THE MYTH OF DEMOCRACY IN A FAILING ECONOMY

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ABSTRACT

THE LONGEVITY OF THE GLOBAL FINANCIAL CRISIS, TRIGGERED IN 2007 AND EMPHASIZED IN 2008 BY THE CRASH OF THE STOCK MARKET RAISES QUESTIONS ABOUT THE EFFICIENCY OF THE MANAGEMENT DURING A PERIOD OF CRISIS. THE FINANCIAL BOOM SPREAD THROUGH A DOMINO EFFECT, INFLUENCING THE GLOBAL MARKET. THIS PAPER FOCUSES ON ANALYZING WHETHER SUSPENDING DEMOCRATIC ELECTIONS AND APPOINTING A GOVERNMENT OF EXPERTS, OR SWITCHING FROM DEMOCRACY TO AUTOCRACY WILL INCREASE THE EFFICIENCY AND SOLVE THE ECONOMIC PROBLEMS WHICH TODAY'S SOCIETY IS FACING.THE EVOLUTION OF THE CRISIS IN A CONTROLLED POLITICAL ENVIRONMENT MIGHT REVEAL SURPRISING RESULTS – IN THE LONG TERM, AN AUTHORITARIAN REGIME OFFERS (WITHIN LIMITED LIBERTIES) A MORE EFFICIENT CRISIS SOLUTION.

KEYWORDS: *ECONOMIC CRISIS, THE GREAT DEPRESSION, KEYNESIANISM, DEMOCRACY, DICTATORSHIP, EFFICIENCY, SOLUTION*

The political evolutions in the last decades, the death of bipolarism in the international system and the shift of the security paradigm created a relative state of instability of the global arena, which is in a constant process of acclimation to the new parameters of security. The technological progress and the fast evolution of the telecommunication systems and Internet generated a series of parameters, within the development of modern wars takes place and which increased significantly the degree of interdependence between the state actors and the non-state ones.

Pursuant to the current globalization tendencies, the military traditional threats transformed gradually in asymmetric transnational threats, the focus shifted from the military area to the economic one. Tanks and cannon shots have been replaced by marketing strategies and public campaigns. The center of a functional society became obtaining strategic competitive advantages, speculations and fighting for market segments. A society without money is a powerless one, regardless the resources it disposes. Placed in the impossibility to exploit the available resources, it rapidly becomes exploited.

Nonetheless, history proves that the desire to obtain economic power exists from ancient times and brings as arguments the economic crises. This paper addresses the main global economic crises, discussing the causes that triggered them and the solutions identified.

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In the context of globalization, shifting from traditional war to economic war, an economic crisis raises concerns regarding the stability and continuity of a powerful state. In this situation, which political regime becomes the most efficient: democracy, dictatorship or technocracy?

For a better understanding of the phenomenon, we will briefly discuss the main theories regarding the causes of the crisis. The liberal doctrines promote the political and economic freedom of the individual unto the state. Any intervention of the state is rejected, as the market is considered a self-regulator organism. The sole cause of bankruptcy is the inefficiency of the institution, its lack of performance and competitiveness. As a consequence, the financial collapse is perceived as progress, a factor that reduces and eliminates unproductive elements.

Major economic crises with global effects brought into attention the necessity of the state's intervention in economy, arguing that it is a necessary evil. The market is the expression of the society. Having that in mind, we can say the democratic state is, ideally, the political reflection of the population it governs and its purpose is generating social welfare. Even if the free-market is a mechanism that promotes competence, it does not guarantee economic prosperity and welfare. So, if the crisis has a significant impact upon a large part of the population, the state decides to intervene in the economy and implements a series of measures in order to limit the damaging effects. The problems that derive from this are numerous: the state will determine an uneven distribution of resources (different from the way it would have been in a free market), affecting in this way competitiveness; mass-nationalization could lead to the end of capitalism and there is no limit defined for when should the state stop its intervention in the economy.[2]

The nature of economic crises varies. On one hand, the keysenianist vision[3] claims that the main cause of the crisis is the human behavior – the individual acts accordingly to his animal instincts, making spontaneous decisions, based on an amplified optimism and not a rational calculus. On the other hand, the Austrians[4] identify as the root cause of the crisis the variation of the monetary mass. Although these explanations are well founded, they fail to explain completely the triggering-mechanism. The Keynesianism does not justify why the crisis is not perpetual (considering that the animal spirit is a constant), while the Austrians do not illustrate the reasons why the crisis was not triggered in situations defined by significant increase in the monetary mass. The speculative bubble reunites these two visions, creating a unique framework that fosters the depression.

CRISES IN HISTORY

The first major economic crisis in history was the tulip and bulb craze back in 1637 and was triggered by a speculative bubble. The tulips began to rise in price, reaching unimagined values, which were not an accurate reflection of the merit of a tulip bulb.[5] The lack of demand and the impossibility to find buyers determined the burst of the speculative bubble and the beginning of the crisis. The identified solution was annulling contracts, on the condition that a payment of 10% from the initial value will be made. The measures did not ameliorate the situation and the negative effects of the crisis persisted a few years.[6]

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[2] Hazlitt, Henry, *Economics in one lesson*, 1946

[3] Keynes, John Maynard, *The general theory of employment, interest and money*, 1936

[4] Piroșcă, Grigore Ioan, *Individualism și opinie publică,* Comunicare în doctrine economice, (București: ed. ASE, 2003)

[5] In Charles Mackay's book (*Extraordinary popular delusions*) the following transaction is mentioned: for a Viceroy tulip bulb, the price was 48 barrels of wheat, 96 barrels of rye, 8 pigs, 12 sheeps, 2 barrels of wine, 1000 liters of beer, 2 tons of butter.

[6] Lybeck, Johan, *Istoria globală a crizei financiare, (*București ed. Polirom, 2012),

In 1929 began what was about to be called the Great Depression – the longest and the most severe crisis in history, which affected the global economy and determined significant changes in macroeconomic politics and in the structure of financial institutions.

Among the causes of the decline, the economists identified consumption reduction (aggregated demand), and implicitly production downfall, while the merchants and the producers observed an unplanned increase of goods in the stock.

The catalyst of the crisis was the sudden lack of confidence of the population in the American economic system. The stock market prices were almost 4 times higher than in the last 8 years. The Federal Reserve increased the interest rates, in the attempt to slow down the accelerated increase of stock holdings. This lead to expenses deadness in domains in which the interest fluctuation was vital (e.g. construction, auto industry). In October 1929, after a series of events that lead to gradual decrease of the prices, the creditors lost their trust, and the speculative bubble burst. 24th October remains in history as the Black Thursday – the beginning of a 10-year crisis. In this amount of time, the industrial production of the United States decreased with 47%, and the GDP with 30%.

The solutions identified by Franklin Delano Roosevelt, the American president at the time, were structured in a series of economic programs known as New Deal and sought to determine relief, recovery and reform. In the first two months of the year 1933, 4004 financial institutions declared bankruptcy and the unemployment rate reached 25%.
Reforestation Relief Act offered 250 000 jobs to the American youth, within the Civilian Conservation Corps and by the end of the program, in 1941, 2 million citizens brought their contribution to the American society. The Agricultural Adjustment Act established ceiling prices for agrarian products and offered subsidies for farmers. Bridges and energetic pipelines were constructed. In other words, the solution identified by Roosevelt for the economic crisis was the major investment in infrastructure and in national producers. Encouraging the economy and reviving some economic agents rendered the population's trust in the financial system, the decrease of the unemployment rate determined a higher purchasing power and thus, favoring the overhaul of the crisis.[7]

Historians still debate the success of the New Deal. Those who sustain the efficiency of the Roosevelt-measures underline on one hand the economic indicators, who never came back to the values recorded during the Great Depression, and on the other hand perceive the investments made in infrastructure as long term advantages for the US economy. On the contrary, critics considered that although the unemployment rate was reduced, it still remained high. New Deal, from their perspective, was not a viable solution, the real factor that determined the end of the crisis being, in fact, the Second World War. Also, the changes that Roosevelt made regarding the executive did not bring benefits to the American nation.

In 2008 the sudden decrease of liquidity in the credit global market and in the banking system determined a new economic crisis. Starting with 2005, the banks began to lower their mortgage loan conditions, granting advantageous initial terms. Considering the long term tendency to rise in price in the real-estate market, a significant percent of the population took more than one mortgage loan, in the hope that it will be able to refinance them later with more advantageous rates. A remarkable number of Americans had real estate properties that did not afford in reality. The mortgage loan with a high degree of risk increased from 5% to 20% in 1944-2006. Granting loans on easy conditions and betaking to Ninja Credits (a stable working place, income and guaranty on assets were not necessary) amplified the economic bubble. The mortgages were transformed into public effects. Based on high degree of trust accorded by rating agencies, the investment banks took risks and although they obtained huge

[7] Cole, Harold; Ohanian, Lee, *New Deal policies and the persistence of the Great Depression: a general equilibrium analysis*, 2001

profits, their degree of risk and debt also increased. In 2007, the collective debt of Lehman Brothers, Bear Sterns, Merrill Lynch, Goldman Sachs and Morgan Stanley reached 4000 billion, which represented approximately 30% of the US economy.

The burst of the economic bubble was caused by the rising interest rates and impossibility of the citizens to refinance their mortgage loans. Shortly after, millions of houses ended up being even (1,3 million only in 2007). The alternatives at that time were not too encouraging: the banks ought to choose between keeping the real estate properties, in order to sell them later, on stable market (but a significant amount of money was needed for maintenance) and selling them at considerably lower price than their actual value.

7th September represented the start of the economic crisis: powerful companies like Fannie Mae, Freddie Mac, Lehman Brothers, AIG collapsed and with them, through domino effect, companies that had equity stakes. The complex mechanisms that govern finances globally determined negative evolutions in numerous states, both in Europe and in the Arab World. In Europe numerous financial institutions declared bankruptcy. One of the most affected states was Island, which was highly dependent on the financial sector. Its long recovery was successful mainly due to IMF loans. The annual rate of decreasing GDP was in the first trimester in 2009 of 14, 4% in Germany, 15, 2% in Japan, 7, 4% in UK and 9, 8% in the Euro zone. The Arab World signaled loss in value of 3 trillion USD, the "explosion" of the unemployment rate being just a matter of time. In May 2009 UK reported a decrease of foreign investments in the Middle East, because of the low demand on the oil market. The Arab banks declared, after only 3 months of crisis, losses of approximately 4 billion USD. [8]

The solution identified by the American government was simple: capital injection. In the absence of other creditors, the billions needed for saving the state from economic collapse came from the Federal Reserve. Can the state intervene in the economy and if so, how much can it do? Does the nationalization of the companies represent the end of capitalism? Are the citizens really benefiting? The debate about the legitimacy of the state's intervention in economy revolves around the idea that this is a crisis solution. The Government will re-sale the institution, once it becomes functional and efficient. However, when talking about a phenomenon that is as severe and complex as the one in 2008, when institutions like AIG – the 18th company in the world – are declared bankrupt, we ask ourselves which company will be in the lucky position to be able to buy such an institution? Furthermore, the entire balance of the market will change: once nationalized and compliant to favorable policies, the institution will increase its capital of image and gain the trust of the population. In this way, the state does not encourage competitiveness and efficiency on the market.

COMING BACK TO RATIONALITY

Although the 2008 crisis left behind bankrupt companies and high unemployment rate, it seems to have had a positive effect also – it determined the population to come back to rationality. In the United States, a significant percent of the population owned real estate properties they did not afford. Implementing harsh measures, stricter fiscal policies and imposing more conditions when it comes to according loans were the first steps to be taken in order to increase the efficiency of the financial system. Although the measures seemed austere at the beginning, on the long term their sole purpose is increasing production, reviving the economy and ensuring national security.

Josh Gerzema[9] pointed the change made upon the regular consumer. The decision-making process envisaged interest rates shifts, capital injections, creating crisis funds and despite all that, the economy continued its descendent trajectory, until the individual changed

[8] Abrudan, Mirela, *Criza economică și reflectarea ei în mass-media*, (București ed. Tritonic, 2010)
[9] *The Brand Bubble,* 2008

its behavior. Unfortunately, the contemporary American society is a projection of the irrational behavior of the consumer, which is based on the false premise that what he owns is what defines him. The American culture is the culture of the consumer, in which the quality of life is defined quantitatively.

The economic crisis in 2008 was an opportunity for the regular consumer to take control over the economy's trajectory and eliminate or reduce the degree of self-risk through daily rational decisions. In 2008, approximately 70%[10] of the United States' GDP was assured by internal consumption. The statistical data collected 11 months later proved that the rate of personal savings increased considerably, which proves the fact that the population became more responsible and forehanded, when it comes to expenses. Gerzema emphasizes the fact that the American citizens still have cash, but they no longer choose to spend them on unnecessary items. The amount of money spent on medical care and groceries proves that they started spending money they have, without resorting to credit cards and loans. Leading from Hobbes'[11] idea that the individual is placed in the center of the society, a new philosophy emerged – economic behaviorism – which emphasizes the importance of the human behavior rather than sterile market forces. The state's intervention in the economy and the measures implemented are based on the classical principles of the economy, approaching crisis in a traditional manner. The economic progress so far, analyzed in comparison with the causes previously mentioned, underlines the fact that behind faulty monetary policies stands the human behavior, as a catalyst of the economic crisis.

Leading from this premise, we have to ask ourselves: which solution is the best for maintaining the crisis under control – state's intervention in the economy or let the market function as a self-regulator organism? Creating a technocrat government, that will manage the crisis from the perspective of an expert, was one of the first solutions implemented in Japan during the 1992-2002 crisis. In 1997 Hokkaido Takushoku Bank, a bank considered too big to fail, was declared bankrupt. Until 1998, the measures imposed by the government did not managed to change the status quo. In 1999 the first real solutions were proposed: creating an independent authority for financial supervision. Thus, Resolution and Collection Bank Corporation appeared on the market and bought the toxic assets. The banks with a faulty management were let to go bankrupt, and the first 20 banks merged into 5 banking groups. The Japanese crisis was even worse than the one in 2008, and it only amplified as the government failed to make a decision[12].

In today's society, major economic decisions are similar to the intelligence process. Collecting information and creating scenarios in order to predict future events is one of the main tasks of the economists. They disseminate their conclusions to political beneficiary. Nonetheless, the system proved to be inefficient, as the 2008 economic crisis was not anticipated and prevented.

Rogoff and Reinhart[13] identified two elements common to all 138 financial crises that took place after the Second World War – an increase in the speculative capital and extremely high prices for real-estate properties located in a residential area or destined to the commercial sector – managing to elaborate a predictability formula for the economic crisis. From their perspective, the 2008-financial boom could have been prevented easily, if the

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[10] Mathews, Rick, *US GDP is 70 percent personal consumption: inside the numbers,* 2012, last accessed 04.09.2014 http://www.policymic.com/articles/15097/us-gdp-is-70-percent-personal-consumption-inside-the-numbers

[11] *Philosopical rudiments concerning government and society,* 1651

[12] Lybeck, Johan, *Istoria globală a crizei financiare*

[13] Reinhart, Carmen, Rogoff, Kenneth, *This time is different: eight centuries of financial folly, (*Princeton Press, 2011)

indicators of the system crisis would have been taken into account (all visible and known). The 2008 crisis was the result of the free market, as it allowed for under regulated or poorly regulated financial entities to play a major part in the financial system. In the context of a political beneficiary who ignores the alarm signals, whose decisions are not made on a rational calculus, the economic crisis diffused in a relatively short time. Imposing a technocrat government could solve these problems, but I prefer revealing a more interesting scenario – how a crisis develops in a controlled market.

Let's take for instance China. After Deng Xiaoping's reforms in the 80s, China had a spectacular economic evolution. The decisions taken by Chinese government apply beyond the law: evacuating millions of citizens, rationalizing food, and other measures, all with the purpose of increased consumption on the long term. This measures and the strict control of the state upon consumption are impossible to implement in a country with a democratic regime, as it exists the constraints of the public opinion. The Chinese state represents an unique mixture of capitalism and communism, promoting a particular economic policy, being open to the global market – elements that favored implementing measures in order to reduce the negative impact of the crisis. "Although the prognoses elaborated by international organisms indicate a compression of the economic development, the appreciation still remains optimistic, (…) it is based on a modification of the market position's roots, from sustained growing rates, as a consequence of cheap and consistent labor force; respectively direct investments into infrastructure, education and technology, to the pressure induced by increasing salary and decreasing demography."[14]

Yasheng Huang[15] analyses India's economic evolution in comparison with China. Although in the last 5 years they had similar economic developments, in the last 30 years, China's progress was incomparably higher. If someone argues that this is the result of infrastructure investments (for instance, like in the case of Roosevelt's New Deal), a quantitative comparative analyses between China and USSR might offer a surprising result. Even if USSR had in 1989 more telecommunication networks and a better infrastructure than China, the Iron Curtain fell and China is now one of the greatest economic superpowers in the world, if not the greatest[16]. The causality link is inversed: economic growth leads to obtaining more financial resources and investment opportunities (infrastructure, education, technology) and not the other way around.

In what concerns the relationship between democracy and economic growth, Lipset[17] considers democracy a product of financial development more than a catalyst for it – China, although an authoritarian form of government, became in the last decades more democratic and open. There is the belief that economic growth is necessary for democracy and not backwards and that a certain level of economic growth is required for the regime to be sustainable, reducing the intensity of conflicts. This conclusion was drawn based on a simple ratiocination: investing in education and communication helps creating and consolidating a security and a democratic culture, efficient business environments, elements that sustain the

[14] Drăghici, Mihai, *O perspectivă asupra relațiilor economice globale*, Revista Sinteza, nr. 5, iunie 2014, 83

[15] International Program Professor in Chinese Economy and Business, Profesor of Global Economics and Management, MITSloan Management

[16] China was on the verge of an economic crisis in 2013. The opinions regarding the causes of this event are diverse: on one hand, the ruling of Bo Xilai lead to a series of decisions whose long-term evolution might determine stagnation; on the other hand, that is China's natural evolutionary rhythm. China's economic growth is remarkable, but not unprecedented. Japan, North Korean, Taiwan had anual growths of 9% for two decades, then the progress was slightly slowed down. The Asian Tigers knew flourishing periods, followed closely by crises. The cause? It is difficult for them to develop rapidly in the conditions of a large economy, sustained mainly by middle class individuals.

[17] *Political man: the social bases of politics*, 1960

democratic path of governmental institutions. Based on Asian countries' evolution, economists consider democracy, as a political regime, an impediment in economic growth. The process of economic development requires massive investments in human and material resources. This type of investment implies reducing consumption, which can be painful for certain social segments. Governments must apply harsh measures[18], through which the amount of money necessary can be obtained. For a dictatorial regime, implementing this measure is favored by the lack of real power of the population and by the political uncomplainingness of the masses. In democracy, on the other hand, the power lies in the hand of the people, and through the electoral levers available the implementation of certain measures can be suspended. The welfare of a state is perceived by the regular individual in terms of own welfare. He is preoccupied of his own workplace, his economic advantages and self-security rather than respecting the democratic principles in organizing elections, state's structure or statistics regarding the unemployment rate. In the moment when decisions that affect his comfort (social, financial) are taken, he will demand the change of the status quo. The major difference between the individual in a democratic state and the one in an authoritarian state derives both from the expectancy regarding individual benefits, and from the degree of power the individual exerts upon the regime.

CONCLUSIONS

It is hard to analyze the impact the political regime has upon economic growth, as the comparison between the evolutions of a democratic state, let's call it X and of the same state X but with an authoritarian regime. Nonetheless, Przeworski and Limogi observed that between 1946 and 1988 the democracies in South America knew an economic growth of 1,31% , compared with non-democratic states 2,15%.

In order to establish the economic trajectory of a state, more than simple statistical data must be taken into account. Elements like historical and social background influence significantly the evolution of the state. A dictatorship which exceeds in infringing human rights and fundamental freedom is continuously threatened by the possibility of a social riot. On the other hand, historical precedents have proven the stability of an authoritarian regime in situations of economic crisis. The statistics coming from a closed regime are almost never precise (for instance, Romania during its communist period was illustrated as a prosperous country, contrary with the disturbing reality of food rationalization and crisis).

For economic success, a country does not require a democratic government, as the state is invested with power (legitimately or not) and takes decisions regarding the allocation of resources for the welfare of its citizens. This function can be performed effectively by a government elected democratically, or, as the studies have shown, by an authoritarian ruler. The efficiency of the measure is actually higher in strictly controlled environments, as the individuals, who only seek self-benefits, lose their ability to change the regime and stop the implementation of harsh policies. The resilience of an authoritarian regime in case of economic crisis is undoubtedly higher than of democracies and proves to be more efficient in applying fiscal policies in order to reduce and limit the negative effects of the crisis.

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[18] Vaman Rao (1984) apud Adam Przeworski, Fernando Limogi, *Political regimes and economic growth*

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