BUSINESS CYCLES AND ECONOMIC DISTORTIONS

[1]RAICU GABRIEL, [2]STANCA COSTEL, [3]RAICU ALEXANDRA

[1,2,3]*Constanta Maritime University, Romania*

ABSTRACT

Business cycles are – as in definition of Burns and Mitchell -a type of fluctuation found in the aggregate economic activity of nations that organize their work mainly in business enterprises: a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals which merge into the expansion phase of the next cycle; in duration, business cycles vary from more than one year to ten or twelve years; they are not divisible into shorter cycles of similar characteristics with amplitudes approximating their own. On the other hand, Julius Shiskin suggested several rules of thumb to identify a recession, which included two successive quarterly declines in gross domestic product (GDP), a measure of the nation's output. What about the present situation - a real, major and global recession or a different kind of business cycle particularity?

Keywords: *Business cycles, GDP, global crisis, Keynesian economy, global market, Eurozone, mortgage, recession*

1. INTRODUCTION

The first systematic exposition of periodic economic crises, in opposition to the existing theory of economic equilibrium, was the 1819 *Nouveaux Principes d'économie politique* by Jean Charles Léonard de Sismondi. [2] Prior to that point classical economics had either denied the existence [3] of business cycles, blamed them on external factors, notably war,[4] or only studied the long term. Sismondi found vindication in the Panic of 1825, which was the first unarguably international economic crisis, occurring in peacetime. Sismondi and his contemporary Robert Owen, who expressed similar but less systematic thoughts in 1817 *Report to the Committee of the Association for the Relief of the Manufacturing Poor,* both identified the cause of economic cycles as overproduction and under consumption, caused in particular by wealth inequality. They advocated government intervention and socialism, respectively, as the solution. This work did not generate interest among classical economists, though underconsumption theory developed as a heterodox branch in economics until being systematized in Keynesian economics in the 1930s.

Sismondi's theory of periodic crises was developed into a theory of alternating *cycles* by Charles Dunoyer,[5] and similar theories, showing signs of influence by Sismondi, were developed by Johann Karl Rodbertus. Periodic crises in capitalism formed the basis of the theory of Karl Marx, who further claimed that these crises were increasing in severity and, on the basis of which, he predicted a communist revolution. He devoted hundreds of pages of *Das Kapital* to crises.

There were frequent crises in Europe and America in the 19th and first half of the 20th century, specifically the period 1815–1939, starting from the end of the Napoleonic wars in 1815, which was immediately followed by the Post-Napoleonic depression in the United Kingdom (1815–30), and culminating in the Great Depression of 1929–39, which led into World War II. See Financial crisis: 19th century for listing and details. The first of these crises not associated with a war was the Panic of 1825.

Business cycles in the OECD after World War II were generally more restrained than the earlier business cycles, particularly during the Golden Age of Capitalism (1945/50–1970s), and the period 1945–2008 did not experience a global downturn until the Late-2000s recession. Economic stabilization policy using fiscal policy and monetary policy appeared to have dampened the worst excesses of business cycles, and automatic stabilization due to the aspects of the government's budget also helped mitigate the cycle even without conscious action by policy-makers.

In this period the economic cycle – at least the problem of depressions – was twice declared dead; first in the late 1960s, when Phillips curve was seen as being able to steer the economy – which was followed by stagflation in the 1970s, which discredited the theory, secondly in the early 2000s, following the stability and growth in the 1980s and 1990s in what came to be known as The Great Moderation – which was followed by the Late-2000s recession. Notably, in 2003, Robert Lucas, in his presidential address to the American Economic Association, declared that the "central problem of depression-prevention [has] been solved, for all practical purposes."[11]

2. EVOLUTION OF CYCLES THEORIES

In 1860, French economist Clement Juglar identified the presence of economic cycles 8 to 11 years long, although he was cautious not to claim any rigid regularity.[6] Later, Austrian economist Joseph Schumpeter argued that a Juglar cycle has four stages: (i) expansion (increase in production and prices, low interests rates); (ii) crisis (stock exchanges crash and multiple bankruptcies of firms occur); (iii) recession (drops in prices and in output, high interests rates); (iv) recovery (stocks recover because of the fall in prices and incomes). In this model, recovery and prosperity are associated with increases in productivity, consumer confidence, aggregate demand, and prices.

In the mid-20th century, Schumpeter and others proposed a typology of business cycles according to their periodicity, so that a number of particular cycles were named after their discoverers or proposers: [7]
the Kitchin inventory cycle of 3–5 years (after Joseph Kitchin); [8]

- the Juglar fixed investment cycle of 7–11 years (often identified as 'the' business cycle);
- the Kuznets infrastructural investment cycle of 15–25 years (after Simon Kuznets also called building cycle]);
- the Kondratiev wave or long technological cycle of 45–60 years (after Nikolai Kondratiev) [9]

Interest in these different typologies of cycles has waned since the development of modern macroeconomics, which gives little support to the idea of regular periodic cycles.[10]

3. ECONOMIC DISTORTIONS AND CRISIS EVOLUTION

The original version of the crisis had its origins in the collapse of the US subprime mortgage derivative deck of cards in 2007 before morphing into a broad-based financial crisis in the fall of 2008. It gradually spread to most other first-world advanced economies, but did not wreck havoc on emerging markets and second and third world nations. Most such economies were insulated from the folly of first-world finance - credit, borrowing, overwhelming debt and onerous interest payments – simply because they did not qualify for the intoxicating elixir of credit [13].

Furthermore, other weaknesses in the global financial system have surfaced. Some financial products and instruments have become so complex and twisted, that as things start to unravel, trust in the whole system started to fail [12].

Securitization was an attempt at managing risk. There have been a number of attempts to mitigate risk, or insure against problems. While these are legitimate things to do, the instruments that allowed this to happen helped cause the current problems, too. In essence, what had happened was that banks, hedge funds and others had become over-confident as they all thought they had figured out how to take on risk and make money more effectively. As they initially made more money taking more risks, they reinforced their own view that they had it figured out. They thought they had spread all their risks effectively and yet when it really went wrong, it all went wrong.

Derivatives, financial futures, credit default swaps, and related instruments came out of the turmoil from the 1970s. The oil shock, the double-digit inflation in the US, and a drop of 50% in the US stock market made businesses look harder for ways to manage risk and insure themselves more effectively [12].

The finance industry flourished as more people started looking into how to insure against the downsides when investing in something. To find out how to price this insurance, economists came up with options, a derivative that gives you the right to buy something in the future at a price agreed now. Mathematical and economic geniuses believed they had come up with a formula of how to price an option, the Black-Scholes model.

In the absence of enough foreign or private sector purchasers, the US central bank, the Federal Reserve Board, has been ‘monetizing’ federal government debt through its purchases of Treasury bonds. The process dubbed Quantitative Easing, by which the FED creates money out of thin air, allows the FED to become the purchaser of last resort of government debt. At the present rate it is expected that the FED will purchase a full 50 percent of all new and maturing Treasury bonds in the current fiscal year [13]. This is necessary simply because there are not enough foreign or domestic, private sector or government buyers to be found at current rates of interest and levels of risk.

Nouriel Roubini [14], famous for his early call on the global financial crisis, has recently pointed to the danger China faces of an economic "hard landing" after 2013. Beijing added massive stimulus to China's economy in 2008 to head off damage to the Chinese economy from the global financial crisis. The government has been relatively unsuccessful in slowing the growth of the money supply, bank credit and fixed investment that helped boost growth - even though the global crisis is clearly in the rearview mirror of a Chinese economy growing 10% a year.

That has led to a major distortion in the Chinese economy, [14] because economic growth in China increasingly depends on investment in fixed assets that may not be economically productive in themselves but produce massive profits for well-connected Chinese officials and businesspeople. That has led to a serious bad-loan problem in China, he says, and has produced massive amounts of excess industrial capacity.

No one will challenge current policies [14] during the leadership transition, but once leaders are in place, China will have to confront these problems. That will mean, I'd say, not only further attempts to dampen bank lending and raise reserve requirements but serious escalation of the battles on these fronts. It will mean new steps to fight inflation. And it might even mean willingness on the part of the new leadership to sacrifice some economic growth to achieve these ends.

One possible alternative to slower growth would be a shift from growth based on exports and investment in fixed assets to one based on domestic consumption. But that would require shifts in the economy - and challenges to powerful interests in that economy - that could be even more disruptive than a slowdown in growth.The bad news, of course, is that the actions of the politicians that support growth now will have to be paid for in 2013.

4. GLOBAL MEASURES

Until September 2008, European policy measures were limited to a small number of countries (Spain and Italy). In both countries, the measures were dedicated to households (tax rebates) reform of the taxation system to support specific sectors such as housing. The European Commission proposed a €200 billion stimulus plan tobe implemented at the European level by the countries. The plan combines short-term measures to stimulate demand

and maintain jobs and longer-term measures to invest in strategical sectors, including research and innovation. The aim is to promote growth and ensure sustainable prosperity. The plan includes targeted and temporary measures amounting to 200 billion euros, or 1.5% of EU GDP, using both the national budgets of the national governments, the budget of the EU and that of the European Investment Bank. The plan is scheduled on a period of two years.

At the beginning of 2009, the UK and Spain completed their initial plans, while Germany announced a new plan.

On September 29, 2008 the Belgian, Luxembourg and Dutch authorities partially nationalized Fortis, a former company active in insurance, banking and investment management. The German government bailed out Hypo Real Estate. On 8 October 2008 the British Government announced a bank rescue package of around £500 billion [15] ($850 billion at the time). The plan comprises three parts. The first £200 billion would be made in regard to the banks in liquidity stack. The second part will consist of the state government increasing the capital market within the banks. Along with this, £50 billion will be made available if the banks needed it, finally the government will write away any eligible lending between the British banks with a limit to £250 billion.

In early December German Finance Minister Peer Steinbrück indicated a lack of belief in a "Great Rescue Plan" and reluctance to spend more money addressing the crisis.[16] In March 2009, The European Union Presidency confirmed that the EU was at the time strongly resisting the US pressure to increase European budget deficits. [17]

On September 15, 2008 China cut its interest rate for the first time since 2002. Indonesia reduced its overnight repo rate, at which commercial banks can borrow overnight funds from the central bank, by two percentage points to 10.25 percent. The Reserve Bank of Australia injected nearly $1.5 billion into the banking system, nearly three times as much as the market's estimated requirement. The Reserve Bank of India added almost $1.32 billion, through a refinance operation, its biggest in at least a month. [18] On November 9, 2008 the 2008 Chinese economic stimulus plan is a RMB¥ 4 trillion ($586 billion) stimulus package announced by the central government of the People's Republic of China in its biggest move to stop the global financial crisis from hitting the world's second largest economy. A statement on the government's website said the State Council had approved a plan to invest 4 trillion yuan ($586 billion) in infrastructure and social welfare by the end of 2010. The stimulus package will be invested in key areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, income-building, tax cuts, and finance.

China's export driven economy is starting to feel the impact of the economic slowdown in the United States and Europe, and the government has already cut key interest rates three times in less than two months in a bid to spur economic expansion. On November 28, 2008, the Ministry of Finance of the People's Republic of China and the State Administration of Taxation jointly announced a rise in export tax rebate rates on some labor-intensive goods. These additional tax rebates will take place on December 1, 2008.[18]

The Federal Reserve, Treasury, and Securities and Exchange Commission took several steps on September 19 to intervene in the crisis. To stop the potential run on money market mutual funds, the Treasury also announced on September 19 a new $50 billion program to insure the investments, similar to the Federal Deposit Insurance Corporation (FDIC) program. [20], [21] Part of the announcements included temporary exceptions to section 23A and 23B (Regulation W), allowing financial groups to more easily share funds within their group. The exceptions would expire on January 30, 2009, unless extended by the Federal Reserve Board.[22] The Securities and Exchange Commission announced termination of short-selling of 799 financial stocks, as well as action against naked short selling, as part of its reaction to the mortgage crisis.[23]

The interconnectedness of global activity will serve to further destabilize the global financial system in 2012. Although the federal government debt to GDP ratio is surging past 100%, if private indebtedness is included our debt to GDP ratio exceeds 350%. The same calculation reveals a debt ratio of 490% in Japan, 443% in Euro currency countries, and 459% in the United Kingdom. Similar to the U.S., their growth rates are also falling rapidly. In fact, there is compelling evidence that Europe and Japan have already entered recessions. In addition, manufacturing recessions have emerged in China and India, and growth in the Brazilian economy came to a standstill in the third quarter. These contracting growth rates suggest that U.S. exports will contribute to slower growth in 2012.

Exports have been critical [24] to the expansion of the U.S. economy since the end of the last recession. Compared with the tepid rates of expansion in consumer expenditures of 2.1% and overall real GDP of 2.4%, real exports have surged at a 9.7% rate. Thus, the fast rising gain in exports equals slightly more than 48% of the increase in real GDP from the recession low. Considering that exports spur the need for increased non-residential fixed investment, as well as higher inventories, it is clear that without a booming export sector our expansion since 2009 would have been truly dismal. Unfortunately, the negative feedback of a global recession will not only impair the U.S. exports sector, but also will cause a steeper downturn overseas.

For instance, in Germany, the United Kingdom, and Japan exports accounted for 51%, 30%, and 16% respectively of their GDPs in 2011. In France, Italy and Spain exports averaged about 29% of GDP. The loss of exports to the United States will be most detrimental to the European economies, feeding back to a slower export sector in the United States. [24] Thus, the main driver of growth (exports) for this expansion will be sharply diminished in 2012. The economic slowdown in the US, the eurozone, and China already implies a massive drag on growth in other emerging markets, owing to their trade and financial links with the US and the European Union (that is, no “decoupling” has occurred). At the same time, the lack of structural reforms in emerging

markets, together with their move towards greater state capitalism, is hampering growth and will reduce their resiliency.

Finally, long-simmering tensions in the Middle East between Israel and the US on one side and Iran on the other on the issue of nuclear proliferation could reach a boil by 2013. The current negotiations are likely to fail, and even tightened sanctions may not stop Iran from trying to build nuclear weapons. With the US and Israel unwilling to accept containment of a nuclear Iran by deterrence, a military confrontation in 2013 would lead to a massive oil price spike and global recession.

These risks are already exacerbating the economic slowdown: equity markets are falling everywhere, leading to negative wealth effects on consumption and capital spending. Borrowing costs are rising for highly indebted sovereigns, credit rationing is undermining small and medium-size companies, and falling commodity prices are reducing exporting countries' income. Increasing risk aversion is leading economic agents to adopt a wait-and-see stance that makes the slowdown partly self-fulfilling.

6. CONCLUSIONS

The political philosopher John Gray, who recently retired as a professor at the London School of Economics, wrote in the London paper The Observer: “Here is a historic geopolitical shift, in which the balance of power in the world is being altered irrevocably.” [25]

Since in the Keynesian view, recessions are caused by inadequate aggregate demand, when a recession occurs the government should increase the amount of aggregate demand and bring the economy back into equilibrium. This the government can do in two ways, firstly by increasing the money supply (expansionary monetary policy) and secondly by increasing government spending or cutting taxes (expansionary fiscal policy). [26]

By contrast, some economists, notably New classical economist Robert Lucas, argue that the welfare cost of business cycles are very small to negligible, and that governments should focus on long-term growth instead of stabilization. All of this seems to be more provocative in the future.

5. REFERENCES

[1]. O'Sullivan, Arthur; Steven M. Sheffrin (2003). Economics: Principles in action. Upper Saddle River, New Jersey 07458: Pearson Prentice Hall. pp.57, 310. ISBN 0-13-063085-3.

[2]. Over Production and Under Consumption, ScarLett, History Of Economic Theory and Thought

[3]. Batra, R. (2002). "Economics in Crisis: Severe and Logical Contradictions of Classical, Keynesian, and Popular Trade Models".

[4]. http://www.thefreemanonline.org/featured/classical-economists-good-or-bad/

[5]. Charles Dunoyer and the Emergence of the Idea of an Economic Cycle, Rabah Benkemoune, History of Political Economy 2009 41(2):271–295; doi:10.1215/00182702-2009-003

[6] M. W. Lee, Economic fluctuations. Homewood, IL, Richard D. Irwin, 1955

[7] Schumpeter, J. A. (1954). History of Economic Analysis. London: George Allen & Unwin.

[8] Kitchin, Joseph (1923). "Cycles and Trends in Economic Factors". Review of Economics and Statistics (The MIT Press) 5 (1): 10–16. doi:10.2307/1927031. JSTOR 1927031.

[9] Kondratieff, N. D.; Stolper, W. F. (1935). "The Long Waves in Economic Life". Review of Economics and Statistics (The MIT Press) 17 (6): 105–115. doi:10.2307/1928486. JSTOR 1928486.

[10] http://www.albany.edu/~bd445/Eco_301/Slides/Business_Cycle_Notes_(Print).pdf

[11] Fighting Off Depression, New York Times, http://www.nytimes.com/2009/01/05/opinion/05krugman.html

[12] Anup Shah, Global Financial Crisis, http://www.globalissues.org/article/768/global-financial-crisis

[13] Arnold Bock, A Financial Crisis in 2012 Is Inevitable! Here's Why, http://www.financialsense.com/contributors/arnold-bock/a-financial-crisis-in-2012-is-inevitable-here-is-why

[14] Nouriel Roubini, http://www.roubini.com/author/nouriel_roubini

[15] "Gordon Brown should say 'sorry'". London: Telegraph.co.uk. 2009-03-09. Retrieved 2009-03-09

[16] "It Doesn't Exist!". Newsweek.com. 2008-12-06. Retrieved 2008-12-15.

[17] 122.^ Waterfield, Bruno (2009-03-25). "EU resists deficits". London: Telegraph.co.uk. Retrieved 2010-01-21.

[18] "Asian central banks spend billions to prevent crash". International Herald Tribune. 2008-09-16. Retrieved 2008-09-21.

[19] "Chinese pharmaceutical exporters to benefit from latest tax rebates increases". Asia Manufacturing Pharma. 2008-12-01. Retrieved 2008-12-01

[20] Gullapalli, Diya and Anand, Shefali. "Bailout of Money Funds Seems to Stanch Outflow", The Wall Street Journal, September 20, 2008.

[21] Bull, Alister. "Fed says to make loans to aid money market funds", Reuters, September 19, 2008.

[22] (Press Release) FRB: Board Approves Two Interim Final Rules, Federal Reserve Bank, September 19, 2008.

[23] Boak, Joshua (Chicago Tribune). "SEC temporarily suspends short selling", San Jose Mercury News, September 19, 2008.

[24] John Mauldin, Expect Recession in 2012, http://www.financialsense.com/contributors/john-mauldin/2012/01/18/expect-recession-in-2012

[25] Paul Reynolds, US superpower status is shaken, BBC, October 1, 2008

[26] ***Wikipedia.org