circumstances and considerations, by two reasons. Firstly, surplus capital utilization problem has arisen again by this time in connection with exhaustion of regions for capital export. Secondly, stoppage in market channels increase complicated significantly processes of STP development (Conaghan, Fischl and Klare 2002). It was impossible to admit tough crises of overproduction or war in the terms of socialistic world system, so capital efficiency started its decrease. This fact has been just reflected on the customers (we can see this on Figure 2, where average salary in the USA since 1950 is shown). It is important to note, that data for the last 10 years must be valuated critically because of significant understating of official inflation indicators in comparison with real indicators.

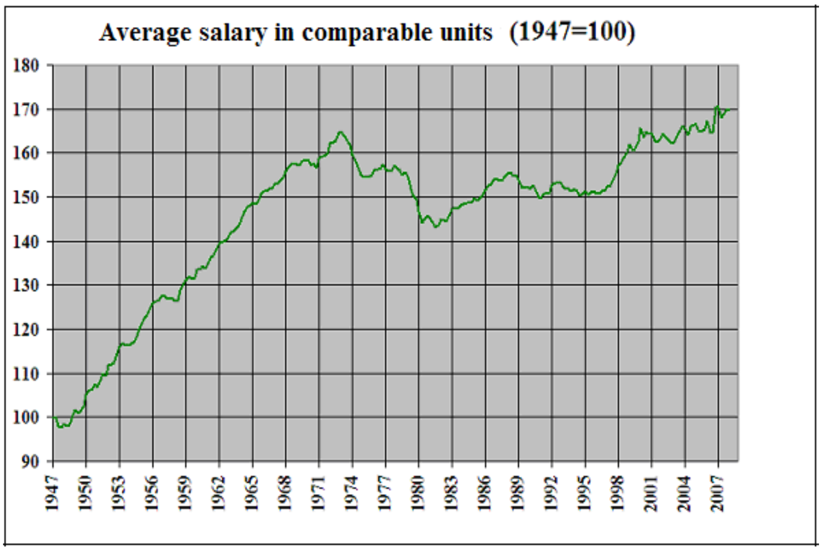

Fig. 2. USA average salary in comparable units

herefore tough crisis was started, and it had not local, but system-wide character. Dollar default was announced by the USA in 1971, oil crisis was started in 1973. The same processes took place in USSR (they are now called as “slack”), and both of them must have looked for way out exactly in frames of capital efficiency increase problem, which must provide the next stage of STP (Boettke 1999). This problem had not been solved by USSR and this led to well-known results.

Depression (i.e. production decrease) and high level of inflation (i.e. stagflation), combination of which was impossible in terms of classical capitalistic economy, became the most important part of this crisis (see Figure 3). It was concerned with necessity of the USA obligation to continue STP race with socialistic system and so to finance by all means innovation processes.

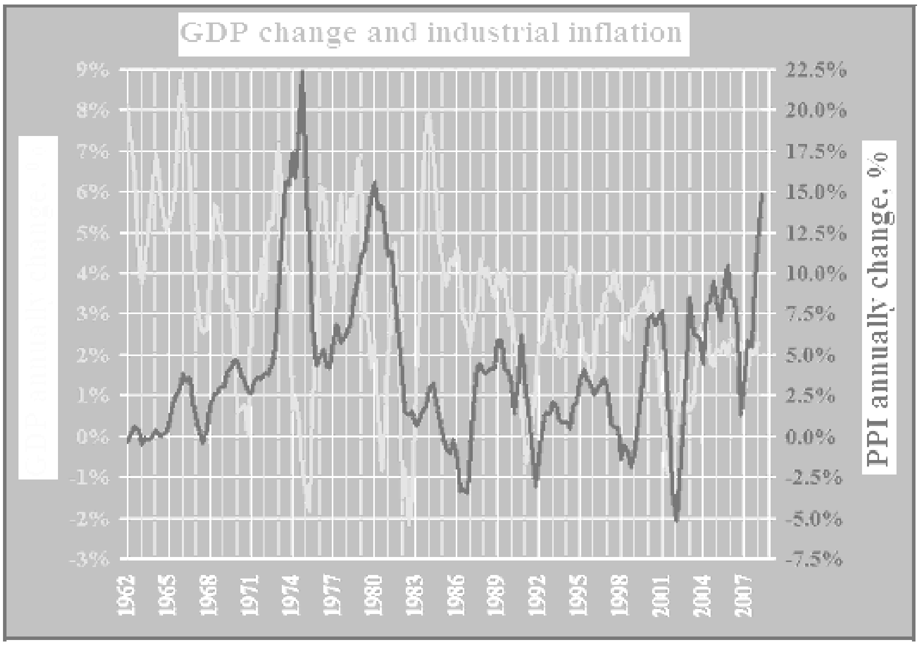

Fig.3. GDP change and industrial inflation in USA

This problem decision had been found by the end of 70s and concerned with the names of head of FRS of that time Paul Walker and councilors group of American president J. Carter. The decision was in paradoxical conclusion: not to decrease monetary “pumping” using emission dollars, but to increase it (Robertson 2000). However to direct it not to the capital support (for this purpose private central bank - FRS – was created in 1913), but to straight final demand stimulation (not only state, but also private). This decision in view of above mentioned labor division mechanisms can be described as following: it is important to increase each market participants' consumption, if market channels extension is impossible.

This plan realization certainly could let us make another stage of STP. But it was necessary to solve several concurrent problems for it: firstly, to decrease considerably inflation in consumption sector, because of increase absence for this sector otherwise (customers' expenses increase would have been compensated by prices increase); secondly, it was obligatory to provide customers' expenses direction to the hi-tech sector, because of its great importance for tight race with USSR; thirdly, it was very important to provide mechanism of investment process stimulation because of redundant liquidity entry to the market (in other words customers' money were mostly directed to development, not to financial speculations) (Granick 2002). And all of these 3 problems have been solved. Inflation was beat by unique in history credit cost growth. Interest rate was increased to 20% (see Figure 4); this fact changed fundamentally economical situation in USA, and strengthened considerably dollar positions at World market (these positions had been strongly weakened by 1971 default). Moreover redundant liquidity was "utilized" using financial bubbles distension, i.e. rapid financial assets share increase. For this reason, the share of profit of the American corporations received for the account of financial sector, began to grow since 80s of the last century sharply (see Figure 5).

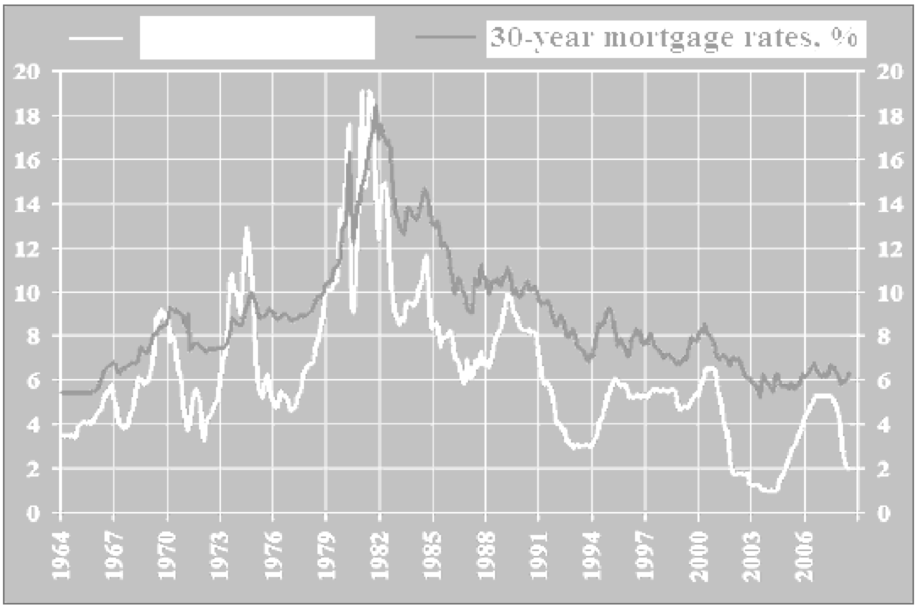

Fig. 4. Interest rate and 30-year mortgage rates for USA

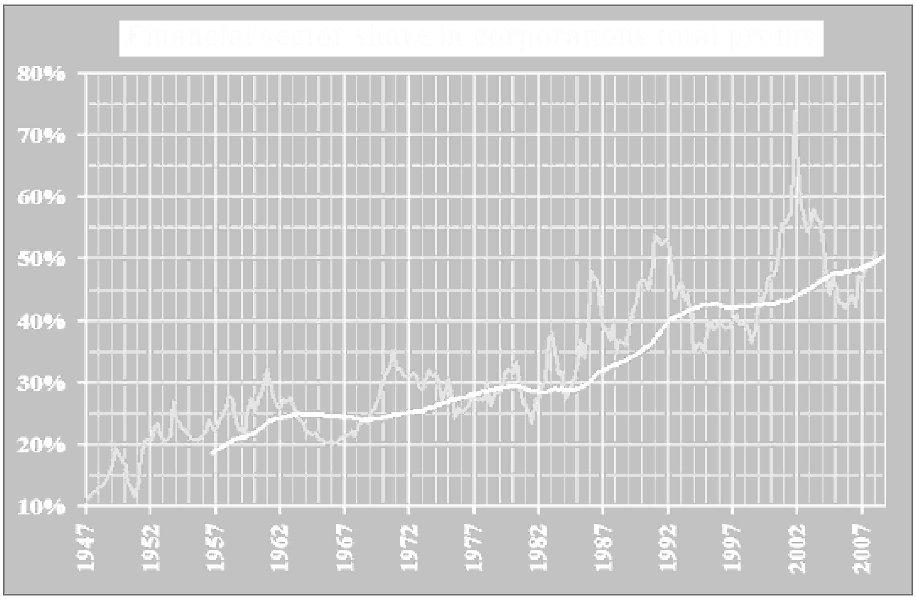

Fig.5. Financial sector share in total corporation profits in USA

For this reason, «reiganomics» has led to essential transformation of world capitalistic system, its transition in the third stage after the classical period and imperialism – stages of financial capitalism. But, as it is clear, the increase in a share of financial actives inevitably demanded increase in the credit multiplier that is the relation of wide monetary weight, for the USA – M3, to narrow monetary weight, cash, unit M1. Corresponding process is well visible on Figure 6. We pay attention to recession on the graph in 90s, connected with "development" of the resources arriving, basically, from territory of the former USSR.

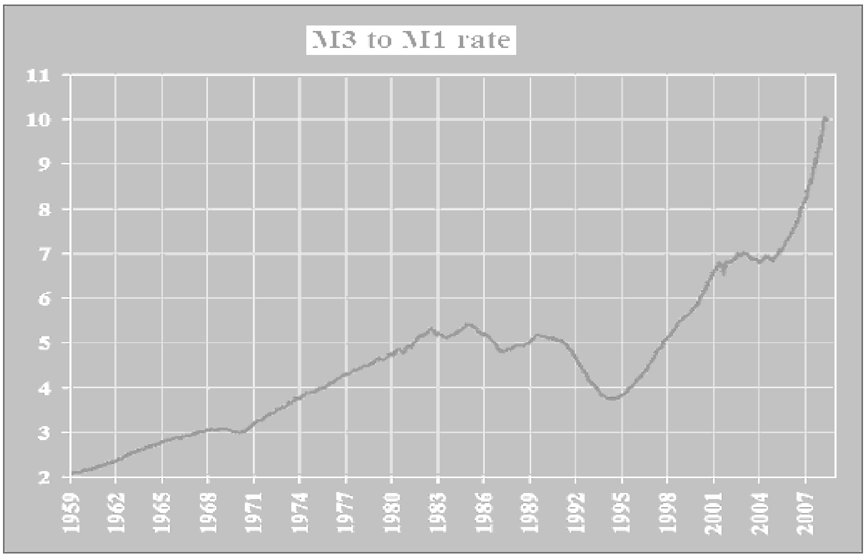

Fig. 6. Monetary multiplier in USA

Let's notice that corresponding "bubbles" regularly burst (the share market in 1987, the market of dotcoms in 2000), however till some moment this process was under the control, in particular, inflation grew in a commodity part of a consumption sector rather poorly.

Direction of consumers' expenses has been provided with the massed propagation, having provided unprecedented increase of those sectors of economy which have been connected with an information technology from the beginning of 80s. Besides, additional resources on purchase of the highly technological results of a domestic production have been received using an export manufacture of the consumer goods in the countries of the "third" world (Gïsta 2000).

As to the third problem it has been solved just because of fact that in the early 90s the discount rate has been tired out on inaccessible height. As it is well visible on Figure 4, from the beginning 80s rate, gradually falling, the monetary policy was softened and this stimulated the credit offer. We must notice that it also facilitated increase in the monetary multiplier that provided use of financial sector of economy as "sponge" which accumulated redundant liquidity, without starting up it in a consumption sector.

Thus, in the mid-term period necessary problems have been solved. Certainly, on a long-term interval problems of the hypertrophied growth of financial sector should affect (there are evident proof of this fact today), but at that moment problems facing to capitalism have been solved and even there was a destruction of world system of a socialism. Must be noticed, that if resources which have been “extorted" from its territory, would have been directed on repayment of debts created in frames of reiganomics, it is not excluded that its negative consequences would have been compensated. But the system of income reception from emission by the largest banks was so nice, and their role in a state policy was so great (we will remind that traditionally a position of the secretary of exchequer, i.e. the Minister of Finance and the main councilors of the White house in USA is occupied just with representatives of bank community, not to mention Federal Reserve System management), that it was impossible to refuse from it.

3. “Financial” capitalism consequences.

The main consequence of this system introduction was the fact that throughout several decades the American economy existed in the conditions of the constant overestimated demand. It could not create under itself corresponding system of manufacture of the blessings requested by the consumers, both material and services. In the frame of this paper has carried out calculation of the American economy according to intersectoral balance which purpose was to find the sectors of the American economy receiving "additional" (not having source within the limits of intersectoral resources turnover) source. The calculations have been made for 1998 year. It was revealed that sector of "new" economy, in which the branches connected with informational economy have been included, and also wholesale and retail trade, occupying approximately 25% of economy of the USA on consumed resources, "gives out" back into economy about 15%. It is clear that the structure of economy of the USA should be changed since then, however "the warp" shared problem remained: the essential part of USA economy exists only so far as there is a noneconomical, issue stimulation of demand. To see it is possible on many indicators which for example may be seen on Figure 7.

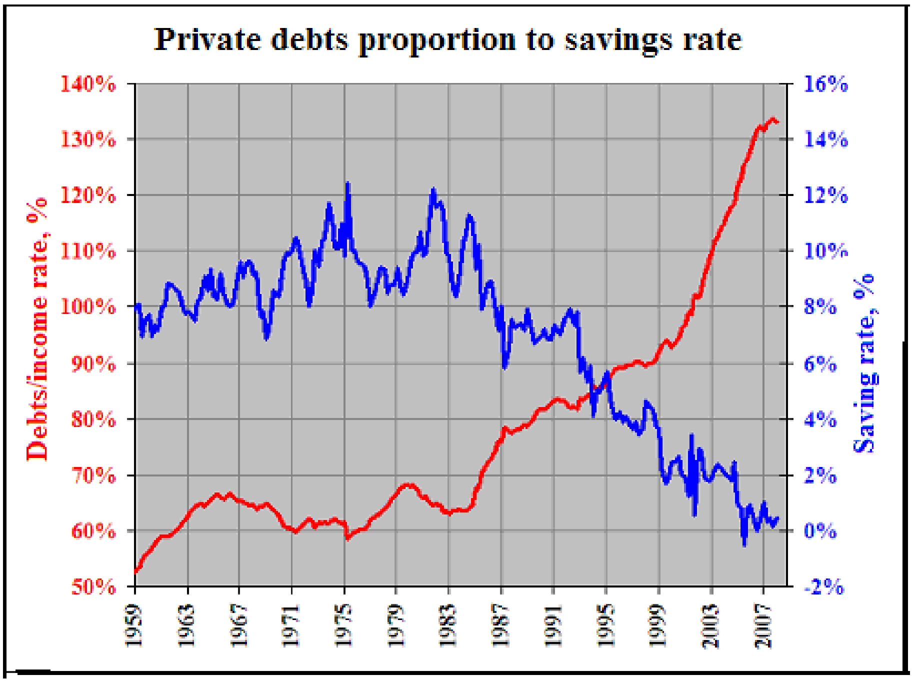

Fig.7. Private American debts proportion to their real disposable income and savings rate

As is well visible, the situation in the American economy began very strikingly in the early 80s of the last century. But the main indicator of structural crisis of the USA economy is shown in the Figure 8.

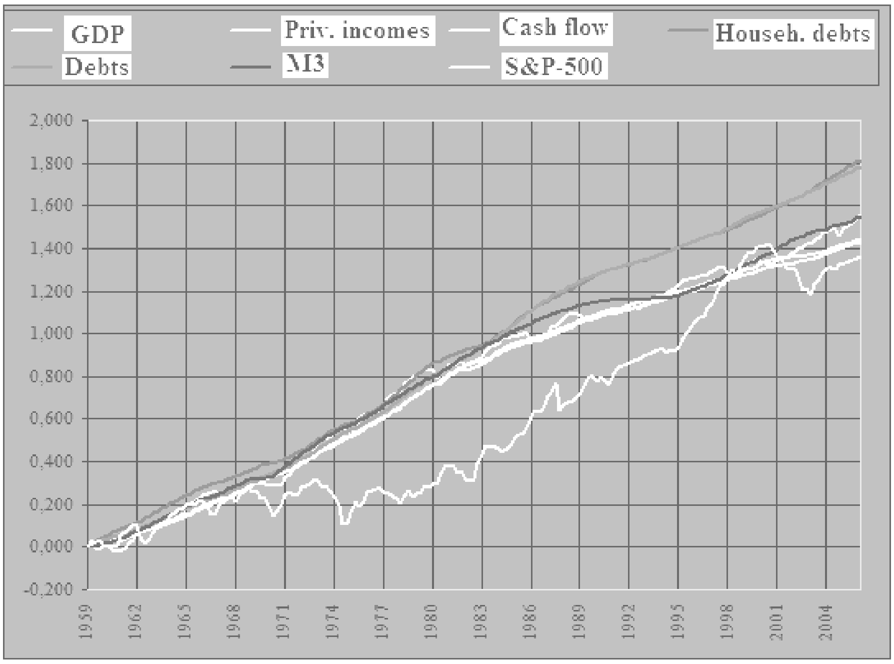

Fig. 8. Main financial indicators of USA economy dynamics for 1959-2006 period with logarithmic scale, without hedonistic indices influence

Financial indicators should grow in any normal economy equally – as was observed in the USA economy prior to the beginning of 80s. And then indices have been divided into two groups, which started to separate from each other with linear speed on the graph with a logarithmic scale, i.e. with exponential speed in practice. The economy with such parameters cannot exist for a long – as it demands constant additional resources on rupture "covering".

We will notice that after 2000, when the positive effect of the markets expansion on territory of the former socialistic Commonwealth, apparently, has come to the end and there was a crisis in the share markets, one of two clusters on the graph was again divided. Most likely, it is connected by the fact, that USA have begun non-market support of separate sectors of the households, directly, passing a consumption sector.

It is simple enough to estimate scale of such support. If we would take a situation of 1998, rupture, as we saw, made at least 10 % from gross national product of the USA, that is, for that period, about 800 billion dollars per year. If we would add growth of state expenses, and also consider all other effects it will be necessary to multiple this figure by about 1.5-2. Thus, the monthly resource thrown to the American economy should make for this period of 1.3-1.6 billion dollars per year or 110-140 billion per month. As this throw occurs in the USA on the debt mechanism, it should be clearly visible on graphs of a cumulative debt of subjects of the American economy; debts of households and the federal government of the USA (see Figure 9).

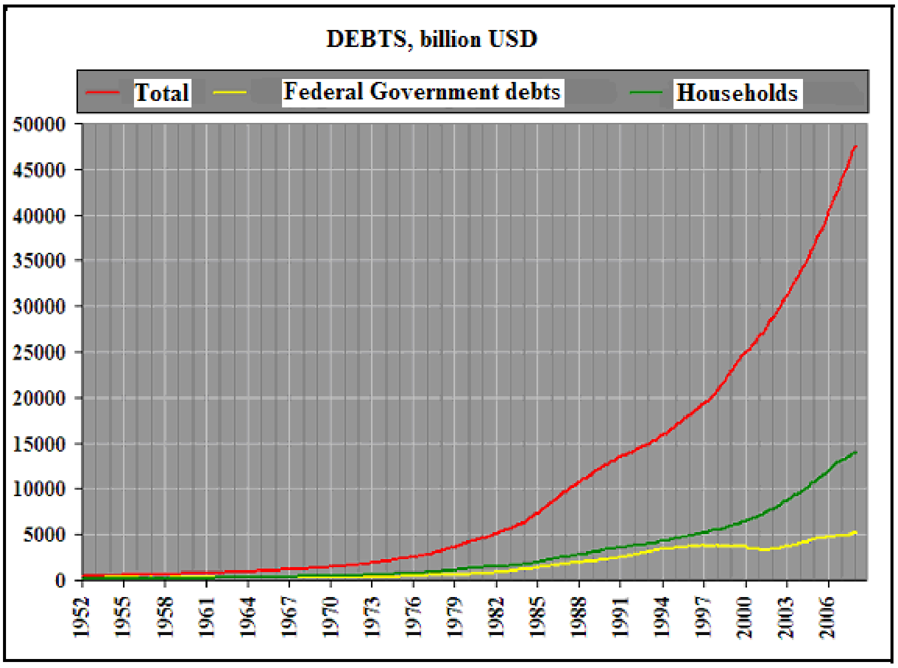

Fig. 9. Federal Government, households' debts and total debt of American economy

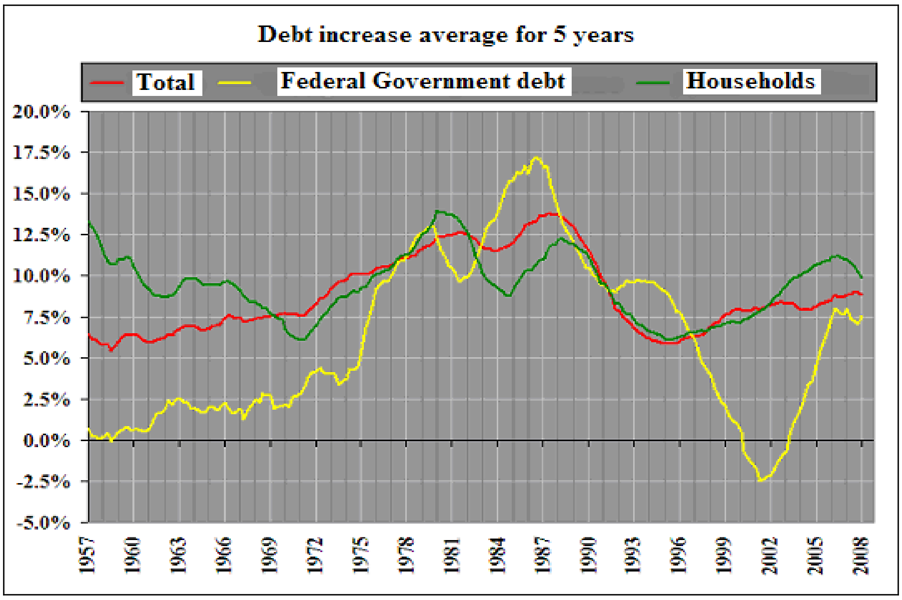

Fig. 10. Debt increase, averaged for 5 years

It is shown that the order of debt loading growth approximately corresponds to the specified figures received according to intersectoral balance, thus we have received the additional proof of structural crisis of USA – rates of increase of a debt steadily exceed rates of the American economy increase. Certainly, using the graph analysis it is necessary to consider that at the first stage the effect of depreciation of the credit was significantly more important, than growth of a cumulative debt.

To note also that since then the economy of USA has grown at least in 1.5 times, so today it is necessary to invest billion of dollars per month to maintain system in rather stable condition.

5. Crisis development mechanisms.

What consequences may the fact that 10 % of the economy function only due to emission bring? In case of ceasing the emission, no matter if it is objective or has a special purpose, this part of economy will no more exist. But not only this. Because of the course of intersectoral balance this part transfers its extra resource to other sectors of the economy, which should also vanish in such situation. Their size can be evaluated using a coefficient which changes depending on the type of economy and in our case it is around 2,5. So, a significant part of the American economy, not less than

25% according to optimistic estimates and around 35% to pessimistic, exists solely due to the fact that there is an emission cash flow to support it.
Over the 30 years of the existence of this system the performance indictors of the financial part of the economy have rise significantly, and the financial bubbles and structural disproportions have reached such a scale that the economy could not bear them any more. This fact is expressed in many effects, for example in the fact that recently the market crediting rate stopped reacting on the changes in the discount rate (see Figure 4). There are serious reasons to believe that the slack in the US economy began some time ago, but it would not be correct to call this slack a recession, as this word is usually used for the definition of cyclic processes in the economy and the contemporary depression has a strong structural character.
But the main thing is that the inflation started growing rapidly including the consumer sector. The official figures are not quite illustrative here as the inflation in the US is lowered significantly both by manipulating the basis for it and by introducing financial "innovations" (hedonistic indexes), and this can be clearly seen from Figure 11. The real year end figures of the inflation rate are not less than 15%.

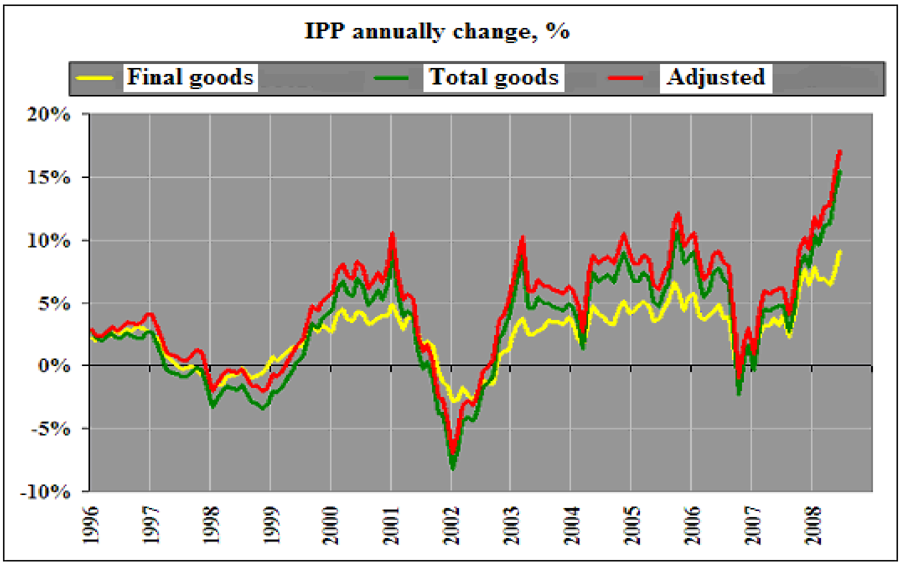

Fig. 11. Industrial inflation in USA

Such situation automatically cuts the real consumption in the US for the same 15% as a minimum, which stands for the 10% decrease in GDP (taking into account the fact that around 70% of the US GDP is formed by consumer demand and consumption). And such a fall will continue as long as the emission increase rates will be greater than the economy growth rates, up to the date when the “unnecessary” part of the US economy will be eliminated. And the emission, which is the reason for the inflation, is also impossible to stop as it will lead to immediate death of the corresponding part of the economy.

Attempts to struggle with inflation in style of Paul Walker, i.e. using discount rate increase, are also doomed to accident as in terms of overheated financial part of economy and debt crisis, it will almost immediately lead to repetition of the 1929 scenario. There where premises to think that this crisis will be much stronger in comparison with that because in the middle of XX century there were not structural warps in American economy, and now rapid destruction of the structural "outgrowth", which scale would vary from 25% on optimistic to 35% on pessimistic estimations, will precede to similar on scale depressive falling (see Figure 12).

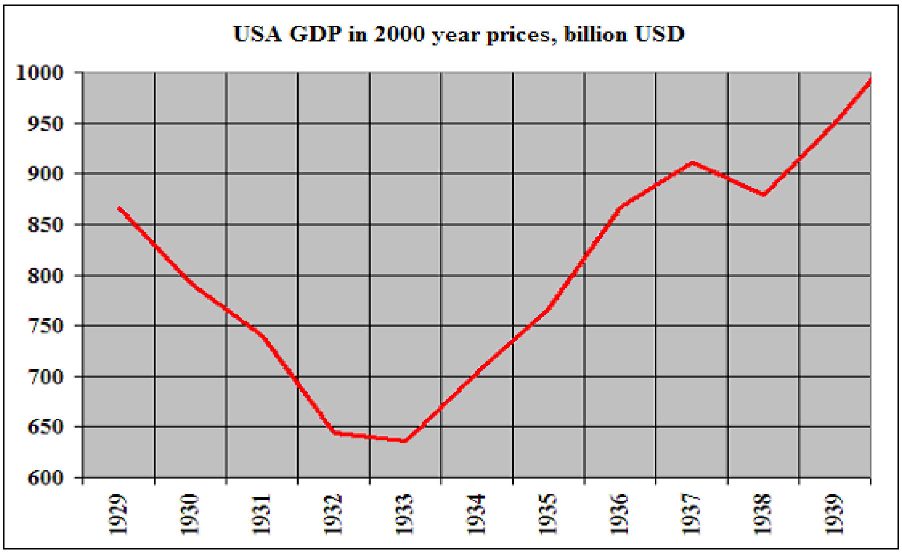

Fig.12. USA GDP in “great” depression period

Let's notice that consumers’ demand observation allows stating an independent estimation of falling of USA gross national product following the results of the first, tough part of crisis. For this purpose it is necessary to estimate annual growth of a cumulative debt of households (10% from 14 trillion, which is about 1.5 trillion dollars) and to add to them part of demand falling which will occur because of growth of savings. Today their level is about 0, and historical average value makes about 10% (actually, in the conditions of crisis this indicator will be even above), please see Figure 7, that is still at least 0.8-0.9 billion per year (the tenth part of 70 % of real gross national product of USA equal approximately to 12 trillion of dollars). Thus, even without falling of real demand from outside budgets of all levels which are also exposed to inflationary pressure, cumulative reduction of annual demand should make at least 2.1-2.3 trillion dollars or approximately 15% from gross national product of USA. If to apply to this value the same multiplier 2.5, we will receive figure on the scale of top border of the range defined above at the rate of intersectoral balance. As at our calculations we used the balance for 1998, it is possible to assume that this growth is caused by deepening of structural crisis over the last 10 years. We deliberately did not add the effects connected with budgetary consumption to an estimation of potential falling of cumulative demand because compensated by this part of a consumers' demand which goes on purchase of the import goods for USA. However, all these specifications influence rather limitedly on the final result.

This paper shows that it was impossible to stop this crisis – as demand falling, either inflationary, or resource (refusal of emission) proceed. Thus there is sufficient space to estimate a scale of structural falling of about 25% of present gross national product of USA (it is already scale of "Great" depression), that may be followed by depressive falling volume, that can be estimated by Russian experience of the beginning of 90s and USA beginning of last century 30s, which makes 30-40% from gross national product, but already reduced.

6. Conclusion

As we can see, the fundamental problem of the American economy is presence of a "redundant" part, which «outgrew» for last 30 years due to constant and all time increasing emission stimulation of a consumers' demand. Today USA faces serious difficulties to finance this part of economy, but it is also impossible to "close" it because it became too great. Today the situation is very clear, the crisis and its impact have been recognized and counter-recessionary policies have been started. There is no 'commonly accepted theory of financial crisis' to provide fail-proof advice on the correct policies that each particular country should adopt in the wake of the crisis (Jonung 2008: 566). However, from past experiences of financial crises and given the analysis of the origin and likely impacts of the current crisis, the likely responses required in USA and every European country would need to include immediate, short-term (stabilization) and long-term (structural) policy responses.

It is desirable that countries coordinate these where possible. Indeed, an area where much future research is now needed is on the implications of the financial crisis for greater global coordination of responses. This is not only hugely important for USA but for European countries as well. Areas for greater coordination in the latter include, for instance, coordination in bailouts to avoid a 'race to the bottom', as different countries all rush in to provide subsidies to their different ailing industries, as well as for better coordination of the responses of central banks[68]. A more inclusive international system for governance of the global financial architecture is a prerequisite for any progress in reform. Finally, there are widespread calls for the reform of the Bretton Woods Institutions, the IMF and World Bank. These institutions have been largely marginally in the response to the financial crisis, despite the fact that this was what they were initially designed to prevent and cure (James 2009). One reason is the lack of sufficient funding—the IMF, for instance, does not have the resources to bail out the US. Another is IMF conditionality, a reason why many developing countries have been self-insuring against balance-of-payments problems by accumulating such massive foreign exchange reserves since the 1998 Asian crisis. The epicenter of the financial crisis is in the US and EU, and this is also where the most substantial economic slowdown will be experienced. Many studies suggest a more optimistic prognosis of the current situation, stating that it is unlikely to turn out to be a crisis of the same magnitude as the great depression. Indeed, the US and EU countries have introduced—and will continue introduce—appropriate countercyclical policies that will in all likelihood reverse further declines in stock and housing prices, and that will boost investment and growth. In any event, honestly, there is very important to recognize that it is absolutely impossible in view of purely political reasons as such scale of falling of the

[68] As James (2009: 2) remarks, "the failure to find a supranational mechanism for dealing with Europe's large and internationally active banks is rapidly developing into the Achilles' heel of the continent's ambiyious project to build a monetary union. The European Union's governing bodies can only leave bank bailouts and their fiscal implications to national authorities".

largest economy in the world makes absolutely impossible for USA to keep not just the role of the unique world leader, but also continuation of existence of a world financial system on the basis of dollar and the American banks.

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