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GREAT DEPRESSION VS. THE CURRENT FINANCIAL AND ECONOMIC CRISIS

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Abstract:
The scientific approach of this research requires, necessarily, evaluating the past by discussing the influence on the future, but also the cyclical developments which in turn can confirm trends or can cause sudden inflections - essential to the global economy. The adverse incidence of the financial market crisis and the analysis of the overall impact of these adverse events represented and still represent a subject of interest for researchers in economics, sociology, history, and the sciences. Analyzing crisis, particularly financial crisis, the factors generating and applying patterns to return to normal is a consistent and timely concern of researchers in economics. After emergence in mid-2007, which I will call the Great Recession, due to the effects felt by the world economy, as was the case with the Great Depression of 1930-1933, an interesting approach is to "confront" these two negative episodes. Thus, this paper proposes a comparative approach on how the Romanian economy faced during the Great Depression of 1930-1933 but also after the onset of the Great Depression in 2008.

Key words: great depression, financial and economic crisis, recession, economic growth, financial globalisation

JEL classification: E20, G01

INTRODUCTION

The effects of the financial crisis triggered in 2007, which had its epicenter in the United States had and still has adverse effects on the economy of our country. I will address the solutions that Romania has implemented and will continue to implement in order to exit the recession through a comparative study between the Great Depression of the 1930s and the Great Recession of 2007 we still face. This approach was taken by Reinhart and Rogoff and (2009), and the authors consider that there are similarities between the two crises, first in that it had as trigger point the same location (USA), and by the fact that in both cases we are dealing with the rising of the public debt of the affected countries and also with a high volatility of asset prices. Certainly, the current crisis differs from the Great Depression by the fact that due to financial globalization, the developments in technology and evolution of information technology, the spillovers are much faster and recovery measures are more diversified. Financial innovation and poor regulation and supervision of financial institutions are distinct elements that differentiate the current crisis.

ROMANIA DURING THE GREAT DEPRESSION

In an article published in late 1939, N. Cornățeanu made the following statement "crises can not be avoided completely and [...] must seek through systemic organization to minimize the effect." Therefore, analyzing the effects of the Great Depression on Romania made the great economists of the time to bring into question the cyclical nature of the crisis and the fact that must be identified the measures leading to reduction of the devastating effects of these crises.

Referring to the factors that led to the crisis in our country, Gh. Şusnea considered that "the gap between the growth of the rational organization technique of enterprise and the lack of organization and direction of social factors has generated the crisis of overproduction, which has generated in turn the unemployment ". Therefore, as in the current crisis, unemployment has been a highly debated issue during the recession of 1930-1933 period. Thus, the height of the crisis in Romanian industry was reached in the years 1931 and 1932, when the number of unemployed increased significantly (Mureşan, 2003)

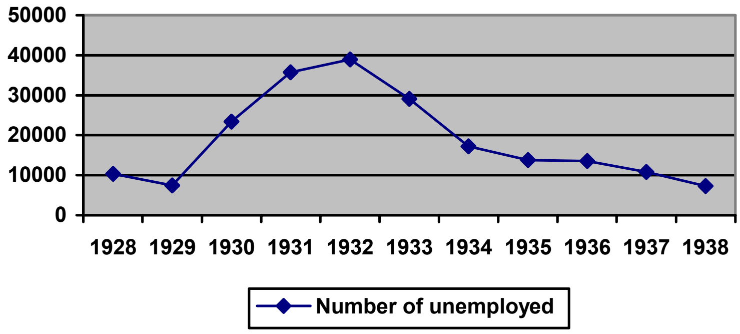

Figure no. 1 – Evolution of the number of unemployed in Romania during 1928-1938
Source: Personal processing according to V. Axenciuc, *Evoluția economică a României. Cercetări statistico-istorice 1859-1947*, vol. I, Ed. Academiei Române, Bucureşti, 1992, p. 532

Analyzing the evolution of unemployment in the period 1928-1938, Mureşan M. (2003) believes that the large number of unemployed after the year 1932 is a direct consequence of "industrial upgrading" that has led to increased labour and machinery productivity within the enterprises that have survived the crisis, without being created new jobs by establishing new businesses.

In economic literature it is estimated that the peak year of crisis in our country was 1932, especially in terms of industrial production. Thus, industrial production declined sharply, averaging 67.3% for the period 1929-1933, and the peaks were recorded in 1931, with a decrease of 53.2%, and in 1932, with a decrease of 54.5% (Mureşan, 2003).

Referring to the evolution of the national currency, D. Rottman (1937) said that "until 1929 Romania has lived under the sign of monetary and credit inflation, then, 1929-1936 into monetary deflation". The author believes that "through the sudden deflation that followed the stabilization of the Romanian leu, the Romanian economy has suffered considerable losses, reaching abnormal situation when Romania, which was the breadbasket of Europe, to pay export subsidies without which it could not keep the markets". Also, analyzing the monetary circulation, V. Madgearu believes that the Great Depression "surprised our country in a time of convalescence" as a result of monetary stabilization in 1929, "and shattered its potentially positive effects".

To counter the adverse effects of the crisis in 1930-1933, the government that runs the country at that time has taken a number of steps, and one of the most important was to reduce taxation. Thus, in 1932 a law was adopted to reduce agriculture tax by 50%, reducing building tax from 12% to 10%, and was also removed the turnover tax for small tradesmen who had up to six employees, under the condition that the income made not to be more than 6000 lei. Also, a law was passed which established only seven categories of taxes, thereby protecting salary income, agriculture and intellectual activity incomes (Mureşan, 2003).

As for reducing budget expenditure, the government imposed "three curves of sacrifice" on wages, and the first of these was to reduce 10% of all public employees' wages since January 1931. Following the implementation of wage cuts, the financial situation for many categories of employees has been deteriorated, leading to triggering social revolt that registered the largest increase at the beginning of 1933.

Although some of the measures taken at that time had a negative impact on living standards, the Government has always been concerned with improving the economic situation of the country, being aware that the economic growth will lead to the welfare of the entire nation.

EFFECTS OF THE GREAT RECESSION ON RUMANIAN ECONOMY

The implications of financial crises on our country have been felt in mid-2008, when the financial stability of Romania was suffering due to speculative attacks of the three American banks

(Barclay's, Goldman Sachs and Morgan Stanley) on currency market, but also as a result of decreased country ratings evaluated by Standard & Poor's and Fitch's agencies. Another major factor that triggers the crises in our country was the liquidity shortages that generated blocking lending as a result of a 50% raise of interbank interest, and implicitly the raise of interests loans granted by commercial banks.

In an article published in 1936, D. Rottman asserted that "is symptomatic that the worst period of chaos almost always had coincided with an intensive foreign trade". Indeed, the situation has not changed even when the crisis burst in 2007 when Romania's trade showed an upward trend and main partners were the EU member states.

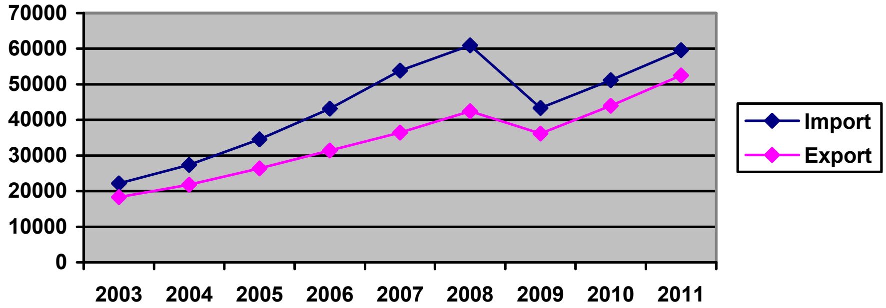

Figure no. 2 – Romanian's trade during 2003-2011 (million Euros)
Source: Personal processing of BNR databases

Graphical representation above shows that in the period before the financial crisis, Romania's trade showed an upward trend, and the first inflection point designating that this trend is changing in mid-2008 when the economy felt the first effects of the crisis. Beginning with the second half of 2009 trade development of our country is again increasing. Unfortunately, the low level of exports versus imports shows lower competitiveness of domestic economic agents compared with external trading partners.

Joining the European Union on 1 January 2007 accounted for Romania the increased volume of FDI flow. It is known that the level of foreign direct investment flows in a country or a region is influenced by local conditions, the economic situation and social and international politics. Therefore, as shown in the figure no. 3, the financial crisis affected decisively the flow of FDI attracted by our country. Major decline in FDI flows recorded in 2009, of 59.6% compared to 2008, is due to currency depreciation as a result of speculative attacks and country risk relegation due to increased foreign debt.

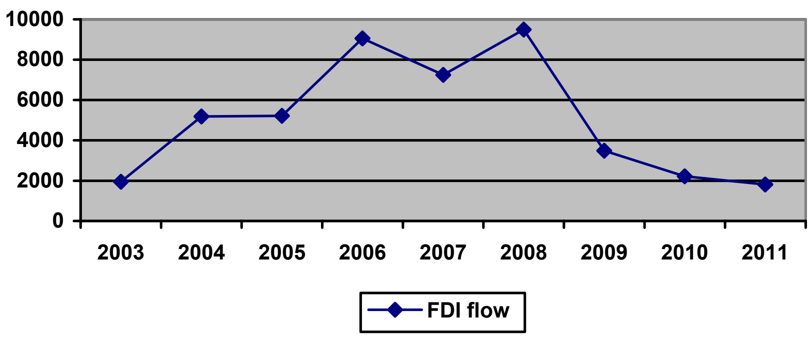

Figure no. 3 – Evolution of FDI's flows during 2003-2011
Source: Personal processing of BNR reports

With regard to the evolution of foreign direct investment for the same period of analysis, the situation is completely different, in that it records a continuous upward trend.

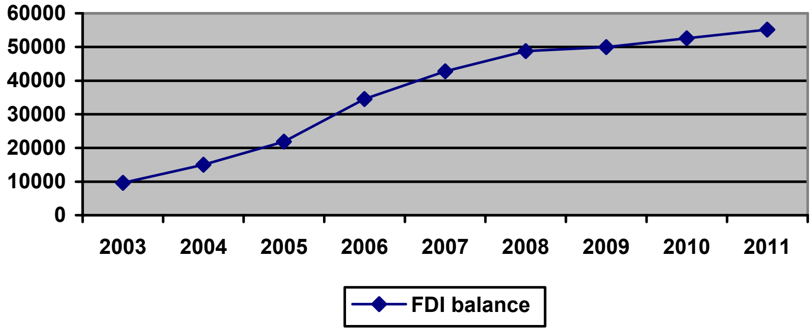

Figure no. 4 – Evolution of FDI's balance during 2003-2011
(amounts registered at the end of each year)
Source: Personal processing of BNR reports

Referring to the importance that the state should give to investments in the national economy Şusnea G. (1937) stated that "under the protection of laws that encourage and protect domestic industries from 1887 to 1912 and tariffs from 1886, 1893 and 1906, were created by 1915, 847 industries with a capital of lei 636,566,000, of which about 80% foreign capital. Because we do not have kept a proportion between national and foreign capital and especially of staff during the war we felt the consequences of this state of affairs". State of affairs referred to the author is the devastating effect of the Great Depression the Romanian economy. Therefore government as Keynes appreciated, should allocate significant funds to support investment, particularly for sectors that do not show interest to private and foreign investors (infrastructure, education, health, culture, agriculture). It is known that the sustainable development of these sectors is major incentives in terms of attracting foreign strategic investment.

Other elements that need to be analyzed in the current crisis are those relating to inflation, volatility of exchange rate and currency depreciation. In their analysis, Reinhart and Rogoff (2009), considers that the inflation threshold of 40% in a year is an important indicator of a crisis with high inflation. In our country, this type of crisis manifested during 1991-2000, when the inflation rate ranged from 256.1%, the highest rate recorded in 1993, and 45.7% rate recorded in 2000. Should be noted that for 1995 and 1996 inflation rate dropped to 32.3% and respectively to 38.8%. Beginning with 2003, the inflation rate registered a downward trend, but is far above the European average recorded for this indicator.

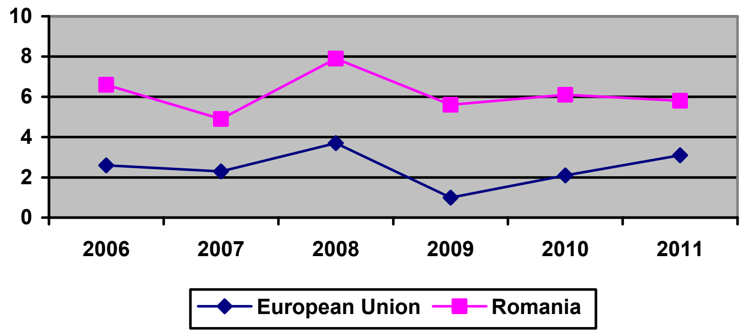

Figure no. 5 – Evolution of inflation rate in Romania comparative with EU during 2006-2011
Source: Personal processing of Eurostat databases

Inflation is considered as the main source of financial instability therefore its retention in 2011 was one of the main objectives of macroeconomic policy. National Bank of Romania therefore always pursued the evolution of this indicator, and at this time the level of inflation rate evolves according with target set limits.

For Romania a major effect of the financial crisis from 2007 is demand deficit faced since 2009. Also, the demand retained at a low level as a result of austerity measures the government has taken in mid-2010 (cutting wages, pensions and social benefits by 25%) and VAT increase to 24%.

Analysis of evolution of exchange rate both on the pre-crisis period from 2007 as well as afterwards, especially after the financial crisis in our country, in mid-2008 when there is an increase of about 15.14 percent, enables us to believe that throughout the period the national currency had an steady evolution, as shown in the following figure.

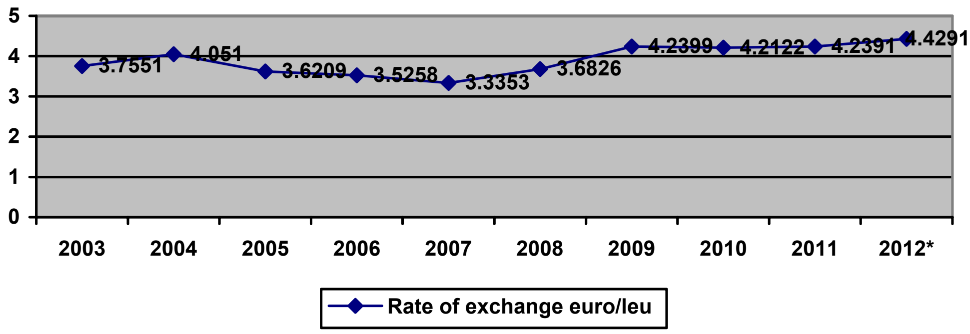

Figure no. 6 – Evolution of rate of exchange Euro/Leu during 2003-2012
Source: Personal processing of Eurostat databases
*estimated value

Organisation for Economic Co-operation and Development (OECD), argues that the current public debt crisis in the euro area is not over, although financial markets have registered some stability during this year (2012), but the region's banking system is still unstable. Also in the European Union sovereign debt levels are rising and fiscal targets are far from being achieved. Economic analysts believe that Romania has a position more stable compared to other countries from the Euro zone periphery, but is considered as a risky country, as the entire region of south-eastern Europe and the financing costs increased over the level of 2010.

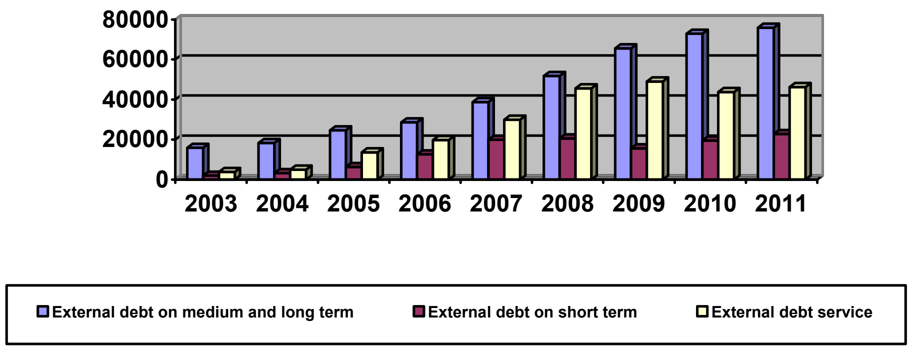

Figure no. 7 – Evolution of the external debt and external debt service during 2003-2011
Source: Personal processing of BNR reports

In its report of October 2012, referring to the sovereign debt crisis, the Romanian central bank estimated that extension of domestic political tensions could lead to additional net capital outflows generating also the enhancement of national currency exchange rate volatility. Fortunately, subsequent events have removed this assumption and the short-term evolution of the exchange rate recorded a downward trend.

With regard to monetary policy, the central bank decided to reduce its level in an attempt to boost lending. Unfortunately this measure hadn't the desired effect, although it is estimated that the level of monetary policy interest rate is appropriate for our country's current economic situation.

I left for the end of this paper the unemployment analysis because this indicator registered the most significant rate of growth as a result of crisis in our country. It is recognized that maintaining unemployment at a high enough level will cause in time the reduction of wages.

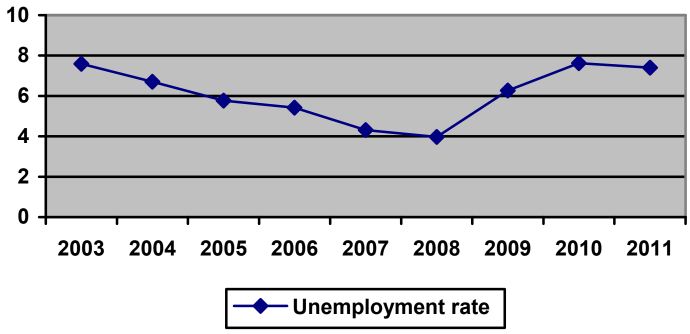

Figure no. 8 – Evolution of unemployment rate during 2003-2011
Source: Personal processing of World Economic Outlook, 2001 and www.insse.ro

Although the unemployment rate has increased significantly in 2009 (an increase of 57.86% compared to 2008), and in 2010 the upward trend maintains (up to 21.51% compared to 2009), the value of this indicator remains below the European average. In terms of progress for the last month of 2011 as well as for the months January to November 2012, the trend is downward, while the European average registers successive increases.

According to the official data our country recorded a lower burden of unemployment than the European average, but that does not mean that Romanians live a better life. The raising of living standards for Romanians will be felt when the average wage will exceed the average of wages from the Euro area.

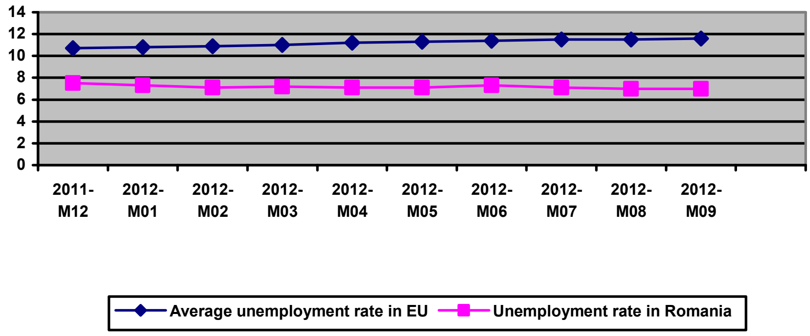

Figure no. 9 – Evolution of unemployment rate during December 2011 - September 2012
Source: Personal processing of Eurostat databases

We left for the end the analysis of the gross domestic product, as it is one of the fundamental indicators of macroeconomic analysis. According to the National Institute of Statistics, GDP for 2009 was 491.27 billion lei current prices, having a decrease of 7.1% compared to 2008, which highlights the devastating effect of the financial crisis in 2008 and the sharp downturn faced by our country in the near future of this time. This decrease was driven primarily by reducing the volume of gross value added in all sectors, and the most affected segments of the economy were trade, hotels and restaurants, transport and telecommunications, but also construction, whose contribution to GDP was 31.1% (INS press release, 2010).

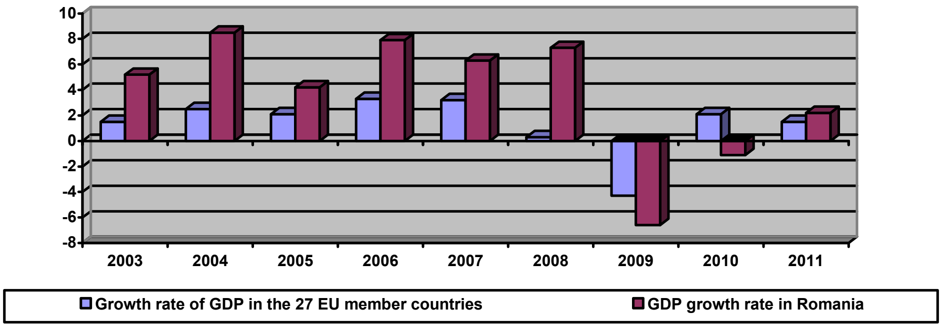

Figure no. 10 – The evolution of the growth rate of GDP during 2003-2011
Source: Personal processing of Eurostat databases

As shown in the graphic representation, the year 2011 represent the return to growth of the GDP for Romania, although for the EU this trend was recorded in 2010. The official statistics announced a GDP volume of 578,551.9 million in 2011, a value by 2.6% higher in nominal terms and by 2.5% in real terms compared to that in 2010. The value of the deflator used to convert the economic growth from nominal domain to the real domain was of 9.9%, the value being situated above the rising prices of the industrial production, situated at 8.93%, above the annual average increase of the prices for the population (5.79%) and above inflation at the end of the year (3.14%).

Quantitative analysis undertaken reveals that, Romania, like all other countries, has been and it is still affected by the financial crisis of 2008. Regarding measures escalating recession that our country faces, we find that these can be considered as consistent with the measures taken by other European countries.

It is widely accepted that drastic cost reduction programs and increase taxes, but also higher interest rates lead to reduced economic activity, also causing reduced budget revenues. Thus, the austerity measures the government has taken in May 2010, to reduce wages, social security and pensions, can be considered similar to those taken by the Executive during the economic recession in 1930-1933.

On the other hand, we can identify the measures that Romanian government envisaged as being the type of "limited interventionism", such measures are consistent with measures taken at EU level, namely: (i) the ratification of Fiscal Stability Treaty that provides common budgetary rules, entitling European Commission with control over national budgets. The Treaty establishes for the limit of structural budget deficit the threshold of 0.5% of GDP, which implies maintaining public debt below 60% of GDP. The "Golden Rule" of the treaty refers to the fact that the budget deficit together with the structural deficit will be within the limit of 3% of GDP. Failure to comply with these terms will automatically trigger a correction mechanism that must be provided for in national legislation. Therefore, the aim of this treaty is to strengthen fiscal discipline. This treaty will enter into force on January 1, 2013; (ii) establishment of the Financial Supervision Authority (FSA) which merges CNVM/ NSC, CSA/ISC and CSSPP and is responsible for the prudential supervision of the capital market, the insurance sector and private pension funds system.

Adverse effects of the crisis have emphasized on the one hand, the fact that globalization involves a high degree of difficulty for macroeconomic governance, and, on the other hand, the relationship between financial system and the effects of unpredictable external events constitute a major impediment for implementing internal policies.

CONCLUSIONS

Since the beginning of the current crisis, the theorists, economists, but also the great actors and governments have sought to identify similarities with the Great Depression in the years 1929-1930, and with the crisis that followed the Second World War. There are also many questions about the ability of quantitative models and analysis to indicate the possibility to trigger such a deep crisis.

Regarding the similarities between the two major crises that have major effects on the entire world economy, both resulted in decreased volume of production due to the lower demand, increasing unemployment, and the increase in sovereign debt as a result of banking crises.

Analyzing the measures our Government has taken to mitigate the effects of the crisis, we can identify both similarities and differences to the measures taken by the executive for the Great Depression. The most relevant difference is related to fiscal policy, so that the executive in 1930-1933 periods considered appropriate to reduce taxation, while in 2009-2010 the government increased the tax by increasing VAT to 25%. In which regards budget expenditure, both governments have resorted to "sacrifice curves", reducing public employees' wages, leading to lower living standards and thus lower demand.

It is widely accepted that the Great Recession that began in 2007, which had the epicenter in the U.S.A, was caused by the speculative bubbles on the real estate market, due to unprecedented growth and no correlation with reality of the house prices. But this was not the only trigger factor, but we can talk about a number of factors, namely: record trade balance deficit and current account deficit which attracted cheap foreign capital inflows and permissive regulatory policy. Profound effects manifested on financial markets but also at the level of global economy emphasize that we are dealing with "the most serious global financial crisis since the Great Depression" (Reinhart and Rogoff, 2009).

ACKNOWLEDGEMENTS

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