THE INSTABILITY OF THE MODERN ECONOMIC SYSTEM

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Abstract:
The economic developments in the first part of the twentieth century, characterized by low inflation and accelerated economic growth, have led a lot of the economists to believe that the problems regarding the economic cycles have been resolved. This new period of relative calm was called "The Great Moderation". However, the economic crisis of 2008 came to challenge these new economic theories reopening the debates on the causes that lead to the emergence of a crisis and the efficiency of the measures taken so far. The paper aims to identify and analyze the factors leading to instability in an economy, trying to find out if economic instability is a normal phenomenon faced by an economy or if it is just an anomaly.

Key words: *financial stability, economic crisis, the Great Moderation, economic theories*

JEL Classification: *G01*

1. Introduction

Economists have always been concerned with the economic imbalances and the causes that lead to them. The traditional theories consider the economy as a system that permanently tends towards equilibrium and that crisis are just rare events.

Nassim Taleb called the crises "black swans". These events called "black swans" have three main characteristics: are unpredictable, they carry a massive impact and after the event, we find an explanation that makes it appear less random and more predictable than it was. The inability to predict these events consists in the fact that the analysis are usually concentrating on things that are already known and not on the unknown thing, and that it puts too much focus on details rather than generalities.

The evolutions of the economy have given rise to other relative contrary theories to these classical ones, who claime that the economy is unstable by nature and the actions of the authorities can amplify or mitigate these imbalances.

In the early 1980s the economies have experienced a period of stability that lasted for about 20 years. This period, known as The Great Moderation, during which the economies have not had to deal with extremely strong shocks induced again the belief that the economy is stable by nature and that the crises are just isolated and unpredictable events, anomalies. The Great Moderation has led many economists to believe that the crisis period has ended, that the new institutional order, the new regulatory framework and policies managed to combat the problem of economic cycles.

The illusion of stability created by The Great Moderation made almost impossible to anticipate the crisis of 2008, which became the most powerful crisis since The Great Depression. Even after the emergence of the crisis many economists and authorities believed that the negative effects were not as serious and that stabilization of the economy will occur shortly.

Over time, the financial imbalance in the United States economy spread to other sectors and to other economies, affecting both emerging and developed economies.

This way, the economic crisis of 2008 has reopened the debate on the causes that lead to instability in the economy. The imbalances that have affected modern economic system have brought again to the attention Minsky's hypothesis according to which the modern economy is unstable by nature.

This article aims to analyze the two visions: stable economy versus unstable economy. The paper is structured in two parts, the first part presents the factors that lead to imbalances and the second part analyzes the factors that have favored the emergence of the stability period called The Great Moderation.

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2. Financial instability - feature of the modern economy?

Financial instability occurs when problems (or concerns regarding potential problems) within the institutions, markets, payment systems or the financial system in general deteriorate significantly the supply of credit so as to substantially impact the expected path of the real economy (Rosengren, 2011, p. 2).

Financial instability is a known problem for most countries. Banking crises have become an event so frequent that very few are the countries that have not faced such a problem. The last financial crisis turned the attention towards finding the causes that lead to financial instability and the solutions to prevent it. The frequency of the economic imbalances manifested not only in the emerging economies but also in the developed economies question the stable character of economy.

The economic theory presents several causes for the emergence of economic imbalances. According to Keynes the economy is experiencing imbalances when there is a collapse in demand. Freidman believes that the economic imbalances are the response of the economy to fluctuations in the money supply (Roubini and Mihama, 2010, p. 91). The theories of the Austrian School indicate that crises are the result of overregulation of the banking sector. According to representatives of the Austrian School, markets are able to self-adjust and the bankruptcies that occur during the crisis are considered a natural market selection of the best companies.

Another factor held liable for instability is innovation. The innovation especially innovation in the financial sector represents the guarantee that problems in the economy will continue to emerge, and that they will be similar if not identical to those manifested so far (Minsky 2011, p. 564). In his work Financial Instability Hypothesis, Minsky argues that banks like any other companies are profit-oriented, and proposes three types of borrowers reflecting the income-debt relations. Hedge financing units are those with enough money to cover both the interest on the loan and the principal, speculative finance units are those who can pay the interest but not the principal, these are the category of borrowers who will refinance their loans and, the third category, Ponzi units, their income is not sufficient to cover either the interest nor the principal. In relation to the three categories, Minsky argues that if the hedge financing units is the predominant category of borrowers, the economy will tend towards equilibrium. Conversely, if speculative and Ponzi borrowers category is the dominant the economy will tend to become unstable. The predominance of one or the other will depend on credit conditions in the banking system. If the conditions are more restrictive, the funds provided by banks as credits will go to those business opportunities with the highest probability of success. The problem in Minsky's view is that over prolonged periods of growth the economy will transit from financial relations that favor financial stability to financial relations that encourage the emergence of speculative and Ponzi borrowers, leading to the emergence of instabilities.

Another economist who has studied the causes of financial instability is Mishkin. Based on the analysis of the structure of the financial system through asymmetric information he identified four categories of factors that lead to financial instability. The four factors identified are: increases in interest rates, increases in uncertainty, problems in the banking sector and asset market effects on balance sheets.

Raising interest rates will reduce demand for loans, eliminating particularly those risk averse borrowers, this way, the credits will be granted to those companies or households with riskier investment projects since these are willing to pay higher interest relying on the fact that if the investment turns out to be profitable they will be the main beneficiaries. Thus, credit rationing by raising interest rates may precipitate the emergence of financial instability.

The significant increase is the level of uncertainty due to recession, political instability or to a bankruptcy of a large financial institution emphasizes the problem of asymmetric information in the system. Therefor banks will be reluctant in granting loans, which will lead to a decrease in investment, economic activity and will accentuate instability.

The deterioration of balance sheets can also contribute to the emergence of financial instability.

The emergence of problems in the banking sector which would prevent banks to fulfill their role will directly affect economic activity.

Other causes that lead to instability in the economy which were identified are fraud, speculative ”mania” and institutional weaknesses.

Fraud has played a significant role in the emergence of the crisis in Albania, where the pension system collapsed in 1990. Another crisis caused by fraud was the Savings and Loans crisis manifested in 1980 in the United States (Wray, 2001, p. 2).

Speculative “mania” occurs when a large number of investors develop unrealistic expectations of profits to be made from investments. These expectations lead to meaningful financial loans in order to purchase the asset which is expected to bring significant revenue in the future, for examples the acquisition of real estate as it happened before the crisis of 2008, this will lead to an absurd increase in the price of the asset. Once this procurement period ends prices fall, the borrowers will not be able to pay back the loans and all these will lead to a series of bankruptcies destabilizing the economy.

The speculative “mania” is often associated with economic euphoria. In the late 1980s, Japan's industrial firms borrow as much as they wanted from Tokyo and Osaka banks. Money seemed free, thus Japan faced an upsurge in investment and consumption, often paying more than the actual value of the asset purchased. In the euphoria a large number of investors seek rather to obtain short-term gains from increases in real estate prices or stocks than the profit generated by the productive use of these assets (Kindleberger and Aliber, 2005, p. 11).

The literature presents as the ultimate cause for financial instability the deficiencies in domestic governance structures. The managers and chief executive officers of the financial institutions are inadequately accountable for their actions, which reduces the degree of caution and risk management. Furthermore, remuneration in the financial system before the crisis of 2008, but also after the crisis was based on the performance of the employee. The employee performance was reworded with significant bonuses. This system of bonuses took into account the annual profit, thus the employees were motivated to take excessive risks to get those bonuses which often reached absurd levels. The level of indebtedness achieved in this way created vulnerabilities within the financial system and solving these vulnerabilities became ultimately the government’s responsibility. This moral hazard problem if not resolved will always be a destabilizing factor.

Governments given their short-term mandates could present a reluctance to distance themselves from the financial institutions and may deny regulatory agencies the autonomy needed for their effective operation.

These public and private institutional weaknesses allow excessive risk-taking resulting in heavily indebted financial structure, with low levels of equity and a high dependency on short-term borrowing (Eichengreen 2004, p.14).

Financial instability is determined by a number of factors, most of these factors are internal causes of the modern economic system operation. The lack of caution of the private and public sector manifested in periods of economic growth based on an "irrational exuberance" are the preconditions for the future economic imbalances.

3. The Great Moderation

In the early 1980s the measures taken by the central banks in order to reduce the inflation have shown their results, the inflation reduced significantly. Meanwhile the volatilities in the economy reduced, the recessions although present were not as strong and their negative effects were relatively low. The period from the early 1980s until 2007, characterized by low inflation, rapid economic growth and weaker recessions was called by the economists "The Great Moderation".

The causes behind the emergence of the Great Moderation were identified as been mainly the inflation and price stability. However, other causes have been identified, most economists proposing three, respectively, better monetary policy, changes in the structure of the economy and good luck.

Monetary policy helped to mitigate the volatility of the economy by reducing and maintaining the inflation within a stable margin. Most studies that analyze the implications of low inflation volatility over the emergence of The Great Moderation identify a positive relationship between the two. In a study from 2005 on the G-7 member states and Australia, by Peter M. Summers, it is found that in five of the eight countries the reduction in the gross domestic product (GDP) volatility coincided with the reduction of inflation. In France, Germany and Italy the decrease in the volatility of GDP took place before the inflation started to reduce.

One of the economists that have supported the idea that monetary policy played an important role in The Great Moderation was Ben Bernanke. He argued in a speech from 2004 that modern macroeconomic policies have solved the problem of business cycles, making them more of an annoyance than a problem (Krugman, 2009, p.13). According to Bernanke the substantial decline in economic volatility is an extremely important breakthrough and monetary policy had a significant contribution to this achievement. He argues this statement by saying that although some effects of the monetary policy are obvious, there are others that are misidentified as exogenous changes in economic structure or in the distribution of economic shocks, due to the pervasive effects of the changes in the monetary policy regime.

The monetary policy applied by Fed during The Great Moderation was based on the so-called "Taylor rule", named after the economist John B. Taylor, who first proposed it in 1993. This principle requires the central bank to tighten monetary policy when output is above its potential and inflation is higher than the target set by monetary policy makers and to ease the monetary policy when output is below its potential and inflation is lower than the target (Hakkio, 2013).

In the European Union, particularly in the euro area GDP volatility reduction occurred while reducing inflation. Arguments for the reduction in the inflation levels were taken into account changes in the monetary institutions like the independence of the European Central Bank and the adoption of inflation targeting policy etc. Thus, reducing the GDP volatility in the euro area was partially attributed to the implementation of a new and a better monetary policy (Cabanillas and Ruscher, 2008, p. 8).

Some economists have argued that changes in the structure of the economy have also helped reduce volatility. Deregulation of trade activities and of the financial system is considered one of the changes that occurred in the economy. The deregulation supposedly permitted the introduction of new technologies, thus creating a more flexible economic system that could cope easier with shocks of any kind. Innovation in the financial sector and the extension of the intermediary financial institutions activities (shadow banking system) proved ultimately to be not as effective as believed. If previously the landing activity was based on the model "initiation and possession", i.e. the granted loans were reported in the banks' balance sheets, financial innovation has changed this pattern, loans were now grouped into a portfolio on which there were issued bonds. Thus, banks were no longer waiting decades to recover loans; they were earning a considerable amount of money by selling bonds. Thus was created the new model "initiation and distribution" (Roubini and Mihama, 2010, p. 116-118). The financial innovation problem was that it was based on the traditional theory that home prices never go down.

Globalization, particularly the increase in trade flows is another explanation given for the stabilization of the international nature of production growth. International trade involves diversification of demand, suggesting that domestic business cycles should have a less pronounced effect on aggregate production and the trade with emerging economies which would be able to produce cheaper goods will help keep inflation stable.

Another structural change would be the existence of a better management of inventory of goods which allows companies to produce and monitor production in a more efficient, reducing the volatility of production and therefore real GDP.

Although the two factors, monetary policy and changes in the structure of the economy seem to have influenced to a certain extent The Great Moderation, some economists are skeptical when it comes to the importance of these factors, supporting instead a surprising theory that, that The Great Moderation was in fact due to an another element, namely, good luck.

The reason for skepticism regarding the role of policies and structural changes is that there is no evidence to show that The Great Moderation is the result of a better response of the economy to shocks due to the application of more effective policies or the result of improved management, but it is rather due to the smaller shocks that affected the economies in the respective period.

The debate on the causes of the Great Moderation ended with the onset of the economic crisis at the end of 2007. According to some economists The Great Moderation ended when the 2008 crisis stroked.

In a study by C. Furman, the hypothesis of The Great Moderation was reassessed by expanding the previous analysis by 10 to 15 years in order to include the economic crisis as well. The study shows that although the economy is subject to substantial fluctuations from year to year or month to month the volatility of a number of key series is reaching a period of moderation, and some are now more stable than they were in the moderation period. This suggests that the factors that led to stability before the crisis are still present in the economy helping it to stabilize. Therefore, The Great Moderation hypothesis is verified, but it presents some limitations. Furman suggested that the policy measures taken by the policymakers did not resolved the business cycle problem, although economic shocks could become rarer they will become stronger.

In its analysis Furman proposes four lines of action to help stabilize the economy, namely: improving fiscal stabilizers, reducing inequalities, better coordination between countries and promoting financial stability.

Although the theories on The Great Moderation show the contribution of certain factors to the relative stability of the economy the imbalances manifested post moderation can not be ignored. These imbalances were in fact the consequences of the lax policies and extensive risks taken during this period of stability. Although inflation remained at a low level the prices on the real estate market experienced a boom, banks were granting more loans without a proper risk assessment, thus encouraging the accumulation of debt. The illusion of long term stability reduced the level of prudence for both consumers and authorities, and the consequences were not far behind.

4. Conclusions

The financial stability periods alternated with the financial instability periods. The new set of regulations and measures taken have managed at best to reduce the frequency of these imbalances without being able to end them.

Although considered by many economists as anomalies of the economic system, the economic crises seem to be more of a feature of the modern economy. Periods of relative calm like The Great Moderation will continue to exist in the economy but to maintain constant this stability it is a difficult if not impossible goal to achieve. A significant decrease in the volatility of modern economy can only be achieved with a high degree of caution from both the consumers and especially the regulators and surveillance authorities' part.

The complexity of the modern financial system makes innovation, as Minsky said, to be both an ally and an enemy of the economy. The system of rules and institutions must continually supervise that the innovation does not lead to an economic euphoria that ultimately would end with a crisis with serious negative effects over the entire economy.

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