

## **How Did We Get to the Deficit Spectrum of the Economic Crisis?**

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### **ABSTRACT**

The economies of developed countries of the 21<sup>st</sup> century benefit from the unseen-till-now prosperity; life standard that suffered a hard landing starting with 2007 and that seems to evolve in a chain-saw model for the crisis development. The forecast is based on the “first in, last out” principle; first in – the US, last out – the emergent countries that are under the contagion process and under inefficient governance and which started as a subprime crisis and continues as a deficit crisis. These nations produced one of the highest life standards in history. How was this possible? It is believed that the origin of this prosperity (before and after the crisis) is in the development of an economic system that embraces the free enterprise, capitalism and competition because prosperity represents is the crossroad between the self interests of many.

This research paper tries to underline the factors that led to the actual development of the crisis; from the bankruptcy of Lehman Brothers to the unstable and not well directed actions of governments around the world and to these first tier layers there are added the second tier layers that include the political vantage point that influences the paths that are followed for limiting the negative aspects of the economic crisis and to improve new opportunities that appear as a result of openness and collaboration. The muddling through principle was adopted by the Obama Administration and this fact is one of the main factors that ease the deployment of near future economic improvement for the United States, but for the long run this isn't a solution to develop a healthy economy and create sustainable economic growth.

**Keywords:** Capitalism, deficit crisis, economic crisis, global synchronism, PIIGSB

**JEL codes:** E32, E63, O16, O47, P12

## 1.Introduction

The free enterprise brings to the economic systems from developed countries the “energy” developed through competition, in those countries we have individuals with creative minds that will want to follow their own interests, and the stable development will be done only under soft regulations. Adam Smith wrote in 1776 the fact that there is a “self-interest invisible hand” that moves to create an environment for the “group interest” when each of us acts to maximize their own interest (Smith, 1994: pp. 207-213). The first step in the amazing journey of economic development was creating the “higher good” that represents sustainable economic growth through multi-lateral progress of all components of the Economic Game and that would be created or used by each of us only through maximizing self interest. Sometimes this idea is counter intuitive on some aspects; the idea still stands as a revelation after 236 years from its creation.

The concept of efficiency of the invisible hand led to the logic of a secondary notion, the one that underlines the fact that individuals follow their own interests and in some points they intersect, and these intersections have as a result the natural state of competition. Specific for the business environment is to sustain competition the framework of raw materials, labor, clients and investment capital. This competitive environment stresses the idea of “survival of the fittest” that empowers the idea that through time it destroys weak competitors and promotes the survival of the successful ones. While some people are afraid of stopping the evolution by the weak ones, this is, actually, the energizer of the enterprise and competition. The third aspect of our economic system is the development of modern capitalism, in which investor’s capital can be cumulated to create large amounts of investment capital that is needed to finance extensive projects and large enterprises. It is an axiom that sums up the idea: the greater the freedom of corporate enterprises in looking for bigger profits the bigger the attraction for individual and institutional investors that can bring to the table the needed capital. The three milestones of the global economic system where, are and will be: the enterprise, competition and capitalism.

Through these ideas we can see that the final purpose of this research paper is give an objective big picture on the development of the crisis and the actual state of the global economy, by putting together the main areas that influence the economic entanglement: politics, social, globalization and leadership, but the path is paved with the relation that was presented earlier in this paper, the idea of intersection between the self interest of many, that intersection is the place where we can find the spark that creates the economic advance for sustainable growth. In the end the result is the information offered by the actual economic results that is interpreted through the classic economics perspective.

As a competitive advantage of this paper is the fact that it uses as work and development instruments the merging of multiple sectors data aggregators, from the financial and economic data offered by Bloomberg Professional, the risk management and policy forecast data offered by Hoisington Asset Management Database, the technical and fundamental analysis on the New York Stock Exchange and its leading indicator, the Dow Jones Industrial Average (DJIA) from Zacks Investment and the political and policy lobbying “in action” know how from the White-House data portal ([www.whitehouse.gov](http://www.whitehouse.gov)). The result is a 360 degree review of the year 2011 based on all economic components, from the policy makers, political issuers, banking sector and the population and the “walk on wire approach” for the near future and the global formal and informal result that will influence the population (the policy receivers) that could give a negative feedback (from protests to violent revolutions), which can lead to a fringe effect in the development of the global economy seen from the abstract perspective.

## **2. The Crisis Evolution and the after Shock Wave**

October 2008 represented the starting point of the freefall of the United States of America and, through the global interconnectivity, of the entire global economy. During the history of economic crises the following types were seen: crises of the stock market, credit crises, real estate crises and crises of direct inventory adjustment. From the Great Depression till today there weren't any periods when all these syncope of the market appeared at the same time. Although these crises typologies have as foundation different components of the economy that haven't functioned properly or have been influenced by information asymmetry, in the Great Recession we had different types of crises, but they all had the same foundation: excessive borrowing that led to the real estate bubble. These types of bubbles aren't new for the economic environment, but the regulation path of the financial markets led to the chronic illness of the economic system under the general stress of the crisis. Deregulation of financial markets led to the accelerated growth of the speculative bubble that was underlined by the way of not to intervene direct and exactly in the market.

The initial measures taken to stop the avalanche created by the systemic failure should have been initiated in August 2007. August was the month with the first signal of the systemic risk: interbank interest rates peaked highest for that period and the interest rates for the government hit the lowest point ever. In financial terms this interest rate for government' actions offered by banks are called T-bills. In everyday situations the interest rates are usually constant, the creation of big gaps between interest rates stress the fact that banks didn't trust each other. Here the information asymmetry of the banking system versus the rest of the world intervened (the population versus the US Government): banks had known the real situation of inefficient credit. The adjustment of the real estate sector under its mortgages, were a risk factor that looked bad in the balance sheets of banks. The economy started to slow down, fact that can be seen through the business cycle theory, explained on the short, medium or long

term. This way the first defaults appeared on real estate credit payments, a normal fact if it were to be in normal standards, and not the new standard to be the default of real estate credits. Covering overdrafts followed the failure of real estate credits. This syncope started to be the rule of the market and it drove to the hard landing of real estate prices, a landing that could be considered normal in a moment of negative cyclicity of the economy (Marin, 2010). Consumption took a negative slope and this fact led to the bankruptcy of companies that were credited by banks, this way they raised the default risk of the entire economy.

Another, voluntarily or involuntarily, partner of the information asymmetry was the president of the U.S.A. at that moment, George Walker Bush, that in the monthly brief "State of the Nation" sustained the idea of the existence of some small syncope of the economic engine, but without repercussions on the long term. In his next address on the state of the nation, Bush Jr. underlined the fact that there were some small syncope, but that there will be solved. In December 2007 he underlined the fact that there are some consistent problems in the economic framework, but the powerful foundation of the American economy will help to get over this general syncope in a linear way.

The normal stage implemented by the American government was the one to re-launch consumption, which would be a high efficiency model if it would be used in an economy that is on a negative trend, which is resulted from the economic cycle. The information asymmetry can be considered as being created by the FED and the Bush Jr. administration through the short sighted vision and not observing the economic syncope, that evolved into crises. By releasing the fiscal pressure, a pressure that was summed up to 168 billion U.S. dollars. As a component of the solution created for solving the problem was the "eased" take-over of Bear Stearns by J.P. Morgan Chase, but the rupture in the asymmetric phenomenon was represented by the bankruptcy of Lehman Brothers. Their bankruptcy underlined the fact that the U.S. entered the recession and it was followed through the global interconnectivity by the entire world. The year 2008 erased 1.8 million jobs and underlined the incapacity to get a part time job by 6.1 million Americans (Bloomberg Professional). In the first 9 months of 2008 DJIA (Dow Jones Industrial Average) lost 24% of its value. The fact that the American economy is not on the right track is the period July – August 2011, DJIA suffered a correction of 26% (Bodislav, 2011b). The American government focused on stimulating consumption and helping banks to restart credit (and to have as a 2<sup>nd</sup> round effect the built up of the consumption). After the bankruptcy of Lehman Brothers, the nationalization of Fannie Mae and Freddie Mac and the first bailout, of AIG, there was conceived a plan for a general bailout: "Trouble Asset Relief Program" (TARP). The initial 700 billion U.S. dollars reached the point of 1 trillion U.S. dollars at the end of 2010, without considering QE (quantitative easing) 1, 2, Lite and the future QE 3 (Bodislav, 2011a: pp. 67 -72). On QE 3 we can add the fact that on the Jackson Hole meeting from 25<sup>th</sup>-26<sup>th</sup> of August 2011, Ben Bernanke didn't released a clear statement on when QE 3 will start, in this way creating uncertainty in the global markets, but this way he created extra pressure on the stock market and increased the price of the "war-metal". "War-metal" is the author's description for gold because it's main characteristic: it grows only in time of uncertainty, economic crisis, war

and general information asymmetry. It can be added the fact that Bernanke's speech from 25<sup>th</sup> of August is helping the American economy to grow the value of their 8965.6 tons of gold (Fort Knox – Bloomberg Professional).

If we consider these programs and the evolution of the rating of the U.S. economy the real costs only through fiscal and credit policies will peak at 3 – 3.5 trillion U.S. dollars and here not considering the fact that Standard & Poor's reduced U.S.A.'s rating from AAA to AA, with negative development and have as direct consequences the fact that U.S.' interbank interest rate should rocket from near 0% (0.25%) to near 3 – 3.25% (history has a bad habit to repeat its self), but the Fed announced at the beginning of August 2011 that they'll pin down the monetary policy interest rate to 0-0.25% until the first quarter of 2014. This way only on the actual debt that is owed to the American people, of almost 10 trillion the cost of interest rate will grow from 50 billion/year to 300 billion/year (Bodislav, 2011b). In the worst case scenario it looked like 1979 all over again, when the American economy was in the same situation as in August 1<sup>st</sup> 2011 to default because their political parties cannot agree on how much should be the tax cuts (~2.4 trillion U.S. dollars in 4 months in theory and 10 years in deployment) and the stock of money (actually, debt!) should be increased with at least 2.1 trillion U.S. dollars, with 400 billion U.S. dollars printed right away (Bloomberg Professional).

For not to create inflation pressure through a QE Lite 2.0, the Fed chose to do an Operation Twist for refinancing the 400 billion U.S. dollars that have their maturity at the end of September, by financing an obligatory component (bonds) that is due to maturity on the short term in amount of 1.67 trillion U.S. dollars and replacing it with a long term one, having as consequence the fact that they covered their needed 400 billion U.S. dollars and lowered on the short term the rate of coupons, but with its price by lowering their rating in the next 6 months (Bodislav, 2011b).

### **3. The Non-sense Politics or the Pseudo Global Salvation**

Another action taken by the FED was to maintain and to decrease the basic interest rate. At that moment one fact was obvious: the Great Recession was installed. The impotent politics for monetary efficiency was underlined by John Maynard Keynes, but he adopted work scenarios that have longer terms for forecasting than the economic vision of Alan Greenspan and his predecessor, Ben Bernanke (Roubini and Mihm, 2010). When sales are on a descending trend, the lowering of interest rate from 2% to 1% wouldn't grow productivity and create new production facilities. Production capacity transforms into a liability when it isn't used. The instability framework was stressed by the election' exam: the battle between Barack Obama and John McCain. The American political model is in a super-flow state, like the evolution on medium term of the economic situation. The political speech, on the economic sector, of McCain and Obama had **three common points**: lowering the inefficient mortgages, the economic stimulus and resurrecting the banking system, but the implementation model that would have been used was diametrical opposite between the two candidates. McCain proposed

fiscal easing to encourage consumption, while Obama proposed increasing government spending, especially on “green” investment to stimulate the economy. McCain wanted that the government should buy-out the underperforming mortgages. Their speeches had a mainstream tendency to see the economy: they presented the problems, but without really stressing the threats for the American people and the global economy (Stiglitz, 2010: pp. 72-77).

After the election of Obama he chose to use a conservatory strategy, the “muddling through” strategy; that it could be understood as the concept of bullet-proof transition through trenches.

#### **4. The Global Economic Action**

The world was divided into two: the one before and the one after the bankruptcy of Lehman Brothers. Although the credit problem was observed with 6 months before the bankruptcy of Lehman Brothers, “the Evil” was seen after the bankruptcy. The higher cost of credit, the decline of the market, companies that tried to remain in flow state, not in stock state (in Physics there is the flow principle: all that is in flow state can evolve. Any flow syncope and transformation in stock results, on the long term, to the death of the entire system) led to the freefall of the American GDP, fact that hit all countries that depended on investment and long life span goods, development spending being postponed.

The unemployment rate started to create pressure through the rising social cost that is created by it, but this is part of the system only for a short period of time, because the ones that are off the unemployment grid they still exist, but they created labor stock. The number of unemployed from the public framework rose because of the fall of revenue receipts. Banks blocked credits, but their profits remained for a short period the same like in the “good old days”, but it was founded on speculative investment. It was and is hoped that through a low interest rate, banks will relax the model for offering credit and will offer larger amounts of money than they borrowed, a model based on real speculative movement being encouraged, the created profit should have been enough to cover the losses in underperforming credits. After this superficial recapitalization the real problem appeared: the loans were 30 times more than the value of assets, this model being founded on the re-mortgaging houses with no real economic foundation, this meant that a decreasing of the loan grade equaled a depreciation of the real value of mortgages, and a lower value for mortgages was seen as a negative component in banks’ balance sheets, this way the bank’s rating will be demoted, resulting on the long run that the bank will have to borrow from the interbank market at higher interest rates and costs, that will lower the profit’ margin.

**The global synchronism** led after the moment T (the moment when the legal bankruptcy of Lehman Brothers was settled) to the moment T+1 at the export inefficiency, the crisis deployed globally, fact that lowered the global demand for American products, and the inefficiency of one of their most important leverages – exports.

The lessons brought by Franklin Delano Roosevelt's New Deal molded the framework for a sustainable economic development of the American economy for almost 60 years. Initially, Obama had a speech that was against bailouts, but the evolving economy made him change his vantage point, and he adopted the idea of bailouts because he wanted to create a trust worthy and full of hope environment through his speech, similar with Ronald Reagan's speech, even if the reality was opposite its speech (Stiglitz, 2010: pp. 80-83). Obama's vision is pragmatic: creating a standalone framework for economic and social disparities and lowering the importance of work ideologies. Probably he didn't used work ideologies because it was a risk he couldn't handle and this way he postponed in 2008 the problem of work politics for the U.S. (and global recovery) that is underlined today by the harsh negotiations between Republicans and Democrats on increasing the American debt limit from 14.3 trillion U.S. dollars to 16.4 trillion U.S. dollars, this way increasing the debt limit at 115% in their GDP and in my forecast of a deficit of 8.5% and an inflation rate of 4.5 – 5.5% (the Fed targeted inflation rate is 2% starting from the 1980's) (Bodislav, 2011b). This way the American political class postponed the systemic failure of their economic system for the Q1-Q2 2013, because even if they make the targeted spending cuts they'll have a deficit of 100 billion U.S. dollars/month to cover (Bodislav, 2011a: pp. 67 - 72).

One of their new solutions is introducing a Value Added Tax of 10%, but this tax will pin down consumption and will worsen the economic development. To the VAT there is added a wealth tax, resulted from the "Buffet Rule", a tax that targets incomes that are higher than 1 million U.S. dollars/year. The Buffet Rule resulted from Warren Buffet's income statement: in 2010, he paid taxes for his direct income in total value of 4.93 million U.S. dollars, representing only 17.4% from direct income. This tax will stop development of any models of entrepreneurship and will pin down the rate of reinvested profits (Bloomberg Professional).

The lack of a clear vision is an impediment in the algorithms used to create reform. The idea of a credit system that could make investment more efficient in the U.S. high-end industry and in the start-up industry was wanted for the United States of America, but the greed of bankers and the super-flow created by high profitability led to an infusion of adrenaline and ephedrine into the neurocortex of the financial and banking policy makers that led to following the supreme goal: profitability justifies the means. The TARP created by the Bush administration and deployed by the Obama administration led to economic inequity in the public-private partnership: banks consumed the money offered by the administration to consolidate their weak establishment, while the "real businesses" that create real added-value (start-ups and new mergers) were taken off the list of beneficiaries.

## 5. The 2011 Crisis

In Europe there are the PIIGS(B): Portugal, Ireland, Italy, Greece, Spain and Belgium are all under the deficit problem, if they wouldn't cut spending, increase taxes and maintain their monetary policies clear and their government' actions under economic clarity of implementation and development they will hit the default state, and if Greece is easy to manage in this state, the other 5 countries can't be managed because they have big deficits, only the fiscal deficit of Italy is at 1.8 trillion Euro and Spain's real estate lending problem is needed to be solved by the government with the minimum effort of 1 trillion Euro (Bodislav, 2011a: pp. 67-72).

In Asia there are the so-called "Asian tigers" that aren't doing well after large investments in their infrastructure by multinationals and their production facilities are used under their optimal productivity level. In the United Arab Emirates (U.A.E.) there is the international credit problem, because they invested in American bonds large sums of money and they need to be sure that all their investments weren't in vain: they need tangible goods to assure their investments (they made an official purpose statement for receiving in the account of the American debt L.A. Ports, the biggest commercial port in the world, and should be established under the management of Dubai World).

In China there is the real estate problem: in Beijing and other developed areas the house prices peaked for a couple of months and to stress the actual situation, the average GDP per capita is of 4.400 U.S. dollars (600 U.S. dollars/capita is the adjusted median average of the Chinese GDP) and the average price of an apartment in down town of well developed areas is of 600.000 U.S. dollars (Bloomberg Professional). To this problem the international credit problem is added. The U.S. government states that they owe to the Chinese government 1.2 trillion U.S. dollars, but the real problem is that the American government is printing money without real foundation (Hoisington Asset Management Database). The debt limit was increased to at least 16.4 trillion U.S. dollars for the American economy and the amount of printed money will peak 2 trillion U.S. dollars, to which is added the weaker U.S. dollar, all these sum up to 5 trillion U.S. dollars, money that are invested or "created" in counter part by the Chinese government (Bodislav, 2011a: pp. 67-72).

The U.S. government wants to design a way to create a bridge between Main Street and Wall Street, but in the turnaround of events they caught President Barack Obama in the middle, a similar situation that was seen in Bill Clinton's first election. The most intense talks were on **corporate welfare**, welfare that has at its foundation Main Street and Wall Street, by offering subsidies and tax cuts to some important players on Wall Street. Equilibrium in this situation underlines the efficient state governance model, but in some limits that wouldn't stop the course of market evolution and its trend. The social behavior must be kept, but after a classic system: give the individual the work tools and not the reward, without any effort. Old Jewish saying: „Give man a fishing rod and teach him how to fish, don't give him the fish without minimum effort.”

## 6. The 2010-2012 Overview

Republicans are known to have a corporate vantage point, this fact was followed by the Bush Jr. administration that stimulated corporate welfare to new peak points, but the plot thickened when the Glass-Steagall law was repealed, the law that created a wall between investment banking and commercial one, starting from the '30s till the year 1998 (at that moment the Congress and the Senate was led by Republicans) and the lower taxation adopted starting with the year 2000, part of election campaign of Bush Jr. and prolonged with two years by the Obama administration at the end of 2010. The big advantage of the Bush Jr. administration was that when a bankruptcy appeared or on the birth of some market asymmetries, the life span of that corporation was settled under the **Chapter 11 (Bankruptcy Law)**. The Obama administration, against all rules of capitalism, didn't let the bankruptcy of corporations because "they were too big to fail", although the Bush Jr. administration allowed the bankruptcy of Enron, at the end of the dot.com crisis. Even after the actual crisis the bankruptcy of Enron remains the biggest stand alone bankruptcy in the world: 65 billion U.S. dollars vanished in 2 weeks (Bodislav, A., 2008). In addition to the chronological review of the measures taken to ease the development and deployment of the actual economic crisis there can be added the three models used in an economic crisis:

1. J.M. Keynes' model: economic contractions are caused by not sufficient aggregate demand which creates deficit through keeping a higher level of government spending (Keynes, 2010).
2. M. Friedman's model: prolonged recession; insufficient aggregate demand that can be stimulated by increasing the stock of money used in the economy (Friedman, 2011).

These two models have as similarities 3 to 7 years of economic growth, followed by 1 to 2 years of recession. This was the average business cycle that was seen after World War 2.

3. I. Fisher's model: The economic contraction is equal with the percentage of deficit in the GDP; stabilizing debts is the solution for lowering the chances of default and of a lean recovery (Fisher, 2011).

Fisher underlined through his model that creation of a prolonged recession or multi-dip recession is seen through an insufficient aggregate demand, the money rotation speed decreases (35% is the actual rotation speed for the U.S. dollar, compared with the year 2007 when it was 69%), the unemployment rate fluctuates, but no new jobs are created (the unemployment rate for November 2011 is 8.6%), trust is at its lowest level ever, decreasing birth rate and the decreasing number of households. The number of households is with 12 to 14 million lower than in 2007 in the American economy and with 5 to 7 million lower than in 2008 in the European economy. The number of households in the U.S. is under 1997's level and situated at the limit of 65.9% owned houses. All the facts that were pointed out almost 90 years

ago by Irving Fisher are today on the verge of destabilizing the U.S. economy and through the process of contagion the world economy.

## **7. Conclusions**

Reviewing the entire process of leveraging the risks, creating a buffer for the near death experiences of the American banking system and reclaiming the logical power of Wall Street through real levers, not by using social imposing force of movement like Occupy Wall Street are the new measures that will put the U.S.A. on their path to sustainable economic growth.

In this moment we can add the fact that the revised forecast of the real rate of economic growth for 2011 for U.S.A. is of 1.3%, for the Eurozone of 1.5% and for the global economy of 3.3-3.8% (all forecasts were lowered from the beginning of the year with 0.2 to 0.5% by the International Monetary Fund and The World Bank) that shows that there is a bigger chance of 50% that the global economy will fall again into another recession exclusively because of the developed countries unhealthy situation, economic structure and development. Joseph Schumpeter calculated that the healthy economic growth must be at least 2% per year, and from the author's calculations and Bloomberg's emerging markets chief economist any yields that are lower than 2% grow the risk of getting into another recession (Schumpeter, 2011).

For closure, the best way to show and underline the actual development of the economic environment, especially on the U.S. and Europe is to briefly show the actual between these two powerful economies. If the Eurozone remains in this state of uncertainty the U.S. is going to continue to muddle through, and this muddle through economic and political development method will grow the Dow Jones Industrial Average Index to a comfortable level of 12.500 to 13.000 points or maybe higher, but on the long term if the European situation does not improve, not only through the business environment, but also on political level or view there we can mark the difference as a turning point to the worst. If the Eurozone implodes, the world economy will go into social recession which is solved through war, we have as examples the First and Second World War. The global economy and society cannot handle an economic and social recession that is solved through war because it creates a quantum leap into the past of at least half of century. The world economy is now walking on thin ice and any mistakes could send us in the dark hours of economy re-creation, but without the support of the actual sources of knowledge or the resources for building a new economy.

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