Chapter 10

The Economic Crisis:
The Result of Reducing the Systemic Links

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ABSTRACT

The current chapter shows the gap between the real economy and the financial markets in the United States during the pre-crisis period at the end of 2007, as well as during the subsequent crisis period. The current research chapter also emphasizes the catastrophic effect that financial markets had inside the whole economic system due to this gap. The premise from which this chapter starts can be found in the systems theory and consists in Heinz von Foerster's theorem. This research has an empirical nature and shows in which way an anomaly within the system can destabilize the entire system, finally resulting in the installation of the crisis period that we are still facing. In order to illustrate this, the authors refer to the evolution of the values of DJIA and real GDP, observed between mid 1940s until 2010 in the United States.

INTRODUCTION: HOW IT ALL BEGAN

The problem of the *economic crises* was pointed out even from the beginning of the economic history, the first recorded crisis being "Tulip Mania" from 1630. Afterwards, there were economic crises in the 18th century and in the 19th century (France, England, United States of America), and the closest greatest crisis from the 20th century was the Great Depression from 1929-1933. Crises in Asia and in Latin America occurred in the economic history during the period best-known as Great Moderation (easy inflation, quick economic growth, weak recession), but, globally speaking, they didn't have many rising effects.

Before 1997, many economists believed that the Theory of Business Cycles cannot be valid anymore (Stiglitz & Walsh, 2005). As we mentioned above, this period, "Great Moderation,"

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was named by Ben Bernanke. The events of the past years at which we all witnessed showed us that "Great Moderation" was not as big as it was thought, and in the Theory of the Business Cycles, we still find the descending component, the component that validates this theory.

In the contemporary economy, the confusion regarding the crisis has rapidly developed for the past four years, when in The United States of America something believed as an "isolated event" broke. We are talking about the speculative bubble bursting, created on the basis of the real estate increase, but also on the basis of toxic financial assets. This "isolated" event led to a global pandemic. The competent bodies tried to oppose this unprofitable force through a mix of macroeconomic politics in order to reduce the effects.

Roubini and Mihm (2010) presented in an epic manner the factors that preceded the crisis and led to the creation of the speculative bubble. Afterwards, these factors led to the collapse of the economy. Among these factors, we can include ex-ante factors like speculations and technologic progress, but also ex-post factors like un-sustainability and inconsistency of macroeconomic policies and the effect that these decisions had between the time of the actual decision-making and the impact, more or less significantly, upon the real economy. Stiglitz (2010) presents the recipe for "success" for the appearance of a crisis: a deregulated market with abundant liquidity and low interest rates, a speculative bubble of the real estate market, loose credit policy and subprime loans. The financial crises have a lot of shapes and wear a lot of masks (Roubini & Mihm, 2010). Why is this crisis different if compared to the precedent ones? No doubts, the most important difference consists in the global character of this crisis, but we will focus upon this idea in a future paper. Another difference is that one of the crisis' premises is represented by the financial markets, which in the past decades took a considerable momentum from the rest of economic activities: derivative tools appeared - that afterwards have been transformed in toxic assets – simply named with three letters, a lot alike with chemical formulas: CMO, CDO, ARS, or TOB (Moroianu & Belingher, 2011). We found two reasons for the appearance of such derivative items: the desire of rapid enrichment and the aversion towards the immediate risk (nevertheless, the risk seriously increased as for the transactions made, but also for the whole economic climate).

Though it is a challenge to trace the beginning of the post-2007 global financial crisis, its preconditions were building from 2001, and in particular after the terrorist attacks on 9.11 to which regulators responded with a state of stability in financial markets through a irrigation of liquidity to financial institutions. This increased liquidity and low interest rates generated a fast expansion in consumer, mortgage, and corporate debt financing.

As observed in Saunders and Allen (2010) the credit problem did not lie only in the expansion of the quantity of consumer and commercial debt but also simultaneously in the decline of the quality of that debt. As the demand for mortgage grew, financial institutions lowered their credit quality standards in order to incorporate those that previously couldn't participate in the market due to poor credit ratings.

Schwartz (2009) discusses the housing price boom underlining the role played by the government. Fannie Mae and Freddie Mac, as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are commonly called, were created in order to expand mortgages for low and moderate income borrowers. The department of Housing and Urban Development (HUD) set targets for these government–sponsored enterprises so as to direct 50 percent of their mortgage financing to borrowers with incomes below the median income in their areas in 2000. In 2005, the percent rose to 52. The social segment targeted were borrows with an income of less than 20 percent of their area's median income for 2000 respectively 22 for 2005.