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Philosophy of the history of the crisis

Abstract: *Prevailing approach which dominates science of economics today, and becomes axiomatic assumtpions say:* ***market is a imperfect mechanism****, and as such it makes big mistakes.These mistakes of market are the main cause of the crisis. In order to prevent market from making mistakes, strong state regulation is needed. If the state regulates the market, i.e. if the state restrain unbridled market wild forces, the crises will not occur. This approach might be close to me once I was a student of economics with no experience. But, even then I didn't quite understand the explanation of Big economic crises, which was the result of hyperproduction – nobody could buy produced goods! Along with acquiring new knowledge and new experiences, this explanation of crisis remained unclear to me. I started to beleive that wrong actors are accused to be responsible for the crisis. Today I firmly believe that* ***the state provokes the crisis when disable the market to function naturally****. As I intend to accept the challenge to prove this notion, this paper will preceed one more comprehensive project aimed to do so. In the paper I'll keep the focus of my attention to two myths: myth of current economic crisis and myth of Big economic crisis.*
Key words: *Crisis, Interest (Rate), Market, Technology, The State, Central Bank*

Resümee: *Standpunkt das dominirt, und aufnimmt den Status eines Axioms ist*: ***Der Markt ist ein imperfekter Mechanismus****, die in ihrer funktion sehr großen Fehler macht und diese Fehler sind die Ursache der Krise! Das der Markt nicht so viele Fehler macht, sollte es von der seite des Staates reguliert werden. Wenn der Staat den Markt reguliert, oder die wilden kräfte der störung des Marktes zügeln, dann wurde es keine Krise geben.Vielleicht war das alles näher fur mich als Wirtschaft Student ohne Erfahrung, aber auch damals war mir nicht eindeutig die Erklärung über die Große Wirtschaftskrise, die das Ergebnis der Überproduktion war - niemand konnte die hergestellten Waren kaufen! Wie ich praktisches erlangte und neues theoretisches Wissen, die Haltung über der ursachen der Krise wurden mir immer mehr unklar und unklarer und imer mehr habe ich angenommen die Philosophie das für die Krise der falsche Spieler belastet wurde. In der Tat heute bin ich der meinung* ***das der Staat der verhindert das der Markt funktionirt, auf seiner natürliche waise die Ursache der Krise ist****. Gerade die Herausforderung diese These zu beweisen hat mich motiviert, in einem umfassenden eingriff zu gehen, das nur eine Vorstufe zu diesem Artikel ist. Hier möchte ich zunächst auf zwei Mythen mich aufhalten: den Mythos von der aktuellen Wirtschaftskrise und der Mythos der Großen Wirtschaftskrise.*
Stich wörter: Krise, Zinsen, der Markt, Technik, Staat, Zentralbank

Резюме: ***М****нение, которое доминирует и приобретает статус аксиомы, следующее:* ***рынок несовершённый механизм,*** *который в своей функциональности делает большие ошибки, и именно эти ошибки рынка являются причиной кризиса! Чтоб рынок не совершал ошибки, он должен регулироваться государством. Если государство регулирует рынок, и внебиржевой рынок дикой силы, то кризиса не будет. Может быть, всё это мне было понятнее, когда был безопытным студентом экономики, но всё-таки не было чёткого объяснения Великого экономического кризиса, который стал результатом перепроизводства некому было покупать ромышленные товары!*

Со временем я усвоил практические и новые теоретические знания, и такое мнение о причинах кризиса для меня становилось все более непонятным, из-за чего понял, что в кризисе обвинили невиновного игрока.

На самом деле, я считаю, что именно ***государство является причиной кризиса, предотвращая функционирование рынка своим природным способом****. К стати, доказать этот тезис было вызвано стремлением идти в комплексный проект, которому данный текст*

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является предшественницей. Здесь останавлюсь в первую очередь на двух мифах: миф нынешнего экономического кризиса и миф Великог экономического кризиса.
Ключевые слова: *кризис, проценты, рынок, технология, государство, Центральный банк*

1. The Idea Behind the Paper

During 2008 and 2009 I took active part at many conferences and seminar type events in Europe, USA and South America which focused the discussion on the financial and economic crisis. Many newspaper articles or professional economists' papers deal with the crisis. As an intellectual entrepreneur and the founder of private university I also have personal experience with the crisis. Of course, neither can I forget our Balkan crisis at the end of previous century, nor I can deny the fact that I belong to the generation who was educated on Marx's theory of crisis, as well as neo-Marxist theories such as Paul Sweezy's.

However, despite all of this, I cannot explain the essence of crisis with the arguments that prevails in scientific, professional and political public today.

The dominant point of view today, which is becoming axiomatic in many terms, says: **the market is imperfect mechanism,** which make failures and those failures cause the crisis! If we want to avoid those market failures, state must regulate the market. If the state regulates the market, then it will restrain the destructive power of wild market forces and the crisis will not occur. These arguments might have seemed closer to me, while I was a student, with no experience, but I remember that even then I didn't understand explanation of the Big Economic Crisis, which was the result of hyper-production – there were no consumers who would buy all goods produced! However, after I started to work, and while acquiring new knowledge and experiences, this viewpoint became completely unclear to me. I started to believe that the wrong subject is being „convicted as guilty". That's why today I believe that **the state is really the one which disable natural functioning of market mechanism and thus the state cause the crisis**. The challenge to prove this thesis made me write this paper, as the first step of one broader undertaking. In the paper, I'll keep my focus on two myths: the myth of contemporary economic crisis and the myth of the Big Economic Crisis.

2. Global Financial Crisis (2007 - ?)

2.1) Where Does This World Go?

United States of America, the cradle of the big crisis, lives in the hope that new elected President will solve all its problems. „We came to the end of economic liberalism – we are going back to the Keynes and the State!" is the doctrine prevailing both in USA and Western Europe today. Some people are going even further and claim that we came to the end of capitalism and entered new system, which still have no name. „Where is this world going?", with or without respect to the crisis – that is the question I don't want to answer. But, I'll quote Alexis de Tocqueville who answered this question in mid 19th century: „Honestly, I don't know the answer and I think it exceeds the power of our mind. The one thing is known – the old world is ending. Who will invent the new one? Even the greatest minds of the present day are not able to say what may be yet to come, as well as the greatest minds of classic time could not foresee the fall of slavery, rise of Christianity, barbarian invasion – the events which changed the face of the Earth.“[1]

That is the reason I am not brave enough to foresee the future of the world, no matter for the fact it is clear to so many people and is related to Obama, IMF, etc.

„Haven’t we come to the conclusion that modern society needs managers ’who know everything’, not philosophers who ‘know nothing’?“ (S. Reljić, NIN, 3041)

Maybe this explains the reason to put the word „philosophy“ in the title of the paper.

2.2. The Necessity of Changes

After capital market fell in 2008, companies faced the problems; uncertainty and economic difficulties spread over USA and global markets, one refrain can be heard everywhere: „The market economy has failed! The change is needed!“.

According to Obama, late Bush administration, both Republicans and Democrats in Congress, as well as many foreign elites and media, the solution of this problem is to strengthen regulation, increase spending, create new money, and increase debts...

More regulation, more subsidies, more state – this is the essence of the philosophy promoted by G-20, which is the strongest group of world capitalists.[2]

They discuss the desirable solutions! But, whose **interests** are being protected through the solutions, which are proposed? Maybe it is the reason why nobody asks the question: “Where has the crisis come from?” The common answer say: it comes from unpaid house loans. But, why these loans were not paid? …Because the banks were giving loans to people who couldn’t pay it back. Why did the banks give the loans easily and with no collateral? The answer to this question is the main crossroad in understanding today’s crisis and its philosophy!

„The greed is the crucial reason for this situation“ – the greed of banks and the greed of loan users![3]

Without the intention to enter these discussions, I agree with the group of economists who claim that accusing greed for the crisis is as same as if we would accuse the gravitation force for the plane crashes.

In this paper I’ll give the arguments which explain the causes of growing „*household bubble*“. In order to do so, I’ll use some papers from the Mont Pelerin Society meeting held in New York in March 2009 and Association of Private Enterprise Education (APEE) held in Guatemala City in April 2009, as well as contemporary literature on this issue.

2.3. Who Created the „Household Bubble“ – the State or the Market?

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[1] De Tocqueville, A. (2002) „*O demokratiji u Americi* (translation of *On the Democracy in America)“*, Sremski Karlovci, pp.45.
[2] Kennedy, P. (2009): „*Karl Marx and the G-20*“, International Herald Tribune, April 2nd
[3] Sen, A. (2008): „*Capitalism Beyond the Crisis*“, The New York Review, February 25th

Almost everybody remembers the advice that investment in the house (real estate) is the most certain, because the value of the house cannot fall. This was the starting point of the policy implemented by many states, so called policy of "ownership society", which means that majority of citizens should own something. That's why these states provided cheap loans. Cheap loans caused the appreciation of real estate prices, especially in USA. The real estate prices started to fall at the end of 2006. It generated the problem how to pay back the loan: while real estate prices were growing the owner could sell the house and pay back the loan; however, when prices started to fall – it was no longer possible. Banks were facing severe difficulties! At the same time, the banks started to create new financial instruments: "attractively packed suspicious loans" and to sell it on the secondary loans market through Fannie Mae (I'll explain the establishment and the role of this institution later in the paper). This contributed to the risk diversification, as „mortgage-backed securities" were involved in the revenue generated from real estate business around USA. The logic behind this is that, if prices are falling in one state, it'll be compensated by high revenues from the other states. But the problem occurred once prices started to fall everywhere in USA. Buyers of „mortgage-backed securities", such as foreign banks, institutional investors, especially those from China and Western Europe, got into troubles.

At the same time, risk rating agencies ranked mortgage-backed securities with AAA in most cases - they were almost treated as risk-free securities and it just encouraged many to invest in it.

Should we accuse the greed for this price-growing spiral? Or should we just look for the answer to the question: **where did so much money for giving cheap bank-loans come from**? Which institutional mechanism enables giving cheap loans? Was this money created by the market? Or may it be the result of state intervention and the decisions made in the public administration?

From this point of view – crucial mistakes made by the state are as follows:

a) Two bodies which had been in the center of the market crash were Federal National Mortgage Association – Fannie Mae and Federal Home Loans Mortgage Corporation – Freddie Mac. These Leviathan corporations were created by Congress and they are officially known as GSC, which stands for Government Sponsored Corporations. These organizations were buying loans from banks and thus created „secondary credit market". After selling the loans, banks didn't keep the information on these loans in their balance sheets. Fannie Mae and Freddie Mac became responsible for the loans, which citizens were taking from banks and they were selling it to the investors, mostly to international investor, from outside of USA. The banks used the money from Fannie Mae and Freddie Mac as the base for giving new loans. That generated spiral of new credit activity, now artificially created. The truth was that the GSC had special sponsorship by the state. The securities of these two corporations were known as the "state securities" (although these organizations were privatized in 1970, they stayed in close relation to the government and politics). The GSCs were used to implement the White House supported policy of so-called "ownership democracy" through giving easy and cheap house loans. Back in 1999, New York Times warned on the danger of interventions of these two corporations in the real estate market. The issue was also discussed in the Congress. For example, in September 2003 Texas congressman Ron Paul spoke about the destructive impact of Fannie Mae and Freddie Mac on US economy.

"The special privileges, granted to Fannie Mae and Freddie Mac, have distorted the housing market, allowing them to attract capital they could not attract under pure market conditions. As a result, capital is diverted from most productive use, into housing. That's how the state create short-term boom in housing"[4]

Despite this, Congress continued to promote and give support to these corporations!

b) Many state institutions encouraged banks to give higher risk loans in order to prevent "racial inequality". A study conducted by Federal Reserve Bank from Boston in 1992 "accused" American banks for discriminating "non-white" people. This study was the reason to enact so called Community Reinvestment Act (CRA), which banned the discrimination of this kind. It automatically meant that implementation of the CRA promoted giving easier and higher-risk loans.

c) The state stimulated speculating activities directly or indirectly. Loans approved out of strict banking standards, as well as low level of Federal Reserve's interest rates influenced the rise or real estate (houses), and thus attracted people to speculative transactions (buy today – sell at the higher price tomorrow). Rating agencies also fell under attack of this euphoria and prevented the true perception of reality.

d) Tax system encouraged buying houses from 1997. For example, the tax on capital gain earned in housing trade transaction was abolished.

e) Low level of FED's interest rates caused business cycles and crisis. When Federal Reserve reduced interest rates through increased money supply, it influenced the production boom, i.e. long-term projects in production of raw materials, construction and capital projects in general. The good example to illustrate this influence of low interest rates is to explain how it generated the boom of construction industry in previous decade. Low interest rates distort consumers' real preferences, as well as the perception of real level of savings. Savings are artificially directed into essentially non-sustainable projects. This non-sustainability becomes visible and the prices started to drop, and the owners of new houses, with no real savings and with loan liabilities face the problems. All of this happens in the period 2000-2007, when the dollars were printed heavily and money supply increased by the highest year rate in history.

f) Many see the lack of banking regulations as the crucial cause of the crisis. Financial deregulation brought us into the crisis – this was often emphasized during electoral campaign of the President Obama. However, many researcher argue that people acted in the way federal administration and central bank wanted. In 2004 President Bush said: „We must help American citizens to buy houses. That's why these 150.000 houses must be bought without giving any down-payment when taking the house loan!".[5] Several economists warned that this policy might cause the real estate market bubble, and one FED's expert group answered through the research, which claimed that this policy wouldn't cause the housing bubble. Alan Greenspen claimed this as well, which means that the measures of the regulators encouraged the desired behavior at the real estate market.

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[4] According to Woods, T.E. (2009) „*Meltdown*", Regency Publishing, Washington, DC, pp.71

[5] Woods, Thomas (2009): „*Meltdown*", Regnery Publishing, Washington DC, 2009

g) Many responsible people and institutions in USA believed that US economy is too big and too strong to fail and to get into crisis. Alan Greenspen was one of these people. The policy he implemented, especially after September 11th 2001, made the investors give him a nickname “Mr. Bailout”. This self-confidence encouraged expansive monetary policy.

The arguments I explain above have one goal **–** I want to make people, who accuse the market in advance and see the solution in active government policy, to re-thing these issues and to ask themselves whether **the market failures are caused by the distortion of market** or they are created by state; I want to made them to wonder whether causes of the crisis come from **the government failures indeed**?

3. Is the State the Problem or the Solution?

3.1 The Course of the Crisis

The bubble moved from real estate market to Wall Street, even though officials were not publically speaking that this might happen. For example, Henry Polson, Secretary of the Treasury said in March 2007, that “it seems that US and global economy are the strongest in his business carrier”. One year later (in March 2008) he said that “our financial institutions are very strong and stable. Our banks are strong. They are strong and stable in long-term period!”[6]

In May 2007, when the break of real estate market started, Ben Bernarke, The Chairman of Federal Reserve said: „We don’t expect that problems from real estate markets will transfer to the economy overall or to the whole financial system.“

US economic reality, however, went in the opposite direction. Wall Street investment bank, “Bear Stearns” bankrupted in March 2008. This bankruptcy influenced JP Morgan, the other investment bank, which borrowed money from FED. That’s when FED, with no single vote against, decided to buy “Bear Sterns” and to merge it to JP Morgan.

In August 2008 Polson and Bernarke started to pursue US nation that the help of Fannie Mae and Freddie Mac are necessary in order to keep the health of US economy! „Don’t panic! Don’t stop the investments! Don’t stop house loans...“ They were lending money from FED and Treasury to banks… But, these warnings just spread the panics!

Struggle against panics just strengthen the logics of justifying bailouts. In early September 2008 Secretary Polson announced that the Government will take over Fannie Mae and Freddie Mac, which made 75% of US secondary real estate market.

Despite the fact that this was the “school example” of nationalization, the act was named „conservatorship“.

Things went in wrong direction and nothing could stop them. At the end of September 2008, Bank of America bought Meryl Lynch. Soon after that the bank Lehman Brothers bankrupted (assets of $639 billion and 26000 employees), a FED injected $85 billion into the failing ING.

[6] IBID, pp.27

Billions of US dollars are injected into financial system in order to save banks and Wall Street actors.

Opinion that the big ones cannot fail was still dominant: thus Fannie Mae and Freddie Mac continued to help and protect parasite sectors in economy.

At the end of September 2008 Bush administration realized that the economy needed much more funds in order to survive. That was the reason to prepare comprehensive program aimed to help economic recovery. It was so called Emergency Economic Stabilization Act of 2008, containing 442 pages and authorized by Treasury. This stimulation package was $700 billion worth. The practice has already shown that this amount was not big enough to overcome the crisis (the amount of $3200 billion is mentioned as the solution). It was the start of „bonanza“ of the state support, i.e. the losses of companies were covered from the budget (taxes paid by citizens and companies). Thus the losses were socialized. The belief in recovery support packages and the power of state to solve the problem (which was also created by state) was strong and is still very strong.

However, USA got into recession. Thus average price at US housing market, which experienced 150% increase in the period 1998-2006, dropped 23% in 2007-2008. On October 9th 2007 Dow Jones Industrial Average reached the highest value ever - 14.164,73 points. On November 20th 2008, after thirteen months, the value of the same index was 7552,29, i.e. it was reduced 46,7%. Economy faced growing unemployment – in November 2008 unemployment rate was 6,7%... But if the data on unemployment would have been calculated using old methodology, used until 1970, unemployment rate would have been 16,7%...[7]

Unemployment caused many personal troubles. Ordinary people faced serious problems. That was exactly the environment which justified state interventions and the need of the state to create "social buffer" and "social network". Are you even allowed to contradict such goals?

Was it the wrong way to fight against crisis? Is it possible that we wrongly accused the market for the occurrence of crisis? Is market behavior prior to the crisis the result of implementing free market rules, or state administration decisions? This is not just an academic question, neither in Montenegro, Serbia nor in US. It is the essential question of many people around the world today. The supporters of state interventionism promised that "market failures will stop" after first packages of help were put in function, and thus "the state will solve the problems". However, if the state really wants to fix the problems, it has to identify the real causes of business cycles.

What are the causes of business cycles? What were the causes of this crisis?

It seems that reasons, which are dominantly considered to be main causes of the crisis (wild capitalism, greed, deregulation), were not the real causes, but the crisis was caused by the state and its behavior; the main cause of the crisis was the interest of bureaucracy in the national states around the world to keep their business of redistribution going - redistribution means taking money from those who create value, giving it to those who don't create value, and charging high provisions for the service (budget).

3.2. The Cluster of State Errors and the Free Market

[7] According to Woods, T.E. (2009) „*Meltdown*“, pp.45

Indisputably, businesses make mistakes. For example, we can make bad estimates of demand; it is possible to make mistake in business concept; business can rely on wrong technology; sometimes, the production result in lower quality products and services, etc. All of these mistakes lead business into problems, and consequently into bankruptcy. Bankruptcy is regular event in the real world of market economy.

However, if most businesses make the same or similar mistakes in the same time sequence, then few questions arise: **Why do every business make mistakes**? **Why all of them make the same or, at least, similar mistake**?

The truth is that the loss of a company is really the matter of that company! But, why does it happen that almost all companies are making losses?

Britain economist Lionel Robbins was trying to prove that the "cluster of errors" (i.e. bundle of errors) need to be scientifically explained. Lionel Robbins asked: „Why did business from different industries make mistakes in estimating market prospects at the same time?".[8] This pattern of businesses' behavior is widely known as the business cycle, the trade cycle, or the boom-bust cycle.

Does the real cause of business cycle lie, as Carl Marx was claiming, in features i.e. in nature of market economy? This Marx's claim was the starting point of all platforms against crisis implemented around the world. Electoral campaign of President Obama was shaped on such platform – deregulation and (free) market are blamed to be causes of crisis occurrence and spread, and common state driven solutions are proposed to fix the problems.

The fact is, that if we want to be sure we can fix the problem of business cycles, we need to know how was it created, and what are the driving forces behind it.

Friedrich Hayek has got Nobel Prize in 1974 for his contribution to the development of business cycles theory. Hayekian theory of business cycles was further developed by one more Austrian economist, Ludvig von Mises. His answer is: **business cycles, business collapses are caused by Central bank.**. In the US case, that is Federal Reserve. But, today Federal Reserve and other central bank authorities declare themselves to be the protector from crisis and the cure from business cycles, don't they? FED has the power to increase and reduce money supply. The level of money supply determines the level of interest rate. Interest rates, similar to the price of any other commodity, depend on the supply and the demand. The truth is that interest rates are the prices of very specific commodity – the price of money, but money supply and money demand determine the price of money – it is what we call the interest rate.

If we analyze the level and trends of money supply we can identify the causes of the fact that **all business are facing crisis at the same time.**

If households have more savings, then the banks will be able to give more loans, because interest rates are going down (more savings = more money). But, if it generates the race for loans, it will push money demand up and interest rate will automatically rise.

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[8] Robins, L.(2001): „*History of Economic Thought*", London

That is explanation of trends at the free market, where supply and demand determine prices. Despite difficulties, this process leads economy to “healthier” and the most efficient outcomes.

How can we explain the functioning of free market mechanism which leads to sustainable “health” of economy and the most efficient outcomes in long term?

We go from the same starting point: households have more savings (more money in banks), and it increase money supply (more money is circulating in the economy), but it also increases the amount of money available for loans (credit activity). Higher supply always pushes the price down – in this case it influence reduction of interest rate. What does this mean from the business perspective? Lower interest rates are giving an entrepreneur (or a business) the possibility to think about investments into long-term projects, which couldn’t be realized if interest rates were high.

Businesses use the low level of interest rates to invest into production, either through expansion of existing, building new production capacities, or buying new equipment. That is the way to increase the level of production or profits.

Let’s analyze the implication of this situation on savings. The level of savings indicates relative importance of the desire to spend money now and satisfy the current needs with respect to the desire to postpone its spending for the future. This is an additional motive to invest in future, in realization of projects which seek longer term prospects, as we have higher preferences to future production (in comparison to the current).

In other words, if households **prefer to spend money today**, then they will **save less** and interest rates will grow. This will influence the businesses to take less loans, and as a rule, to use it for producing goods which will be consumed in short-term prospect. Long-term projects come into question. Increased money supply, i.e. increased level of consumption at the markets means favorable situation **to produce and sell now**.

This explains the fact that the level of interest rates **coordinates the level of production in the time**. The level of interest rates ensures compatible mix of market forces if households want to spend in present time; if population wants to spend in the future, however, the level of interest rates influence business to allocate resources so as it can satisfy the future preferences. Companies cannot invest in the development resources for the future (new production capacities and equipment), if consumers prefer spending in present time.

3.3 Central Bank and Its Role in Generating Crisis

What is going on when Central bank, as the money printing authority, intervenes in the situation described above?

When Central bank, FED in US case, start to **manipulate** with the level of interest rates (changing it independently from free-market logics), then we should not be surprised by uncoordinated economic activity at large scale. Central banks have many ways to manipulate the level of interest rates! What happens if Central bank is following the policy of low interest rates? In free-market setting low level of interest rates indicate rise of household savings. But, if Central bank holds interest rates artificially low, their level is no more the reflection of real economic conditions, i.e. it is not the indicator of the real demand and savings of consumers.

Households didn't increase their savings, so it is clearly shows that they have no desire to spend less today. Artificially low interest rate gives **wrong signal to investors.** They invest into project which would be non-profitable in real economic conditions. It opens a door of irrational (non-economic) thinking, which de-stabilizes whole economy. The policy of low interest rates, which FED was promoting for very long time, made investors to think that **today is the right time to invest money in projects with long-term prospects.** However, there was no indication that households will postpone current consumption (and thus save more) for the future, and this is exactly the philosophy long-term projects should rely on.

Low level of interest rates, as the result of Central bank manipulations, makes the confusion in functioning of the markets and market forces. It interrupts the coordination of production level in time. Long-term investments can bring return only in future, and, if interest rates are kept low, long-term projects are encouraged in the situation when households are satisfied with the level of their spending and consequently households doesn't increase savings. In addition to that, low level of interest rates stimulates households to spend today more than they would spend otherwise (if interest rates were higher), i.e. low interest rates don't give households incentives to save. That moves the trigger of the crisis in the situation when Central bank follows the policy of artificially low level of interest rates: **low level of interest rates stimulates households to save less, and spend more and give incentives to long-term investment projects**! Investments into long-term projects, if they are not based on savings (as the source to finance long-term project) will necessarily result in crises, sooner or later. Mises compared this situation to the one when a man wants to build a big house with a small number of bricks. Building the house is a long-term project, and the number of bricks is the level of savings. If we started to build the house irrespectively big to the number of bricks we have, then the crisis will reduce the house to its real size. That's why we say that the crisis is bringing us back into reality!

3.3 What Can We Learn From the Great Depression And Other Crisis From the Past?

The break of the free market as the main cause of the Great Depression and the New Deal, as the solution to the crisis (i.e. so called state capitalism) are two myths which form the base for globally prevailing economic and political thought related to the crisis.[9]

Large scale of today's literature analyzes the Great Depression from this time distance. I want to recommend two of them: Ben Bernarke "Essays on the Great Depression" (2000) and Roberta Higgs „Depression, war and cold war" (translated in Zagreb, 2007). However, it's very important to use results of many researches to point out important facts about the existence and the real nature of crisis, the real nature of FED and the reasoning behind its establishment (1913.godine).

Back in 1819 (at the time of de Tocqueville stay in US) panics overwhelmed US markets. The panics originated from the fact that US banks printed more paper money then they had covered by gold in their deposits. The assumption is that the paper money can always be

[9] I was educated on this myth. I believed in it. The first time I became a member of the Government of Montenego (1985) made me rethink about this myth, shaked my belief, and I started to doubt and requestion it – this gave me completely different view on the proglem of the crisis. In addition to that, as a student I started to read, at the time, banned books such as „*The Great Contraction 1929-1933*" written by Milton Friedman i Ana Swartz. I also started to explore literature and authors from the Austrian School of economics. All of that shaped the opinion on the crisis I have today.

exchanged for gold at certain price. As the banks printed more paper money, the value of that paper money (measured by the volume of goods that can be bought for that money) started to fall and that caused the panics in the whole economy.

Similar thing happens during 1830's, and inflation rates reached high levels.[10]

Loans and credit activities of banks, artificially driven, brought the economy into very difficult position.

The crisis that occurred in 1857 was also the result of credit expansion.

But, the problems were solved through adaptation of behavior of market actors and sometimes bankruptcy of banks and companies.

Economic historians also mention the crisis from 1920, after the First World War. This crisis occurred just 7-8 years after FED was established. US authorities chose not to intervene at the markets to solve the crisis. They left market mechanism to work and market actors to adapt to the new conditions. On the other side of the world, Japan, tried to solve the same crisis through introduction of planned economy. This attempt resulted in economic disaster, which brought Japan to its national-socialism and Second World War.

I felt the need to mention these crises from 19th century, as their causes were always the result of state interference into market activities. Actually, the state was endangering the logics of free markets, by printing more money, but the solution lied in adaptation of behavior of market actors.

The Great Depression has preceding history in the years 1920-29. FED maintained inflationary policy in that period. The level of production rapidly grew in all industries in the period 1922-1927 (automotive industry 4,2%; production of oil 12,6%; industrial goods 4%; raw materials 2,5%). Why didn't this growth of supply result in the price decrease? The question is why prices didn't fall?

The explanation lies in money supply. In the period between 1921 and 1929 the money supply grew by 55%, or by average yearly rate of 7,3%.[11] But the amount of currency which circulated in the economy was not changing. The money supply grew due to increase of the total amount of credits (loans) in the economy.

Given loans were encouraging businesses to invest into long-term projects, i.e. into production of capital goods. As the value of firm, represented through the price of its shares at the capital market, depend on the value of capital goods, all of this influenced growth of shares'… This further stimulated growth of real estate prices. As Friedman said, people thought that 1920's are the eternal end of business cycle, similar to the claim that the end of First World War was the end of all wars ever.

[10] The opinion of economists from the time about the consequences of the sudden inflation and weakening money were very interesting (William Leggett). Business is stimulated to get into wrong and economically „sick“ activities, large share of production was based on the tricks and the fraud, many speculations with property ended with the crisis, which made the economy unstable... „Many people went to bed rich, and woke up poor... Anybody could see that the banks were using tricks to sell the papers they issued to people (money banknotes and securities) and suddenly the economy was overwhelmed with such „papers“.“

[11] Data accodring to: Ben Bernarke „Essays on the Great Depression“ (pp.14, 15, 16)

The leading economist of the time, and one of founders of what we call mainstream economics today, Irving Fisher thought that the prices were stabilized on long-term and that US economy is entering the upward phase. Only two months before the Wall Street break, Fisher wrote that shares' prices can experience a slight drop, but he didn't think of the possibility of complete market crash!

However, Austrian economist Ludwig von Mises claimed that inflationary boom will unavoidably end in the market break and the break of the economy. „Permanent prosperity is the fantasy of mainstream economists. It is completely clear that the crisis will occur sooner or later. It's also clear that the crisis is always caused, directly or indirectly through changes in managing banks, i.e. FED's mistakes ".[12]

Collection of such mistakes leaded to the crash of capital market in October 1929. The crisis reached its peak in 1931, which was known as "the tragic year". Sharp decline in the production level and the rise of unemployment overwhelmed first US, and later world economy.

What was the reaction on crisis?

Contrary to proposals of Austrian economics, the US President at the time, Herbert Hoover, who claimed to be the supporter of laisezz-faire capitalism, said that the laissez-faire approach had died indeed. Hoover was the first US President who introduced strong protectionist measures, such as the tax increase, public works, measures aimed to limit and reduce international trade, recovery projects were financed through borrowings. Frank Roosevelt criticized high level of public spending of Hoover's administration in his Presidential campaign and Hoover's tendency to centralize the administration in Washington. Although, most economists of the time supported Hoover and his interventionist policies, there was a group of economists who criticized him, and whose arguments relied on the Austrian economics. For example, Haberler called Hoover's policy – "the public foretell", and Professor from Columbia Parker Willis said that his policy "harmed already bad allocation of resources in US economy".

But, regardless initial critics of Hoover's protectionist policies, Roosevelt continued its implementation through New Deal. The goal of Hoover-Roosevelt's program was to "prevent economic bubble from exhaling", i.e. to bring economy in the deflation zone. Their programs were keeping "ill businesses" in life. Their measures were directing private capital and real savings, not into the market, but into non-economic public works and projects, which didn't contribute to the long-term adaptation of economy to market conditions. Did the New Deal really save US and world economy, as official history says? Or it just slowed down the recovery of US economy and prolonged it to 1948, as many researchers of crisis are claiming today?

This is what Robert Higgs wrote about in his book "Depression, War and Cold War"[13]. Higgs claimed that the New Deal with large number of laws, stronger regulations, and increased taxes created the discouraging environment, which dragged investors from investing. Such distrust of investors "kept economy in depression for 15 years".

[12] IBID: pp.15

[13] Higgs, Robert (2008) „Depresija, rat i strah (translation of *Depression, War and Cold War*)", Politička kultura, Zagreb (prevod)

3.4. Should We Get Back to Keynes or to Austrian Economics?

It seems that popularity of Keynesian economic theory, left in 1970's after the oil crisis, comes back![14] In order to keep economy "in growth and prosperity" the state should increase its spending, realize public works and other public projects and finance all these activities through budget deficits. In other words the economy (banks) needs more money in order to keep itself out of recession, or not to get into crisis. That is crucial economic philosophy in world today and the base of all recovery packages in US and West Europe. Even Joseph Stieglitz says in his text „Obama ersatz capitalism" published by International Herald Tribune-u that Obama's policies are not win-win-win, but win-win-lose: banks gain, investors gain, tax payers lose![15] „We suffer from the crisis of trust. When high expenses of recovery packages become obvious to ordinary people, their distrust will deepen and solving the crisis will additionally complicate!"

What does Austrian economics say about the crisis and the causes of the crisis?

(a) Interest rates can decrease for two reasons: (1) increased savings; (2) Central bank pushes interest rated down by its measures;
(b) New projects are the answer of businesses to the reduced level of interest rates. Low level of interest rates encourages long-term investments – investments into capital goods.
(c) If interest rates are pushed down by natural reason – increase in savings – then the market works with no interruption.
(d) If interest rates are pushed down artificially – through Central bank manipulations – then these initiated projects cannot be finished;
(e) Mises compares this situation with construction of the house, when the constructor thinks he has 20% of bricks more then he really has. He will construct the house completely different from the one he would build if he had the information on the exact number of bricks (if we assume he is not able to buy missing bricks). Dimensions of the house and its style will be completely different. Farther he gets in construction, without realizing the mistake, the situation will get worse.
(f) Economy acts similar to the house constructor. Following the policy of low interest rates, keeping interest rates below the market level, economic actors behave as if they have more money, then they really have. It gives incentives to invest money in wrong purposes, and those investments don't have foundation in real consumers' savings.
(g) Housing boom is the classical example of this dynamic theory. Artificially low interest rates were giving the wrong investment incentives and huge amount of resources went into constructing houses. It's obvious this was unsustainable!
(h) As soon as we abandon monetary manipulation, we will avoid wrong investment incentives, and thus wrong allocation of resources. House constructor is in better position if he stops the construction, then to continue it while living in illusion. The same is valid for an economy.

In a nutshell, the longer Central bank injects new money into economy, the longer and more painful the crisis will be.

[14] I recommend the book „Keynes For the Twenty-First Century", edited by Mathew Forstarer and Randale Wray, Palgrave Macmilan, 2008. I also find interesting the series of articles on crisis and its origins in International Herald Tribune, New York Times, Financial Times and The Economist!

[15] See the series of article on crisis in International Herald Tribune, New York Times, Financial Times and The Economist!

3.5. Where Does the Money Come From?

„The state should make the money and give it to the banks in order to recover the economy and bring it back in normal condition!“ Does this sentence describe the essence of most statements made on the issue of crisis? Does it describe the basic idea of the measures that G-20 will undertake? Does anybody ask where that money is coming from?

But before that, what is money? Is it just an ordinary piece of paper, which can be printed whenever we want and as much as we want? Didn’t we learn the consequences of such approach from our experience?

Money is always the represent of goods. Without desire to enter strict mathematical proofs of economic models, we can say that the quantity of money should be equal to the value of goods and services R=N! How much money we need, if there is no any goods or services (R=0)? The sum of money is also equal to 0 (N=0)! If the value of goods is 100, then the quantity of money is also 100! Of course, this is just a rough simplification introduced so as we should not analyze money isolated from goods and services (production)!

Will these “injections” of fresh money solve the crisis? Hardly, because the analysis in this paper proves that the crisis occurred as the result of money surplus and low interest rates. Injecting money into economic system will just postpone the solution for the future. Some estimates say that the money quantity which circulates in world economy today is 3-4 times larger than the value of global gross product. The balloon had to pop, sooner or later.

Even George Stiglitz, who supports Keynes logics, said in his interview to German “Spiegel” in April 2009: “State is giving money to the banks as they can survive on the market, and banks are spending billions of dollars on bonuses and dividends. They rob tax payers and it must change!“

4. Instead of Conclusion

It is indisputable that the current crisis influenced change in behavior and change in understanding economics. The crisis encouraged catastrophic scenarios on the end of capitalism and voices that call for disappearance of free-market ideology. The solution is seen in increased regulation of banking industry and financial markets, i.e. in stimulating packages for recovery and nationalization of banks.

Is the transformation of banks into public service the way out of crisis? Czech President Vaclav Klaus strongly opposes this idea. Can bank industry function as the public service, partially owned by state, which guarantees and regulates this service? Imagine banks as a public service, similar to national state-owned TV stations! In this paper I was trying to emphasize the fact that if free-market logic is endangered in financial sector, it will necessarily lead to the distortion of other markets!

The problem, as I see it now, practically and intuitively bring me closer to the need to respect the vision of development of free-market and the institutions, which enable its functioning. The idea of free markets makes the base of contemporary civilization, and digital technology is one of its fundaments. The world is the global stage – according to Japanese expert Kenichi Ohmae. The questions our civilization should answer today are not how to close ourselves, or how to give more power to national state, as Keynes was suggesting. The logic of so called "Keynes tub" is anachronism in contemporary world based on "the logic of the ocean". If we follow "Keynes tub" logic today, it is as we would "plow the sea"! Of course, it is easier to control the level and the temperature of water in a tub, then in the ocean! It is probably not possible to control the level and the temperature of the ocean! I am trying to point out the fact that if we don't understand and don't accept the necessity to implement "the logic of the ocean" **–** that is the crucial philosophical and practical problem world is facing today!

I see the deeper sources of the crisis in the clash between "the tub logic" (closed system with large role of state) and "the ocean logic" (open system and free-market)! The crisis pointed out **the clash between national and global**; the need to understand the fact that the term "national" acquire new dimensions and thus become more distant from the economics, and closer to national culture, art and education! The crisis has shown that the world is economically inter-dependent and that inter-dependency will just grow. This growth of interdependence is caused by, among other things, **economic interests,** but also by the level and the features of **technology**.

I would use one Stiglitz association, despite the fact I agree with him only partially. Stiglitz said that "the fall of Berlin wall has shown that communist economy is not sustainable, and the bankruptcy of "Lehman Brothers" has shown that unrestrained capitalism is not sustainable. In my opinion, the crash of "Lehman Brothers" just proves that globalization brings the power of national bureaucracies to an end. That opens the process of breaking down the logic of welfare state, and developing the new **logic of united solidarity and philanthropy**! Does this crisis open the history of future, in which national states (bureaucracies) will disappear, and the world will become the community contained of hundreds small communities, which will be organized completely different from the organization of today's bureaucracy? Can we consider the attempts to solve the crisis by money printing and injecting fresh money into economic systems as the attempts to keep the power of bureaucratic administration all around the world? If today's civilization acted according to economic principle that the sum of values of all goods and services on global level is equal to the quantum of money in global terms, what would happen with "all those unproductive excrescences on the body of human community"?... But, free-market (capitalism) will not disappear from the parliament decisions or NGO requests, as well as global and national bureaucracy. That is global conflict of interests.

Did Samuel Huntington read Maltus (who said that "population is increasing in geometric progression, while the growth of resources (food) follow arithmetic progression") when he wrote "The Clash of Civilization"?

The only solution to this civilization conflict, which is becoming visible, is tolerance and democracy of free-market. Edgar Moren says that this crisis brings many dangerous and confirms that the world is sliding into disaster: „The crisis brings dangerous, but it also brings the opportunities! The crisis increase uncertainty and rigidity of the institutions, but the waves of new forces occur, whether these forces are creative or destructive."[16]

A question arises in my head: Is this the replication of 15th century, when Nicolo Machiavelli "broke down" the role of church and created the condition for the birth of national state? Is

[16] Magazin NIN, April 7th 2009

Bill Gates this new Machiavelli, which is "breaking down" the role of state and create conditions for birth of global community of world's nations?

Can we think of "globalism and localism" as of the "humanism and renaissance" of modern age?

This seems too much philosophical question! However, Einstein said "Imagination is more important than the knowledge ".

The crisis we are facing today reveal great lack of knowledge, but even more, it reveals the lack of imagination and vision!

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