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### **The Current Economic Crisis: Effects, Consequences, Measures and Solutions**

*Liana-Antonela BONTA (cas. MITEA)*

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# The Current Economic Crisis: Effects, Consequences, Measures and Solutions

Liana-Antonela BONTA (cas. MITEA)<sup>1</sup>

## Abstract:

*The main objective of the present research project is the current economic crisis, its effects, consequences but especially the measures and the solutions that we can find to resolve this situation. A key problem preoccupying developing countries today is the global economic crisis and how they can address it. The epicenter of the crisis is in the developed countries, especially the USA. But the developing countries that have no role in causing the crisis have suffered the most severe "collateral damage". I will try to present the similarities with other periods of recession that we have crossed-over time. I will propose a few measures to remedy this situation, both long-term and short-term, referring of course to Romania and EU as well.*

## Keywords:

*economic crisis, measures, solutions, The Great Depression*

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<sup>1</sup> Ph.D. student, Faculty of Economics and Business Management/Department of Political Economy, "Babes-Bolyai" University, Cluj-Napoca, Romania, [tonyaliana@yahoo.com](mailto:tonyaliana@yahoo.com)

## Introduction

The economic crisis is a phenomenon that affects everyone, be they economists, businessmen, workers, or common people. Studying this phenomenon we observe that, over time, the society has faced numerous periods of economic instability, resulting in economic crisis and large-scale recession.

Specialists have shown that economic recessions are quite similar, but they also feature elements that make them unique, which is why we cannot develop a doctrine of economic crises.

Some U.S. politicians believe that the current crisis could not have been predicted, invoking the concept of "black swans" (Taleb, N., 2007), advanced by Taleb, under which the crisis is an anomaly of an overwhelming importance, but which could not have been foreseen. However, there have been a few economists who have paid attention to what will follow.

Nouriel Roubini, "the crisis prophet", as he is called, issued a warning according to which the economy of the U.S. will suffer a brutal shock in the housing market and a deep recession, appreciating the global dimensions of the future disaster. Raghuram Rajan, finance professor, stressed that, the way in which bank employees are discounted, pushes them to take risks that will lead to a vulnerability of the banking system.

Alan Greenspan recently defined the current crisis as a "credit tsunami that occurs once a century", caused by a collapse whose root causes are found in the U.S. housing sector.

I. Wallerstein calls the current crisis, "systemic crisis", fitting it between a phenomena that show the end of civilization. "Structural crises can be superimposed over the economic crisis and even cyclical crisis, as it seems to be the case of the current crisis, which is exposed to confusion and interpretative reductionist approach".

Certainly we all know the causes that have led to this period of instability felt worldwide, which is why I won't insist on this part. The financial crisis that started just after the bursting of the bubble in the US housing market in late 2008 is still continuing to affect the whole world but especially the developed countries. Economic measures taken by developed countries against the crisis which causes the global economic recession appears to be insufficient and this situation poses a great threat to the global economy. I will try to show what are the consequences of

the current crisis, and also a few solutions that could help us overcome this period. I will then show, the main differences between the Current Crisis and The Great Depression, because there aren't few those who find the two alike. The extent of this crisis is considered to be comparable to the extent of the economic crisis of the 1930s.

### **Effects and consequences of The Current Crisis**

No one was immune to the crisis. Countries like Japan and China, which depended on the manufactured products export have also experienced worsening U.S. recession. The demand for raw materials from the Middle East has diminished considerably. "The economies of Latvia and Dubai, which are different, have felt the negative effects of the collapse".

U.S. crisis severely affected all worlds' markets because the financial systems are interconnected, and the banks were filled with U.S. real estate debt mark. This phenomenon manifests itself in the world economy and is, in my opinion the most felt impact of the financial crisis at the moment. Bank losses have reached impressive levels. This phenomenon occurred both in the U.S. banks and the European ones, the difference being that the first were faced with much higher losses.

Stock markets were also destabilized, falling a lot. Some were even closed a period of time. On October 8th, 2008, the Bucharest Stock Exchange (BVB), suppressed the trading session due to the decrease of 10% of the quotations.

Crediting of individuals faces restrictive conditions by limiting the investments in real estate and product lifespan. We are dealing with a limitation of consumption. As far as it concerns legal entities, the observed constraints at this level consist in limiting their investments, by restricting access to credits.

One of the effects of the crisis is a substantial decrease of all countries' exports, as the rapid growth in trade seen this decade will drastically reduce. Exports from Central and Eastern Europe are strongly correlated with those of the Euro area due to their importance as material goods in the supply chain.

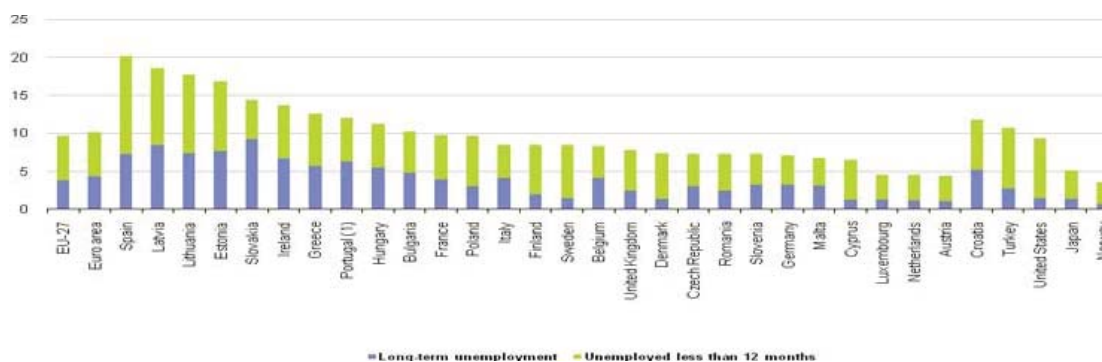
The foreign capital inflow was strongly affected by the financial crisis. The global slowdown reduced the demand for consumption goods and industrial products, reducing export earnings. Developing countries now borrow with higher interest because of the exodus to safer markets and higher risk aversion.

In the past, major crises in developing countries focused on a regional level, but the current crisis epicenter is located in developed economies, therefore we see that all developing regions are affected by shocks. Investments decreased especially in emerging markets.

The impact of the international economic crisis on the new EU member states proved to be more severe than anticipated. Here the Greek situation has reached alarming levels and threatens the existence of the Euro and the European Union. There are several factors that clarify the different impact of the crisis in the EU. Countries with current account deficit of less than 10% of GDP have lower external financing needs. Baltic Countries, Bulgaria and Romania need a larger volume of external financing. The exchange rate is another differentiating factor. Countries that have a floating exchange rate, Romania included, registered a sharp depreciation of the exchange rate during the financial crisis.

The recession has reduced capital flows in the EU, leading to the collapse of direct foreign investments in the region. The crisis had a high social cost in Europe, resulted in a strong increase in unemployment. In 2008 the unemployed accounted for 7% of the workforce in the EU-27. In 2010, their number was about 10%, with the prospect that the unemployment rate to remain above 9% in 2012, as shown in the chart below. Unemployment is particularly high, exceeding 12% in Estonia, Ireland, Greece, Slovakia, Latvia, Lithuania and Spain. Youth unemployment rate exceeds 20% in more than half of EU Member States and reaches 42% in Spain (European Commission, 2011).

**Fig.1 Unemployment rates in the long term and short term**

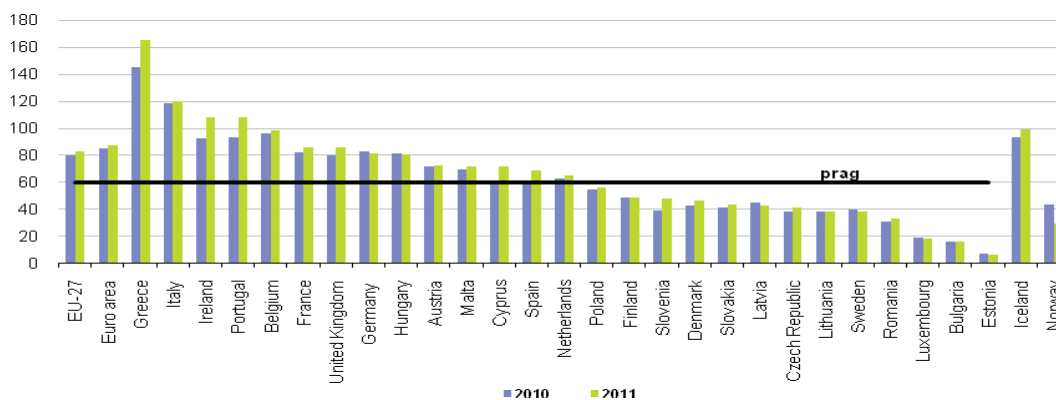


Source: Eurostat

The crisis has especially affected public finances in the euro area and the EU. In a short period of time, the weights of the public debt in GDP have strongly increased in nearly all Member States, negating the moderate progress registered in the years previous to the crisis. In EU-27, public debt to GDP increased from 80.0% at the end of 2010 to 82.5% in late 2011 and in the euro area increased from 85.3% to 87.2%. A total of 14 Member States reported in 2011a debt level of 60% of GDP.

In late 2011, the lowest shares of public debt to GDP were recorded in Estonia (6%), Bulgaria (16.3%) and Luxembourg (18.2%), according to the schedule below. In 2011, the 21 Member States, public debt to GDP increased compared to 2010 and decreased for six Member States: Germany, Estonia, Latvia, Luxembourg, Hungary and Sweden. The most significant increases in debt between 2010 and 2011 were registered in Greece (20.4 %), Ireland (15.7 %), Portugal (14.4 %) and Cyprus (10.2 %).

Fig. 2 The public debt in 2010-2011



Source: Eurostat

Although the crisis has its origins in the United States, all international economic actors should take urgent measures. It is essential that developing countries should be as prepared as possible to minimize the risk of recession. Measures have been taken with regards to the deposits guarantee degree, so that people can feel their savings safe. Emerging countries' administrations have two main macroeconomic instruments of reaction to the negative shocks that they are ready to face: monetary policy and fiscal policy.

During 2009 - 2010, the EU most affected countries were: Greece, Portugal, Spain, Ireland, and Italy. Neither our country has escaped unscathed from the meltdown that we cross. EU situation is similar to the Asian crisis of 1997-1999. The most affected are developing countries due to high budget deficits and public debt generated by this crisis. Capital market contraction is in fact real economic contraction.

The economic crisis that Romania is going through is primarily an internal crisis, resulting from an unhealthy growth, because it volatilized in a single quarter. We had during these years a growth based on debt financed consumption, which can be considered a major cause of the crisis.

The international financial crisis was only the trigger of the domestic economic crisis, because it has affected funding. Now we borrow more expensive if at all. This is true both for the government and for businesses and population. The vulnerabilities of an unbalanced economy, with many delayed structural reforms, are now obvious.

The current economic downturn has manifested by slowing exports, production being correlated with the evolution of the global economy. The access to external financing was limited and this reflected in the depreciation of the national currency. There was damage to the net assets of individuals and companies due to the large share of loans in foreign currency correlated with the Ron's depreciation, and falling asset prices and real estate securities. The international financial crisis has important implications on the Romanian financial system, and many analysts have questioned whether Romania will resist.

The situation of Greece is not very comfortable either. Failed to meet the criteria set by the EU in terms of 60% debt and budget deficit to 3% of GDP. Government debt is approx. 150% of GDP. At the same time it is also faced with a mix of inappropriate policies, hostile legislation and black labor market. Over 70% of Greek businesses are family businesses. Because it is supported only on IMF and European banks' infusions, Greek's situation is threatening to endanger the monetary stability of the European Union.

### **Similarities/Differences to other periods of recession The Tulip Mania versus The Current Crisis**

I will try to present some similarities with other periods of recession that we have crossed-over time.

The onset and development of the tulip bulbs mania is similar to the economic crash that we currently face, the difference being the asset that started it all. The speculative bubble was caused now, not by the rare tulip bulbs, but by the real estate market. After an artificial increase in the real estate prices, the bubble broke and housing prices began to fall. The warranty's value didn't covered the value of the contracted loans

### **The Great Depression versus The Current Crisis**

The Current crisis is a sensitive subject. More and more analysts compare the current situation with the cross during the Great Depression. Below, I will try to present the similarities and differences between the two periods of economic instability.

In our presentation we start with the most visible facts and features. Here the nuclei of both crises have emerged in the United States. Then as now, U.S. wealth is in the hands of a few people, with an important gap between the rich and the poor. In the '20s, although production was growing, the income of common people registered insignificant increases in earnings. Large companies and corporations were benefiting from the economic development, collecting profits over 65%.

The main causes of the onset of these recessions are also somewhat similar. In both cases, the causes of crisis were due to excessive consumption, risky loans and out of control speculation, which are deep roots of the two crises.

All these causes send U.S. back eight decades ago, to relive the disaster that shocked the entire world's financial system. However the magnitude of the current crisis has made us to turn our gaze to the 1930 situation. Since then till now, the international financial system has never been questioned.

Both recessions were faced with a speculative bubble. Real estate speculation before the current crisis is similar to the stock market game from the '20s. During The Great Depression, ordinary common people were indebted beyond measure to get a stock. Unfortunately, the actions



and real estate prices began to fall, leaving people without life savings and even debt from banks, because the warranty value didn't cover the contracted loans.

Now let's talk about the differences. The Great Depression was a crisis of overproduction, limited to a few developed countries and colonies, while the current crisis caused damage all over the world. Now we talk about a crisis of confidence and a subprime crisis.

In the late '30s, the government intervention was delayed, and it did not take any action against hazardous investments. We cannot say the same about the current situation, because the loans are sustained by government programs. Losses were reduced by government intervention. During the Great Depression, unemployment reached 25% and stock market fell by 75%. During the current crisis we have faced resounding but reduced failures.

### **Crisis impact on the Romanian economy**

The economic crisis faced by Romania is primarily a domestic crisis, caused by an unhealthy growth, because it volatilized in a single quarter. It was based on increased consumption financed by debt, which can be considered a major cause of the current crisis in our country.

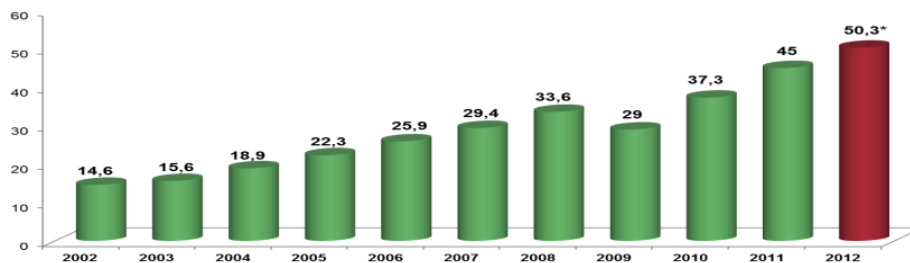
The international financial crisis was only triggered by the domestic economic crisis, because it has affected funding. We consume on credit, and now we are borrowing more expensive, if at all. This is true both for the government, for economic agents and population. Vulnerabilities unbalanced economy, with many delayed structural reforms, which are now obvious.

Economic downturn manifested by slowing exports, production being correlated with the global economy. The limited access to external finance is reflected in the domestic currency. There was damage to the net assets of people and companies due to the large share of loans in foreign currency related depreciation, and falling asset prices and real estate securities.

**Fig. 3 Exports evolution in billion**

**Evoluția exporturilor 2002-2012**

- miliarde Euro -



Source: National Institute of Statistics

\*) National Prognosis Commission forecasts

Macroeconomic developments in our country have grown amid deepening international crisis inadequate. Economic growth during 2005-2009 was based mainly on domestic demand represented by consumption, economic and government consumption. Efficient and healthy would have been the application to be based on foreign demand.

Reduced exports caused a fall in production and a contraction in domestic demand. Decreased production led to a lower turnover of trade and services, since July 2008 and exacerbating the following year. As of 2008 there is a decrease in net investment, new construction works. All this has led to bankruptcies of enterprises and increasing unemployment.

Economic growth, greater satisfaction of domestic consumption and higher investment was made on account of foreign capital. Short-term, medium and long term foreign debt increased from year to year, and since 2007 has deepened further. Romania was forced to seek an IMF loan to get through this period of economic downturn.

Due credit contraction, decreased both domestic and foreign demand for metallurgical products, petrochemicals, including car production. Our country has experienced a decline in industrial production due to dependence on international demand. The crisis was felt by reducing imports and exports, foreign capital flows, the depreciation and high volatility of our currency.

The current financial crisis brought an abrupt reversal of the trend of the currency appreciation, with emphasis on episodes of volatility. Romanian experience has shown that financial stability is of particular importance to price stability. Our country has been criticized for delays in disinflation. They were due to insufficient structural

reforms. If the Central Bank would have filled this gap by reform of interest rates increases steepest economic and financial situation of the population would be damaged.

Indirect effects have resulted in reducing lending, strongly affected by the cost of financing and increased uncertainty. A low consumption due to rising unemployment and declining incomes. Reducing external and domestic demand and increased financing costs reposition investment plans, resulting in reduction or postponement of investments in the economy. Decreased budgetary financing, bad loans have reached high rates through a reduction in income.

The crisis came to affect Romania's real economy due to increased vulnerability of reduced economic activity, dependence on foreign capital, the need for external financing and exposure to exchange rate volatility.

The Romanian economy recovers slowly because the domestic and external demand didn't increase concomitant and economic growth depends on the euro area situation. Foreign demand was affected by foreign investors', risk aversion and liquidity deterioration in the euro area, domestic demand being the only engine of economic growth.

### **The Current Crisis: measures and solutions**

I will propose a few measures to remedy this situation, both long-term and short-term, referring especially to Romania and the EU as well

It was observed that real estate prices have reached very high values, which not being able to be sustained, began to decline. The government intervention was necessary to sustain banks and leading companies not to go bankrupt, thus diverting artificially the course of the economy.

The Invisible hand theory can also be tackled in the current crisis. Although theory says that the welfare of society is achieved by acquiring wealth by each individual, it is exactly the large companies' greed and their desire to increase the profit that brought us into this situation.

The Theory of state interventionism is supported by J.M. Keynes, who believes that the state should be involved in the economy through fiscal and monetary measures, which help to mitigate the negative effects of financial crisis. Here is that with the collapse of Lehman Brothers bank, the state became a major player.

The bank's rescue measures through cash injection, as part of the stabilization policy, was received and reviewed in 1963 by Milton Friedman and Anna Schwartz in their "Monetary History of the U.S., 1867-1960. U.S. and EU countries save the banking system, based on Friedman's thought 40 years ago.

These measures are applied differently from country to country. U.S. prefers a more liberal model of saving the banking system, while the Europeans a more socialist. Britain has nationalized several banks. In September 2008, the British state bought from the banks the preferred shares, which doesn't entitle it to vote at the general meetings of shareholders. Today's banking "Nationalization" is totally different from the banking nationalization model practiced 60 years ago as not affect shareholders. Once the crisis will be overcome, actions will increase and the British government will probably sell with a good yield.

During 2007-2008, the Fed opened some unprecedented credit lines, turning to the lessons of the Great Depression and helping banks and companies like GM to avoid bankruptcy. In 2009, we implemented the teachings of Keynes, through a legislative proposal for economic stimulus.

The rescue attempt was extremely expensive, reaching trillions of Euros. American government has placed under the guardianship of the government mortgage giants (e.g. Fannie Mae Freddie Mac). To save these entities, the Treasury has injected approximately 200 billion dollars. This government support has limits, because aid is borne by taxpayers, making the number of firms receiving such treatment limited.

Central banks have injected liquidity in November, but with caution as there is a significant risk of inflation. Creation of currency without coverage could lead to soaring prices. They try to recover titrize devalued loans. So the FED has recovered 29 billion of toxic assets from investment bank Bear Stearns and facilitated its takeover by JP Morgan. The solution has its limit as not all toxic assets can be isolated in a short period of time.

A solution to overcome the situation in which we find ourselves would be promoting coherent and credible policies for internal and external imbalances adjustment.

Austrian economists believe that to overcome the crisis, banks and indebted companies should be left to fail, to allow the strong to thrive. They believe that the very excess of regulation caused the crisis, showing skepticism about the regulation. If the volume of public debt

increases, becoming unsustainable, creating fiscal deficits, the government will have to raise interest rates. The bill issuance will lead to inflation, resulting in unhealthy growth, stagflation like in 1970. This view is opposed to Keynes's thought that believes that capitalism can be stabilized by the timely intervention of the state.

### **Short term measures**

To overcome this crisis well, we must take the best from each school of economic thought. Thus, on **short-term the solutions** that Keynes proposed are most suitable. It is preferable to prevent collapse of the financial system through loans of last resort, equity injections, supporting aggregate demand through spending and reduce taxes. Doing so will prevent the passage of a crash similar to the Great Depression.

At EU level, but not only, I believe that the most appropriate measures are a mix of the following: EU and IMF financing of Greece and the affected countries, restrictive fiscal policy, interest rate reductions, elimination of toxic assets, recapitalize damaged institutions, government expenses to support the real economy, depreciation of national currencies to improve external competitiveness.

### **Long term measures:**

In the long run, the Austrians have a more appropriate vision. Overcoming the recession must be based on debt reduction. It is preferably bankruptcy insolvent banks and companies. The EU requires stricter control mechanisms of the EU Member budgets at the European Commission level. At The Same Time is recommended reforming the European financial supervision and stricter regulation of credit. Avoiding macroeconomic imbalances, sustainable growth and reform of credit rating agencies would help all countries to have a healthier economy. A solution is focusing on the capital market and better absorption of funds.

External grant funds may be a solution in particular for Romania, because we speak of external capital. We need an engine of economic growth, which should be exercised by an insufficient infrastructure as mastered areas, tourism, and agro food sector.

At present, Germany and the U.S. have overcome this period of economic downturn, passing on economic growth. However many of the EU states, including Romania have struggled with the crash that hit the international economies. Unfortunately, due to economic differences,

we cannot implement packages of measures taken in these countries as it would have no effect.

In our country's case, due to the large current account deficit, we must orderly reduce it, because its reduction by the market in the current conditions of tension and mistrust would have dramatic consequences for exchange rate and economic growth (Isarescu, M. 2008).

The long term objective of the monetary policy should be to achieve a low and stable inflation. It was observed that low and stable inflation helps long-term sustainable growth. There is also the need to accelerate reforms.

An important long-term measure is restructuring of banks to ensure proper function of the credit mechanism. Banks will have to strengthen their capital base and improve their ability to cope with shocks. The effect of these measures should be financial stability. An important role is the bank's image crisis.

Bank behavior in this period will remain etched for a long time, in memory of customers and partners. It is advisable to act in a manner to inspire confidence. A lack of crediting inevitably leads to a marked weakening of purchasing power, which in the long term, without a call, declining prices and a weaker economy, may lead to deflation.

BNR should relax lending rules by separating the consumer mortgage loans and those guaranteed by the unsecured mortgage, so that credit risk will not affect banks' functioning. To prevent these imbalances it's necessary to revise the lending policies that led to the generation of these bubbles. A challenge for decision makers is to implement structural reforms to restrict or eliminate the occurrence of these imbalances.

The crisis exposed factoring financing option in terms of significant reductions in cash flows in the economy. In the current period of economic uncertainty, factoring is a solution that more companies have joined, from Romanian SMBs to multinational corporations. The main purpose of factoring services is the supply of liquidity on the basis of future receipts.

Business process is conducted at high speed during the crisis. Economic and social environment must be considered soberly. We need to carefully consider the facts and to act reactive. Particular attention should be paid to costs. In crisis, cost and process optimization is essential, and the actions will be taken in accordance with a long term vision.

Economic turmoil offers new business opportunities for companies that have identified market opportunities.

### **Conclusions**

The current crisis differs in its scope of all other periods of economic instability, currently affecting a large number of countries. If until now the developing countries were mainly affected, in the current crisis even the most developed countries of the world have been involved.

Globalization has been proven to bring great benefits to many countries and people in the world. However it has been observed that due to globalization some chain reactions can be produced that can affect economies around the world. However it is doubtful that foreign investors are the main destabilizing group, as we saw in this paper, that recessions are based on multiple factors, both internal and external. To raise living standards, countries must integrate in the global economy. It can bring, in addition to increasing volume and speed of international capital, the risk of financial crisis. Developing countries which do not benefit from globalization can "zoom out" even more from the other countries' level.

By analyzing the root causes of the financial crisis, it is possible to estimate the costs of resolving that crisis utilizing current policies of bailing out investors who made poor investment decisions. It would seem imperative that the financial managers of the future be better educated in the art of credit analysis.

International financial crisis has increased the cost of capital, availability of funds and lack of confidence in the financial system. The global recession has resulted in lowering the level of global GDP, lower revenues and bankruptcies in the international market.

Crisis in one area can adversely affect operations of other areas of the social life, and in some contexts can produce a succession of crisis, which has very serious consequences on the functioning of human society. Political crisis and economic crisis have the greatest social impact, generating situations that are difficult for citizens, because of their direct consequences on other areas of social activity. However this period should be seen as an opportunity for redefining the economics and public finance reform.

As we have seen many crises follow the same pattern. "The Great Depression was the most difficult" of all so far, with an explosion on Wall Street, bankruptcies, affected the whole the world.

The current crisis has shown the inability of regulatory and supervisory institutions to adapt to market realities.

As a conclusion to the above, we could say that the economy has its own natural laws that guide it and on which interference can only be limited, ensuring a stable legal environment and in which it can manifest.

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